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MISS DHUN DADABHOY KAPADIA

v.

COMMISSIONER OF INCOME-TAX, BOMBAY

October 31, 1966

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[J. C. SHAH, V. RAMASWAMI AND V. BHARGAVA, JJ.]

Income-tax Act (11 of 1922), s. 12B(2)—Renunciation of right shares for money value—Depreciation in value of original shares—Capital gain how calculated.

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The assessee was holding as an investment 710 shares in a company. She became entitled to receive 710 new shares issued by the company, with an option to renounce them. She renounced her right to receive the new shares by sale in the open market and realised a sum of Rs. 45,262.50. The Income-tax Officer sought to tax the entire amount as a capital gain. Immediately before the renunciation, the old shares were valued at Rs. 253.00 per share. After renunciation the price of the old shares fell to Rs. 198.75 as a result of which, the assessee suffered a capital loss of about Rs. 38,000. The assessee claimed a set off of this loss against the capital gain of Rs. 45,262.50. The plea was rejected by the Income-tax Authorities, the Appellate Tribunal and the High Court.

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In appeal to this Court,

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HELD : The claim of the assessee that her net capital gain was not represented by Rs. 45,262.50 was correct. The net capital gain could only be properly computed after deducting the sum which approximately represented the loss incurred simultaneously, by the assessee, in her original asset of 710 old shares as a result of the depreciation in their value.

[4 E, H]

In working out capital gain or loss, the principles that have to be applied are those which an ordinary man of business will resort to when making computation for his business purposes, or which are a part of the commercial practice. [5 G]

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Immediately before the assessee renounced her right to take the new shares, the capital asset she possessed consisted of her old 710 shares valued at Rs. 253.00 per share plus the right to take the new 710 shares. After renunciation her capital assets were 710 old shares valued at Rs. 198.75 per share together with the sum of Rs. 45,262.50. Therefore, the value of the capital asset after renunciation would be $Rs. 710 \times 198.75$ plus Rs. 45,262.50 while the value of the asset, immediately before renunciation, would be $Rs. 710 \times 253.00$, there being no cash value, at the time of the right to receive the new shares, to be taken into account; and, the net capital gain of the assessee would be the difference between the two. [4 C-G]

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Alternatively, at the time of the issue of new shares the assessee possessed 710 shares and the right to obtain the new shares allotted. When she sold that right and realised Rs. 45,262.50, she capitalized that right and converted it into money. A concomitant of the acquisition of the right was the depreciation in the value of the old shares, and the depreciation, is, in a commercial sense, the value of the right which she subsequently transferred. The net capital gain by her would, therefore, be represented, only by the difference between the money realised on transfer of the right, and the amount which she lost in the form of depreciation of her original shares in order to acquire that right. [5 A-E]

C.I.T., Bihar v. Dalmia Investment Co. Ltd. [1964] 7 S.C.R. 210 followed.

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 757 of 1965.

Appeal from the judgment and order dated August 24/25, 1962 of the Bombay High Court in Income-tax Reference No. 12 of 1961.

R. J. Kolah and *O. C. Mathur*, for the appellant.

S. K. Aiyar and *R. N. Sachthey*, for the respondent.

S. T. Desai, *O. C. Mathur*, for interveners.

The Judgment of the Court was delivered by

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Bhargava, J. This appeal by certificate granted by the High Court of Bombay under section 66A(2) of the Indian Income-tax Act, 1922 (hereinafter referred to as "the Act") is directed against the answer returned by the High Court to the following question referred to it by the Income-tax Appellate Tribunal under s. 66(1) of the Act:—

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"Whether having regard to the provisions of section 12B(ii), the assessee is entitled to claim a deduction from the full value of the consideration of Rs. 45,262.50 nP. received for the capital asset, the sum of Rs. 37,630 or any similar sum?"

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The case arose out of proceedings for assessment of the appellant for the assessment year 1957-58, the corresponding previous year being the financial year 1956-57. The appellant was holding 710 ordinary shares of the Tata Iron and Steel Company Ltd. (hereinafter referred to as "the Company"), which she had inherited some time prior to 1st January, 1954, as an investment. It was admitted that she was not a dealer in shares. Under a special resolution passed at an Extraordinary General Meeting of the Company on 12th March, 1956, the appellant, as holder of 710 ordinary shares, became entitled to purchase new ordinary shares issued in the ratio of one new ordinary share for one existing ordinary share as held on 26th April, 1956. In pursuance of this resolution, an offer was made to the appellant by the Company by its circular letter dated 15th May, 1956, that she was, in terms of the resolution, entitled to apply for 710 new ordinary shares to be paid for at the rate of Rs. 105 per new ordinary share. This payment was to represent Rs. 75 as the face value of the share and Rs. 30 as premium. She was also given the option of either taking the shares wholly or partly, or renouncing them either wholly or partly, in favour of any other person or persons. The appellant chose to renounce her right to all the 710 ordinary shares instead of taking the shares herself, and when renouncing the shares, she sold them in the open market on 12th June, 1956, as a result

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- A of which she actually realised a sum of Rs. 45,262/50 nP. It was common ground before the Income-tax authorities as well as the Tribunal that this amount received by her was a capital gain and the whole of this amount was sought to be taxed as capital gain received by the appellant. On behalf of the appellant, the plea was that, on the issue of the new ordinary shares, the
- B value of her old ordinary shares depreciated, because the assets of the Company remained stationary, while the number of shares increased. It was in consideration of this depreciation in her original holdings that she was given the right to purchase these new ordinary shares, or to renounce them in favour of some other person and make up the loss which she would suffer on her original shares.
- C The Board of Directors of the Native Stock and Share Association Ltd. had passed a resolution that the transactions in these shares were to be cum-right up to and including 1st June, 1956, and were to be ex-rights from 4th June, 1956, onwards. The intervening days, 2nd and 3rd June, being official holidays, there were to be no transactions on those days. The market quotation of the old Tata ordinary shares was Rs. 253 per share on 1st June, 1956, and fell to Rs. 198/75 nP on 4th June, 1956. There was, thus, a fall in the market quotation of old shares of Rs. 54/25P per share. It was claimed by the appellant that, as a result of this depreciation in the price of her old ordinary shares, she suffered a capital loss in those shares to the extent of Rs. 37,630, and she was entitled to set off this loss against the capital gain of Rs. 45,262/50P which she realised on selling her right to take the new ordinary shares.
- D In the alternative, the case was put forward on the basis that the right to receive these new ordinary shares was a right which was embedded in her old ordinary shares, and consequently, when she realised the sum of Rs. 45,262/50P by selling her right, the capital gain should be computed after deducting from this amount realised the value of the embedded right which became liquidated. The value of that right, according to the appellant, should be calculated in accordance with the principles of Accountancy as laid down by various authors on the subject to be applied in such situations. Even if this principle be accepted, the amount taxable as capital gain in her hands would have to be reduced by at least a sum of Rs. 37,630, if not more. This plea put forward
- E on behalf of the appellant was rejected by the Income-tax Authorities as well as by the Income-tax Appellate Tribunal. Thereupon, the question, reproduced by us above, was referred to the High Court by the Tribunal, and the High Court also answered it against the appellant. The appellant has, therefore, come up to this Court in this appeal.

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In order to answer the question referred to the High Court, it appears to us that the nature of the transaction, which resulted

in this receipt of Rs. 45.262/50P by the appellant, must be analysed and properly understood. The amount, it is the agreed case of the parties, was a capital gain. The capital asset which the appellant originally possessed consisted of 710 ordinary shares of the Company. There was already a provision that, if the Company issued any new shares, every holder of old shares would be entitled to such number of ordinary shares as the Board may, by resolution, decide. This right was possessed by the appellant because of her ownership of the old 710 ordinary shares, and when the Board of Directors of the Company passed a resolution for issue of new shares, this right of the appellant matured to the extent that she became entitled to receive 710 new shares. This right could be exercised by her by actually purchasing those shares at the prescribed rate, or by renouncing those shares in favour of another person and obtaining monetary gain in that transaction. At the time, therefore, when the appellant renounced her right to take these new shares, the capital asset which she actually possessed consisted of her old 710 shares plus this right to take 710 new shares. At the time of her transaction, her old shares were valued at Rs. 253 per share, so that the capital asset in her possession can be treated to be the cash value of 710 multiplied by Rs. 253 of the old shares plus this right to obtain new shares. After she had transferred this right to obtain new shares, the capital assets that came into her hands were the 710 old shares, which became valued at Rs. 198/75P per share, together with the sum of Rs. 45,262/50P. The net capital gain or loss to the appellant obviously would be the difference between the value of the capital asset and the cash in her hands after she had renounced her right and realised the cash value in respect of it, and the value of the capital asset including the right which she possessed before those new shares were issued and before she realised any cash in respect of the right by renouncing it in favour of some other person. As we have indicated above, the value of the capital asset, after renunciation, would be 710 multiplied by Rs. 198/75P plus the sum of Rs. 45,262/50P, while the value of the asset, immediately before the renunciation, would be 710 multiplied by Rs. 253, there being no cash value at that time of the right to be taken into account. Thus, the capital gain or loss would be worked out at Rs. 45,262/50P after deducting from it the sum worked out at 710 multiplied by the difference between Rs. 253 and Rs. 198/75P. This last amount comes to a little more than the sum of Rs. 37,630 which the appellant claimed should be deducted from Rs. 45,262/50P in computing her capital gain. The claim made by the appellant was thus clearly justified, because the net capital gain by her in the transaction, which consisted of issue of new shares together with her renunciation of the right to receive new shares and make some money thereby, could only be properly computed in the manner indicated by us above.

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- A In the alternative, the case can be examined in another aspect. At the time of the issue of new shares, the appellant possessed 710 old shares and she also got the right to obtain 710 new shares. When she sold this right to obtain 710 new shares and realised the sum of Rs. 45,262/50P, she capitalised that right and converted it into money. The value of the right may be measured by setting off against the appreciation in the face value of the new shares the depreciation in the old shares, and consequently, to the extent of the depreciation in the value of her original shares, she must be deemed to have invested money in acquisition of this new right. A concomitant of the acquisition of the new right was the depreciation in the value of the old shares, and the depreciation may, in a commercial sense, be deemed to be the value of the right which she subsequently transferred. The capital gain made by her would, therefore, be represented only by the difference between the money realised on transfer of the right, and the amount which she lost in the form of depreciation of her original shares in order to acquire that right. Looked at in this manner also, it is clear that the net capital gain by her would be represented by the amount realised by her on transferring the right to receive new shares, after deducting therefrom the amount of depreciation in the value of her original shares, being the loss incurred by her in her capital asset in the transaction in which she acquired the right for which she realised the cash. This method of looking at the transaction also leads to the same conclusion which we have indicated in the preceding paragraph.

The view that we have taken finds support from the principle laid down by this Court for valuation of bonus shares issued by a company to holders of original shares in the case of *Commissioner of Income-tax, Bihar v. Dalmia Investment Co. Ltd.*⁽¹⁾

- F The High Court, in dealing with this question, had expressed the view that principles of Accountancy applicable to valuation of such right to receive new shares issued by a company are not applicable when computation has to be made for purposes of taxation; but we are unable to accept this proposition. In working out capital gain or loss, the principles that have to be applied are those which are a part of the commercial practice or which an ordinary man of business will resort to when making computation for his business purposes. The principles of accounting indicated by us above are clearly the principles that must be applied in order to find out the net capital gain or loss arising out of a transaction of the nature with which we are concerned. The application of those principles indicates that the claim of the appellant that the net capital gain by her is not represented by the whole amount of Rs. 45,262/50P realised by her on renunciation of her right to

(1) 1964] 7 S.C.R. 210: 52 I.T.R. 567.

receive the new shares was correct and that the net capital gain can only be properly computed after deducting the sum of Rs. 37,630 which approximately represents the loss incurred simultaneously by the appellant in her original asset of 710 old shares as a result of the depreciation in their value. The question referred to the High Court must, therefore, be answered in favour of the appellant. The appeal is, consequently, allowed, the answer returned by the High Court is set aside, and the question is answered in the affirmative. The appellant will be entitled to her costs in this Court as well as in the High Court.

V.P.S.

Appeal allowed.

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