Privy Council Appeal No. 104 *of* 1938

The Commissioner of Income-tax, Bengal - - - *Appellant*

v.

Himalaya Assurance Co. Limited - - - - *Respondent*

FROM

THE HIGH COURT OF JUDICATURE AT FORT WILLIAM IN BENGAL

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 12TH MAY, 1939

Present at the Hearing:
LORD RUSSELL OF KILLOWEN
LORD ROMER
SIR GEORGE RANKIN
[*Delivered by* LORD ROMER]

The respondent company is a life assurance company incorporated in British India, and the question to be determined in this appeal is how its profits ought to be ascertained for the purpose of assessment to income tax for the year 1936-7 under the Indian Income-tax Act, 1922, and the amending enactments. The determination of this question depends upon the proper construction of rule 25 of the rules made by the Board of Revenue under section 59 of that Act; but before considering the language of that rule it will be convenient to set out section 8 (1) of the Indian Life Assurance Companies Act, 1912. The subsection so far as material is in these terms:—

> "Every life assurance company shall once in every five years or at such shorter intervals as may be prescribed by the instrument constituting the company, or by its regulations or bye-laws, cause an investigation to be made into its financial condition, including a valuation of its liabilities, by an actuary, and shall cause an abstract of the report of such actuary to be made in the form set forth in the Fourth Schedule."

For the purposes of this investigation and report a consolidated revenue account and a valuation balance sheet must be prepared in the forms set out in the Fourth Schedule.

The form of consolidated revenue account which shows the state of the company's life assurance fund at the beginning and end of the quinquennium or other period is as follows:—

CONSOLIDATED REVENUE ACCOUNT OF THE FOR YEARS COMMENCING AND ENDING

		Rs.		Rs.	Rs.
Amount of life assurance fund at the beginning of the period ...			Claims under policies paid and outstanding ...		
Premium			By death		
Consideration of annuities granted			By maturity ...		
	Rs.				
Interests, dividends and rents			Surrenders		
Less income-tax thereon...			Annuities		
			Bonuses in cash		
			,, ,, reduction of premiums		
Other receipts (accounts to be specified)			Commission		
			Expenses of management ...		
			Other payments (accounts to be specified)		
			Amount of life assurance fund at the end of the period as per Third Schedule ...		
Rs.			Rs.		

The form of the valuation balance sheet is as follows:—

VALUATION BALANCE SHEET OF AS AT 19 .

DR.	Rs.		CR. Rs.
To net liability under life assurance and annuity transactions (as per summary statement provided in Fourth Schedule)...		By life assurance and annuity funds (as per balance sheet under Third Schedule) ...	
To surplus, if any		By deficiency, if any	

In the case of a company which like the respondent company only transacts life assurance business, the first item on the left hand side of this balance sheet will show the liabilities of the company in respect of its policies outstanding at the end of the period, and these liabilities will have been ascertained by actuarial valuation in the usual way. The first item on the right hand side of the balance sheet will be the amount of its life assurance fund at the end of the period as shown by the consolidated revenue account. It is plain therefore that the balance sheet will merely show the financial position of the company at the end of the period, and that the surplus or deficiency disclosed by it will not necessarily be the result of its business transactions during the period. In order to ascertain the result of those business transactions it will be necessary to compare the surplus or deficiency with the surplus or deficiency disclosed by the valuation balance sheet drawn up at the end of the preceding period. In the case, for instance, of a company like the respondent company whose financial condition is ascertained once in every five years, there may be a surplus disclosed at the end of the first quinquennium of the company's trading. That

surplus will of course represent the profit made during such quinquennium and the life assurance fund at its end will be swollen by the amount of such profit. But if that profit be not wholly distributed amongst the shareholders or participating policy holders during the succeeding quinquennium, the life assurance fund at the end of this second quinquennium will be swollen by the amount of that profit which remains undistributed and to that extent will increase the surplus or diminish the deficiency as the case may be, that is disclosed by the second valuation balance sheet. It is this consideration that gives rise to the difficulty occasioned by the terms of rule 25. That rule is as follows:—

> 25. " In the case of Life Assurance Companies incorporated in British India whose profits are periodically ascertained by actuarial valuation, the income, profits and gains of the Life Assurance Business shall be the average annual net profits disclosed by the last preceding valuation, provided that any deductions made from the gross income in arriving at the actuarial valuation which are not admissible for the purpose of income-tax assessment, and any Indian income-tax deducted from or paid on income derived from investments before such income is received, shall be added to the net profits disclosed by the valuation."

The first observation to be made about this rule is upon the words " whose profits are periodically ascertained by actuarial valuation ". It is plain that the actuarial valuation here referred to is the actuarial investigation into the company's financial condition required by section 8 (1) of the Act, and not merely the actuarial valuation of its liabilities which by itself can never ascertain the profits. The words, too, at first sight, would seem to point to an ascertainment of the profits made in each successive period of five years or whatever shorter period may be prescribed in respect of the particular company. If that be so, then the words " by actuarial valuation " cannot be referring merely to the actuarial investigation made at the end of the period; for, as already pointed out, the surplus or deficiency shown by the valuation balance sheet drawn up at the end of any period except the first one does not necessarily represent the result of the company's trading during that period. The profits earned during each of the later periods will be ascertained by a comparison of the valuation balance sheet at the end of the period with the valuation balance sheet at the end of the preceding period. Profits periodically ascertained in this way can be accurately described as being ascertained by actuarial investigation, and none the less because they are ascertained by an investigation made partly at one time and partly at another, and it may be partly by one actuary and partly by another. It must after all be remembered that, in order to ascertain the amount of the life assurance fund at the end of the period, the actuary must prepare the consolidated revenue account for the period, and in so doing must necessarily ascertain its amount at the beginning of the period, and that this latter amount can only be discovered from the actuarial investigation made at the end of the preceding period. The rule so far does not therefore seem to give rise to any great difficulty. Nor would there be any difficulty

if the rule had proceeded as follows: "the income, profits, and gains of the life assurance business shall be the average annual net profits of the last preceding period as ascertained by actuarial valuation". But the words actually used in the rule do undoubtedly create a serious difficulty. What are the average annual net profits disclosed by the last preceding "valuation" in cases where the last preceding "valuation" (i.e., investigation) was not the first one? As already pointed out the profits "disclosed" by the last preceding investigation taken by itself may include part, or even the whole, of the profit disclosed by the last but one of the preceding valuations, and these last-mentioned profits themselves may include part or the whole of the profits disclosed in a still earlier valuation. Now it is plain that the divisor to be used for the purpose of ascertaining the average must be the number of years in the period. It is impossible to suggest any other. But in that case the average so obtained may be something very different from the average "annual" profits of the period. If in one quinquennium, for instance, a profit of £2,000 be earned and be not distributed during the succeeding quinquennium during which a further profit of £2,000 be earned, the profit disclosed by the valuation at the end of this second period will be £4,000, and the average obtained by dividing this sum by five will be £800; whereas in truth the average "annual" profit of the period will have been £400. If, however, the true construction of the rule be that in such a case £800 is to be taken to be the average annual profits disclosed by the last preceding valuation, the result will be that, whereas during the second of the two quinquenniums the company will pay each year income tax on a sum of £400, during the succeeding quinquennium it will pay income tax each year on a sum of £800, although its average annual profits over the whole ten years will have been £400. A company could of course avoid this by distributing the profits disclosed at the end of one period before the end of the next, and the framers of the rule may have acted upon the footing that this would in fact be done. But the valuation balance sheet at the end of one period may show a deficiency, and the one at the end of the next period may show a smaller deficiency. In such a case the company will have earned a profit during the later period, although according to the construction of the rule referred to above, no average annual profits will be disclosed by the valuation balance sheet made at the end of the period.

Now this is exactly what happened in the present case. The valuation balance sheet of the respondent company for the five year period ending on the 28th February, 1930, showed a deficiency of Rs.2.08.228. The balance sheet for the period ending on the 28th February, 1935, showed a deficiency of Rs.1.13.490, one fifth of which is Rs.22.698. In the assessment year 1936-7 the respondent company accordingly submitted a return showing a loss of this last-mentioned amount. But the deficiency on the 28th February, 1935, was Rs.94.738 less than that on the 28th February, 1930, indicating that this amount of profit had been earned

during the preceding five years. The income-tax officer, therefore, after adding back to this last-mentioned sum certain items that are not material to the present question and so making in all a sum of Rs.1.34.014, assessed the respondent company in a fifth of such sum, viz.: Rs.26.803. The company duly appealed from such assessment to the Assistant Commissioner who by order dated the 24th February, 1937, rejected the appeal. He held that the words "Net profits disclosed by the last preceding valuation" in rule 25 meant the profits actually made during the last valuation period.

The respondents thereupon in pursuance of section 66 (2) of the Act required the Commissioner of Income-tax, Bengal, who is the appellant in the present case, to refer to the High Court of Judicature at Fort William the question of law arising out of the order of the Assistant Commissioner. The Commissioner accordingly drew up a statement of the case and referred it with his own opinion thereon to the High Court. The case after setting forth the facts narrated above, stated the question of law to be decided as follows:—

> "The assessee's actuarial valuation Balance Sheet on the last date of the last preceding valuation having shown a deficiency, does the provision of Rule 25 of the rules under the Income-tax Act for ascertaining the average annual net profits of a Life Assurance Company permit the department to go behind the said valuation Balance Sheet to find out if there were any profits in respect of the period of the last preceding valuation?"

His own opinion upon the question was expressed in these words:—

> "The result of the actuarial valuation of a Life Assurance Company as disclosed in the actuarial accounts at the end of a given period is really a continuation of previous valuation, and adjustment must necessarily be made to find out what really is the surplus or deficit of a given period (in this case a quinquennium) in order to determine the assessability or otherwise of the company in terms of Rule 25. If the result of the valuation of a period preceding the period which is made the basis of an assessment is a surplus, such portion of that surplus as has not been appropriated by way of bonus, etc., automatically comes to be merged in a subsequent valuation and, unless such unappropriated surplus is taken out of the next valuation results, there will obviously be double taxation of some income. Similarly, if the result of the valuation of a period preceding the valuation which is made the basis of assessment of a given year is a deficit, such deficit will automatically find its way into the next valuation. To arrive at the annual average net profit, adjustment will therefore have to be made to avoid the results as above stated and such adjustment is accordingly permissible by Rule 25 . . . I would respectfully submit that the actuarial valuation (i.e. the Valuation Balance Sheet as at 28th February 1935 in this case) really disclosed a positive surplus."

The case in due course came before the High Court, and on the 11th January, 1938 the question of law was answered by them in the negative, that is to say in favour of the respondent company. The learned judges held that the matter was concluded by the decision of this Board in the case of *Bharat Insurance Company* v. *Commissioner of Income-tax* L.R. 61 I.A. 41. From that judgment of the High Court this appeal is now brought by the Commissioner to His Majesty in Council.

Their Lordships feel that there is much to be said for the construction put upon rule 25 by the Assistant Commissioner and by the appellant, and if the matter were free from authority it is possible that this construction would have been adopted by their Lordships, though not perhaps for all the reasons given by the appellant in his opinion. Their Lordships cannot for instance agree with the Commissioner that the construction put forward by the respondent company can ever result in double taxations of any income. For the rule does no more than provide a measure for ascertaining for the purposes of taxation the income of a life assurance company accruing in the years following the end of the period covered by the last actuarial investigation; and however that income may be measured it can never properly be said that it has already been taxed. All that can truthfully be said about it is that it is being measured by income which has or may have been already taxed in part or possibly in whole. But the construction contended for by the respondent company does certainly lead to a result that can hardly have been contemplated by the legislature. By virtue of section 3 of the Income-tax Act, 1922, tax is charged for the year of assessment in respect of all income profits and gains of the previous year of every company. In the case of an insurance company there is usually an insuperable difficulty in ascertaining precisely its income profits and gains for any particular year. This fact was recognised by the legislature, and it was accordingly provided by section 59 that the Central Board of Revenue might by rule prescribe (amongst other things) the manner in which and the procedure by which the income profits and gains should be arrived at in the case of insurance companies. Having regard to section 3 this would necessarily seem to mean the income, profits and gains for the year preceding the year of assessment. It was in pursuance of this power that rule 25 was formulated. It might therefore be said with some show of reason that the rule should be so construed as to produce something that can fairly be said to represent the income that the company is likely to earn in a year, judged by the average income that it was earning during the last preceding period. The construction contended for by the respondent company would, however, produce something that might be in certain circumstances double the income earned by the company in any year of its existence, or even more. But however this may be their Lordships feel bound to agree with the High Court that the matter is concluded in favour of the respondent company by the decision of this Board in the *Bharat Insurance Company's* case (*ubi sup.*)

In that case the facts were substantially as follows. The valuation balance sheet of the company as at 31st December, 1923, for the previous quinquennium showed a surplus of Rs.5.96.952. Of that surplus the participating policy holders were entitled under their contract to 90 per cent. In the course of the succeeding quinquennium the question accordingly arose between the company and the income-tax authorities whether the company should be assessed to

income-tax on a notional income equal to one-fifth of the surplus, or whether the company were entitled to treat the 90 per cent. payable to the policy holders as an expenditure incurred in earning such notional income and therefore to be assessed on an income equal to one-fifth of one-tenth of that surplus. In point of fact it seems that the whole of the surplus represented profits earned during the quinquennium ending on the 31st December, 1923. The difficulty with which their Lordships are confronted in the present case did not therefore arise. But the Board were undoubtedly called upon to determine the meaning and effect of rule 25, inasmuch as the contention on the part of the Income-tax Commissioner was that by reason of that rule nothing but the surplus disclosed by the balance sheet could be looked at in determining the assessable income of the company.

The judgment of the Board in favour of the Commissioner was delivered by Sir John Wallis. He said this:—

> Under Rule 25 made under Section 59 of the Indian Income-tax Act, 1922: " the income, profits and gains of a life assurance business shall be the average annual net profits disclosed by the last preceding valuation "; that is to say, shall be arrived at by taking one-fifth of the surplus disclosed in the valuation balance sheet already mentioned and treating it as the average annual income of the business for the next quinquennium.

And later on he said:—

> The " net profits " in this rule clearly mean the " surplus if any " in the statutory form of valuation balance sheet . . . of " life assurance and annuity funds (as per balance sheet under third Schedule) " over the " net liability under life assurance and annuity transactions (as per summary statement provided in fourth Schedule) ".

It is impossible to treat these observations as merely *obiter dicta*. They were the grounds upon which the decision of the Board was based. In these circumstances it is only proper that their Lordships should follow them, even though the attention of the Board on that occasion was not drawn to the difficulties that might be caused by the construction of the rule that was there adopted. Their Lordships feel less hesitation in doing so by reason of the fact that in consequence of recent legislation such difficulties as have arisen in the present case will not, they are informed, arise in the future.

For these reasons their Lordships are of opinion and will humbly advise His Majesty that the judgment of the High Court should be affirmed and the appeal dismissed.

The respondent company's costs must be paid by the appellant.

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In the Privy Council

THE COMMISSIONER OF INCOME-TAX, BENGAL

v.

HIMALAYA ASSURANCE CO. LIMITED

DELIVERED BY LORD ROMER

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