

Explanation to Sec.73: A Deeming Provision

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1. Introduction:

The Taxation Laws (Amendment) Act, 1975 inserted an explanation to sec.73 w.e.f.1.4.77 and created a legal fiction whereby that part of business of companies as consists of dealing in shares is treated as "speculation business" except in the cases of companies having specified nature of principal business or having main component of income from the specified sources.

The said "explanation" has created "legal fiction" in the sense that it treats even those transactions which results into delivery of shares as speculative though in the normal course such transactions cannot be termed as speculative. Sec.43(5) defines "speculative transaction" to be a transaction in which a contract for the purchase or sale of any commodity or shares is periodically or ultimately settled otherwise than by the actual delivery. The net effect of the insertion of the explanation to sec. 73 is that the companies, except the ones specifically excluded, shall not be able to set off losses from share dealing/ trading business from the profits of any other business or any other head of income.

What was the purpose of creating a "legal fiction" in this regard ?

Circular No.204 dtd. 24.7.76 containing explanatory notes relating to amendments brought in by the Taxation Laws (Amendment) Act, 1975 states at para 19.2:

"The object of this provision is to curb the device sometimes resorted to by business houses controlling groups of companies to manipulate and reduce the taxable income of companies under their control."

2. Explaining the "Explanation"

2.1 The provision and changes made therein

Explanation to sec. 73 states:

"Where any part of the business of a company *other than a company whose gross total income consists mainly of income which is chargeable under the heads "Interest on securities", "Income from house property", "Capital gains" and "Income from other sources"*, or a company the principal business of which is the business of banking or the granting of loans and advances consists in the purchase and sale of shares of other companies, such company shall, for the purpose of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares."

The words in italics have been substituted for " other than an investment company , as defined in clause (ii) of section 109" by the Finance Act, 1987, w.e.f.1.4.1988. It is pertinent to note here that the substitution of the words in italics was necessitated by the removal of chapter XI relating to "Additional Income -tax on undistributed profits" from the statute, which contained in sec. 109(ii) the definition of the term "investment company". However, the words in italics are directly imported from the definition of the "investment company" provided in the erstwhile sec. 109(ii). For the purpose of our discussion, we shall use the term "investment company" for the words in italics for the sake of brevity.

2.2 Broad features

The broad features of " "explanation to sec.73" are as follows-----

- a) It applies only to companies and not to individuals, firms, HUFs or AOPs. This is in line with the objective of bringing in the "Explanation" on the statute as spelt out in Circular No. 204 dtd. 24.7.76 discussed in para 1 above.

b) Following companies are excluded from its mischief-

(i) investment companies

i.e., companies whose major part of gross total income comprises of income chargeable under the

head-

-interest on securities

-income from house property

-income from capital gains and

-income from other sources

Thus in order to be an " investment company " the sum of incomes under the heads enumerated above has to be more than the income under the head business.

(ii) companies whose principal business comprises of banking business and

(iii) companies whose principal business is of granting of loans and advances.

What constitutes an "investment company" is a major area of controversy which shall be discussed a little later.

c) Where the whole of the business of a company comprises of dealing/trading in shares (even if ultimately resulting in delivery), explanation to sec. 73 is applicable as the term "any part" used in the opening portion of explanation denotes "whole" as well. (According to a Calcutta High Court judgement discussed a little later)

d) Some isolated transactions in shares do not constitute "business". Hence losses on this account are outside the "mischief " of the explanation.

3. Innocent victims

The innocent unsuspecting victims of the explanation to sec. 73 are invariably the share trading/ dealing companies even if they did not indulge in speculation and in spite of the fact that it was not the legislative intention to apply the explanation against such companies. Whenever the stock market bubble bursts. On the one side, mounting losses in the face of falling prices and on the other, the government demanding its pound of flesh by virtue of explanation to sec. 73 in the form of taxes on profits or incomes they could

manage from any other business or from any other head of income unabated by loss on share business.

To add to their woes are some of the High Court and Tribunal judgements which have taken "narrower" view and laid more emphasis on the words used rather the legislative "intent".

Some relevant case laws

3.1 In Eastern Aviation & Industries Ltd. v. CIT 208 ITR 1023, the assessee company had incurred a loss of Rs.12,90,145/- in share dealings for which delivery was taken by it. Loss on account of purely speculative transactions was Rs. 7,95,447/-. The dividend income under the head income from other sources was Rs. 3,87,603/-.The ITO held that the assessee was not an "investment company" within the meaning of section 109(ii). He therefore, took the view that the business loss of Rs. 12,90,145/- had to be taken as speculation loss in view of the explanation to section 73. On appeal, however, the Commissioner (Appeals) accepted the contention of the assessee that as the "dividend income" under the head "income from other sources" is greater than the "income from business", it was an investment company." He therefore, directed the ITO to treat the loss from share dealings as an ordinary business loss and not as a speculation loss.

On a reference by the assessee against the order of the Tribunal which went against the assessee, the hon'ble Calcutta High Court held that it is by now well settled that the words "income" or "profits and gains" should be understood as including losses also so that in one sense "profit and gains " represent "positive income" whereas losses represent "negative income". In other words, "loss "is negative profit. If the total income of the assessee was computed according to the provisions of the Act without giving effect to Explanation to section 73, it would be found that as against the dividend income of Rs. 3,87,603/-, assessable as income from other sources, business loss from share dealings and speculation was clearly more. Therefore the assessee company could not be said to be an "investment company". As such, the Explanation to sec. 73 was clearly applicable and the loss suffered by the assessee company in share dealings was rightly treated by the

Tribunal as a loss in speculation business. In other words, business loss in share dealings was not liable to be set off against the dividend income in this case and had to be carried forward for being set off against speculation profit only.

3.2 In CIT v. Arvind Investments Ltd. 192 ITR 365, the issue for consideration before

the hon'ble Calcutta High Court was whether the Explanation to sec. 73 has no application where the entire business of the assessee was in share dealing.

It is to be noted that this is important from the point of view of 100% share dealing companies inasmuch as in the case of applicability of the "Explanation" they shall not be able to set off the loss under the "business head" from other heads of income.

The hon'ble High Court negated the contention of the learned counsel for the assessee that although the usual rule of construction is that "part" should include "whole", such construction should not be given to the Explanation to sec. 73 in view of the scheme of the Act and the wording of the statute.

Their lordships observed towards the end of the judgement-

"The word "any" or the phrase "any part" has a well understood legal connotation and has been explained in a number of cases both in England and also by the Courts of India-----

Therefore the legal implication of the phrase "any part of the business of the company" does not create any difficulty. Dr. Pal (the counsel for the assessee) has not been able to cite any case where the word "any" has been used in the restrictive sense so as not to include "all". Moreover, we fail to see why "part" should not include "the whole" in this case as suggested by Dr. Pal".

At the end, their lordships answered the questions referred in the negative and in favour of the Revenue.

3.3 Comments on the above judgements

With due respect to the hon'ble High Court, it is most humbly submitted that both the above judgements need reconsideration as they are not in consonance with the "legislative intent" of bringing in the "Explanation". The legislative intent is quite evident from the para 19.2 of the **circular no. 204 dtd. 24.7.76** which states that the provision has been brought in to curb the device resorted to by business houses

controlling groups of companies. This particular intention of the legislature gets further confirmation by the fact that the provision has been made applicable only to the companies and not to other type of assesseees. If the intention was otherwise, then one does not understand the wisdom of sparing the rod of "Explanation" to other type of assesseees.

It will not be out of place to mention what the hon'ble Supreme Court had observed in **Girdharilal & Sons v. Balbir Nath AIR 1986 SC 1499 at pg. 1503-**

-----" the primary and foremost task of the court in interpreting a statute is to ascertain the intention of the legislature, actual or imputed. Having ascertained the intention, the court must then strive to so interpret the statute as to promote/ advance the object and purpose of the enactment. For this purpose, where necessary, the court may even depart from the rule that plain words should be interpreted according to their plain meaning. There must be no meek and mute submission to the plainness of the language. To avoid patent injustice, anomaly or absurdity or to avoid invalidation of a law, the court would be well justified in departing from the so called golden rule of construction so as to give effect to the object and purpose of the enactment by supplementing the written word if necessary."

4. View applying legislative intent overruled

The Delhi Bench of the ITAT in the case of **Aman Portfolio (P) Ltd. 92 ITD 324** had taken a view that Explanation to Sec.73 cannot be invoked unless it is proved that there is device or manipulation by controlling group of companies to reduce the taxable income. This view has now been overruled recently by the Special Bench, Ahmedabad Tribunal in the case of **AMP Spg. & Wvg. Mills (P) Ltd. 100 ITD 142.**

5. How the "culprits" go scot free-

In one of the reported case before the Bombay Tribunal in the case of **Rajan Enterprises (P) Ltd. 41 ITD 469**, it was observed that the assessee company had been doing business in purchase and sale of cold rolled stainless steel strips alongwith purchase and sale of shares. The company made a net loss of Rs. 2.5 lacs in the share

dealings out of sale of shares, which comprised mostly of private limited and unlisted holding companies and the shares were sold within three months of their purchase. The company made profits in the steel transactions and received interest income besides dividend income of Rs. 16,000/-. The ITO invoked explanation to sec. 73 and treated the loss of Rs. 2.5 lacs on the sale of shares as speculation loss. The ITO's order was confirmed by the CIT (Appeals). Before the Tribunal, the learned counsel for the assessee contended that to determine whether the loss incurred by the assessee was speculation loss or not, one has to compute gross total income, without looking to the provisions of explanation to sec. 73. In other words, as the assessee was dealing in shares, its loss was to be set off first under sec. 71 against income under other heads. Proceedings on this basis, the gross total income (GTI) would be Rs. 9,000/- which consisted wholly of dividend income chargeable under the head "income from other sources" and so, the assessee would be an investment company.

The Department Representative on the other hand, submitted that the gross total income of an assessee has to be the total income before chapter VI A deductions, computed as per the provisions of the Explanation to sec. 73. When one has to consider the treatment to be given to a transaction with the reference to the gross total income of the assessee, that transaction has to be ignored and kept out of consideration. The loss on share dealings amounting to Rs. 2.5 lacs was to be ignored and the gross total income of the assessee in such a situation would be Rs. 2.60 lacs as determined in the assessment order and that would be mainly consisting of income under the head "business". As the major part of GTI comprises of business income, the company is not an investment company and therefore does not enjoy exemption from the Explanation. The Tribunal after considering rival submissions came to the conclusion that although both the situations are plausible, however, looking to the scheme of the Act, it is found that whenever such a situation arises, the Act has provided specific exclusion of that item from the GTI. As there is no specific exclusion of the loss incurred on share dealings from the GTI under sec. 73, the contention of the assessee is preferred to the one canvassed by the revenue. Before

coming to the conclusion, the Tribunal cited instances of such specific exclusions to drive home the point.

The case stated above demonstrates how the adherence to literalness while interpreting a provision may come to the rescue of the companies resorting to “devices”.

6. Whether it is permissible to file revised computation

Many a times it is seen that while filing returns, the assesses do not properly bifurcate the incomes under the correct head and clubs all types of incomes under the head “Business”. For example, the assessee earning a commission income out of a solitary transaction otherwise chargeable to tax under “income from other sources” includes it under the head “Business”. The mistake is realized when the A.O invokes Explanation to sec.73. The assessee then files a revised computation to show that its income from non-business activity is more and it is an investment company. This is rejected by the A.O on the plea that the assessee could have filed a revised return and as the statutory time limit has expired, the revised computation of income is not entertained.

In the author’s opinion, the A.O’s action in such cases is not proper. In the case of **Smt. Snehlata vs. CIT 61 ITR 139**, the Hon’ble Allahabad High Court held that income of an assessee is to be computed under the correct head. In **Bihar State Co-operative Bank vs. CIT 39 ITR 114**, the Hon’ble Supreme Court held that if the assessee wrongly offers an exempt income for taxation, he can claim before the appellate authority that his income is exempt. Hon’ble Madras High Court in the case of **N.C. Srinivasan vs. CIT 211 ITR 236** held that officers of the Department cannot take advantage of the ignorance of the assessee.

Recently, in the case of **M/s Megapade Vyapaar (P) Ltd.** , ITA no. 314/k/05, Order dtd. 22.08.2005, the ‘A’ Bench of the Kolkata Tribunal held, in the context of Explanation to Sec.73, that the assessee can revise its return only within the time limit prescribed, but the revised computation can be filed at any time before the computation of total income by the A.O.

7. Conclusion

With the McDowell's case providing the stick to the revenue for taking care of "colourable devices", the only value that the Explanation to sec. 73 can boast of is the nuisance value. But till the final nail in its coffin is delivered by the mandarins of the north block, it is hoped that the judiciary will take the ground realities into consideration and not adhere to literalness which has delivered unjust and absurd results in this regard.

Justice Krishna Iyer of the Supreme court had observed (AIR 1981 SC 234, 242) -

"Courts can and must interpret words and read their meanings so that the public good is promoted and power misuse is interdicted. As Lord Denning said : A judge should not be a servant of the words used. He should not be a mere mechanic in the powerhouse of semantics-----"