

A COMMISSIONER OF INCOME TAX  
v.  
G. NARSHIMHAN (DIED) BY HEIRS

DECEMBER 14, 1998

B [SUJATA V. MANOHAR AND A.P. MISRA, JJ.]

*Income Tax Act, 1961:*

C *Sections 2(22)(e) and 194—Dividend—Deemed dividend—Treatment of in computing accumulated profits of the company—Private limited company reducing its share capital—Pro rata distribution of some properties of the company and payment of money to its shareholders—Treated by the shareholders as deemed dividend and taxed accordingly in relevant accounting year—Held, the amounts have to be treated as dividend for all purpose and would reduce the accumulated profits (whether capitalised or not ) and be considered as adjusted against the accumulated profits to the extent it is treated a deemed dividend—Income Tax—Accumulated profits—Quantification of—Companies Act, 1961, Section 205.*

E *Sections 45(1), 2(47) & 2(22) (d) & (e)—Dividends—Capital receipts—Amounts received by shareholders on reduction of company's capital—If constitute capital gains—For reduction of company's value the shareholders received cash as well as property—Held, portion of the total amount so received including the value of the property to the extent attributable to accumulated profits of the company (whether capitalised or not would be a return thereof and, therefore, taxable as dividend—Only a balance amount would be a capital receipt out of which capital gains will have to be determined looking to the cost of acquisition of that portion of the share which has been diminished—Income Tax—Capital gains.*

G **The assessee was a shareholder in a private limited company. For the accounting year relevant to AY 1963-64, the company reduced its capital and consequent to such reduction of the face value of each share, there was a pro rata distribution of some properties of the company and payment of money to the shareholders, including the assessee. In the income tax proceedings connected with the property/amounts so received by the assessee on the reduction of his share capital, the Tribunal held that no capital gains accrued to the assessee. At the request of the Revenue two questions were referred**

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by the Tribunal to the High Court. The questions were, (i) whether the Tribunal had rightly held that the amounts advanced by the company to its shareholders and assessed in their hands as dividends should be deducted from the surplus while determining the 'accumulated profits' in the hands of the company; and (ii) whether the Tribunal had rightly held that no capital gains accrued to the assessee on receiving the amounts and property consequent to reduction in the face value of the shares. The High Court found the above questions in favour of the assessee. Hence this appeal by the revenue.

Partly allowing the appeal, this Court

**HELD:** 1. In view of Section 205 of the Companies Act and Sections 194 and 2(22)(e) of the Income Tax Act, 1961 when a loan by a company to a shareholder in the manner set out in Section 2(22)(e) is treated as a deemed dividend, it is to be treated as payment out of the accumulated profits of the company. Any legal fiction has to be carried to its logical conclusion. Therefore, this payment must be treated to be dividend for all purposes and must, therefore, be considered as adjusted against the company's accumulated profits to the extent it is treated as deemed dividend. [537-B-C]

2.1. In view of Section 2(22)(d) of the Income Tax Act, any distribution which is made by a company on a reduction of its share capital which can be correlated with the company's accumulated profits (whether capitalised or not), will be dividend in the hands of the assessee. Therefore, it will have to be treated as income of the assessee and taxed accordingly. It is only when any distribution is made which is over and above the accumulated profits of the company (capitalised or otherwise) that the question of a capital receipt in the hands of a shareholder arises. The original cost to that shareholder of acquisition to that right in the share which stands extinguished as a result of the reduction in the share capital will have to be deducted from the capital receipts so determined. Only when the capital receipt is in excess of the original cost of the acquisition of that interest which stands extinguished, will any capital gains arise. [538-F-H]

2.2. By using the expression "whether capitalised or not" in Section 2(22) in the Income Tax Act, 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. This would clearly exclude return of a part of the capital by the company from Section 2(22), as the same can not be regarded as profits capable of being capitalised,

**A** the return being of the capital itself. Thus the amount distributed by a company on reduction of its share capital has two components-distribution attributable to accumulated profits and distribution attributable to capital (except capitalised profits). Therefore, to the extent of the accumulated profits in the hands of a company, whether such accumulated profits are capitalised or not, the return to the shareholder on the reduction of his share capital, is a return of such accumulated profits. This part would be taxable as dividend. The balance may be subject to capital gains tax if they accrue. [539-C-E]

*Commissioner of Income Tax v. Urmila Ramesh*, (230 ITR 422), referred to.

**C** 2.3. The assessee in the present case has been paid not merely cash but also given a property for the reduction in the value of his shares. Out of the total amounts so received including the value of the property so received, the portion attributable to accumulative profits will have to be deleted. Only the balance amount can be treated as capital receipt. Thereafter looking to the cost of acquisition of that portion of the share which has been diminished, capital gains will have to be determined. [539-F]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 6799 of 1983.

**E** From the Judgment and Order dated 30.3.78 of the Madras High Court in T.C. No. 116 of 1975.

Ranbir Chandra and C.V.S. Rao, (Rajiv Nanda) for B.K. Prasad for the Appellant.

**F** A.T.M. Sampath, S. Rajappa and V. Balaji for the Respondents.

The Judgment of the Court was delivered by

**G** **MRS. SUJATA V. MANOHAR, J.** At all material times, the respondent who is the assessee was a shareholder in M/s Kasthuri Estates (Pvt.) Ltd., Madras. During the accounting period relevant to the assessment year 1963-64, the assessee held 70 shares in M/s.Kasthuri Estates (Pvt.) Ltd. The face value of each share was Rs. 1,000. During the said accounting period, the said company passed a resolution to reduce its capital. The procedure prescribed under the Companies Act for the reduction of share capital was undergone. An appropriate order was obtained from the court. The reduction was given effect on and from 26.5.1962. As a result, the face value of the shares in the

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company was reduced from Rs.1,000 each to Rs. 210 each. As a result. of this reduction, there was a pro-rata distribution of some properties of the company and payment of money to the shareholders, including the assessee.

In the income-tax proceedings connected with the property/amounts so received by the assessee on reduction of his share capital in the said company, the Tribunal was required to consider whether any capital gains accrued to the assessee. The tribunal held that no capital gains accrued to the assessee. At the request of the department, the following two questions were referred by the Income-tax Appellate Tribunal, Madras Bench to the High Court for its opinion under Section 256(1) of the Income-tax Act. These questions are:

1. Whether on the facts and in the circumstances of the case, the Appellate Tribunal was right in directing that a sum of Rs. 64,517 being the deemed dividends assessed in the hands of the various shareholders in the past assessment years, should be deducted from the surplus while determining the 'accumulated profits' in the hands of the Company?
2. Whether on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding that no capital gain was assessable in the hands of the assessee as there was no extinguishment of any right of the assessee and consequently there was no transfer within the meaning of Section 2(47) of the Income-tax Act, 1961, by the assessee of any capital asset for the assessment year 1963-64?"

*Question No. 1,*

For the purpose of answering Question No. 1, some further material facts are as follows:

The said company in the previous year had advanced to four of its shareholders sums of Rs 48,250, Rs. 14,667, Rs. 1400 and Rs. 200. Thus the total advances to shareholders by the company were to the tune of Rs. 64,517. We have to consider whether the accumulated profits of the company would stand reduced by the sum of Rs.64,517 at the time of the company's reduction of share capital.

Under Section 2(22) of the Income-tax Act, 1961, dividend includes :

"2(22): (a)....."

A (b).....

(c).....

B (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 end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;

C (e) any payment by a company, not being a company in which the public are substantially interested of any sum (whether as representing 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 in either case possesses accumulated profits;

D .....”

E Under Section 2(22)(e) of the Income-tax Act, 1961, any payment by a company in which the public are not substantially interested, of any sum by way of any loan to a shareholder, will, to the extent that the company possesses accumulated profits, be considered as a deemed dividend paid to the shareholder. In the present case, the said four amounts paid to the four shareholders were treated as deemed dividends in the hands of those shareholders and were taxed accordingly in the relevant assessment years. We have to consider whether these amounts will go to reduce the accumulated profits of the company for the purposes of calculating the distribution of accumulated profits under Section 2(22)(d) of the Income-tax Act, 1961.

F It was contended by the department that Section 2(22)(e) only notionally treats such loan to a shareholder by a company as a deemed dividend to the extent that the company possesses accumulated profits. Therefore, the payment so made should not be deducted from the accumulated profits of the company for the purpose of determining the extent of such accumulated profits. We fail to appreciate this contention. A dividend under Section 205 of the Companies Act can be paid only out of the profits of a company whether for that year or out of the profits of the company for any previous financial years as set out in that section, and in the manner set out in that section. Therefore, under Section 2(22) of the Income-tax Act 1961, when any payment by a company is treated as a deemed dividend the section has provided that it should be

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treated as payment out of the accumulated profits of the company whether capitalised or not. In fact, under Section 194 of the Income-tax Act, an obligation is cast upon the principal officer of the company to deduct from the payment so made under Section 2(22)(e) income tax at the rates in force. Section 194 clearly treats such payment as dividend. Therefore, when a loan by a company to a shareholder in the manner set out in Section 2(22)(e) is treated as a deemed dividend, it is to be treated as payment out of the accumulated profits of the company. Any legal fiction will, therefore, have to be carried to its logical conclusion. If the payment under Section 2(22)(e) is treated as a deemed dividend and is required to be so treated to the extent that the company possesses accumulated profits, the logical conclusion is that this payment must be considered as adjusted against the company's accumulated profits to the extent that it is treated as deemed dividend while calculating accumulated profits of the company. Whenever accumulated profits of the company are required to be determined such an adjustment will have to be made.

The High Court was, therefore, right in coming to the conclusion that when Section 2(22)(e) is read with the language of Section 194 which provides for deduction of tax on such "dividend", as also the statutory restriction under the Companies Act on payment of dividend out of any capital assets, it would be reasonable to come to the conclusion that the sum of Rs. 64,517 must be taken to have come out of the accumulated profits. It must, therefore, be treated as dividend for all purposes, and would go to reduce the accumulated profits of the company whether capitalised or not whenever such accumulated profits are required to be determined. Question No 1 is, therefore, answered in the affirmative and in favour of the assessee.

*Question No. 2.*

We have to consider whether the assessee in the present case was assessable to any capital gains tax in respect of the amounts/property received by him from the Company as a result of the reduction of his share capital.

Under Section 45(1) of the Income-tax Act, any profits or gains arising from the transfer of a capital asset are chargeable to income-tax under the head 'capital gains'. "Transfer" is defined in Section 2 (47) of the Income-tax Act, 1961 as follows:

"2(47): 'Transfer' in relation to a capital asset includes -

- (i) the sale, exchange or relinquishment of the asset or;

A (ii) the extinguishment of any rights therein; or .....

In the case of *Kartikeya Sarabhai v. Commissioner of Income-tax*, [228 ITR 163] this Court examined the question of capital gains in the context of an amount received by a shareholder from a company on reduction in the face value of shares on account of a reduction in the share capital of the company.

B This Court said that it is not necessary for capital gain to arise that there must be a sale of a capital asset. Relinquishment of the asset or extinguishment of any right in it, which may not amount to a sale, can also be considered as a transfer. Any profit or gain which arises from the transfer of a capital asset is liable to be taxed under Section 45. As a result of a reduction in the face value of the share, the share capital is reduced, the right of the shareholder to the dividends and his right to share in the distribution of net assets upon liquidation, is extinguished proportionately to the extent of reduction in the capital. Even though the shareholder remains a shareholder, his right as a holder of those shares stands reduced with the reduction in the share capital. Therefore, this extinguishment of right is transferred. The amount received by the assessee for such reduction is liable to capital gains under Section 45. The Court followed an earlier decision of this court in *Anarkali Sarabhai Ltd. v. Commissioner of Income-tax*, (224 ITR 422). In view of this judgment, the property and money received by the assessee from the company on the reduction in the face value of his shares in a capital receipt subject to Section 45.

E However, in the case of *Kartikeya Sarabhai v. Commissioner of Income-tax* (supra) this Court did not consider the provisions of Section 2(22)(d) in the context of capital gains arising on a reduction of the share capital. Under Section 2(22)(d) any distribution to its shareholders by a company on the reduction of its capital, is deemed to be a distribution of dividend to the extent that the company possesses accumulated profits whether such profits have been capitalised or not. Therefore, any distribution which is made by a company on a reduction of its share capital which can be correlated with the company's accumulated profits (whether capitalised or not), will be dividend in the hands of the assessee. Therefore, it will have to be treated as income of the assessee and taxed accordingly.

H It is only when any distribution is made which is over and above the accumulated profits of the company (capitalised or otherwise), that the question of a capital receipt in the hands of a shareholder, arises. The original cost to that shareholder of acquisition of that right in the share which stands extinguished as a result of reduction in the share capital will have to be

deducted from the capital receipt so determined. Only when the capital receipt is in excess of the original cost of the acquisition of that interest which stand extinguished, will any capital gains arise.

In the case of *Commissioner of Income-Tax v. Urmila Ramesh* (230 ITR 422), this Court, in the context of a balancing charge, dealt with Section 2(22) of the Income-tax Act in a similar manner. The Court held that under Section 2(22) only the distribution of the accumulated profits can be deemed to be dividend in the hands of the shareholders. 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. This would clearly exclude return of a part of the capital by the company from Section 2(22), as the same can not be regarded as profits capable of being capitalised, the return being of the capital itself.

Thus the amount distributed by a company on reduction of its share capital has two components distribution attributable to accumulated profits and distribution attributable to capital (except capitalised profits). Therefore, in the present case, to the extent of the accumulated profits in the hands of M/s. Kasthuri Estates (Pvt). Ltd., whether such accumulated profits are capitalised or not, the return to the shareholder on the reduction of his share capital, is a return of such accumulated profits. This part would be taxable as dividend. The balance may be subject to tax as capital gains if they accrue.

The assessee in the present case has been paid not merely cash but has also been given a property for the reduction in the value of his shares from Rs. 1,000 to Rs. 210. Out of the total amounts so received including the value of the property so received, the portion attributable to accumulative profits will have to be deleted. Only the balance amount can be treated as a capital receipt. Thereafter looking to the cost of acquisition of that portion of the share which has been diminished, capital gains will have to be determined.

The questions before us do not require us to examine how the property transferred to the assessee by the company has to be valued. The company obviously has transferred the property in lieu of the return of Rs. 790 per share to the assessee. This property has not been sold to the assessee. The Tribunal, while computing capital gains, will have to decide how this property should be valued for the purpose of deciding what the assessee has received on reduction in the value of his shares, and whether any capital gains have accrued to the assessee or not. This question was not required to be



**A** considered by the Tribunal because the Tribunal came to the conclusion that there being no transfer of any capital asset, the question of capital gains did not arise. But the question will now have to be considered and decided by the Tribunal when the matter goes back before it for the determination of capital gains, if any. Question No. 2 is, therefore, answered in the negative and in favour of the Revenue. The appeal is disposed of accordingly.

**B**

R.K.S.

Appeal partly allowed.