A COMMISSIONER OF INCOME TAX, KANPUR

v.

U.P. STATE INDUSTRIAL DEVELOPMENT CORPORATION

B APRIL 11, 1997

[S.C. AGRAWAL AND G.T. NANAVATI, JJ.]

Income Tax Act, 1961 :

C *"Underwriting Commission" earned by assessee in respect of shares, which were not subscribed by public, and were purchased by assessee—Held, could not be treated as a part of assessee's taxable income.*

P.M. Mohammed Meerakhan. v. *Commissioner of Income Tax, Kerala,* **(1969) 73 ITR 735, relied on.**

D *Kedar Nath Jute Manufacturing Company* **v.** *Commissioner of Income Tax,* **(1971) 82 ITR 363 and** *Morvi Industries Ltd.* **v.** *Commissioner of Income Tax,* **(1971) 82 ITR 835, held not applicable.**

State of Tranvancore **v.** *Commissioner of Income Tax,* **(1986) 158 ITR**
E **102;** *Whimster & Co.* **v.** *Commissioners of Inland Revenue,* **12 T.C. 813 and** *Commissioner of Inland Revenue* **v.** *Cock Russell & Co. Ltd.,* **29 T.C. 387, referred to.**

Accountancy by William Ribbles, **3rd Edn., page 1144 (Chapter XXVI);** *Book Keeping and Accounts by Ernest Evan Spicer and Ernest C.*
F *Pagler,* **10th Edn., page 650** *Dicksee's Auditing* **17th Edn., pages 279 and** *Auditing Theory and Practice by R.K. Montogomri,* **2nd Edn., pages 215-216, referred to.**

Words and Pharases :

G *"Underwriting", "Underwriting Commission"—Meaning of.*

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 1739-40 of 1981.

From the Judgment and Order dated 30.6.80 of the Allahabad High
H Court in I.T.R. Nos. 31 and 137 of 1976.

P.A. Choudhary, Dhruv Mehta and B.K. Prasad for the Appellant. A

Manoj Swarup and Mrs. Lalitha Kohli for the Respondent.

The Judgment of the Court was delivered by

S.C. AGRAWAL, J. These appeals, by certificate granted under B
Section 261 of the Income Tax Act, 1961 (hereinafter referred to as 'the Act'), have been filed by the Revenue against the judgment of the Allahabad High Court dated June 30, 1980 in Income Tax References Nos. 31 and 137 of 1976. By the said judgment the High Court has answered the following question against the Revenue and in favour of the U.P. State C
Industrial Development Corporation (hereinafter referred to as 'the assessee') :

> "Whether on the facts and in the circumstances of the case, the Tribunal was justified in holding that under writing commission in the case of shares held by the assessee itself and not actually D
> subscribed by others was reducing the cost of the shares in the hands of the assessee and was not separately taxable as the assessee's income of that year?"

The references relate to the assessment years 1970-71 and 1971- 72. E

The assessee is a State undertaking. Its shares are wholly subscribed by the State of Uttar Pradesh. It has been incorporated with the object of developing industries in the State of Uttar Pradesh and with that end in view it finances industrial projects or enterprises, whether owned or run by F
the Government, a statutory body, private company, firm or individuals etc. One of the clauses for financing the company by the assessee was that on the shares of such companies subscribed by public the assessee was entitled to get commission as well as brokerage on the sale of shares of such companies and in case the shares of such companies were not subscribed by the public in toto the assessee was obliged to subscribe those shares at G
face value but was entitled to underwriting commission and brokerage in the same manner as if the shares of such companies were subscribed by the public. The method adopted by the assessee was that instead of crediting the underwriting commission and brokerage to its profit and loss account in the case of such companies the shares of which had to be H

A subscribed by the assessee itself, it used to reduce the cost of the shares held by it as stock-in-trade. During the previous year relevant to the assessment year 1970-71 the assessee had earned by way of underwriting commission a sum of Rs. 1,01,250 and brokerage to the extent of Rs. 33,719 while the assessee offered a sum of Rs. 12,535 out of the aforesaid receipts B as its taxable income. In the previous year relevant to the assessment year 1971-72 the assessee earned by way of underwriting commission and brokerage a sum of Rs. 1,15,000 and no part of it was included in its taxable income. While making the assessment the Income Tax Officer added the entire amount received by the assessee by way of underwriting commission and brokerage as part of taxable income for both the assessment years. The C Appellate Assistant Commissioner, however, held that underwriting commission was assessable as assessees' income in the year in which it accrues, i.e., in the year in which the underwriting agreement was made. But as regards brokerage he held that brokerage on the shares held by the assessee was not includable in the income of the assessee and that it had D to be adjusted against the cost of the shares taken. The assessee filed appeals against the orders of the Appellate Assistant Commissioner before the Income Tax Appellate Tribunal (hereinafter referred to as 'the Tribunal'). The Revenue did not question the order of the Appellate Assistant Commissioner regarding brokerage. The Tribunal held that the E underwriting commission in respect of the shares held by the assessee would reduce the cost of the shares and would not be separately assessable as the assessees' income. The Tribunal has observed :

> "And this difference by way of commission and brokerage is F charged by the underwriter because it agrees to subscribe for a large amount of the capital of the company. As such whatever amount the underwriter earns as underwriting commission it does not automatically become its income. It is postponed unless the risk of taking or not taking the shares is over. If the shares are fully subscribed, the institution gets commission, but it does not G pay for the capital. In that event, the commission earned by the corporation is an income and it could be taken into profit and loss account of the assessee. But, if the assessee subscribes some share out of the underwritten shares, the commission relating to those shares goes towards the cost and, therefore, no income is earned H by the underwriter."

After referring to various books on accountancy, namely, Account- A
ancy by William Ribbles, 3rd Edn., page 1144 (Chapter XXVI); Book
Keeping and Accounts by Ernest Even Spicer and Ernest C. Pagler, 10th
Edn., page 650; Dicksee's Auditing, 17th Edn., page 279; and Auditing
Theory and Practice by R.K. Montogomri, 2nd End., pages 215-216, the
Tribunal has held that the underwriting account is a part of profit and B
loss account, which includes not only the income from underwriting
commission and brokerage but the same is debited by the expenses and
the cost of shares, which the underwriter is called upon to take and as
much underwriting commission could not be taken into consideration
leaving aside the other items of this account. According to the Tribunal,
if the nature of the underwriting account is taken into consideration, the C
practice followed by the assessee to first adjust the brokerage and under
writing commission towards the cost of the shares, which are underwrit-
ten by it, but the commission and brokerage earned on shares not
subscribed by it are taken to the profit and loss account, was absolutely
correct and was in accordance with accountancy principles and, since D
there is no contrary provision in the Act, the system followed by the
assessee must be respected. At the instance of the Revenue the Tribunal
has referred the question above mentioned for the opinion of the High
Court.

E

The references were considered by the High Court along with
Income Tax Reference No. 37 of 1976 relating to the assessment years
1965-66, 1966-67, 1967-68, 1969-70 wherein also similar question had
been referred for the opinion of the High Court. The High Court agreed F
with the view of the Tribunal and has held that the commission earned
by the assessee as underwriter in respect of the shares offered by the
company and purchased by the public, would undoubtedly be the profit
of the assessee which has to be accounted for in its profit and loss
account, but so far as the shares agreed by the assessee to be under-
written and purchased by it are concerned, the transaction in substance G
results in the assessee purchasing those shares for a consideration which
is equal to the face value of the shares as reduced by the amount of
commission and brokerage and in such a case, the amount of underwrit-
ing commission and brokerage merely goes to reduce the value of the
shares and it cannot be considered to be the income of the assessee. H

A The High Court, however, felt that the question whether the underwriting commission in relation to shares which the assessee itself subscribed as underwriter went to reduce the cost of those shares or whether such underwriting commission could be taxed as an income is a substantial question of law of general importance and, therefore, it granted certificate
B of fitness for appeal to this Court under Section 261 of the Act. Hence these appeals.

In the case of public companies, when shares are offered to the public for subscription, it is usual to make certain of obtaining the necessary capital by having the shares underwritten. The word "under-
C writing" means that a person agrees to take up shares specified in the underwriting agreement if the public or other persons fail to subscribe for them. The consideration for this contract takes the form of payment of commission, called "underwriting commission". Underwriters are thus paid for the risk they expose themselves to in placing of shares before
D the public. The Payment of underwriting commission is permissible under Section 76 of the Companies Act, 1956.

The question that falls for consideration is whether the underwriting commission in respect of shares which could not be subscribed by the public and had to be purchased by the assessee has to be regarded
E as the income of the assessee or it goes towards reducing the cost of the shares so purchased. In the accounts maintained by the assessee the underwriting commission is first adjusted towards the cost of the shares that are underwritten and thereafter the commission on shares not subscribed by the assessee is taken to the profit and loss account. The
F Tribunal has found that the said practice followed by the assessee was in consonance with principles of accountancy governing underwriting account. The Tribunal, after referring to authoritative books on Accountancy, has held that the underwriting commission is a part of profit and loss account which includes not only the income from underwriting commission and brokerage but the same is debited by the expenses and
G the cost of shares, which the underwriter is called upon to take and as such, underwriting commission could not be taken into consideration leaving aside the other items of this account and, therefore, the underwriting commission in respect of the shares purchased by the assessee could not be treated as taxable income in the hands of the assessee. The
H High Court has agreed with the said view of the Tribunal.

The main contention urged by the learned counsel appearing for A
the Revenue in support of the appeals was that the entitlement to
reduction is to be governed by the provisions of law and not by the
accounting practice adopted by the assessee and in support of his submis-
sion the learned counsel has placed reliance on the decision of this Court
in *Kedar Nath Jute Manufacturing Company* v. *Commissioner of Income* B
Tax, (1971) 82 ITR 363; *Morvi Industries Ltd.* v. *Commissioner of Income*
Tax, (1971) 82 ITR 835 and *State of Tranvancore* v. *Commissioner of*
Income Tax, (1986) 158 ITR 102.

In our opinion, this contention is devoid of force. The accounting
practice followed by the assessee in the instant case was in consonance with C
general principles of accountancy governing underwriting accounts. It is a
well accepted proposition that "for the purposes of ascertaining profits and
gains the ordinary principles of commercial accounting should be applied,
so long as they do not conflict with any express provision of the relevant
statute". (See : *Whimster & Co.* v. *Commissioners of Inland Revenue*, 12 T.C. D
813 and *Commissioners of Inland Revenue* v. *Cock, Russell & Co. Ltd.*, 29
T.C. 387). This proposition has been affirmed by this Court in *P.M.*
Mohammed Meerakhan v. *Commissioner of Income Tax, Kerala*, (1969) 73
ITR 735. In the said case it has been observed :

> "For that purpose it was the duty of the Income Tax Officer to find E
> out what profit the business has made according to the true
> accountancy practice." (p. 743)

The decisions on which reliance has been placed by the learned
counsel for the Revenue do not depart from this principle. F

In *Kedar Nath Jute Manufacturing Company* v. *Commissioner of*
Income Tax (supra) this Court was considering the question whether the
amount of sales tax paid or payable by the assessee is an expenditure
within the meaning of Section 10(2)(xv) of the Income Tax Act, 1922.
The said claim of the assessee was disallowed by the Income Tax Officer G
on the ground that the assessee was following the mercantile system of
accounting and had made no provision in its books with regard to
payment of that amount. Upholding the claim of the assess for deduc-
tion of said amount, this Court has held that whether the assessee is
entitled to a particular deduction or not will depend on the provision H

A of law relating thereto and not on the view which the assessee might take
of his rights nor can the existence or absence of entries in the books of
account be decisive or conclusive in the matter. In this case the question
whether the principles of accounting have to be taken into account for
ascertainment of profit did not fall for consideration.

B

The decision in *Morvi Industries Ltd.* v. *Commissioner of Income Tax*
(supra) also does not deal with this question. In that case this Court has
explained the meaning of the word "accrued" used in Section 4(1)(b)(i) of
the Income Tax Act, 1922 and has observed that income can be said to
have accrued when it becomes due and the postponement of the date of
C payment has bearing only so far as time of payment is concerned but it
does not affect the accrual of income.

State of Tranvancore v. *Commissioner of Income Tax* (supra) was a
case where the assessee-Bank, instead of carrying the interest on sticky
D advances, i.e., advances which had become extremely doubtful of
recovery, to the profit and loss account, had credited it to a separate
account called 'the Interest Suspense Account'. The question was
whether the said interest was taxable, Tulzapurkar J., in his dissenting
judgment, held that the said income was not an income and was not
E taxable and observed that even in mercantile system of accounting it is
only the accrual of real income which is chargeable to tax and accrual
is a matter of substance to be decided on commercial principles having
regard to the business character of the transactions and the realities and
specialities of the situation and cannot be determined by adopting a
purely theoretical or doctrinaire or legalistic approach. The learned
F Judge has referred to standard text books on accountancy to show that
in case of interest on sticky loans the practice of debiting the accounts
of the concerned debtors with interest and carrying the same to Interest
Suspense Account instead of the interest account or profit and loss
account is well recognised and accepted practice of commercial ac-
G countancy which is wholly consistent with the mercantile system of
accounting. Sabyasachi Mukharji J. (as the learned Chief Justice then
was), however, held that the interest on sticky advances had accrued
according to the mercantile systems of accounting because the assessee-
Bank had debited the respective parties with the interest and that after
H the close of the accounting year the assessee-Bank without giving up the

interest, which it could have, as a bad debt, did not offer it for taxation but A
carried it to the Interest Suspense Account and that carrying a certain
amount which had accrued as interest without treating it as a bad debt or
irrecoverable interest but keeping it in suspense account was repugnant to
Section 36(1)(iii) read with Section 36(2) of the Act. The learned Judge,
after taking note of the recognised books on accountancy to which refer- B
ence had been made by Tulzapurkar J., observed :

> "Even if in a given circumstance, the amounts may be treated
> as interest suspense account for accountancy purpose, that
> would not affect the question of taxability as such. This must be
> determined by well-settled legal principles and principles of C
> accountancy which have been referred to hereinbefore".

Ranganath Misra J. (as the learned Chief Justice then was) con-
curred with reasonings and conclusions of Mukharji J. The aforemen-
tioned observations of Mukharji J. also postulate that for determining D
the question of taxability well settled legal principles as well as prin-
ciples of accountancy have to be taken into account. In that case the
learned Judge held that without treating the amount which had accrued
as interest as a bad debt or irrecoverable interest but keeping it in
suspense amount was repugnant to Section 36(1)(vii) read with Section
36(2) of the Act and, therefore, even if the amount might be taken to E
the Interest Suspense Account for accounting purposes, that would not
affect its taxability as such.

In the present case, the Tribunal after referring to authoritative
book on Accountancy, has found that the assessee was maintaining the F
accounts correctly in accordance with the principles of accountancy
applicable to underwriting accounts and keeping in view the said prin-
ciples the underwriting commission on the shares which were not sub-
scribed by the public and were purchased by the assessee could not be
treated as profit earned by the assessee in the transaction and the said
commission could only be treated as reducing the price of the shares G
purchased by the assessee. The Tribunal has also stated that there is no
contrary provision in the Act. The learned counsel for the Revenue has
not shown that the accountancy practice followed by the assessee is
repugnant to any provision of the Act. In the circumstances, it must be
held that the Tribunal has not committed any error in taking the view H

A that the underwriting commission earned by the assessee in respect of the shares which were not subscribed by the public and were purchased by the assessee could not be treated as a part of its taxable income. The question referred was, therefore, rightly answered by the High Court against the Revenue and in favour of the assessee.

B As a result, the appeals fail and are accordingly dismissed. No order as to costs.

R.P. Appeal dismissed.