VANIA SILK MILLS (P) LTD.

v.

COMMISSIONER OF INCOME-TAX, AHMEDABAD

AUGUST 14, 1991

[K.N. SINGH AND P.B. SAWANT, JJ.]

Income Tax Act, 1961: Ss. 2(47), 41(2), 45—Capital asset—Destruction of—Money received as insurance claim—Nature of—Whether chargeable to capital gains tax.

The appellant company purchased machinery worth Rs.2,81,741 in the year 1957 and gave it on hire to another company which insured the machinery. In the year 1966, a fire broke out in the lendee company causing extensive damage to the machinery of the appellant. On a settlement of the insurance claim the lendee company paid to the appellant a sum of Rs.6,32,533 on account of the destruction of its machinery. The difference between the actual cost of the machinery and its written down value worked out to Rs.2,62,781 which the appellant (the assessee) showed in its income tax return for the relevant year as profit chargeable to tax under s. 41(2) of the Income-Tax Act. The Income-Tax Officer subjected to tax also the additional amount of Rs.3,50,792 the difference between the amount of insurance claim and the original cost of the machinery—treating the same as capital gains chargeable under section 45 of the Act, and rejected the case of the appellant that the capital gains tax was not attracted to the amount received on account of the insurance claim since there was no transfer of capital asset as was contemplated by s. 45 read with s. 2(47) of the Act.

The appeal of the assessee was dismissed by the Appellate Assistant Commissioner, but its claim was accepted by the Income Tax Appellate Tribunal which held that the amount was not received on account of transfer of the capital asset but on account of damage to it and that s. 45 was attracted only when there was a transfer of the capital asset.

The reference at the instance of the revenue was answered by the High Court against the assessee. Aggrieved the assessee filed the appeal before this Court on a certificate granted by the High Court.

On the question: whether the money received towards the insurance claim on account of the damage to or destruction of the capital

asset was so received on account of the transfer of the asset within the meaning of s. 45 of the Act and was, therefore, chargeable to the capital gains tax under the said section,

Allowing the appeal, this Court,

HELD: 1.1 The money received under the insurance policy is by way of indemnity or compensation for the damage, loss or destruction of the property. It is not in consideration of the transfer of the property or the transfer of any right in it in favour of the insurance company. It is by virtue of the contract of insurance or of indemnity, and in terms of the conditions of the contract. [584C-D]

1.2 In the case of damage, partial or complete, or destruction or loss of property there is no transfer of it in favour of a third party. The fact that while paying for the total loss of or damage to the property, the insurance company takes over such property or whatever is left of it, does not change the nature of the insurance claim which is indemnity or compensation for the loss. The payment of insurance claim is not in consideration of the property taken over by the insurance company, for one is not consideration for the other. The insurance claim is not the value of the damaged property. The claim is assessed on the basis of the damage sustained by the property or the amount necessary to restore it to its original conditions. It is not a consideration for the damaged property. [584C, F-G]

1.3 In the instant case, the amount received by the assessee was the one received by it as damages on account of the loss of its machinery. The lendee company, as a bailee, had insured the machinery hired from the assessee, since it was liable to make good the loss of the machinery to the assessee. This was implied under a contract of bailment unless it was provided to the contrary. The lendee company paid the insurance amount *pro rata* to the assessee. [587D-G]

1.4 The insurance was on reinstatement basis which meant that the property was to be restored to the condition in which it was, before the fire. The insurance company paid the amount for the restoration of the machinery which had to be on the basis of its value at the time of the fire. The machinery in question was purchased in the year 1957 and the fire broke out on August 11, 1966. Taking into consideration the ordinary course of events, it was legitimate to presume that the cost of machinery had gone up during the intervening period and the assured and, therefore, the assessee, was entitled to recover on the basis of the

increased value of the machinery. [584H; 585A-B] A

Halsbury's Laws of England, Fourth Edition, **Vol. 25, referred to.**

2.1 The capital gains is attracted by transfer and not merely by extinguishment of right howsoever brought about. The transfer may be B **effected by various modes and one of the modes is the extinguishment of right on transfer of the asset itself or on account of the transfer of the right or rights in it. The extinguishment of right or rights must in any case be on account of its or their transfer in order to attract the provisions of Section 45 which speaks about capital gains arising out of "transfer" of asset and not on account of "extinguishment of right" by itself. [583G-H; 584A]** C

If extinguishment of right or rights is not due to transfer and is on account of the destruction or loss of the asset, it is not a transfer and does not attract the provisions of s. 45 which relate to transfer and not to mere extinguishment of right but to one by transfer. Hence an extinguishment of right not brought about by transfer is outside the purview D **of s. 45. [584A-B]**

Whatever the mode by which a transfer is brought about, the existence of the asset during the process of transfer is a pre-condition. Unless the asset exists in fact, there cannot be a transfer of it. [583E] E

Transfer presumes both the existence of the asset and of the transferee to whom it is transferred. [584C]

2.2 When an asset is destroyed there is no question of transferring it to others. The destruction or loss of the asset, no doubt, brings F **about the destruction of the right of the owner or possessor of the asset, in it. But it is not on account of transfer. It is on account of the disappearance of the asset. The extinguishment of right in the asset on account of extinguishment of asset itself is not a transfer of the right but its destruction. By no stretch of imagination, the destruction of the right on account of the destruction of the asset can be equated with the** G **extinguishment of right on account of its transfer. [583E-G]**

3.1 Although the definition of "transfer" in Section 2(47) of the Act is inclusive, and, therefore, extends to events and transactions which may not otherwise be "transfer" according to its ordinary, popular and natural sense, yet it also mentions such transactions as H

A sale, exchange etc. to which the word "transfer" would properly apply in its popular and natural import. Since those associated words and expressions imply the existence of the asset and of the transferee, according to the rule of *noscitur a sociis,* the expression "extinguishment of any rights therein" would take colour from the said associated words and expressions, and will have to be restricted to the sense
B analogous to them. [585C-E]

If the legislature intended to extend the definition to any extinguishment of right, it would not have included the obvious instances of transfer, viz. sale, exchange etc. Hence the expression "extinguishment of any rights therein" will have to be confined to the extinguishment of
C rights on account of transfer and cannot be extended to mean any extinguishment of right independent of or otherwise than on account of transfer. [585E-F]

3.2 The High Court, was not correct in reading the expression "extinguishment of any rights" in the assets as any extinguishment of
D right whether it resulted in or was on account of transfer nor was it right in assuming that for "transfer" within the meaning of Section 45 the asset need not exist. It erred in ignoring the basic postulate that Section 45 does not relate to extinguishment of right but to transfer. Having concentrated its attention on the words "extinguishment of right" rather than on "transfer", the High Court, misdirected itself
E and proceeded on the basis that every extinguishment of right whether by way of transfer or not, is attracted by Section 45. [585F-G; 584B]

Commissioner of Income-Tax v. *Madurai Mills Co. Ltd.,* [1973] 89 ITR 45 and *Commissioner of Income-Tax* v. *Mohanbhai Pamabhai,* [1973] 91 ITR 393, referred to.

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4. Whether the lendee company had insured assessee's machinery as bailees or as agents of the assessee would make no difference. The insurance policy contained the reinstatement clause requiring the insurer to pay the cost of the machinery as on the date of the fire. [587G-H; 588A]

G 5. In an insurance policy with the reinstatement clause, the insurer is bound to pay the cost of the insured property as on the date of destruction of loss, and it matters very little if the amount so paid by the insurance company is invested for purchasing the destroyed asset or for any other purpose. [588A-B]

H *C.Leo Macho do* v. *Commissioner of Income-Tax,* [1988] 172 ITR 744, approved.

Income-tax Commissioner **v.** *J.K. Cotton Spinning & Weaving Mills Co. Ltd.*, **[1987] 164 ITR 18, disapproved.** A

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 1106 (NT) of 1976.

From the Judgment and Order dated 22nd/23rd January 1976 of B the Gujarat High Court in Income Tax Ref. No. 122 of 1974.

Joseph Vellappilly, K.J. John and Ms. Deepa Dikshit for the Appellant.

S.C. Manchanda, Ranvir Chandra and Ms. A. Subhashini for the C Respondent.

The Judgment of the Court was delivered by

SAWANT, J. The appellant/Company, hereinafter referred to as the assessee, carries on the business of manufacture and sale of D art-silk cloth. In the year 1957, it purchased machinery worth Rs.2,81,741 and gave it on hire to M/s. Jasmine Mills Pvt. Ltd., Bombay at an annual rent of Rs.33,900. On August 11, 1966, a fire broke out in the premises of M/s. Jasmine Mills causing extensive damage to the machinery installed in their premises including the machinery hired by them from the assessee. The machinery belonging E to the assessee became useless for any further use on account of the damage. M/s. Jasmine Mills had insured along with its own machinery, the assessee's machinery as well, and on a settlement of the insurance claim, M/s. Jasmine Mills received a certain amount out of which it paid a sum of Rs.6,32,533 to the assessee on account of the destruction of its machinery. The difference between the actual cost of the machi- F nery and its written-down value worked out to Rs.2,62,781. The assessee in its income-tax return for the assessment year 1967-68 (relevant accounting year being the year ending on 31st August, 1966) showed the said amount as profit chargeable to tax under Section 41(2) of the Income-Tax Act (hereinafter referred to as the "Act"). The Income-Tax Officer, however, subjected to tax also the additional amount of G Rs.3,50,792 being the difference between the amount of Rs.6,32,533 received on account of the insurance claim and the original cost of the machinery, i.e., Rs.2,81,741, treating the same as capital gains chargeable under Section 45 of the Act. The contention advanced by the assessee that the capital gains tax was not attracted to the amount received on account of the insurance claim since there was no transfer H of capital asset as was contemplated by Section 45 read with Section 2(47) of the Act, was negatived by the Income-Tax Officer.

The assessee appealed against the order to the Appellate Assistant Commissioner who also negatived the said contention of the appellant and dismissed the appeal. The assessee's contention was, however, upheld in the appeal before the Income-Tax Appellate Tribunal, the Tribunal holding that the amount was not received on account of a transfer of the capital asset but on account of the damage to it and that Section 45 was attracted only when there was a transfer of the capital asset. Being aggrieved, the Revenue applied for reference of the case to the High Court on the following two questions:

> (i) whether on the facts and in the circumstances of the case the transfer was justified in law in holding that there was no transfer of capital asset by the assessee within the meaning of Section 2(47) of the Act?
>
> (ii) whether on the facts and in the circumstances of the case the sum of Rs.3,50,792 being the excess of the cost of the machinery received from M/s. Jasmine Mills Pvt. Ltd. was chargeable to tax as capital gains under Section 45 of the Act?

The High Court answered the first question in the negative, and consequently the second question in the affirmative, i.e., both questions in favour of the Revenue and against the assessee.

This appeal has been filed by the assessee on a certificate granted by the High Court.

2. The short question that falls for our consideration is whether the money received towards the insurance claim on account of the damage to or destruction of the capital asset is so received on account of the transfer of the asset within the meaning of Section 45 of the Act and is, therefore, chargeable to the capital gains tax under the said section.

3. It would be convenient to reproduce here the provisions of Section 45 of the Act as they stood at the relevant time:

> "45. Capital gains—Any profits or gains arising *from the transfer* of a capital asset effected in the previous year shall, save as otherwise provided in sections 53 and 54, be chargeable to income-tax under the head 'capital gains', and shall

> be deemed to be the income of the previous year in which the transfer took place". A
>
> Emphasis supplied

Section 2(47) of the Act which defined transfer at the relevant time read as follows: B

> "2. Definitions—In this Act, unless the context otherwise requires,—
>
> ....
>
> (47) 'transfer', in relation to a capital asset, includes the sale, exchange or relinquishment of the asset or the extinguishment of any rights therein or the compulsory acquisition thereof under any law." C

A reading of the two sections makes it abundantly clear that the profits or gains which are amenable to Section 45 must arise from the transfer of the capital asset which is effected in the previous year. The D transfer may be brought about by any of the modes of transfer which include sale, exchange, relinquishment of the asset or the extinguishment of the rights therein or the compulsory acquisition of the asset under any law. It may be of the asset itself or of any rights in it. It may further be the result of a voluntary act or a compulsory operation. Whatever the mode by which it is brought about, the existence of the E asset during the process of transfer is a pre-condition. Unless the asset exists in fact, there cannot be a transfer of it.

4. When an asset is destroyed there is no question of transferring it to others. The destruction or loss of the asset, no doubt, brings about the destruction of the right of the owner or possessor of the asset, in it. F But it is not on account of transfer. It is on account of the disappearance of the asset. The extinguishment of right in the asset on account of extinguishment of the asset itself is not a transfer of the right but its destruction. By no stretch of imagination, the destruction of the right on account of the destruction of the asset can be equated with the extinguishment of right on account of its transfer. Section 45 speaks G about capital gains arising out of "transfer" of asset and not on account of "extinguishment of right" by itself. The capital gains is attracted by transfer and not merely by extinguishment of right howsoever brought about. The transfer may be effected by various modes and one of the modes is the extinguishment of right on transfer of the asset itself or on account of the transfer of the right or rights in H

it. The extinguishment of right or rights must in any case be on account of its or their transfer in order to attract the provisions of Section 45. If it is not, and is on account of the destruction or loss of the asset, as in the present case, it is not a transfer and does not attract the provisions of Section 45 which relate to transfer and not to mere extinguishment of right but to one by transfer. Hence an extinguishment of right not brought about by transfer is outside the purview of Section 45. The High Court erred in ignoring the basic postulate that Section 45 does not relate to extinguishment of right but to transfer. Having concentrated its attention on the words "extinguishment of right" rather than on "transfer", the High Court, with respect, misdirected itself and proceeded on the basis that every extinguishment of right whether by way of transfer or not, is attracted by Section 45.

5. Transfer presumes both the existence of the asset and of the transferee to whom it is transferred. In the case of the damage, partial or complete, or destruction or loss of the property, there is no transfer of it in favour of a third party. The money received under the insurance policy in such cases is by way of indemnity or compensation for the damage, loss or destruction of the property. It is not in consideration of the transfer of the property or the transfer of any right in it in favour of the insurance company. It is by virtue of the contract of insurance or of indemnity, and in terms of the conditions of the contract. Under an insurance contract, the assured cannot claim more amount than the sum insured. The sum insured is the maximum liability of the insurer and the assured secures it by paying his premium which is accordingly fixed. Even within the maximum limit, the insured cannot recover more than what he establishes to be his actual loss, whatever may be his estimates of the loss that he was likely to bear and whatever the premium he may have paid calculated on the basis of the said estimate.

The fact that while paying for the total loss of or damage to the property, the insurance company takes over such property or whatever is left of it, does not change the nature of the insurance claim which is indemnity or compensation for the loss. The payment of insurance claim is not in consideration of the property taken over by the insurance company, for one is not consideration for the other. It is incorrect to argue that the insurance claim is the value of the damaged property. The claim is assessed on the basis of the damage sustained by the property or the amount necessary to restore it to its original condition. It is not a consideration for the damaged property. In the present case, the insurance was on reinstatement basis which meant that the

property was to be restored to the condition in which it was, before the A
fire. The insurance company paid the amount for the restoration of the
machinery which had to be on the basis of its value at the time of the
fire. The machinery in question was purchased in the year 1957 and the
fire broke out on August 11, 1966. Although nothing has come on
record on the point, taking into consideration the ordinary course of
events, it is legitimate to presume that the cost of machinery had gone B
up during the intervening period and the assured and, therefore, the
assessee, was entitled to recover on the basis of the increased value of
the machinery (refer to Halsbury's Laws of England, Fourth edition,
Vol. 25 under the heading Insurance, in para 654).

6. It is true that the definition of "transfer" in Section 2(47) of C
the Act is inclusive, and therefore, extends to events and transactions
which may not otherwise be "transfer" according to its ordinary,
popular and natural sense. It is this aspect of the definition which has
weighed with the High Court and, therefore, the High Court has
argued that if the words "extinguishment of any rights therein" are
substituted for the word "transfer" in Section 45, the claim or compen- D
sation received from the insurance company would be attracted by the
said section. The High Court has, however, missed the fact that the
definition also mentions such transactions as sale, exchange etc. to
which the word "transfer" would properly apply in its popular and
natural import. Since those associated words and expressions imply
the existence of the asset and of the transferee, according to the rule of E
noscitur a sociis, the expression "extinguishment of any rights therein"
would take colour from the said associated words and expressions, and
will have to be restricted to the sense analogous to them. If the legisla-
ture intended to extend the definition to any extinguishment of right, it
would not have included the obvious instances of transfer, viz., sale,
exchange etc. Hence the expression "extinguishment of any rights F
therein" will have to be confined to the extinguishment of rights on
account of transfer and cannot be extended to mean any extinguish-
ment of right independent of or otherwise than on account of transfer.

7. The High Court, as stated earlier, read the expression "extin-
guishment of any rights" in the assets as any extinguishment of right G
whether it resulted in or was on account of transfer. For the reasons
which we have discussed earlier we find that that approach is not
correct. For the same reasons, we are unable to accept the reasoning of
the High Court that for "transfer" within the meaning of Section 45
the asset need not exist. We are afraid that the High Court's reliance
on *Commissioner of Income-Tax* v. *R.M. Amin,* [1971] 82 ITR 194 H

Gujarat to hold that for the transfer contemplated by Section 45, the asset neet not exist is not well-merited. There, the High Court was concerned with a chose-in-action, viz., the shares, and the amount received by the assessee-shareholder on liquidation of the company representing his share in the assets of the company. The Court there had pointed out that the extinguishment of right of the assessee-shareholder in his share which was an incorporeal property had come about on account of receipt by him of the amount representing the value of the shares.

The amount received by the assessee-shareholder does not represent any consideration received by him as a result of the extinguishment of his rights in the shares. The share merely represents the right to receive money on distribution of the net assets of the company in liquidation and it is by satisfaction of that right, that the right is extinguished when such monies are received by the shareholder. The consideration presumes *quid pro quo* and, therefore, transfer of the property or of the rights in the property, whether the property is corporeal or incorporeal.

When the assets themselves are being distributed, it is correct to say that to the extent of distribution, they are wiped out. It is in that sense that the assets do not exist to the extent that they are distributed. When the company's assets are thus distributed, is a sense the assets which are converted into money and which, therefore, exist in the form of money are transferred from the liquidator to the shareholder. His rights in the assets come to an end when he receives his liquidated share of the asset. In such a case the assets do exist though in the converted form, viz., cash and what is transferred is also the converted form of the asset. With respect, therefore, it is not correct to say that in such cases the capital asset does not exist and does not change hand as capital asset. That the receipt of his share in the asset brings about automatically the extinguishment of the shareholder's rights in the asset cannot, however, be gainsaid. The decision of the Gujarat High Court in *R.M. Amin's* case (supra) was appealed against and this Court while approving the ratio of the said decision further explained the nature of the money received by a shareholder on the liquidation of a company. This Court reiterating its earlier view in the case of *Commissioner of Income-tax* v. *Madurai Mills Co. Ltd.*, [1973] 89 ITR 45, held that the act of the liquidator in distributing the assets of the company does not result in the creation of new rights. It merely recognises the legal rights which were in existence prior to the distribution. The shareholder receives money in recognition and satisfaction of his

right and not by operation of any transaction which amounts to sale, A
exchange, relinquishment of asset or extinguishment of any of his
rights in such asset.

8. So also when a partner retires from the partnership what he
receives is his share in the partnership which is worked out and
realised. It does not represent consideration received by him as a B
result of the extinguishment of his interest in the partnership assets.
He has no share in any particular asset of the firm. Therefore, there is
no transfer of interest in any particular asset of the firm on account of
the receipt of his share by a retired partner. As held in *Commissioner
of Income-tax* v. *Mohanbhai Pamabhai,* [1973] 91 ITR 393 (Gujarat)
no part of the amount received by the assessee as a retired partner is C
assessable to capital gains tax under Section 45.

9. The High Court has explained these two decisions by giving
reasons which do not appeal to us. The Court has tried to distinguish
them from the facts of the present case pointing out, firstly, that there
was no foundation either in law or in fact to believe that the amount D
which the assessee received from M/s. Jasmine Mills was paid to it in
satisfaction or in working out of its right, if any, to recover damages
under law or contract for the loss or damage caused to the machinery.
We do not see any difficulty in holding that it was an amount received
by the assessee as damages on account of the loss of its machinery. It is
difficult to describe it otherwise. The second reason given by the High E
Court is, with respect, equally fragile. It is held that the alleged right,
if any, of the assessee to recover damages was not an absolute statu-
tory right but one which was subject to a contract to the contrary and
even if there was no such contract it was merely an inchoate or contin-
gent right in respect of which some investigation or legal proceeding
and settlement or adjudication would be necessary for its satisfaction F
or fulfilment. We do not agree with this reasoning as well. The facts
clearly show that M/s. Jasmine Mills as a bailee had insured the
machinery hired from the assessee, since it was liable to make good the
loss of the machinery to the assessee. This is implied under a contract
of bailment unless it is provided to the contrary. M/s. Jasmine Mills
further admittedly paid the insurance amount *pro rata* to the assessee. G
In the circumstances, we are unable to appreciate the distinction
sought to be made by the High Court.

10. We are also unable to see how it would make any difference
to the point involved in the present case whether the Jasmine Mills had
insured the assessee's machinery as bailees or as agents of the assessee. H

There is further no dispute that the insurance policy contained the reinstatement clause requiring the insurer to pay the cost of the machinery as on the date of the fire. As we have pointed out earlier, in an insurance policy with the reinstatement clause, the insurer is bound to pay the cost of the insured property as on the date of the destruction or loss, and it matters very little if the amount so paid by the insurance company is invested for purchasing the destroyed asset or for any other purpose. In the circumstances, for the purposes of answering the question in hand, it was not necessary to inquire whether the amount received by the assessee was spent in replacement of the machinery or not.

11. For the reasons given above, the decision of the Allahabad High Court in *Commissioner of Income-tax* v. *J.K. Cotton Spinning & Weaving Mills Co. Ltd.*, [1987] 164 ITR 81 which proceeds on the same reasoning as the impugned judgment is also not a good law. Instead, we approve of the conclusion reached by the Madras High Court in *C. Leo Machodo* v. *Commissioner of Income-tax*, [1988] 172 ITR 744 for the reasons given by us above.

12. In the result, the appeal succeeds and the impugned decision is set aside. In the circumstances of the case, however, there will be no order as to costs.

R.P. Appeal allowed.