THE COMMISSIONER OF INCOME-TAX, MADRAS

v.

URMILA RAMESH

JANUARY 23, 1998

[S.C. AGRAWAL, B.N. KIRPAL AND S. RAJENDRA BABU, JJ.]

Income Tax Act, 1961 :

Ss. 2(22)(c), 32(1)(iii) and 41(2)—Assessees-shareholders of company—Liquidation—Amount realized on sale of assets in excess of written down value but less than purchase price—Distribution of dividends to shareholders—Assessment order treating the sale amount as "accumulated profit" and its distribution to shareholders as "deemed dividend"—Validity of—Held, amount received by the company on sale of assets does not constitute" accumulated profit"—Return of capital on sale of assets is not capable of being capitalised and hence is not "deemed dividend"—Income Tax Act, 1922—Section 10(2)(vii).

Section 2(22)(c)-"accumulated profit"—Nature and scope of.

S.41(2)—Whether contains any legal fiction as regards income of an assessee—Held, yes.

Respondents-assesses were share-holders of a private Limited Company which went into voluntary Liquidation. After sale of its assets, the liquidator distributed the dividends to the share-holders. The Income Tax Officer by determining the accumulated profits of the company taxable under Section 41(2) of the Income Tax Act, 1961, passed assessment orders treating the dividends distributed as income of the respective share-holder under Section 2(22)(c) of the Act. The respondents-assesses' appeals against the said assessment orders were allowed by Appellate Assistant Commissioner and further upheld by Income Tax Appellate Tribunal. On reference, High Court held that the profits assessed under Section 41(2) of the Act could not form part of the accumulated profits for the purpose of Section 2(22)(c) of the Act. Hence, the present appeals.

The contention of the appellant-Revenue was that if the amount for which the assets were sold, exceeds the written down value, then the amount

A which is assessed under Section 41(2) of the Act represents accumulated profits and on its distribution amongst the share-holders it should be assessed as dividend.

The contention of respondents-assessees was that the amount realized by the liquidator on the sale of the assets admittedly being less than the B purchase price, it only represented the return of capital and the excess of realization over the written down could not be regarded as profit under section 2(2)(c) of the Act; it is only by legal fiction that the excess amount received by the official liquidator was deemed to be income and taxed by virtue of provisions of Section 41(2) of the Act and cannot be regarded as C profit or capital gain.

Dismissing the appeals, this Court

HELD : 1. The amount received by the company, which was taxed under Section 41(2) of the Income Tax Act, 1961 did not represent "accumulated profits" within the meaning of that expression in Section 2(22) of the Act. D

2.1. Section 41(2) of the Act is a special provision whereby the amount received in excess of written down value becomes chargeable to income-tax as income of the business or profession of the previous year in which the money payable for the building, machinery, plant or furniture become due. But for this specific provision, this amount would not have been taxed as E income from business. Building, machinery, plant or furniture, on which depreciation has been allowed, would be the capital asset of the assessee. Any sum received in respect thereof would ordinarily represent a capital receipt. But section 41(2) regards this amount as income from business or profession and of the year in which the amount becomes due. Even though the word F "deemed" is not used in Section 41(2) of the Act, as has been used in Section 10(2)(vii) second proviso of 1922 Act, nevertheless this provision creates a legal fiction whereby an amount received in excess of the written down value is firstly treated as income and secondly regarded as income from business or profession and thirdly it is considered to be the income of the previous year in which the money payable became due. Thus, both the provisions, viz. G Section 10(2)(vii) second proviso of the 1922 Act and Section 41(2) of the 1961 Act create a legal fiction, difference in language notwithstanding.

Cambay Electric Supply Industrial Co. Ltd. v. *Commissioner of Income-Tax, Gujarat-II,* 113 ITR 84, relied on.

H *Commissioner of Income-Tax, Gujarat* v. *Girdhardas and Co. Private*

Limited, 63 ITR 300, referred to. A

3.1. Section 2(22) of the Act has used the expression 'accumulated profits' "whether capitalised or not". This expression tends to show that under Section 2(22) it is only the distribution of the accumulated profits which are deemed to be dividends in the hands of the share-holders. By using the expression "whether capitalised or not" the legislative intent clearly is B that the profits which are deemed to be dividend would be those which were capable of being accumulated and which would also be capable of being capitalised. The amounts should, in other words, be in the nature of profits which the company could have distributed to its share-holders. This would clearly exclude return of part of a capital to the company, as the same cannot C be regarded as profit capable of being capitalised, the return being of capital itself.

Commissioner of Income-Tax, Bombay City v. *Bipinchandra Maganlal & Co. Ltd.,* (41 ITR 290); *Commissioner of Income-Tax, west Bengal* v. *Gangadhar Banerjee and Co. (Private) Ltd.,* (57 ITR 176) and *P.K. Badiani* D v. *Commissioner of Income-Tax, Bombay,* (105 ITR 642), relied on.

Commissioner of Income-Tax, Madras v. *Express Newspapers Ltd.,* (53 ITR 250), held inapplicable.

Bishop v. *Smyrna and Cassaba Railway Company,* (No. 2)(1895 2 Ch. E 596), referred to.

3.2. In the instant case, when the assets have been sold at price less than the purchase price, the amounts so received, apart from being in the nature of return of capital, cannot represent profits of the company. If the sale proceeds had been more than the original cost, then to the extent of the F excess amount received it could have been said that profits had been made by the company on the sale of its assets. But merely because the amount realised by the liquidator is more than the written down value but less than the original cost, it is not possible to hold that the company has made any actual or commercial profit. [338-F-G]

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4.1. The scheme of depreciation, balancing charge under Section 32(1)(iii) and balancing allowance is a composite one. The balancing charge and the balancing allowance are part of the scheme of depreciation allowance granted by the statute and the rules, on percentages not necessarily related to the actual wear and tear and which are not capable of accurate H

A determination. In any year, so long as the asset is in use, the amount of depreciation allowed would not only be correct but also be legitimate and legal and the allowance would be strictly in accordance with the provisions of the act and the rules. If the realisation of the sale proceeds and the capital asset is more than the written down value it would mean that the assessee had been allowed depreciation in excess of the actual wear and tear of the B asset. It is to withdraw the excess depreciation allowed that the balancing charge is provided for by Section 41(2) of the 1961 Act. A fiction is created that the excess above the written down value upto the actual cost of the asset is deemed to be profit or income of the year in which the asset is sold. In actual fact this is neither income or profit nor a capital gain. The deeming C under Section 41(2) is solely for the purpose of withdrawing the excess depreciation allowance which had been allowed to the assessee in the earlier years. Similarly the act also provides a corresponding allowance called the balancing allowance when the asset on sale fetches less than the written down value. By this, more allowance or deduction is given to the assessee in the year in which the asset was sold inasmuch as the actual wear and tear D was more than the depreciation allowed as per the Act and the rules.

[339-G-H; 340-A-D]

4.2. Merely because Section 41(2) and section 32(1)(iii) recognise the extent to which the actual wear and tear and the capital asset had taken place and permits by a fiction to make adjustment does not mean that in actual fact E in the case of balancing charge, any profit has been made. As far as share-holders are concerned the company had sold the assets at a price less than the actual cost and the amount taxable under Section 41(2), from their point of view, can never be considered to be profit which is or could be distributed as dividend. In any event as this amount has already been assessed in the F hands of the company obviously the same amount cannot also be regarded as capital gains. In other words both Section 41(2) and Section 50 of the 1961 Act cannot apply to the same amount. [340-E-F-G]

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 2141-2143 of 1982.

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From the Judgment and Order dated 9.3.1979 of the Madras High Court in T.C. No. 267 of 1975.

T.A. Ramachandran and J. Ramamurthy, Ranbir Chandra, S. Rajappa, Ms. Renu George, B.Krishna Prasad, A.T.M. Sampath, V. Balaji and Mrs. Janki H Ramachandran for the appearing parties.

The Judgement of the Court was delivered by A

KIRPAL, J. These appeals arise by virtue of a certificate having been granted by the Madras High Court under Section 261 of Income Tax Act, 1961 and the common questions of law referred relate to the interpretation of Section 2(22) of Income Tax Act, 1961 (hereinafter referred to as "the Act"). B

Briefly stated, the facts are that the respondents-assessees were share-holders of Tinnevely Motor Service Company Private Limited. The road transport business of the respondents was taken over by the then State of Madras as a result of which the said company went into voluntary liquidation on 28.3.1970. After the sale of its assets the liquidator distributed the first dividend on 31.3.1970 at the rate of Rs. 100 per share, the second dividend C on 17.4.1970 at the rate of Rs. 40 per share and the third dividend on 20.10.1971 at the rate of Rs. 25 per share. In the assessment of several share-holders, the income-tax Officer held, *inter alia*, that the accumulated profits of the company on the date of liquidation amounted to Rs. 6,61,065. Based on this figure, the income-tax officer treated 17.5% per share as dividend for the year D 1970-71,57.75% of the dividend of Rs. 40 per share for the year 1971-72 and 57.5% of the dividend of Rs. 25 per share for the year 1972-73 as the income of the respective share-holder under-section 2(22) (c) of the Act.

The respondents filed appeals against the order of assessment and contended before the Appellate Assistant Commissioner that the sum of Rs. E 7,28,760, which was the profit assessed under Section 41(2) of the Act in the preceding years and had been taken into consideration by the Income Tax Officer in determining the accumulated profit at the aforesaid figure of Rs. 6,61,065, could not be treated as accumulated profits under Section 2(22)(c) of the Act. The submission was that there were, in fact, no accumulated F profits in the commercial sense on the date of liquidation. The Appellate Assistant Commissioner accepted the contention of the respondents and allowed their appeals. The Income-Tax Tribunal upheld the said decision and, thereupon, at the instance of Revenue, it referred the following questions of law to the High Court of Madras.

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(i) Whether, on the facts and in the circumstances of the case, the appellate Tribunal was justified in confirming the deletion of the Income assessed as deemed dividends under the provisions of Section 2(22) (c) in the assessees's case?

(ii) Whether the Appellate Tribunal was right in law in holding that H

A the sum of Rs. 7,28,760 representing profits assessed under Section 41(2) in the preceding years cannot form part of the accumulated profits for the purpose of Section 2(22) (c) of the Income Tax Act, 1961 ?

The High Court, by its judgment dated 9.3.1979, answered the aforesaid B questions of law in the affirmative and against Revenue. It came to the conclusion that the profits assessed under Section 41(2) of the Act could not form part of the accumulated profits for the purpose of Section 2(22) (c) of the Act and in coming to this conclusion, it followed the ratio of decision of this Court in *Commissioner of Income-Tax, Bombay City* v. *Bipinchandra* C *Maganlal & Co. Ltd.,* (41 ITR 290). As already noticed, these appeals arise pursuant to certificate having been granted by the High Court from the aforesaid judgment.

On behalf of the appellant, it has been submitted by the learned counsel that if the amount for which the assets were sold, exceeds the written down D value, then the amount which is assessed under Section 41 (2) of the Act represents accumulated profits and on it's distribution amongst the share-holders it should be assessed as dividend. Reliance was placed on the decision in *Bishop* v. *Smyrna and Cassaba Railway Company* (No. 2) (1895 2 Ch. 596) and certain observations of this Court in *Commissioner of Income-Tax, Madras* v. *Express Newspapers Ltd.,* (53 ITR 250) and it was contended E that this amount of excess realized over the written down value was profits and, therefore, was rightly taken into consideration by the Income Tax Officer in computing the amount of accumulated profits. There being no dispute that when accumulated profits are distributed among the share-holders by the official liquidator during the winding up proceedings, the amount to the extent of the accumulated profits is deemed to be dividend and, therefore, taxable F in the hands of share-holders. Therefore, the Income Tax Officer, it was contended, rightly regarded the aforesaid sum of Rs. 7,28,760, which had been assessed as profit under Section 41(2) of the Act, as being liable to be taken into consideration in determining the accumulated profits within the meaning of that expression in Section 2(22) (c) of the Act.

G Repelling the aforesaid contention, the submission of the learned Counsel for the respondents was that the amount, which was realized by the liquidator on the sale of the assets, was admittedly less than the purchase price. The amount, so realized, only represented the return of capital and the excess of realization over the written down value could not be regarded as profit under H Section 22(2) (c) of the Act. It was contended that it is only by legal fiction

that this excess amount of Rs. 7,28,760 received by the official liquidator is deemed to be income and taxed by virtue of provision of Section 41(2) of the Act. It cannot be regarded as profit or capital gain. The learned counsel for the respondents did not dispute that if any amount had been received in excess of the purchase price, then to the extent of that excess amount, the provision of Section 22(2) (c) of the Act could have been attracted. But, here infact the company had suffered a capital loss, as the amount realized by it on the sale of the assets was less than the purchase price thereof.

These appeals came up for hearing before a Bench of two Judges of this Court who, by order dated 4.2.1997 (reported as 224 ITR 301), were *prima facie* of the view that the language employed in Section 10(2) (vii) of the Income Tax Act, 1922 and that employed in Section 41(2) of the Act was materially different and that it was doubtful whether the language used in Section 41(2) of the Act was akin to a legal fiction. It was observed that the decision in *Bipinchandra's* case (supra) was based on the relevant provisions of 1922 Act while a later decision in *Cambay Electric Supply Industrial Co. Ltd.* v. *Commissioner of Income-Tax, Gujarat-II,* (113 ITR 84) was with reference to Section 41(2) of the Act. This decision was rendered by mainly placing emphasis on Section 80(E) of the Act. As the matter was regarded as not being free from difficulty, this batch of cases was referred to a larger Bench.

In order to appreciate the rival contentions, we may now refer to the relevant provisions of Income Tax Act, 1961 with which we are concerned in the present case and the corresponding provisions of Income Tax Act, 1922 which were considered in the earlier cases of Bipinchandra and Express Newspapers cases (supra).

"1922 Act

Section 2(6-A) (a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;

(b) any distribution by a company of debentures, debenture-stock or deposit certificates in any form, whether with or without interest, to the extent to which the company possess accumulated profits, whether capitalised or not;

(c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the

A accumulated profits of the company immediately before its liquidation whether capitalized or not;

(d) any distribution by a company on the reduction of its capital to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day
B of April, 1933, whether such accumulated profits have been capitalised or not;

(e) any payment by a company, not being a company in which the public are substantially interested within the meaning of section 23-A, of any sum (whether as representing a part of the assets of the
C company or otherwise) by way of advance or loan to a shareholder or any payment by such company on behalf or for the individual benefit of a shareholder, to the extent to which the company in either case possesses accumulated profits;

but "dividend" does not include-
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(i) a distribution made in accordance with sub-clause (c) or sub-clause (d) in respect of any share issued for full cash consideration where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets;

E (ii) any advance or loan made to a shareholder by a company in the ordinary course of its business where the lending of money is a substantial part of the business of the company;

(iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it
F and treated as a dividend within the meaning of clause (e), to the extent to which it is so set off.

Explanation:- The expression "accumulated profits" wherever it occurs in this clause, shall not include capital gains arising before the Sixth day of April, 1946, or after the 31st day of March, 1948 and before the 1st of April, 1956.
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10. (2) Such profits or gains shall be computed after making the following allowances, namely-

(vi) in respect of depreciation of such buildings, machinery, plant or furniture being the property of the assessee, a sum equivalent,
H where the assets are ships other than ships plying ordinarily in

inland waters, to such percentage on the original cost thereof to the assessee as may in any case or class of cases be prescribed and in any other case, to such percentage on the written down value thereof as may in any case or class of cases be prescribed.

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provided that-

(a) the prescribed particulars have been duly furnished;

(vii) in respect of any such building, machinery or plant which has been sold or discarded or demolished or destroyed, the amount by which the written down value thereof exceeds the amount for which the building machinery or plant, as the case may be, is actually sold or its scrap value;

Provided that such amount is actually written off in the books of the assessee :

Provided further that where the amount for which any such building, machinery or plant is sold, whether during the continuance of the business or after the cessation thereof, exceeds the written down value, so much of the excess as does not exceed the difference between the original cost and the written down value shall be deemed to be the profits of the previous year in which the sale took place.

1961 Act :

S2(22)(a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;

(b) any distribution to its shareholders by a company of debentures, debenture-stock or deposit certificates in any form, whether with or without interest and any distribution to its preference shareholders of shares by way of bonus to the extent to which the company possesses accumulated profits, whether capitalised or not;

(c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its

liquidation, whether capitalised or not;

(d) any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;

(e) any payment by a company, not being a company in which the public are substantially interested, of any sum (whether as representing a part of the assets of the company or otherwise) by way of advance or loan to a shareholder, being a person who has a substantial interest in the company, or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company possesses in either case accumulated profits;

but "dividend" does not include-

(i) a distribution made in accordance with sub-clause (c) or sub-clause (d) in respect of any share issued for full cash consideration, where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets.

(i-a) a distribution made in accordance with sub-clause (c) or sub-clause(d) in so far as such distribution is attributable to the capitalised profits of the company representing bonus shares allotted to its equity shareholders after the 31st day of March, 1964 and before the 1st day of April, 1965;

(ii) any advance or loan made to a shareholder by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company;

(iii) any divided paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is set off.

Explanation 1—The expression "accumulated profits", wherever it occurs in this clause, shall not include capital gains arising before the 1st day of April, 1946, or after the 31st day of March, 1948 and before the 1st day of April, 1956.

Explanation 2—The expression "accumulated profits" in sub-clauses (a), (b), (d) and (e), shall include all profits of the company up to the date of distribution or payment referred to in those sub-clauses and in sub-clause (e) shall include all profits of the company up to the date of liquidation, but shall not, where the liquidation is consequent on the compulsory acquisition of its undertaking by the Government or a corporation owned or controlled by the Government under any law for the time being in force, include any profits of the company prior to three successive previous years in which such acquisition took place;.

32.(1) In respect of depreciation of buildings, machinery, plant or furniture owned by the assesses and used for the purposes of the business or profession, the following deductions shall, subject to the provisions of section 34, be allowed-

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(ii) In the case of buildings, machinery, plant or furniture, other than ships covered by clause (i), such percentage on the written down value thereof as may in any class of cases be prescribed.

Provided that where the actual cost of any machinery or plant does not exceed seven hundred and fifty rupees, the actual cost shall be allowed as a deduction in respect of the previous year in which such machinery or plant is first put to use by the assessee for the purposes of his business or profession;

(iii) In the case of any building, machinery, plant or furniture which is sold, discarded, demolished or destroyed in the previous year (other than the previous year in which it is first brought into use), the amount by which the moneys payable in respect of such building, machinery, plant or furniture, together with the amount of scrap value, if any, fall short of the written down value thereof :

Provided that such deficiency is actually written off in the books of the assessee.

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41. (2) Where any building, machinery, plant or furniture which is owned by the assessee and which was or has been

A used for the purposes of business or profession is sold, discarded, demolished or destroyed and the moneys payable in respect of such building, machinery, plant or furniture, as the case may, together with the amount of scrap value, if any, exceed the written down value, so much of the excess as does not exceed the difference between the actual cost and the written down B value shall be chargeable to income-tax as income of the business or profession of the previous year in which the money's payable for the building, machinery, plant or furniture became due.

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C *Explanation*—Where the moneys payable in respect of the building, machinery, plant or furniture referred to in this sub-section become due in a previous year in which the business or profession for the purpose of which the building, machinery, plant or furniture which was being used is no longer in existence, D the provisions of this sub-section shall apply as if the business or profession is in existence in that previous year"

It will be appropriate to first consider whether Section 41(2) of the act contains any legal fiction or not. The second proviso to Section 10(2)(vii) of the Income Tax, 1922 clearly provides that where the amount for which the E building, machinery or plant is sold, exceeds the written down value, then so much of the excess as would not exceed the difference between the original cost and written down value "shall be deemed to be the profit of previous year in which the sales took place". Section 41(2) of the Act does not, however, use the expression "shall be deemed.....". This, however, in our opinion would make no difference. Section 41(2) of the Act is a special F provision whereby the amount received in excess of written down value becomes chargeable to income-tax as income of the business or profession of the previous year in which the money payable for the building, machinery, plant or furniture become due. But for this specific provision, this amount would not have been taxed as income from business. Building, machinery, G plant or furniture, on which depreciation has been allowed, would be the capital asset of the assessee. Any sum received in respect thereof would ordinarily represent a capital receipt. But Section 41(2) regard this amount as income from business or profession and of the year in which the amount becomes due. Even though the word "deemed" is not used in Section 41(2) of the Act, as has been used in Section 10(2)(vii) second proviso of 1922 Act, H nevertheless this provision creates a legal fiction whereby an amount received

in excess of the written down value is firstly treated as income and secondly regarded as income from business or profession and thirdly it is considered to be the income of the previous year in which the money payable became due. That this section creates a legal fiction has been held by this Court in *Cambay Electric* Case (supra) where at page 93 of the report, it was observed as under :-

> "It is true that by a legal fiction created under Section 41(2) a balancing charge arising from sale of old machinery or building is treated as deemed income and the same is brought to tax; in other words, the legal fiction enables the revenue to take back what it had given by way of depreciation allowance in the preceding years since what was given in the proceeding years was in excess of that which ought to have been given. This shows that the fiction has been created for the purpose of computation of the assessable income of the assesse under the head "Business income". It was rightly pointed out by the learned Solicitor General that legal fictions are created only for a definite purpose and they should be limited to the purpose for which they are created and should not be extended beyond their legitimate field. But, as indicated earlier, the fiction under Section 41(2) is created for the purpose of computation of assessable income of the assessee under the head "Business Income" and under Section 80E(1), in order to compute and allow the permissible special deduction, computation of total income in accordance with the other provisions of the Act is required to be done and after allowing such deduction the net assessable income chargeable to tax is to be determined, in other words, the legal fiction under Section 41(2) and the grant of special deduction in case of specified industries are so closely connected with each other that taking into account the balancing charge (i.e. deemed profits) before computing the 8% deduction under Section 80E(1) would amount to extending the legal fiction within the limits of the purpose for which the said fiction has been created."

We are unable to agree with the submissions of Shri Ranbir Chandra that reference to the language of Section 41(2) in *Cambay Electric* case (supra) was only incidental. It is evident from the reading of the aforesaid passage that this Court was called upon to construe the meaning and effect of Section 41(2) of the Act in that case, which it did. The two provisions namely Section 10(2)(vii) second proviso of the 1922 Act and Section 41(2) of the Act both create a legal fiction, difference in language notwithstanding.

A As has been already observed out of the amount distributed by the liquidator of a company to the extent that said amount is attributable to accumulated profits is deemed to be dividend. As to how this determination takes place has been dealt with by this Court in *Commissioner of Income-Tax, Gujarat* v. *Girdhardas and Co. Private Limited,* (63 ITR 300) where at page 305, while considering Section 2(6A) (c), it observed as follows :

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> "There is in the hands of the liquidator only one fund. When a distribution is made out of the fund, for the purpose of determining tax liability, and only for that purpose, the amount distributed is disintegrated into its components-capital and accumulated profits—as they existed immediately before the commencement of liquidation. In any distribution made to the shareholders of a company by the liquidator, that part which is attributable to the accumulated profits of the company immediately before its liquidation, whether such profits have been capitalized or not, would be treated as dividend and liable to tax under the Act."

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While undertaking this exercise of separating capital from the accumulated profits, the Income Tax Officer has in the present case determined Rs. 6,61,065 as representing accumulated profits on the basis that the amount of Rs. 7,28,760 taxable under Section 41(2) forms part of the accumulated profits. But does this conclusion follow from the language of Section 2(22) of the Act, is the question.

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Section 2(22) of the Act has used the expression 'accumulated profits' "whether capitalised or not". This expression tends to show that under Section 2(22) it is only the distribution of the accumulated profits which are deemed to be dividends in the hands of the share-holders. By using the expression "whether capitalised or not" the legislative intent clearly is that the profits which are deemed to be dividend would be those which were capable of being accumulated and which would also be capable of being capitalised. The amounts should, in other words, be in the nature of profits which the company could have distributed to its share-holders. This would clearly exclude return of part of a capital to the company, as the same cannot be regarded as profit capable of being capitalised, the return being of capital itself. In this connection, it is important to examine the decision of this Court in Bipinchandra Maganlal's case (supra) that where this Court had the occasion to deal with the concept of balancing charge. That company was one in which the public was not substantially interested within the meaning of Section 23A of the Income Act, 1922. It computed its trading profits at Rs. 33,245 in the

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year of account 1946-47, and distributed dividend accordingly. The Income Tax Officer was, however, of the view that a sum of Rs, 15,608 , being the amount realized by the company on the sale of machinery in excess of its written down value which had been included in computing its assessable income, should also be taken into consideration and on that basis, the Income Tax Officer passed an order under Section 23A of the Income Tax Act, 1922 to the effect that the sum of Rs. 15,529 being the undistributed portion of the assessable income of the company, shall be deemed to have been distributed as dividend. The assessee had contended that this amount of Rs. 15,529 not being in the nature of commercial profit, but being a balancing charge includible in the assessable income by virtue of second proviso to Section 10(2)(vii), could not be taken into account in considering whether in view of smallness of the profits a larger dividend would be unreasonable. In this context, while considering Section 2(6C) and the second proviso to clause (vii) of Section 10(2) of 1922 Act, this Court at page 295-296 observed as follows:

> "In computing the profits and gains of the company under Section 10 of the Act for the purpose of assessing the taxable income, the difference between the written down value of the machinery in the year of account and the price at which it was sold (the price not being in excess of the original cost) was to be deemed to be profit in the year of account and being such profit, It was liable to be included in the assessable income in the year of assessment. But this is the result of a fiction introduced by the Act. What is truth is a capital return is by a fiction regarded for the purposes of the Act as income. Because this difference between the price realised and the written down value is made chargeable to income-tax, its character is not altered, and it is not converted into the assessee's business profits. It does not reach the assessee as his profits: it reaches him as part of the capital invested by him, the fiction created by section 10(2)(vii), second proviso, notwithstanding. The reason for introducing this fiction appears to be this. Where in the previous years, by the depreciation allowance, the taxable income is reduced for those years and ultimately the assest fetches on sale an amount exceeding the written down value, i.e, the original cost less depreciation allowance, the Revenue is justified in taking back what it had allowed in recoupment against wear and tear, because in fact the depreciation did not result. But the reason of the rule does not alter the real character of the receipt. Again, it is the accumulated depreciation over a number

A of years which is regarded as income of the year in which the asset is sold. The difference between the written down value of an asset and the price realized by sale thereof though not profit earned in the conduct of the business of the assessee is notionally regarded as profit in the year in the which the asset is sold, for the purpose of taking back what had been allowed in the earlier years. "

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We are in respectful agreement with the aforesaid observations and the same will apply even to Section 41(2) of the Act. There are cases where this Court had to consider situations relating to distribution of dividend by company and it has consistently maintained that profits meant only commercial profits. In *Commissioner of Income-Tax, West Bengal* v. *Gangadhar Banerjee and* C *Co. (Private) Ltd.*, (57 ITR 176), the question arose in connection with the payment of dividend by a company to whom Section 23A of the income Tax Act, 1922 was applicable. While considering the question of smallness of profit, the Court after referring to the observations in *Bipinchandra Maganlal's* case (supra) at page 183 observed "that in arriving at the assessable profits, D the Income Tax Officer may disallow many expenses actually incurred by the assessee; and in computing this income, he may include many items on notional basis. But the commercial or accounting profits are the actual profits earned by an assessee calculated on commercial principles."

Again in *P.K. Badiani* v. *Commissioner of Income-Tax, Bombay,* (105 E ITR 642), a three Judges Bench of this Court while considering the question of "deemed dividend" observed at page 647 as follows :

> "We think that the term "profits" occurring in Section 2(6A)(e) of the 1922 Act means profits in the commercial sense, that is to say, the profits made by the company in the real and true sense of the term."

F

When, as in the present case, the assets have been sold at price less than the purchase price, the amounts so received, apart from being in the nature of return of capital, cannot represent profits of the company. If the sale proceeds had been more than the original cost, then to the extent of the excess amount received it could have been said that profits had been made G by the company on the sale of its assets. But merely because the amount realized by the liquidator is more than the written down value but less than the original cost, it is not possible to hold that the company has made any actual or commercial profit.

The decision in the case of *Bishop's* (supra) can be of little assistance H to the appellant for the reason that the facts in the present case and in

Bishop's case (supra) are entirely different. Here, we are concerned with the sale of capital assets where the amount received is less than the original cost and the question is whether the excess over the written down value can, in such circumstances, be regarded as profit, whereas in *Bishop's* case (supra), amount of depreciation had been debited to the Revenue account an entry which was subsequently reversed and it was held that the amount subsequently credited must be treated as income and not capital. More over in *Bipinchandra's* case (supra), this Court has in no uncertain terms stated that the amount so realized, though taxable under the second proviso to Section 10(2)(vii) of 1922 Act as deemed income, is nothing else but a return of capital and we see no reason as to why we should take a different view in the present case. Express Newspaper's case (supra) again was not concerned with a question which we have to consider in the present case, namely, whether the amount received in excess of written down value can be regarded as accumulated profits under Section 2(6-A) of the income Tax Act, 1922 corresponding to Section 2(22) of the Act. Merely because at page 254 of the report, it is stated in passing that "the second proviso, therefore, in substance, brings to charge an escaped profits or gains of the business carried on by the assessee" cannot persuade us to hold that this Court had considered and decided that the amount received on the sale of the assets does not represent capital but represents profits to the extent that it is an excess of the written down value. This Court, in *Express Newspaper's* case (supra) was concerned only with the question whether the amount could be taxed under second proviso to Section 10(2)(vii), as then stood, if the sale took place after the close of the assessee's business. This Court came to the conclusion that in such a case the second proviso did not apply. This decision, therefore, has no application to the present case.

CONCLUSION :

Examining the relevant statutory provisions it is clear that the scheme of depreciation, balancing charge under Section 32(1) (iii) and balancing allowance is a composite one. The balancing charge and the balancing allowance are part of the scheme of depreciation allowance granted by the statute and the rules, on percentages not necessarily related to the actual wear and tear and which are not capable of accurate determination. In any year, so long as the asset is in use, the amount of depreciation allowed would not only be correct but also be legitimate and legal and the allowance would be strictly in accordance with the provisions of the act and the rules.

When the asset is sold, on which depreciation had been allowed in the

A earlier years as per the act and the rules, the actual amount of depreciation or appreciation in fact becomes known. That calls for adjustment being made to the depreciation which had earlier been allowed as per the formula contained in the act and the rules. This adjustment is made, in the year of sale, by virtue of balancing charge or balancing allowance. If the realisation of the sale proceeds and the capital asset is more than the written down value it would B mean that the assessee had been allowed depreciation in excess of the actual wear and tear of the asset. It is to withdraw the excess depreciation allowed that the balancing charge is provided for by Section 41(2) of the 1961 Act. A fiction is created that the excess above the written down value upto the actual cost of the asset is deemed to be profit or income of the year in which C the asset is sold. In actual fact this is neither income or profit nor a capital gain. The deeming under Section 41(2) is solely for the purpose of withdrawing the excess depreciation allowance which had been allowed to the assessee in the earlier years. Similarly the act also provides a corresponding allowance called the balancing allowance where the asset on sale fetches less than the written down value. By this, more allowance or deduction is given to the D assessee in the year in which the asset was sold inasmuch as the actual wear and tear was more than the depreciation allowed as per the act and the rules.

Merely because Section 41(2) and Section 32(1) (iii) recognize the extent to which the actual wear and tear and the capital asset had taken place and E permits, by a fiction, to make adjustment does not mean that in actual fact, in the case of balancing charge, any profit has been made. As far as share-holders are concerned the company had sold the assets at a price less than the actual cost and the amount taxable under Section 41(2), from their point of view, can never be considered to be profit which is or could be distributed as dividend.

F

The counsel for the appellant also sought to contend that by virtue of Section 50 the written down value of the assesses became the actual cost of acquisition and the amount realised in excess thereof was capital gain and on its distribution it could be taxed as deemed dividend. We do not think that learned counsel can be permitted to raise this contention for the first time in G this Court especially when the questions of law, as referred, do not cover this aspect of the case at all. In any event as this amount has already been assessed in the hands of the company obviously the same amount cannot also be regarded as capital gains. In other words both Section 41(2) and Section 50 of the 1961 Act cannot apply to the same amount.

H For the aforesaid reason, we hold that the amount received by the

company, which was taxed under Section 41(2) of the Act did not represent "accumulated profits" within the meaning of that expression in Section 2(22) of the Act. This being so, the High Court was right in answering the questions of law referred to it in affirmative and in favour of the assessee. We accordingly, dismiss these appeals with costs. A

S.V.K.I. Appeals dismissed. B