
[2022] 145 taxmann.com 84 (Article)

[2022] 145 taxmann.com 84 (Article)

Date of Publishing: November 21, 2022

‘Accumulated Profits’ – The term that accumulates controversies!!



JATIN BANKA

Chartered Accountant

1. Background :

1.1 The term 'accumulated profits' is of significant importance for the purpose of taxation of dividends under the Income-tax Act, 1961 ('the Act'). The very foundation of taxation of dividends under section [2\(22\)](#) of the Act is the existence of profits, whether accumulated or current profits. Dividends are taxable under section 2(22) of the Act to the extent of the accumulated profits available in the hands of the distributing/payer company.

1.2 Under the previous law of Indian Income-tax Act, 1922, the term 'accumulated profits' was not defined. Accordingly, if distribution/payment happened in the middle of the financial year, dispute arose as to whether accumulated profits would include current year's profits, i.e. the profits of the financial year in which distribution/payment takes place or whether the quantum of accumulated profits was restricted to profits of prior years.

1.3 Based on preponderant judicial views, it was a settled position under the 1922 Act that 'accumulated profits' should not include 'current profits' i.e., the profits of the financial year in which distribution/payment takes place. In this regard, the **Hon'ble Bombay High Court** in case of *CIT v. P.K. Badiani* [\[1970\] 76 ITR 369](#) observed that the term 'accumulated profits' under 1922 Act would mean the profits which have been accumulated before the beginning of the accounting year and held that the current year's profits cannot be included in 'accumulated profits'. The relevant extracts of the decision are reproduced below :

"Question No. 2 raised at the instance of the assessee raises the question whether the development rebate reserve provided for the accounting year 1957 alone would constitute "accumulated profits" of the company within the meaning of section [2\(6A\)\(e\)](#) to the exclusion of the development rebate reserve provided in earlier years. Now, the word "accumulated" in the phrase "accumulated profits" in section 2(6A)(e) clearly indicates that "accumulated profits" mean, profits which have been accumulated before the beginning of the accounting year which would be the previous year relevant to the assessment year. The provision of section 2(6A)(e) may fall for consideration during that previous year and at that point of time it would not be even possible to know whether in that previous year there were any profits or to ascertain their amount and even if there were profits of that previous year up to that point of time, whether they would not be wiped out during the subsequent period of that previous year. The profits of that previous year would be current profits as distinguished from "accumulated profits". Therefore, the profits of that previous year cannot be included in "accumulated profits"

[emphasis added]

1.4 Similarly, the **Hon'ble Supreme Court** in case of **CIT v. V. Damodaran** [1979] 2 Taxman 397/[1980] 121 ITR 572, relying upon judicial precedents on the subject, held that the term 'accumulated profits' in section 2(6A) of the 1922 Act cannot be construed to include current profits.

1.5 Subsequently, vide 1961 Act, *Explanation 2* to section 2(22) was introduced to expand scope of the term accumulated profits to include profits up to the date of distribution/payment or the date of liquidation, as the case may be. The relevant extract of *Explanation 2* to section 2(22) of the Act is reproduced below :

"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 (c) 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 immediately preceding the previous year in which such acquisition took place."

[emphasis added]

2. Controversy:

2.1 The introduction of *Explanation 2* to section 2(22) of the Act sought to remove distinction between 'current profits' and 'accumulated profits'. In spite of the clear language of *Explanation 2* to section 2(22) of the Act, issue arose as to whether current profits upto the date of distribution/payment needs to be taken into account for determining the quantum of accumulated profits in a scenario where distribution/payment of dividend under section 2(22) took place in the middle of the year.

2.2 The controversy culminated in the context of current year's 'business profits', where it was argued that the ascertainment of business profits in the middle of the year may not be feasible as the same arises only at the end of the year. This view was supported by the decision of the **Hon'ble Supreme Court** in case of **E.D. Sassoon & Co. Ltd. v. CIT** [1954] 26 ITR 27 wherein the Court observed that profits do not accrue from day-to-day or even from month to month and have to be ascertained by a comparison of assets at two stated points i.e. at the beginning and end of the year, and further held that the profit or loss should be determined at the end of every year. The aforesaid principles were followed by the **Hon'ble Supreme Court** in case of **CIT v. Ashokbhai Chimantbhai** [1965] 56 ITR 42.

2.3 In context of the provisions of section 2(22)(e) of the Act, the **Hon'ble Ahmedabad Tribunal** in case of **M.B. Stock Holding (P.) Ltd. v. Asstt. CIT** [2003] 84 ITD 542¹, while acknowledging that accumulated profits includes all profits up to the date of distribution or date of payment, observed that the intention of the Legislature for introducing *Explanation 2* to section 2(22) of the Act was not to override the Supreme Court decision in case of *V. Damodaran (supra)* but to provide for adjustments for all other profits accrued up to the date of payment of the loan (like capital gains, interest, dividend, etc.) in working out the accumulated profits and thereby concluded that since the business profits of the company accrue only at the end of the year, the current year's business profits are not to be included in the computation of accumulated profits.

2.4 The aforesaid principles laid down by the Ahmedabad Tribunal were followed in at least following cases :

- ◆ *ITL Fabrics (P.) Ltd. v. Asstt. CIT* [2013] 33 taxmann.com 385 (Mum. - Trib.)
- ◆ *P. Satya Prasad v. ITO* [2013] 31 taxmann.com 267/141 ITD 403 (Vishakapatnam - Trib.)
- ◆ *Mohit Kamboj v. ITO* [IT Appeal No. 3365 & 3366/Mum/2013]
- ◆ *Bharat Bir Mohindra v. Asstt. CIT* [2017] 88 taxmann.com 322 (Chennai - Trib.)
- ◆ *Rajmal Lakhchand v. Jt. CIT* [2018] 92 taxmann.com 94 (Pune - Trib.)

2.5. On the contrary, the **Hon'ble Delhi Tribunal** in case of **ITO v. Gurdip Singh** [2008] 19 SOT 525 distinguished the decision of the Supreme Court decision in case of *V. Damodaran (supra)* holding that the said judgment pertained to

erstwhile provisions of section 2(6A)(e) of the 1922 Act wherein the term 'accumulated profit' was not defined, which has been now defined in *Explanation 2* to section 2(22) of the Act. The Court further observed that the companies are entitled to declare interim dividend without the finalization of annual accounts, which fortifies the view that profits accrue from day to day and not only when annual accounts are prepared and signed and thereby concluded that the tax officer was justified in apportioning profits of the year till the date of payment of deemed dividend.

2.6 Similarly, the **Hon'ble Jaipur Tribunal** in case of **Dy. CIT v. Rajasthan Wires (P.) Ltd. [2003] 1 SOT 648** observed that:

21. ...The present definition of accumulated profits by Expln. 2 to s. 2(22) of the IT Act, 1961, only clarifies that the words "accumulated profits" shall also include current profits of the company which are upto the date of distribution or payment referred in s. 2(22)(e) of the IT Act, 1961. This explanation was not available in the old Act and, therefore, the relevant provisions being different, the decision of the Supreme Court that current profits cannot be included in accumulated profits shall not apply in the present provisions of law..."

[emphasis added]

2.7 The **Hon'ble Mumbai Tribunal** in case of **NCK Sons Exports (P.) Ltd. v. ITO [2006] 102 ITD 311** distinguished Ahmedabad Tribunal decision in *M. B. Stock Holding Private Limited (supra)* in light of the object of the legislature for introduction of *Explanation 2* to section 2(22) of the Act. It is pertinent to note the below observations of the Court:

"13. ...Once it is shown that the case of the assessee comes within the letters of law, he must be taxed, however great hardship may appear to the judicial mind to be. In the light of all these judicial pronouncements, if we examine the facts of the instant case, we would find that through Explanation 2, the Legislature has defined the word "accumulated profit" in an unequivocal terms and there is no ambiguity therein. Whatever judgments are relied on, they pertain to the old provisions in which the accumulated profits were not defined and the definition of accumulated profits were developed through various judicial pronouncements. We have also carefully examined the order of the Tribunal in the case of M.B. Stock Holding (P.) Ltd. (supra) which were rendered on 27th December, 2001 in which the Tribunal has examined Explanation to section 2(22)(e) of the Act in the light of judgment of the Apex Court in the case V. Damodaran (supra), but, did not look to the object of introduction of Explanation 2 to section 2(22)(e) of the Income-tax Act and the Tribunal has drawn an inference that the Legislature has no intention to override the decision of Supreme Court in the case of V. Damodaran (supra), whereas, the facts are otherwise. In the original provisions of section 2(6A)(c) of the Income-tax Act, 1922, the accumulated profit was not defined. Its definition was developed on account of judgments of the Apex Court in the case of Damodaran and other judgments of various High Courts through which it has been clarified accumulated profits relate to the past profits and current profit cannot be included therein. If the Legislature had a same intention and they did not want to have a different meaning of accumulated profits, there would be no need to introduce the Explanation 2 to section 2(22)(e) through which they have made it abundantly clear that the expression "accumulated profit" means shall include all profits of the company up to the date of distribution or payment referred to in sub-clauses (a), (b), (d) and (e) and in sub-clause (c) shall include profit of the company up to the date of liquidation.

14. In fact, in order to neutralize the aforesaid decision of the Apex Court holding that accumulated profits in section 2(6A) of the 1922 Act do not include "current profits", the expression "accumulated profits" was defined in 1961 Act through Explanation 2 to section 2(22)(e) so as to include profit up to the date of distribution or payment. We, therefore, of the view that much assistance cannot be drawn from this Order of the Tribunal in favour of the assessee. Once the Legislature has defined the words 'accumulated profit', no other meaning of accumulated profits can be inferred or interpreted."

[emphasis added]

2.8 Following the aforesaid principles, the **Hon'ble Mumbai Tribunal** in case of **Ketan Bhanuchandra Mahta v. ITO [ITA Nos. 1939/1943 & 1187 (Mum.) of 2010]** held that the profits earned by the company upto the date of payment of deemed dividend shall be included for determining the accumulated profit for the purpose of application of section 2(22)(e) of the Act.

2.9 At this juncture, it is imperative to draw inference from the **Twelfth Report of the Law Commission of India**, which provides that the intention of the legislature to introduce *Explanation* was to include the current profits in the definition.

The relevant extracts of the Report are reproduced below:

"There is no change in the existing definition in section 2(6A), except that we have added another explanation to the effect that the accumulated profits "shall include all profits of the company up to the date of distribution or payment referred to in this clause".

*The reason for this alteration is this. **In the case of Girdhar Das and Co. Ltd. vs. CIT, the Bombay High Court observed that in this section, "accumulated profits" have been used in contra-distinction to current profits. In our opinion, the intention of the legislature was to include the current profits also in the definition; and to make this clear we have made the proposed alteration "***

[emphasis added]

3. Conclusion:

3.1 As one may observe, the issue of inclusion of 'current year's business profits' for the purpose of quantification of 'accumulated profits' under section 2(22) of the Act is highly contentious with divided judicial views. The recent judicial trend on the subject however seems to support the view that current year's business profits should not be included in the computation of accumulated profits based on the argument that business profits accrue at the end of the year and not on day-to-day basis.

3.2 If the current year's business profit is included for determination of accumulated profits, the company may need to prepare provisional financial statements in order to substantiate methodology of computation of current year's business profit till the date of distribution or payment and thereby comply with the applicable withholding tax obligations under section [194](#) of the Act. While there is no statutory requirement under the Act, it is always advisable to get such provisional accounts certified and approved by the Board.

3.3 Apart from business profits, where the current year's income includes certain categories of income in the nature of capital gains, interest, dividends, rental income or subsidies, etc. which have already accrued and arisen prior to the date of distribution or payment, the same should be included in the computation of the accumulated profits.

■ ■

[1.](#) Affirmed by the Hon'ble Gujarat High Court in *CIT .v M.B. Stockholding (P.) Ltd.* [\[2015\] 64 taxmann.com 138](#)