Section 41 of the Income Tax Act, 1961
A complete analysis

By
Ms.Bhavya Rangarajan, Advocate
Ms.B.Mala, Associate
Subbaraya Aiyar, Padmanabhan & Ramamani (SAPR)
Advocates

Introduction:

The Income Tax Act deems certain income as profits and gains of business and profession. One such provision in the Act is Sec. 41.

Sec. 41 deals with a situation where:

- A loss, expenditure or trading liability has been incurred in the course of business or profession;
- Allowance or deduction has been made in respect of such loss, expenditure or trading liability in the course of assessment; and
- A benefit is subsequently obtained in respect of such loss, expenditure or trading liability by way of remission or cessation thereof

In such a situation, the value of the benefit accruing to the assessee is deemed to be profits and gains of business or profession.

The receipts so taxable under this section are given clause-wise in detail below.

Clause (1) : Recovery of loss, expenditure or trading liability incurred, against any deduction/allowance

(1) Where an allowance or deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee (hereinafter referred to as the first-mentioned person) and subsequently during any previous year,—

(a) ***the first-mentioned person*** *has obtained, whether in cash or in any other manner whatsoever, any amount in respect of such loss or expenditure or some benefit in respect of such trading liability* ***by way of remission or cessation thereof****, the amount obtained by such person or the value of benefit accruing to him shall be deemed to be profits and gains of business or profession and accordingly chargeable to income-tax as the income of that previous year,* ***whether the business or profession*** *in respect of which the allowance or deduction has been made* ***is in existence in that year or not****; or*

(b) ***the successor in business has obtained****, whether in cash or in any other manner whatsoever, any amount in respect of which* ***loss or expenditure was incurred by the first-mentioned person*** *or some benefit in respect of the trading liability referred to in clause (a) by way of*

remission or cessation thereof, the amount obtained by the successor in business or the value of benefit accruing to the successor in business shall be deemed to be profits and gains of the business or profession, and accordingly chargeable to income-tax as the income of that previous year.

Explanation 1.—For the purposes of this sub-section, the expression "loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof" shall include the remission or cessation of any liability by a unilateral act by the first mentioned person under clause (a) or the successor in business under clause (b) of that sub-section by way of writing off such liability in his accounts.

Explanation 2.—For the purposes of this sub-section, "successor in business" means,—
(i) where there has been an amalgamation of a company with another company, the amalgamated company;
(ii) where the first-mentioned person is succeeded by any other person in that business or profession, the other person;
(iii) where a firm carrying on a business or profession is succeeded by another firm, the other firm;
(iv) where there has been a demerger, the resulting company.

In short, section 41(1) says that the benefit which accrues in respect of loss or expenditure or which accrues by way of remission or cessation of trading liability will be taxable under the head 'Profits and Gains of business or profession' only when an allowance or deduction has been made with respect to such loss or trading liability.

Clause (a) deals with a situation where such benefit is received by the assessee (the person who has incurred the liability), whereas clause (b) deals with the situation where the successor in business receives such benefit.

In order to apply Sec. 41(1), the Supreme Court held that the following points are to be kept in view:
(1) in the course of assessment for an earlier year, allowance or deduction has been made in respect of **trading liability** incurred by the assessee;
(2) subsequently, a **benefit is obtained** in respect of such trading liability by way of **remission or cessation** thereof during the year in which such event occurred;
(3) in that situation the value of benefit accruing to the assessee is deemed to be the **profit and gains of business** which otherwise would not be his income; and
(4) such value of benefit is made chargeable to income-tax as the income of the previous year wherein such benefit was obtained[1].

---

[1] CCIT Vs. Kesaria Tea Co. Ltd - 254 ITR 434 (SC)

From the above conditions, we see that there are many issues to be considered before applying this provision.

ISSUE 1:
Identity of the assessee

Identity of the assessee is very important. Clause (1) of sec. 41 talks about two situations:

a) when the assessee or first mentioned person is allowed a deduction and he subsequently obtains a benefit thereof.
b) when the assessee or first mentioned person is allowed a deduction and the successor-in-business gets the benefit thereof

In **Saraswati Industrial Syndicate Ltd. Vs. CIT[2],** the Hon'ble Supreme Court made it clear that in order to attract the provisions of s. 41(1) for enforcing the tax liability, _the identity of the assessee in the previous year and the subsequent year must be the same._

ISSUE 2:

Allowance or deduction should be given in an earlier year

The Section starts with, 'Where an allowance or deduction has been made in the assessment for any year........ and subsequently during any previous year....'

This makes it clear that an allowance or deduction should be made in the assessment, ie, in the earlier year. Unless it is proved that an allowance or deduction has been made in the assessment in any

[2] 186 ITR 278 (SC)

previous year in respect of loss, expenditure or trading liability, it is not open to the revenue to refer to section 41(1) for taxing the receipt, by refund or otherwise, of such expenditure in a subsequent year.

In **CIT Vs Mohan Meakin Ltd[3],** excess provision for doubtful debts was written back. Since the finding of the CIT that the provision was not allowed in the earlier year as a deduction was not under challenge, the Delhi High Court upheld the Tribunal's order and held that the amount cannot be added under Section 41(1).

Similarly, in **CIT Vs Rose Services Apartment India (P) Ltd[4],** the Delhi High Court held that addition under s. 41(1) could not be made because no deduction or allowance in respect of expenses, loss or trading liability had been allowed in the earlier years. Tribunal was justified in confirming the deletion of the addition under s. 41(1).

---

[3] (2012) 69 DTR (Delhi) 397

[4] (2010) 326 ITR 100 (Del)

ISSUE 3:

Double benefit

The main principle behind this provision is that the assessee should not get double benefit – first, by way of allowance or deduction and second, by way of cessation of liability. This principle has been clearly explained by the High Court in **CIT Vs Vardhman Overseas Ltd**[5] where the Court has held that:

[5] 343 ITR 408 (Delhi)

"The provisions of s. 41(1) have been specifically incorporated in the Act to cover a particular fact situation. The section applies where a trading liability was allowed as a deduction in an earlier year in computing the business income of the assessee and the assessee has obtained a benefit in respect of such trading liability in a later year by way of remission or cessation of the liability. In such a case the section says that whatever benefit has arisen to the assessee in the later year by way of remission or cessation of the liability will be brought to tax in that year. The principle behind the section is simple. It is a provision intended to ensure that the assessee does not get away with a double benefit once by way of deduction in an earlier assessment year and again by not being taxed on the benefit received by him in a later year with reference to the liability earlier allowed as a deduction."

ISSUE 4:

- **Refund of statutory duties**
- **Interpretation of the term *'by way of remission or cessation thereof'***
- **Tax liability does not depend on the final verdict**

In **CIT Vs Thirumalaiswamy Naidu & Sons**[6]**,** the Supreme Court held that sales tax refund will have the character of revenue receipt and that this position has been placed beyond doubt by the express provisions of s. 41(1) of the IT Act.

One important case in this regard is **Polyflex (India) (P) Ltd. Vs CIT**[7]**.** In this case, the Supreme Court not only laid down conditions for invoking the section but also laid down certain principles regarding the interpretation of the section. The Court dealt with the **interpretation** of the phrase '***by way of remission or cessation thereof***' and held as follows:

"***7.*** *We are inclined to think that in a case where a* statutory levy *in respect of goods dealt in by the assessee is discharged and subsequently the amount paid is refunded***,** it is the first clause that more appropriately applies. *It will not be a case of benefit accruing to him on account of cessation or remission of trading liability*. It will be a case which squarely falls under the earlier clause, namely, "obtained any amount in respect of such expenditure". ….

8. *True, expenditure and trading liability may be overlapping concepts; but the law-makers apparently intended to deal with allied concepts separately and specifically so as to make the provision as comprehensive as possible ……* the test of cessation or

[6] 230 ITR 534 (SC)
[7] 257 ITR 343 (SC)

remission of liability has to be applied vis-a-vis trading liability and it cannot be projected into the previous clause."

Another issue which arose in this regard is the ***tax liability*** when the ***issue is pending*** before the court/tribunal. To decide this issue, the courts again dealt with in detail, the **nature of the refund** and the interpretation of the term ***'remission and cessation thereof'.***

The Courts have taken divergent views on this, depending on the facts and circumstances of each case.

In **Rameshwar Prasad Vs. V.K. Arora[8],** the assessee, who was following the mercantile system of accounting, was allowed deduction in respect of its liability towards excise duty. The assessee, however, filed writ petition disputing its liability to pay the duty. During the pendency of the writ petition, the excise duty amount was deposited with the Court. The writ petition was ultimately allowed and the amount deposited by way of security was refunded to the petitioner. However, that decision of the High Court did not become final as the State went in appeal to the Supreme Court. Therefore, the assessee still treated the security deposit amount received from the Court as a possible liability and objected to its inclusion in the taxable income under s. 41(1). The High Court held as follows:

"The excise duty had been deposited by the petitioner in the Court itself and that amount was directed to be refunded to it. The amount,

[8] 141 ITR 763 (All)

therefore, was refunded *to the petitioner* by the Court and not by the State Government. .... *That payment was not by way of discharge of the liability but was* only by way of security *and when the writ petition was allowed by the Court the amount was refunded to the petitioner. It was not, therefore, a case where an allowance had been made in respect of any expenditure incurred by it or reimbursement of the expenditure subsequently.* It was an allowance in respect of a trading liability *and in view of the fact that* the decision *of* this Court has not become final *and is the* subject-matter of appeals before the Supreme Court, there has been no remission or cessation of the liability so as to attract s. 41(1) of the Act."

In **Union of India & Anr Vs J.K.Synthetics Ltd[9],** the Supreme Court held that:

"So far as the second question is concerned, it is obvious that the liability to tax *under s. 41 of the Act will* depend on the outcome of the appeal before this Court. *It is also stated that, as regards* another part of the liability, the issue is pending before the Tribunal. *It would, therefore, appear that* no cessation of liability can be postulated *until the Tribunal has decided the matter."*

In **Polyflex (India) (P) Ltd. Vs CIT[10],** the Supreme Court held that:

"7. .... In other words, where expenditure is actually incurred *by reason of payment of duty on goods and the* deduction or allowance

[9] 199 ITR 14 (SC)
[10] 257 ITR 343 (SC)

had been given *in the assessment for earlier period, the assessee is liable to* disgorge that benefit as and when he obtains refund of the amount so paid. *The consideration whether there is a possibility of the refund being set at naught on a future date will not be a relevant consideration. Once the assessee gets back the amount which was claimed and allowed as business expenditure during the earlier year, the deeming provision in s. 41(1) of the Act comes into play and* it is not necessary that the Revenue should await the verdict of higher Court or Tribunal. *If the Court or Tribunal upholds the levy at a later date, the assessee will not be without remedy to get back the relief."*

Agreeing with the view taken by the Karnataka High Court in **K.G. Subramanyam vs. CIT[11],** the Supreme Court in the above mentioned Polyflex held that the *amount of refund is taxable, irrespective of the fact that the special leave petition filed by the excise department against the grant of refund is pending.*

Therefore, the issues are to be decided on the facts, circumstances and accounting treatment in each case.

[11] 195 ITR 199 (Kar)

ISSUE 5:

Unilateral entries and cessation of liability

Explanation 1 to sub-section (1) of this section clearly lays down that the term 'loss or expenditure or some benefit in respect of any such trading liability by way of remission or cessation thereof' ***includes*** the remission or cessation of any liability by a unilateral act (by the

first mentioned person under clause (a) or the successor in business under clause (b)). This Explanation has been inserted by Finance Act 1996, wef 1/4/1997. Let us now take a look at the judgments in this regard.

In **CIT Vs Sugauli Sugar Works (P) Ltd[12],** the Supreme Court held that Sec. 41 contemplates the obtaining by the assessee of an amount either in cash or in any other manner whatsoever or a benefit by way of remission or cessation and it should be of a particular amount obtained by him. Thus, the obtaining by the assessee of a benefit by virtue of remission or cessation is sine qua non for the application of this section. *The mere fact that the assessee has made an entry of transfer in his accounts unilaterally will not enable the Department to say that s. 41 would apply* and the amount should be included in the total income of the assessee.

Similarly, in **CCIT Vs Kesaria Tea Co. Ltd[13],** a similar view has been held and the Supreme Court has also mentioned that this controversy relates to the period anterior to the introduction of Expln. 1 to s. 41(1). The relevant para is as follows:

"5. The learned senior counsel appearing for the IT Department has contended that the assessee itself took steps to write off the liability on account of purchase-tax by making necessary adjustments in the books, which itself is indicative of the fact that the liability ceased for all practical purposes and, therefore, the addition of amount of Rs.

[12] 236 ITR 518 (SC)
[13] 254 ITR 434 (SC)

3,20,758 deeming the same as income of the year 1985-86 under s. 41(1) is well justified of the Act. But, what the assessee has done is not conclusive. As observed by the Tribunal, an unilateral action on the part of the assessee by way of writing off the liability in its accounts does not necessarily mean that the liability ceased in the eye of law. *In fact, this is the view taken by this Court in CIT vs. Sugauli Sugar Works (P) Ltd. (1999) 152 CTR (SC) 46 : (1999) 236 ITR 518 (SC). We, therefore, find no substance in the contention advanced on behalf of the appellant. Incidentally,* we may mention that the controversy relates to the period anterior to the introduction of Expln. 1 to s. 41(1)."

However, as the Court has pointed out, both these judgments relate to assessment year prior to the introduction of this explanation.

In **CIT Vs Eid Mohd. Nizammudin[14],** the Rajasthan High Court held that the fact that clarification was introduced by inserting Expln. 1 under s. 41(1) clearly shows that doubt was prevailing in respect of applicability of s. 41(1) in case of unilateral write off. Sec. 16 of Finance (No. 2) Act, 1996, clarifies that Expln. 1 is effective from 1st April, 1997, and is applicable in relation to asst. yr. 1997-98 and subsequent years. Thus, the Tribunal was justified in holding that the liabilities written back unilaterally by the assessee were not chargeable to tax under s. 41(1) in asst. yr. 1996-97.

---

[14] 294 ITR 139 (Raj)

However, in **Jay Engineering Works Ltd. Vs. CIT**[15]**,** the Delhi High Court held that unclaimed wages and credit balance unilaterally written back to P&L a/c *were chargeable to tax under s. 41(1) even prior to insertion of Explanation* to s. 41(1) w.e.f. 1st April, 1997. Position in law which already existed was only made explicit by insertion of Explanation in s. 41(1).

Subsequently, **CIT Vs Smt. Sita Devi Juneja**[16] dealt wit the same issue**.** This case pertains to AY 2004-05 and the Punjab and Haryana High Court held that:

"It is the conceded position that in the assessee's balance sheet, the impugned liabilities have been shown, which are payable to the sundry creditors. Such liabilities, shown in the balance sheet, indicate the acknowledgment of the debts payable by the assessee. Merely because such liability is outstanding for the last six years, it cannot be presumed that the said liabilities have ceased to exist. *It is also conceded position that* there is no bilateral act of the assessee and the creditors, *which indicates that the said liabilities have ceased to exist. In absence of any bilateral act, the said liabilities could not have been treated to have ceased. In view of these facts, the CIT(A) as well as the Tribunal have rightly come to the conclusion that the* AO has wrongly invoked the Expln. 1 of s. 41(1) *and made the addition on the basis of presumption, conjectures and surmises. ….."*

[15] 2 DTR (Del) 91
[16] 325 ITR 593

However, in **CIT Vs Agarpara Co. Ltd**[17]**,** the Court held that assuming that there can be a cessation only on bilateral act by both the creditor and debtor, such acts may be inferred from the conduct of the debtor and creditor. It *need not be a positive conduct*. It can be inferred from the surrounding circumstances that there has been a cessation or remission of the liability of the assessee. In this case, a *portion of the bonus for several years remained undrawn by the employees* for about 5-7 years. Bonus is payable in each year. In the absence of any dispute, *it cannot be said, a liability to pay bonus not claimed by the employees subsists*. The assessee has written back in the accounts the amount representing the unclaimed bonus. The assessee by its aforesaid act and conduct has declared that there is no liability in respect of that portion of the bonus not claimed by the employees. The persons who are entitled to claim such bonus, by not claiming it for years together, should be deemed to have abandoned their claims, if any……. This benefit is given to the assessee only because of the provisions of the IT Act, Therefore, *when the unclaimed bonus is no longer shown as a liability and the amount representing such unclaimed bonus is transferred to the profit and loss account, it cannot be said that there has been no remission or cessation of liability of the assessee under the provisions of the IT Act***.** If unclaimed bonus being a portion of bonus allowed as deduction in computing the income of the assessee is carried forward from year to year and thereafter written back in the account and no tax is levied thereon, *the assessee would be getting a benefit which it was not entitled to.*"

[17] 158 ITR 78 (CAL)

Similarly, in **Kesoram Industries and Cotton Mills Ltd Vs CIT**[18], the High Court held that where an assessee treats a given amount as his own income in his P&L A/c and had also mentioned that the said amount has become his own income as a result of forfeiting the same itself, then the *assessing authority would be entitled to treat the amount as the income of the assessee.* ...... The onus was upon the assessee to establish that in law it was not entitled to treat the said amount as part of its income or that it was not entitled to forfeit the same and, therefore, its liability did not cease. Whether the liability of the assessee has been fully discharged is within the special knowledge of the *assessee*. He has to *prove that in fact the liability subsists.*

However, in **CIT Vs Silver Cotton Mills Co. Ltd**[19]**,** the Gujarat High Court held that unless there is a cessation of liability or there is a remission of liability by the creditor, the liability subsists and, therefore, even if entries are made to write back the expenditure, the amount so written back cannot be added in the income of the assessee as per the provisions of s. 41(1).

The most recent judgment is probably **ITO Vs Shailesh D. Shah/Yusuf R Tanwar Vs ITO dt 11/12/2013**, where it has been held that liability outstanding for long period of time is assessable as

[18] 196 ITR 845
[19] 125 TAXMAN 741

income (despite no write-back in A/cs) if assessee is unable to prove genuineness of liability.

Therefore, we see that prior to the introduction of Explanation 1, the position was that a mere unilateral entry by the assessee does not mean that the liability has ceased and that the Dept can invoke Sec 41. However, the Explanation has clarified the position now and liability that is outstanding for a long period is considered as income assessable u/s 41, unless the assessee can prove otherwise. The courts however are divided on the issue of a unilateral act affecting the nature of the liability.

ISSUE 6:
Waiver of loan

This is an exhaustive topic in itself and has been dealt with in a separate article. Refer our http://www.saprlaw.com/taxblog for the same.

ISSUE 7:
Limitation

When we talk of liability, one issue which crops up is the limitation. Limitation is basically setting the time period within which action

may be taken or suit initiated for a breach of law. In most cases, after the period of limitation, the remedies available for breaches are extinguished. Therefore, it is necessary to see if such limitation will lead to a cessation of liability for the purposes of this section.

In **CIT Vs Silver Cotton Mills Co. Ltd[20],** the Gujarat High Court held that for the purpose of adding any amount in a case like the one which is on hand, there should be either remission of the liability by the concerned creditor so that the liability with regard to making payment comes to an end or there should be cessation of liability. In the instant case, it is very clear that the creditors, namely the workmen, who were to be paid bonus for the earlier years had not executed any writing for remission of the liability. There is nothing on record to show that the workmen had waived their right to get the bonus from the assessee. The liability of the assessee had not come to an end otherwise also. Thus, there was no cessation of liability. *Simply because the period of limitation had come to an end for the purpose of filing a suit for recovery of the said amount or for taking appropriate action against the assessee, it cannot be said that there was a cessation of liability.* The liability still remains, though it may not be enforceable at law on account of the provisions of the law of limitation.

In **CIT Vs Chase Bright Steel Ltd[21],** the Bombay High Court held that the liability of an assessee does not cease merely because it has

[20] 125 TAXMAN 741
[21] 177 ITR 128 (BOM)

become barred by limitation. The liability ceases when it has become barred by limitation and the assessee has unequivocally expressed its intention not to honour the liability even when demanded. Essentially, therefore, it will always be a question of fact whether or not the assessee has expressed unequivocally his intention not to honour the liability after it has become barred by limitation.

Similarly, in **CIT Vs Chipsoft Technology Pvt. Ltd[22],** the Delhi High Court held that mere lapse of time given to the creditor or the workman to recover the amount due, does not efface the liability of the debtor or employer, though it bars its remedy.

Therefore, the courts are clear on this issue and it has been universally held that liability of an assessee does not cease merely because it has become barred by limitation.

ISSUE 8:

Provisions of the relevant statute must be applied

[22] 80 DTR (Del) 250

In **CIT Vs Chipsoft Technology Pvt Ltd[23],** the Court relied on Kesoram Industries and Cotton Mills Ltd Vs CIT[24] and Commissioner of Income Tax v Agarpara Co. Ltd[25]and held that whether a trading *liability that was once incurred ceases to exist* for the purpose of Section 41(1) has to be decided in the *light of the provisions of the Income-tax Act, 1961,* and the statute, if any, governing such liability.

ISSUE 9:

Successor in business

[23] 80 DTR (Del) 250
[24] 196 ITR 845 (Cal)
[25] 158 ITR 78

Clause (b) of sub-section (1) deals with a situation where an allowance or deduction is made for loss, expenditure or trading liability incurred by the assessee and the benefit is derived by the successor-in-business. Explanation 2 to this sub-section defines the term 'successor-in-business' as:

- the amalgamated company (where there has been an amalgamation)
- the person who succeeds the assessee in that business or profession
- the firm which succeeds a firm carrying on a business or profession
- the resulting company (where there has been a demerger).

In **CIT Vs Rose Services Apartment India (P) Ltd[26],** the Court held that Explanation 2 to s. 41(1) was also not applicable since assessee merely took over the liability which was due to be paid by its subsidiary and assessee was not the successor in the business.

Clause (2) : Sale / demolition of assets that are used in business and in respect of which depreciation has been claimed

(2) Where any building, machinery, plant or furniture,—

(a) which is owned by the assessee;

[26] 326 ITR 100 (Del)

(b) in respect of which depreciation is claimed under clause (i) of sub-section (1) of section 32; and
(c) which was or has been used for the purposes of business,
is sold, discarded, demolished or destroyed and the moneys payable in respect of such building, machinery, plant or furniture, as the case may be, together with the amount of scrap value, if any, exceeds the written down value, so much of the excess as does not exceed the difference between the actual cost and the written down value shall be chargeable to income-tax as income of the business of the previous year in which the moneys payable for the building, machinery, plant or furniture became due.

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 for the purpose of which the building, machinery, plant or furniture was being used is no longer in existence, the provision of this sub-section shall apply as if the business is in existence in that previous year.

This section merely says that:

- when the assessee owns an asset; *and*
- uses it for the purposes of business; *and*
- claims depreciation under section 32(1)(i); *and*
- subsequently sells, discards, demolishes or destroys the asset; *and*
- the moneys payable in respect of such asset together with the scrap value, if any, exceeds the written down value, ***then***

- so much of the excess moneys up to the actual cost would be chargeable as income from the business or profession of the previous year in which moneys payable for the asset became due

The Supreme Court has dealt with this issue in quite a number of cases.

In **CIT Vs United Provinces Electric Supply Company**[27]**,** the Supreme Court reiterated that Sec. 41(2) provides the method of calculating **balancing charge**, which inter alia, states that where any building, machinery, plant or furniture is sold and moneys payable in respect of such building, machinery, plant or furniture exceed the WDV, so much of the excess as does not exceed the difference between actual cost and the WDV is chargeable to income-tax as income of the business of the previous year in which the 'moneys payable' became 'due'.

However, where there was nothing to indicate the price attributable to assets like machinery plant or building out of consideration received on transfer of business as a going concern, the Supreme Court in **CIT Vs Electric Control Gear Mfg. Co**[28] held that it could not be said that anything in excess of their written down value was received.

[27] 244 ITR 764 (SC)
[28] 227 ITR 278 (SC)

SALE OF UNDERTAKING

Regarding the transfer or sale of the undertaking as a whole, the Supreme Court held in **PNB Finance Ltd. Vs. CIT**[29] that to attract s. 41(2) the subject-matter should be depreciable asset and the consideration received should be capable of allocation between various assets. In the instant case, the assessee's entire undertaking was acquired and hence, section 41(2) is not attracted.

However, in **CIT Vs Artex Manufacturing Co.**[30]**,** the business of a registered firm was taken over by a company as a going concern with all assets and liabilities for a slump price. Evidence on record was that the plant, machinery and deadstock were revalued by a valuer, though not separately shown in the agreement of transfer. *This is not a case in which it cannot be said that the price attributed to the items transferred is not indicated and, hence s. 41(2) cannot be applied.* It is, therefore, not possible to agree with the view of the High Court that s. 41(2) is not applicable. But the liability under s. 41(2) is limited to the amount of surplus to the extent of difference between the written down value and the actual cost.

PRINCIPLE BEHIND THE 'BALANCING CHARGE'

[29] 307 ITR 75
[30] 227 ITR 260 (SC)

The principle behind the 'balancing charge' has been explained by the Supreme Court in **Cambay Electric Supply Industrial Co. Ltd. Vs CIT**[31]**.** The Supreme Court held that:

"....It is true that by a legal fiction created under s. 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 preceding 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 assessee under the head "Business income". The fiction under s. 41(2) is created for the purpose of computation of assessable income of the assessee under the head "Business income" and under s. 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 s. 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 per cent deduction under s. 80E(1) would amount to extending the legal fiction within the limits of the purpose for which the said fiction had been created."*

[31] 113 ITR 84 (SC)

INTERPRETATION

There has been a lot of debate regarding scope or ambit of the terms 'moneys payable' and 'sold'. The courts have explained the terms in the following judgments.

- **United Provinces Electric Supply Company** (*supra)* - Explanation to the phrase '*moneys payable*' is wide enough and includes 'any compensation moneys payable in respect thereof'. Similarly, the expression "*sold*" includes a compulsory acquisition under any law for the time being in force.
- **Chandra Katha Industries Vs CIT**[32] - The word "*sold*" which occurs in this sub-section includes a transfer by way of exchange or a compulsory acquisition under any law for the time being in force and the expression "*moneys payable*" includes the sale price or insurance, salvage or compensation moneys as provided in cl. (iii) of sub-s. (1) of s. 32 r/w the Explanation.
- **CIT Vs Kasturi & Sons Ltd.**[33] - the word '*money*' used in s. 41(2) has to be interpreted only as actual money or cash and not as any other thing or benefit which could be evaluated in terms of money[34].

BALANCING CHARGE AND FOREIGN EXCHANGE FLUCTUATION

[32] 138 ITR 168 (ALL)
[33] 237 ITR 24 (SC)
[34] Also see CIT Vs Sirpur Paper Mills Ltd 112 ITR 776 (SC)

The question of foreign exchange fluctuations arose for the purpose of valuation of assets. The Supreme Court held that the rupee value of the capital assets has to be taken into account for calculating its actual cost at the time of acquisition. Subsequent fluctuations in the value of foreign currency are immaterial for this purpose. The relevant part of the judgment is as under:

"2. So far as the first question is concerned, we agree with the view expressed by the High Court. Assessment of total income in India will have to be in Indian rupee. *The company may keep its account in foreign currency. But depreciation will have to be calculated in Indian currency at the point of time of acquisition of the asset. The assessee-company maintains its accounts in pound sterling but while making assessment in India, rupee value of the capital asset has to be taken into account for calculating its actual cost at the time of acquisition of the asset. Subsequent fluctuations in the value of pound sterling is immaterial for this purpose. Hence, the first question was rightly answered by the High Court."*

PENDENCY OF LITIGATION

The Supreme Court in **United Provinces Electric Supply Company** (*supra)* also dealt with the issue of taxability during the pendency of litigation and it held that Pendency of proceeding for additional moneys payable would not be relevant so far as taxability of the compensation amount received is concerned. Amount received by assessee was compensation in respect of acquisition of its undertaking and is taxable in the year of receipt. The fact that the matter has been referred to the arbitrator under s. 7A of the Electricity Act would not mean that the amount determined and paid would cease to be compensation moneys payable. If additional Amount is received in the subsequent year, it would be business income of that year

In **Central India Electric Supply Company Vs CIT[35],** the Court held that as the matter relating to adjudication of price of assessee's assets acquired by Government was referred to arbitration and the arbitrator's award was made a rule of Court within the previous year relevant to asst. yr. 1970-71, income accrued to assessee under s. 41(2) in asst. yr. 1970-71, *notwithstanding the fact that appeal was pending in respect of part of compensation*.

Clause (3) : Sale of asset representing capital expenditure on scientific research

[35] 247 ITR 54 (SC)

(3) Where an asset representing expenditure of a capital nature on scientific research within the meaning of clause (iv) of sub-section (1), [or clause (c) of sub-section (2B),] of section 35, read with clause (4) of section 43, is sold, without having been used for other purposes, and the proceeds of the sale together with the total amount of the deductions made under clause (i) or, as the case may be, the amount of the deduction under clause (ia) of sub-section (2), [or clause (c) of sub-section (2B),] of section 35 exceed the amount of the capital expenditure, the excess or the amount of the deductions so made, whichever is the less, shall be chargeable to income-tax as income of the business or profession of the previous year in which the sale took place.

Explanation.—Where the moneys payable in respect of any asset referred to in this sub-section become due in a previous year in which the business is no longer in existence, the provisions of this sub-section shall apply as if the business is in existence in that previous year.

This section basically says that:

- once deduction in respect of capital expenditure is claimed; and
- that asset is sold without having been used for any other purpose; and
- the proceeds of the sale together with the amount of deductions made exceed the capital expenditure; ***then***

- the excess, or the amount of deductions so made, which ever is less, shall be taxable as income of the business or profession of the previous year in which the sale took place.

In **Maharashtra Hybrid Seeds Co. Ltd. Vs. ACIT[36],** the assessee sold assets on which deduction under s. 35(1)(iv) was claimed and allowed, worked out indexed cost of assets and computed capital loss to be carried forward to next year. The Tribunal held that this was not justified and that once assets were allowed deduction under s. 35(1) (iv), receipts on sale thereof were chargeable to tax under s. 41(3) and no capital loss could further be allowed by working out indexed cost. The relevant part of the judgment explaining the principle behind this sub-section is as under:

"*The reasons for inserting s. 41(3) and old s. 41(2) was to create fiction. In computing the profits and gains for the purpose of assessing the taxable income, the difference, the amount provided in s. 41(3) and the price at which assets sold (the price not being in excess of the original cost) was 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. The reasons for introducing this fiction appear to this***.** Where in the previous year, by the scientific research allowance, the taxable income is reduced for those years and ultimately assets fetch on sale an amount exceeding the deduction allowed, the Revenue is justified in taking back what it had allowed as

[36] 120 TTJ (Mumbai) 634

scientific research expenses because in fact the deduction did not result..... *So far as the deduction under s. 35 which has been already allowed, care is taken by the s. 41(3). Sale consideration received more than the cost of the asset on which deduction has been allowed such receipt is subject to capital gain."*

Clause (4) : Recovery of bad debt against an allowance or deduction

(4) Where a deduction has been allowed in respect of a bad debt or part of debt under the provisions of clause (vii) of sub-section (1) of section 36, then, if the amount subsequently recovered on any such debt or part is greater than the difference between the debt or part of debt and the amount so allowed, the excess shall be deemed to be profits and gains of business or profession, and accordingly chargeable to income-tax as the income of the previous year in which it is recovered, whether the business or profession in respect of which the deduction has been allowed is in existence in that year or not.

Explanation.—For the purposes of sub-section (3),—
(1) "moneys payable" in respect of any building, machinery, plant or furniture includes—
(a) any insurance, salvage or compensation moneys payable in respect thereof;
(b) where the building, machinery, plant or furniture is sold, the price for which it is sold,
so, however, that where the actual cost of a motor car is, in accordance with the proviso to clause (1) of section 43, taken to be twenty-five thousand rupees, the moneys payable in respect of such motor car shall be taken to be a sum which bears to the amount for which the motor car is sold or, as the case may be, the amount of any insurance, salvage or compensation moneys payable in respect thereof (including the amount of scrap value, if any) the same proportion as the amount of twenty-five thousand rupees bears to

the actual cost of the motor car to the assessee as it would have been computed before applying the said proviso;

(2) "sold" includes a transfer by way of exchange or a compulsory acquisition under any law for the time being in force but does not include a transfer, in a scheme of amalgamation, of any asset by the amalgamating company to the amalgamated company where the amalgamated company is an Indian company.

This section basically says that:

- once a deduction has been allowed
- with respect to bad debts or part of debts u/s 36(1)(vii)
- subsequently, an amount has been recovered on this behalf
- this amount is greater than the difference between the debt and the amount so allowed; ***then***
- the excess shall be deemed to be profits and gains of business or profession;
- irrespective of whether the business or profession is in existence in that year or not.

In **CIT Vs Sushila Mallick[37],** the Allahabad High Court held that by virtue of section 41(4), where a deduction has been allowed in respect of a bad debt, which is irrecoverable and amount or a part thereof is subsequently recovered, then that amount shall be deemed to be profits and gains of business or profession of that relevant previous year. In order to obtain a deduction in relation to bad debts,

[37] (2013) 85 CCH 212 AllHC

it is not necessary for the assessee to establish that the debt, in fact, has become irrecoverable; *it is enough if the bad debt is written off as irrecoverable in the accounts of the assessee*.

In **CIT Vs P.K. Kaimal[38],** the Madras High Court held that continued existence of the business is not a condition for applying s. 41(4). If the continued existence of the business is not the criterion, then there could be only one basis for applying both ss. 41(1) and 41(4) and that is *the identity of the assessee being the same*. In s. 41(1) also, the liability to pay the tax arises even if the business or profession in respect of which allowance or deduction had been made was in existence in the relevant year or not. Thus notwithstanding the closure of the business, so long as the assessee continued to be the same, the assessee would have to be taxed in the manner contemplated by s. 41(1) or 41(4), as the case may be. In the instant case, the assessee was a partner in a firm. The firm dissolved and the assessee took over the business and carried on the same as sole proprietor. Assessee subsequently recovered a bad debt written off by the firm for which deduction was claimed by the firm. Bad debt recovered shall be charged to tax under s. 41(4), only if the assessee availing the allowance for bad debts and the assessee recovering the debt are same.

Clause (4A) : Amount withdrawn from a Special Reserve in respect of which deduction has been allowed

[38] 123 ITR 755 (MAD)

(4A) Where a deduction has been allowed in respect of any special reserve created and maintained under clause (viii) of sub-section (1) of section 36, any amount subsequently withdrawn from such special reserve shall be deemed to be the profits and gains of business or profession and accordingly be chargeable to income-tax as the income of the previous year in which such amount is withdrawn.

Explanation.—Where any amount is withdrawn from the special reserve in a previous year in which the business is no longer in existence, the provisions of this sub-section shall apply as if the business is in existence in that previous year.

This section basically says that:

- where a deduction has been allowed
- in respect of any special reserve created and maintained u/s 36(1)(viii)
- subsequently an amount is withdrawn from such special reserve; ***then***
- such amount shall be deemed to be the profits or gains from business or profession

In **CIT Vs Industrial Finance Corporation of India Ltd[39],** the Delhi High Court held that prior to asst. yr. 1998-99, the only requirement for claiming deduction under s. 36(1)(viii) was creation

[39] 66 DTR (Del) 490

of reserve equivalent to 40 per cent of the total income by debit to the P&L a/c. It is only from the asst. yr. 1998-99 that the Act has provided for such reserve to be maintained intact and in case of any withdrawal from such reserve, the amount withdrawn is deemed to be income liable to tax under s. 41 (4A) in the year of withdrawal. Provisions of s. 41(4A) are not applicable, being prospective in effect.

A similar view has been held by the Kerala High Court in **Kerala Financial Corporation Vs. CIT**[40] and in **Rural Electrification Corporation Ltd., In Re**[41]**.**

Clause (5) : Adjustment of Loss of business or profession no longer in existence

[40] 261 ITR 708 (Ker)
[41] 312 ITR 122

(5) Where the business or profession referred to in this section is no longer in existence and there is income chargeable to tax under sub-section (1), [***] sub-section (3), sub-section (4) or sub-section (4A) in respect of that business or profession, any loss, not being a loss sustained in speculation business [***], which arose in that business or profession during the previous year in which it ceased to exist and which could not be set off against any other income of that previous year shall, so far as may be, be set off against the income chargeable to tax under the sub-sections aforesaid.

This section says that:

- where the business or profession referred to in this section is no longer in existence; and
- there is income chargeable under sub-sections 1, 3, 4 or 4A;
  then
- any loss, not being loss sustained in speculation business;
- which arose during the previous year in which it ceased to exist;
  and
- which could not be set off against any other income of that previous year;
- shall be set off against the income chargeable to tax under the above said sub sections.

In **CIT Vs Official Liquidator, New Era Mfg. Co. Ltd**[42]**,** the company was wound up in 1963-64. Plant and machinery of assessee company sold in 1969-70 giving rise to profits assessable under s. 41(2). The Kerala High Court held that the income computed under sub-s. (2) of s. 41, which with the aid of the Explanation is made chargeable to tax even when the business was no longer in existence in the relevant previous year, has to be, before it is charged, subjected to a set off against the carried forward depreciation allowance by giving full play to the provisions of sub-s. (2) of s. 32 and sub-s. (5) of s. 41.

In **CIT Vs Ardee Mechanical Industries (P) Ltd.**[43]**,** the **a**ssessee claimed to have suffered a loss in asst. yr. 1967-68 but no return was filed and no assessment was made. The Delhi High Court held that the same could not be set off against deemed profit under s. 41(2) which accrued in asst. yr. 1974-75 and that Sec. 41(5) does not permit set off of loss incurred in a period for which no return was filed.

---

[42] 109 ITR 262 (KER)
[43] 247 ITR 87 (Del)