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COMMISSIONER OF INCOME TAX, KANPUR

v.

SARAN ENGINEERING CO. LTD.

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JULY 31, 1986

[R.S. PATHAK AND SABYASACHI MUKHARJI, JJ.]

Computation of capital—Super Profits Tax Act, 1963, Second Schedule—Whether capital reserve, stock and stores Reserves, Bad and doubtful debts reserves, Rehabilitation Reserve, Obsolescence reserve, Loans and Insurance reserve, Investment reserve and Forfeited moneys reserves are to be included in the computation of capital reserve.

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Company (Profits) Surtax Act, 1964, Rule (1) of the Second Schedule—Computation of the company law made—Whether the Gratuity Reserve, Reserve for Special Survey, Reserve for contingencies, Fleet Replacement Reserve, Reserve for exempted profits under section 84 of the Income Tax, Reserve for investment depreciation and Dividend Equalisation Reserve etc. are includible.

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The assessee, in CA 1546 of 1974, M/s British India Corporation Ltd. claimed capital Reserve, Stocks and Stores Reserves, Bad and doubtful debts Reserves, Obsolescence reserve, Loans and Insurance reserve, investment reserve and forfeited moneys reserves as "standard deduction" as defined in section 2(a) of the Super Profits Tax Act, 1963 in the computation of its profits under the relevant Income Tax Act.

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The claim having been disallowed, the question has been referred to this Court by the Tribunal.

In Civil Appeal No. 1599/74 the Saran Engineering Company Ltd. claimed similar deductions in respect of capital reserve, Rehabilitation Reserve, Stores Reserve forfeited moneys Reserve and Bad and doubtful debts reserve. The Income Tax Officer rejected the claim. On appeal the Appellate Assistant Commissioner allowed the claim in part. The Tribunal however allowed the assessee's claim in full in further appeal while rejecting the Revenue's appeal against A.A.C's order. At the instance of the Revenue, the Tribunal referred the matter to the High Court. The High Court answered the reference partly in favour of the Revenue by negativing the claim as to forfeited moneys reserve and

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restricting the quantum of amount allowed by the AAC regarding capital reserve, as the assessee did not seek a reference against it. Hence the appeal by Revenue by Special Leave. A

In the Special Leave Petition No. SLP (C) 4815A/77 the High Court's rejection order of the revenue's request under section 256(2) for calling for a case against the Tribunal's findings regarding the Gratuity Reserve, Reserve for Sepcial Survey, Reserve for contingencies, fleet Replacement reserve, Reserve for exempted Profits under section 84 of the Income Tax Act, Reserve for Investment depreciation and Dividend Equalisation Reserve but allowing only in relation to the Reserve for special Survey come to be considered. B C

Allowing the two civil appeals in part and dismissing the Special Leave Petition, the Court

HELD: 1. In the facts and circumstances of the case, except the obsolescence Reserve and the forfeited moneys reserve, all the Reserves, namely, capital Reserve, Stocks and Stores Reserve, Bad and doubtful debts reserves, Loans and Insurance Reserve, Investment reserve, and rehabilitation reserve are to be included in the computation of capital according to the provisions in the Second Schedule to the Super Profits Tax Act, 1963. D E

2. Where the liability has actually arisen or anticipated legitimately by the assessee though the quantum of the liability has not been determined, to meet such present liability cannot be treated as "reserve". A fund, however, created for payment of a liability which had not already arisen or fallen due but only a provision with regard to the sum that might become liable to be paid is "other reserve within the meaning of rule (1) of second schedule and should be taken into account in computing the capital of the company for the purpose of the Companies (Profit) Surtax Act, 1964. Except the item relating to Reserve for special survey, it is not necessary to call for any statement of the case in respect of other items in SLP (C) 4815A/77. [406G-H; 407A] F G

Commissioner of Income Tax, Kanpur v. *The Elgin Mills Ltd., Kanpur,* [1986] 3 SCR P. 408, followed.

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 1599 of 1974 H

A From the Judgment and Order dated 19.7.1973 of the Allahabad High Court in I.T. Reference No. 200 of 1971.

and

B Civil Appeal No. 1546 of 1974

From the Judgment and Order dated 21.7.1972 of the Allahabad High Court in I.T. Reference No. 172 of 1971.

S.L.P. No. 4815A of with 1977

B.B. Ahuja for the Appellant in C.A. No. 1599 of 1974.

C Dalip Singh, Ms. A. Subhashini and K.C. Dua for the Appellant in C.A. No. 1546 of 1974 and S.L.P. No. 4815A of 1977.

Harish Salve, K.J. John, Ranjit Kumar and B.P. Singh for the Respondents.

D The Judgment of the Court was delivered by

SABYASACHI MUKHARJI, J. In Civil Appeal No. 1546 of 1974 the following items were involved: (a) Capital Reserve (b) Stocks and stores reserves, (c) Bad and doubtful debts reserves, (d) Obsolescence reserve, (e) Loans and Insurance reserve (f) Investment reserve E and (g) Forfeited moneys reserves. The question was whether these were to be included in the computation of capital according to the provisions in the second schedule to the Super Profits Tax Act, 1963.

Under Section 4 of the Super Profits Tax Act, 1963, every company F shall be charged for every assessment year commencing from 1st April, 1963 a tax as Super Profits tax in respect of so much of its chargeable profit of the previous year as exceed the standard deductions at the rate or rates specified in the third schedule. 'Standard deduction' had been defined in clause (9) of section 2 as follows:

G > "An amount equal to six per cent of the capital of the company as computed in accordance with the provisions of the second schedule; on an amount of Rs.50,000 whichever is greater."

The second schedule contained rules for computation of capital H of a company for the purpose of the said Act.

None of the reserves claimed by the assessee had been allowed as deductions in the computation of its profits under the relevant Income-tax Act. The question was whether these represented reserves.

The Tribunal has referred to this Court the following question:

> "Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that: (a) Capital Reserve, (b) Stocks and stores reserves, (c) Bad and Doubtful debts reserve (d)Obsolescence reserve, (e) Loans and Insurance reserves, (f) Investment reserve and (g) Forteited moneys reserves were to be included in the computation of capital according to the provisions in the second schedule to the Super Profits Tax Act, 1963?"

We must observe that so far as the capital reserves are concerned, in view of the findings recorded by the High Court that the amount represented reserve and it was not ear-marked for any existing liability for being utilised by the company, it must be held to be reserve.

The capital reserve which was a sum of Rs.11,73,952 consisted of two amounts namely Rs.12,212 and Rs.11,61,770. The amount of Rs.12,212 represented an insurance claim received by the assessee company on account of a fire which had destroyed some assets of the assessee company. The said receipt of fire insurance claim has directly been credited to the capital account and the sum of Rs.11,61, 770 was credited by transfer from the Profit & Loss Account in the earlier years. This was not provided for against any existing or future liability. It was rightly treated as capital reserve.

The next item was Stocks and Stores Reserve. This was created in 1950 by transfer from the Profit and Loss Appropriation Account. This did not represent any existing provision for existing liability to meet any specific contingency for safeguarding against diminution of the value of the stocks and stores. It was in the nature of a reserve for safeguarding against any possible diminution of the value of stocks and stores on any future occasion. In our opinion, the Tribunal was right in treating it as reserve.

Bad and Doubtful Debts Reserve was created in 1956 through the Profit and Loss Appropriation Account. The amount involved was

A Rs.5,00,000. It was submitted on behalf of the assessee by Shri Salve that this was created by transfer from the Appropriation Account and not a charge against profit. Furthermore, a separate provision was made for bad and doubtful debts which provision was reduced from the value of the assets. It was not the revenue's case that the provision for bad and doubtful debts provided was less than the amount reason-
B ably necessary to be provided. If the amount as it appears to be is more than the amount reasonably necessary to be provided in respect of bad and doubtful debts then it constituted a 'reserve'. It is not correct to state that by very nomenclature this was not a reserve. True nature of the transaction has to be examined.

C The next item is Obsolescence Reserve of Rs.1,72,259. This was created in 1959 by transferring a sum of Rs.12,05,000 from the Profit and Loss Account. Some amounts were written off out of this reserve in 1960 and 1961. This appears to be provision to meet future liability and contingency. But there are not much facts about it. Had it been neces-
D sary we might have remanded the matter to the High Court to direct the Tribunal to find facts on this aspect. But as in that view of the matter, this item was not pressed before us, so this item is deleted from reserve of the assessee.

So far as Loan and Insurance Reserve is concerned, this was created prior to 1947. It was found that it was free from any burden
E and it was not utilised for any purpose and was transferred to the General Reserve Account in 1963. Therefore, it was rightly treated, in view of the principles mentioned hereinbefore as reserve.

The next item is Investment Reserve. This fund was created out of the surplus on the sale of investment which was not held by the
F respondent company as its stock in trade. The surplus did not have its origin in business profits and was transferred directly to the reserve account but this was created prior to 1954 and was further credited in 1955 to 1957 out of the profits on sale of investments. In the later years, whenever a loss of a capital nature was incurred it was debited to this account. It appears that at the time of creating this Reserve, the
G Directors could not have possibly anticipated the losses which might occur in future but merely created a reserve so that losses which do normally arise in the course of business might be adjusted against this amount. It appears therefore that this was a reserve created out of the capital profit. This reserve can rightly be treated as other reserves.

H Forfeited moneys reserve, in our opinion, cannot be treated as

reserve, and the High Court has also not treated it as such. In that view of the matter except the item indicated as Obsolescence Reserve which is deleted from the reserve as indicated before, we uphold the order of the High Court. This appeal is dismissed subject to the extent indicated above. There will be no order as to costs.

In Civil Appeal No. 1599 of 1974, the following facts were recorded:

> "The assessee is a limited company. In proceedings under the Super Profit Tax Act, 1963, the assessee claimed that the following amounts appearing as credit balances in the various accounts mentioned against each be treated as reserves and included in the capital of the company for the purposes of determining the standard deductions, as contemplated under section 2(9) of the Act:
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> |---|---|---|
> | (a) | Capital reserve | Rs.9,41,488 |
> | (b) | Rehabilitation reserve | Rs.6,00,000 |
> | (c) | Stores reserve | Rs. 75,000 |
> | (d) | Forfeited moneys reserve | Rs. 8,000 |
> | (e) | Bad and doubtful debts reserve | Rs. 25,000 |

The Income-tax Officer rejected the assessee's claim. On appeal the Appellate Assistant Commissioner allowed the claim of the assessee in part. The revenue and the assessee both went up in appeal before the Tribunal. The Tribunal had allowed the claim of the assessee in full. The revenue feeling aggrieved referred the following question to the High Court:

> "Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that:
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> (a) Capital reserve
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> (b) Rehabilitation reserve,
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> (c) Stores Reserve
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> (d) Forfeited moneys reserve; and
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> (e) Bad and doubtful debts reserve,

A were to be included in computation of capital according to the provisions of the second Schedule to the Supper Profits Tax Act (Surtax) 1963."

So far as the capital reserve is concerned, in the light of discussion in Civil Appeal No. 1665 of 1974—*CIT, Kanpur* v. *The Elgin Mills Ltd., Kanpur* (Infra p. 408) and also in Civil Appeal No. 1546 of 1974—*CIT, Kanpur* v. *M/s British India Corporation Ltd.*, the High Court was right in treating this account as reserve. It must be further noted that so far as capital reserve was concerned, the Appellate Commissioner had allowed a sum of Rs.7,19,488 out of a claim of Rs.9,41,488. In appeal, the Tribunal upheld the order of the Appellate Commissioner. The assessee did not seek a reference against this in the High Court. The controversy before the High Court was confined to the claim allowed by the Appellate Commissioner. The High Court held in favour of the assessee in treating it a reserve. The High Court was right.

So far as the rehabilitation reserve and stores reserve are concerned, in view of the facts found by the Tribunal and in the light of the reasons indicated in Civil Appeal No. 1546 of 1974, in our opinion, this must be treated as reserve as was held by the Tribunal.

The High Court has disallowed the forfeited money reserve to be treated as reserve. We are of the opinion that the High Court was right.

So far as Bad and Doubtful Debts are concerned, in the light of the observations made in Civil Appeal No. 1546 of 1974 and in the light of the facts found, this must be treated as reserve.

In the aforesaid view of the matter, the appeal fails and is accordingly dismissed. In the facts and circumstances of the case, there is no order as to costs.

Special Leave Petition No. 4815A of 1977 arises out of the decision of the Bombay High Court where the High Court rejected the application under section 256(2) of the Income-tax Act, 1961, for an order directing the Income-tax Appellate Tribunal, Bombay to state a case in relation to the various items specified in the question. The question was as follows:

"Whether, on the facts and in the circumstances of the

case, the Tribunal was right in holding that Gratuity Reserve of Rs.2,00,000, Reserve for Special Survey of Rs.13,04,600, Reserve for Contingencies of Rs.56,00,000. Fleet Replacement Reserve of Rs.54,35,250, Reserve for exempted profits under section 84 of Rs.1,64,900, Reserve for Investment depreciation of Rs.7,09,144 and Dividend Equalisation Reserve of Rs.2,00,000 were reserves with the meaning of the Second Schedule to the Act?"

The Tribunal by its order dated 21st July, 1976, rejected this application as one of fact and the principles not being in dispute.

The revenue thereafter applied to the High Court under section 256(2) of the Act read with section 18 of the Companies (Profits) Surtax Act, 1964. By its order dated 20th June, 1977, the Bombay High Court allowed the application only in relation to the Reserve for Special Survey for Rs.13,04,600 and rejected the application so far as other items are concerned.

Being aggrieved, the assessee has come in Special Leave Petition. The facts regarding the same as found by the Tribunal are as follows:

"(i) *The Gratuity Reserve of* Rs.2,00,000 was created for the first time during the preceding year. The amount was not claimed as revenue expenditure. Some payments were acutally paid during the preceding accounting year. The amount was to be included in the capital base as "other Reserves".

(ii) *Reserve for Special Survey:* Rs.13,04,600: The balance in this reserve account on the first day of the preceding accounting year was Rs.9,32,500 to which was added Rs.15 lakhs by transfer from the Profits and Loss Account making a total of Rs.24,32, 500. During that preceding year expenses of Rs.11,26,900 were incurred and debited to this reserve and the balance of Rs.13,04,600 was carried forward. This amount was to be included in the capital base.

(iii) *Reserve for contingencies:* Rs.56,00,000: This reserve account was meant to be utilised in case of contingencies and there was no specific liability for spending even a part

of this amount on the first day of the accounting year and it was therefore includible in the capital base.

(iv) *Fleet replacement reserve:* Rs.54,35,250: This reserve was like the reserve for contingencies. Here also there was no liability in presenti towards purchase of any vessel on the first day of the accounting year and this sum also was includible in the capital base.

(v) *Reserve for exampted profits under section 84 of the Income-tax Act*: Rs.1,64,900: This was not meant for meeting any liability and had therefore to be included in the capital base.

(vi) *Reserve for investment depreciation:* Rs.7,09,144: This reserve was created originally in order to cushion the effect of fluctuations in the prices of foreign securities held by the assessee. This amount was ultimately transferred in 1971 to the Profits and Loss Appropriation Account. Here also the reserve was not created by way of making provision for liability already accrued on or before the first day of the accounting year and had therefore to be included in the capital base.

(vii) *Dividend Equalisation Reserve:* Rs.2,00,000: This reserve was set apart to enable the assessee to declare reasonable dividend in a year in which the profit was likely to go down. This amount was subsequently transferred to the General Reserve in 1971. This amount was also to be included in the capital base."

In view of the facts as recorded by the Tribunal and in the light of the principles settled by various decisions and reiterated by this Court in Civil Appeal No. 1665 of 1974, (supra) it is not necessary to call for any statement of the case and the High Court was right. It may be mentioned that where the liability has actually arisen or anticipated legitimately by the assessee though the quantum of the liability has not been determined, to meet such present liability cannot be treated as 'reserve'. A fund, however, created for payment of a liability which had not already arisen or fallen due but only a provision with regard to the sum that might become liable to be paid is 'other reserve within the meaning of rule (1) of second schedule and should be taken into ac-

count in computing the capital of the company for the purpose of the Companies (Profit) Surtax Act, 1964. A

In that view of the matter, we are of the opinion that the decision of the High Court was right. The principles applicable in these types of cases have been discussed by this Court in several decisions. It is not necessary to reiterate these again. B

In the premises this application fails and is accordingly dismissed. In the facts of this case, parties will pay and bear their own costs.

S.R. Appeals allowed in part.