

A                   **COMMISSIONER OF INCOME-TAX, GUJARAT**

v.

**GIRDHARDAS & COMPANY PRIVATE LTD.**

October 7, 1966

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

*Indian Income-tax Act, 1922, s. 2(6A)(c)—Distribution of accumulated profits on liquidation of company to be treated as dividend—Extent to which distribution represents accumulated profit, how to be determined.*

C                   By a resolution dated August 23, 1952 it was resolved to wind up the respondent company and to appoint a liquidator for that purpose. The paid-up capital of the assessee was Rs. 25 lakhs, and on the date of commencement of winding up it had an accumulated profit of Rs. 5,34,041. From time to time the liquidator distributed the assets in his hands among the shareholders. Out of Rs. 15 lakhs distributed on September 9, 1952 the Income-tax Officer brought, in the assessment year 1953-54, to tax Rs. 52,400 as 'dividend' within the meaning of s. 2(6A)(c) of the Income-tax Act 1922 as it then stood. By virtue of an amendment of the said clause as effected by the Finance Act 1956 dividend was to include 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. On July 24, 1957, the liquidator distributed Rs. 75,000 among the shareholders. The Income-tax Officer in the course of assessment for the year 1958-59 sought to bring the entire amount so distributed to tax as 'dividend'.

D                   The Appellate Assistant Commissioner confirmed the order of the Income-tax Officer. In appeal to the Tribunal it was urged on behalf of the assessee that when Rs. 15 lakhs were distributed on September 3, 1952 and Rs. 2 lakhs 25 thousand on September, 25, 1952 the entire accumulated profit was exhausted and thereafter there were no accumulated profits which could be distributed, and that in any event whenever distribution is made of the assets in the hands of the liquidator, accumulated profits and the capital must be deemed to be distributed in the same proportion in which the accumulated profits and the capital stood on the date of the liquidation. The Tribunal rejected the first contention and did not consider the second. In reference the High Court held that since the Tribunal had not disintegrated Rs. 75,000 distributed for ascertaining whether any part of it came out of the accumulated profits, no part of Rs. 75,000 could be regarded as dividend. The Revenue appealed.

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G                   **HELD :** The language used by the Legislature in s. 2(6A)(c) as amended by the Finance Act 1956, is fairly clear. 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 capitalised or not, would be treated as dividend and liable to tax under the Act. The amount distributed would therefore be deemed to be received by the shareholders partly as accumulated pro-

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fits and the rest as capital, the proportion being the same which the accumulated profits bore to the capital in the accounts of the company at the commencement of winding up, and that part of the receipt which is attributable to the accumulated profits would be taxable. The Income-tax Officer has therefore in the first instance to determine the accumulated profits in the hands of the company whether capitalised or not, and the remaining capital immediately before the liquidation; he has to determine the ratio between such capital and the undistributed profits, and then to apply the ratio to the amount distributed to determine the component attributable to accumulated profits. [782 H; 783 C]

In the present case therefore the Income Tax authorities had to determine what part of the sum of Rs. 75,000 distributed among the shareholders represented accumulated profits. Only that part of Rs. 75,000 which bore the same ratio to Rs. 75000 which the accumulated profits at the liquidation bore to the total assets of the company immediately before liquidation was dividend. [783 G]

*Commissioners of Inland Revenue v. George Burrell*, L.R. (1924) 2 K.B. 52, referred to.

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 690 of 1965.

Appeal from the judgment and order dated June 22, 1964 of the Gujarat High Court in Income-tax Reference No. 10 of 1963.

*B. Sen, T. A. Ramachandram and R. N. Sachthey*, for the appellant.

*S. T. Desai and I. N. Shroff*, for the respondent.

The Judgment of the Court was delivered by

**Shah, J.** By a resolution dated August, 23, 1952, it was resolved to wind up the respondent company and to appoint a liquidator for that purpose. The paid-up capital of the assessee was Rs. 25 lakhs, and on the date of commencement of winding up it had an accumulated profit of Rs. 5,34,041. From time to time the liquidator distributed the assets in his hands among the shareholders. The following table sets out the distributions made by the liquidator:

Assessment year	Distribution per share Rs.	Date of distribution	Amount distributed Rs.
1953-54 .. .. .	600	9-9-1952	15,00,000
Do .. .. .	90	25-9-1952	2,25,000
1954-55 .. .. .	60	10-11-1952	1,50,000
Do .. .. .	30	6-5-1953	75,000
Do .. .. .	30	23-2-1953	75,000
1955-56 .. .. .	80	10-11-1953	2,00,000

Out of the distribution made on September 9, 1952, the Income-tax Officer brought, in the assessment year 1953-54, to tax Rs. 52,400

A as "dividend" within the meaning of s. 2(6A)(c) of the Income-tax Act, 1922, as it then stood. On July 24, 1957, the liquidator distributed Rs. 30/- per share among the shareholders. The Income-tax Officer in the course of assessment for the year 1958-59 sought to bring the entire amount of Rs. 75,000/ distributed to tax as "dividend" within the meaning of s.2(6A)(c) of the Income-tax Act

B as amended by the Finance Act, 1956. The objections raised by the liquidator were rejected and the amount was brought to tax. The Appellate Assistant Commissioner confirmed the order of the Income-tax Officer. In appeal to the Tribunal on behalf of the assessee, it was urged that the entire accumulated profit was exhausted when Rs. 17,25,000/ were distributed in the year 1952 and

C thereafter there were no accumulated profits in the hands of the liquidator which could be distributed: and that in any event whenever distribution is made of the assets in the hands of the liquidator, accumulated profits and the capital must be deemed to be distributed in the same proportion in which the accumulated profits and the capital stood at the date of liquidation. The Tribunal rejected the first contention and did not consider the second.

D The Tribunal referred the following question to the High Court of Judicature at Bombay under s. 66(1) of the Income-tax Act, 1922:

E "Whether on the facts and in the circumstances of the case the sum of Rs. 75,000/ or any part thereof could be treated as dividend under s. 2(6A)(c) of the Indian Income-tax Act, 1922?"

F The reference was transferred after reorganisation of the State under the Bombay State Reorganisation Act, 1960, to the High Court of Gujarat for hearing and disposal. The reference was heard before a Bench consisting of Shelat, C. J. and Bhagwati J., The two learned Judges differed, and the case was referred to Bakshi, J. Bakshi, J., agreed with Bhagwati, J., and answered the question referred to in the negative.

G To appreciate the arguments advanced at the Bar, it is necessary to notice the changes which were made from time to time in s. 2(6A)(c) of the Indian Income-tax Act, 1922, and the reasons for enacting and amending that clause. Clause (6A) which defines 'dividend' was inserted in the Indian Income-tax Act by Act 7 of 1939. As originally enacted, it provided insofar as it is material for the purpose of this appeal:

H " 'dividend' includes:—

- (a) .. .. .
- (b) .. .. .

(c) any distribution made to the shareholders of a company out of accumulated profits of the company on the liquidation of the company:

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“Provided that only the accumulated profits so distributed which arose during the six previous years of the company preceding the date of liquidation shall be so included;”

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By s. 3 of the Finance Act, 1955, the proviso to cl. (c) was deleted and by s. 3 of the Finance Act, 1956, with effect from April 1, 1956, the following clause (c) was substituted:

“(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;”

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By s. 17(2) of the Indian Companies Act, 1913, Reg. 97 of Table A was one of the obligatory regulations which had to be adopted in terms identical with or to the same effect in the Articles of Association of every Company. Regulation 97 provided that “No dividend shall be paid, otherwise than out of profits of the year or any other undistributed profits.” Distribution of the profits of the year or of accumulated profits was therefore “dividend” within the meaning of the Companies Act, 1913, and also of the Income-tax Act, 1922. By Act 7 of 1939 an inclusive definition of ‘dividend’ was devised, so as to include therein heads of distribution by a Company which may not normally be regarded as dividend: and one such head was in cl. (c). The reason for insertion of the clause was that on winding up of a company the distinction between the assets and undistributed profits disappears. It is well settled that a Company as a going concern distributing profits of the year or accumulated profits is regarded as distributing dividend among the shareholders, but if the company is wound up before distributing its accumulated profits, any distribution of profits by the liquidator is not regarded under the Companies Act as dividend. In *Commissioners of Inland Revenue v. George Burrell*, Pollock, M. R., observed:

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“ . . . it is a misapprehension, after the liquidator has assumed his duties, to continue the distinction between surplus profits and capital. Lord Macnaghten in *Birch v. Cropper* (14 App. Cas. 525, 546), the case which finally determined the rights *inter se* of the preference and ordinary shareholders in the Bridgewater Canal, said: ‘I think it rather leads to confusion to speak of the assets which are the subject of this application as ‘surplus assets’ as if they were an accretion or addition to the capital of the company capable of being distinguished from it and open to different

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A considerations. They are part and parcel of the property of the company—part and parcel of the joint stock or common fund—which at the date of the winding up represented the capital of the company’.”

B The amounts distributed to the shareholders by a liquidator are therefore distributed as capital of the company, since the liquidator has no power to distribute dividend, and the sums received by the shareholders cannot be disintegrated into capital and profits, by examining the accounts of the Company when it was a going concern.

C The scheme of the Indian Companies Act closely followed the English Companies Act and the view expressed in *George Burrell's* case<sup>(1)</sup> applied to distributions made by liquidators, and those distributions were not liable to be taxed as dividend. The Parliament with a view to avoid escapement of tax devised a special definition of the word ‘dividend’ and incorporated it by Act 7 of 1939 as s. 2(6A)(c). The effect of the provision was to assimilate D the distribution of accumulated profits by a liquidator to a similar distribution by a company as a going concern, but subject to the limitation that while in the latter the profits distributed will be dividend whatever the length of the period for which they were accumulated, in the former such profits may be dividend only insofar as they come out of profits accumulated within six years prior to E liquidation. It also appeared from the language used that profits of the current year during which the Company was ordered or resolved to be wound up could not be included in the expression “dividend”: see *Sheth Haridas Achratlal v. Commissioner of Income-tax, Bombay North, Kutch and Saurashtra, Baroda*<sup>(2)</sup>. By the Finance Act, 1955, the proviso to cl. (c) was deleted and in consequence thereof the limitation relating to the period during which the profits were F accumulated ceased to apply in the determination whether the amount distributed by the liquidator was dividend. Even after the amendment by the Finance Act, 1955, the language of the clause was found to be somewhat inapt and the Legislature by the Finance Act 1956 recast cl. (c).

G The Tribunal was of the view that “if earlier any distribution has been made, but such distribution or part of such distribution has not been considered as dividend, then, any subsequent distribution, if it is capable of being considered as dividend must be so held to be so.” Shelat C. J., opined that s. 2(6A)(c) is not a charging section which levies tax on a particular fund from out of which a limited fund is carved out by the proviso. The learned Chief Justice H observed: “The legislative intent is clear, namely, to treat that portion of the amount distributed by the liquidator as chargeable as

(1) L.R. [1924] 2 K.B. 52, 63.

(2) 27 I.T.R. 684.

dividend which the Income-tax Department can trace to accumulated profits of the last six years and that portion only. . . . and therefore it is in respect of that limited fund only that the Department is permitted to go behind the liquidation proceedings and to disintegrate the assets lying with the liquidator". The reasoning underlying these observations of the learned Chief Justice is that in the process of disintegration of an amount distributed, only the share which is brought to tax is dividend and the rest continues to bear the character of capital.

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Bhagwati, J., observed "that what the Legislature intended to achieve by enacting s. 2(6A)(c) was to bring within the ambit of taxation the fund constituted of what were accumulated profits at the date of liquidation when it reaches the hands of the shareholders in liquidation. If a distribution in liquidation comes out of the source of accumulated profits—and whether it comes out of that source or not is not a question dependent on s. 2(6A)(c)—s. 2(6A)(c) declares that though under law, apart from the section, it would be capital and, therefore, not chargeable, it shall be regarded as dividend and taxed as such in the hands of the shareholders."

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Bakshi, J., substantially agreed with Bhagwati, J., and held that since the Tribunal had not disintegrated Rs. 75,000/- distributed, for ascertaining whether any part of it came out of the accumulated profits, no part of Rs. 75,000/- could be regarded as dividend.

The Tribunal was therefore of the view that in a distribution by a liquidator in any year, only that amount which is brought to tax as dividend may be deemed to come out of the accumulated profits on disintegration of the two components, and that process will go on till the accumulated profit account in a notional sense is exhausted. On this view the amount distributed is disintegrated, as if it came out of two funds notionally distinct—to the extent to which any part bears tax, it is to be regarded as coming out of the accumulated profits, and the rest out of the capital. Shelat, C. J., expressed substantially the same view. Bhagwati & Bakshi, JJ., were of the view that since the enactment of s. 2(6A)(c), in the hands of the liquidator, accumulated profits and capital may be deemed separate funds, and in the case of each distribution the source from which the amount is withdrawn should be determined. If the source from which the amount is distributed is capital, the distribution is not taxable, if it is accumulated profit, it is taxable.

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The language used by the Legislature in s. 2(6A)(c) as amended by the Finance Act, 1956, is fairly clear. 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

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- A 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 capitalised or not, would be treated as dividend and liable to tax under the Act. The provision was intended to supersede the application
- B of the principle of *George Burrell's case*<sup>(1)</sup>, that is to enact that even though on a winding up of a company the distinction between the assets and the accumulated profits disappears, the taxing authority may disintegrate the amount distributed into its component parts and determine the share attributable to accumulated profits. The amount distributed would therefore be deemed to be received by
- C the shareholders partly as accumulated profits and the rest as capital, the proportion being the same which the accumulated profits bore to the capital in the accounts of the company at the commencement of winding up, and that part of the receipt which is attributable to the accumulated profits would be taxable. The Income-tax Officer has therefore in the first instance to determine the accumulated profits in the hands of the Company whether capitalised or not, and the
- D rest of the capital immediately before the liquidation: he has then to determine the ratio between such capital and the undistributed profits and to apply the ratio to the amount distributed to determine the component attributable to accumulated profits. There is in s. 2(6A)(c) no warrant for the view that in the course of liquidation the accumulated profits exist as a separate fund even in a notional sense. Each distribution is of a consolidated amount which represents both capital and accumulated profits. There is also nothing in the clause which supports the view that whatever is brought to tax by the taxing authorities in a given year is dividend, and the rest represents the assets of the company. The fund in the hands of the liquidator is one: when the fund or a part of it is distributed,
- E the distribution is deemed to take place in the same proportion in which the capital and accumulated profits stood in the accounts of the company immediately before the winding up.
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We discharge the answer recorded by the High Court, and record the answer that "that part of Rs. 75,000/- which bears the same ratio to Rs. 75,000/- which the accumulated profits at the date of liquidation bore to the total assets of the company immediately before liquidation is dividend". In the present case the Tribunal has not determined what part of Rs. 75,000/- represents accumulated profits. But on the view we have taken of the true meaning of s. 2(6A)(c) of the Act, the Tribunal was bound to do so.

H The appeal is therefore partially allowed. There will be no order as to costs.

G. C.

*Appeal allowed in part.*

(1) L.R. [1924] 2 K.B. 52.