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COMMISSIONER OF INCOME TAX, KANPUR

v.

THE ELGIN MILLS LTD., KANPUR

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JULY 31, 1986

[R.S. PATHAK, SABYASACHI MUKHARJI AND  
K.N. SINGH, JJ.]

C      *Companies (Profits) Surtax Act, 1964, Schedule 2 Rule 1—“Investment reserve”, “rehabilitation reserve”, “capital reserve”, “depreciation reserve” and “forfeited dividends”—Whether statutory deductions—“provision” and “reserve”—Distinction between.*

D      In Civil Appeal No. 1665 of 1974, a dispute arose between the respondent-assessee and the Revenue with regard to the computation of “standard deductions” under the provision of Companies Profits (Surtax) Act, 1964. The respondent—assessee claimed that the three amounts in respect of three accounts, namely, (a) investment reserve (b) rehabilitation reserve and (c) forfeited dividend reserve should be treated as reserves for the purposes of computation of its capital for the assessment year 1964-65 of which the relevant previous year ended on 30th Sept., 1963. The Income-tax Officer did not include any of the said “reserves” in the capital of the respondent—company on the basis that these did not represent “reserve” in the real sense. The matter, ultimately went before the Tribunal. It held: (i) that all the three accounts represented “reserves” for the purposes of assessment under the Super Profits Tax Act, 1963 and as the principle involved was the same as under the Companies Profits (Surtax) Act, 1964, the accounts in question represented “reserves” under the latter Act also. The High Court also, relying on its earlier decision in *Commissioner of Income-tax, Kanpur v. British India Corporation (P) Ltd.* 92 ITR 38, affirmed the view taken by the Tribunal and held (i) that under both the Acts charging sections (s. 4) were identically worded except that expression (Standard Deduction) in Super Profits Tax Act, 1963 had been replaced by the expression “statutory deductions” in Companies Profits (Surtax) Act, 1964; (ii) that under both Acts these deductions had to be computed with reference to the capital employed in the assessee’s—Companies; and (iii) that under both the Acts reserves of the company were to be treated as its capital and the only difference was in the

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Second Schedule to the Companies Profits (Surtax) Act, 1964 where an explanation had been added, and this explanation merely clarified what was implicit in the Super Profit Tax Act, 1963.

In C.A. No. 145 of 1976 the assessee—respondent had shown capital of Rs.2,63,79,218 which included *inter-alia* investment reserve, rehabilitation reserve, capital reserve, depreciation reserve and forfeited dividends. The High Court held that the first four items constituted reserves and the forfeited dividends account did not represent reserve.

Dismissing the C.A. No. 145 of 1976 and allowing CA No. 1665 of 1974 in part,

HELD: 1.1 The conclusion of the High Court in CA 1665 of 1974 holding that the investment reserve and rehabilitation reserve were reserves and were entitled to be treated so under the relevant Act is right. But, in the facts of the case, the High Court was not right in holding that the “forfeited dividend reserve” was reserve. However, in CA No. 145 of 1976, the Tribunal and the High Court had rightly excluded “forfeited dividend account” from the reserve. [417G-H; 418D]

2.1 The Supreme Court in *Vazir Sultan Tobacco Co. Ltd. v. Commissioner of Income Tax* [1981] 132 ITR, 559 held that the expression “reserve” in Super Profits Tax Act, 1963 and the Companies Profits (Surtax) Act, 1964 are *in pari materia*. [413C-D]

2.2 The distinction between “provision” and “reserve” is while the “provision” is a charge of profits which are taken into account in the gross receipt of Profits and Loss Account, “reserve” is an appropriation of profit to provide for the asset which it represented. Reserve might be general or specific reserve, what is required is that the amount should be kept apart for one or the other purpose either general or specific. The distinction between provision and reserve must be found out bearing in mind the main features of the reserve. These are: (i) it must be an appropriation of profits, current or accumulated and not a charge against the profits for the year; (ii) the conduct of the parties must bear out that intention; (iii) it must not be to set apart to meet any known liability—a liability known to exist on the date of the balance-sheet. [416A-C]

In the instant cases, keeping in view the aforesaid tests, invest-

A ment reserve, rehabilitation reserve, capital reserve and depreciation reserve constituted "reserves" and are entitled to be treated as such under Companies Profits (Surtax) Act, 1964. The "forefeited dividends" do not represent "reserve". [417G-H; 418A-B]

B *Vazir Sultan Tobacco Co. Ltd. v. Commissioner of Income Tax*, [1981] 132 ITR 559; *Metal Box Co. Ltd v. Their Workmen*, 73 ITR 53 at 67-68; and *Commissioner of Income Tax (Central) Calcutta v. Standard Vaccum Oil Co.*, 59 ITR 685 at 698 relied upon.

*Commissioner of Income-tax, Kanpur v. British India Corporation (P) Ltd.*, 92 ITR 38 approved.

C *Commissioner of Income Tax v. Eyre Smelting Private Ltd.*, 118 ITR 857 referred to.

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 1665 of 1974

D From the Judgment and Order dated 28.9.1973 of the Allahabad High Court in I.T. Reference No. 195 of 1971.

With Civil Appeal No. 145 of 1976.

E *Dalip Singh, K.C. Dua and Miss A. Subhashini* for the Appellant.

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

The Judgment of the Court was delivered by

F **SABYASACHI MUKHARJI, J.** These two appeals were heard together. Civil Appeal No. 1665 of 1974 arises from the decision of the High Court of Allahabad in Income-Tax Reference No. 195 of 1971.

G The assessee, Elgin Mills Ltd., at the relevant time, was a public limited company engaged in the business of manufacture of textile goods. The assessment year involved is the year 1964-65 of which the relevant previous year ended on 30th September, 1963. For the purposes of assessment under the provisions of Companies Profits (Surtax) Act, 1964, a dispute arose between the assessee and the revenue with regard to the computation of "Standard deductions". The company claimed that the following amounts should be treated as

reserves for the purposes of computation of its capital:

- (a) Investment Reserve—Rs.85,00,000
- (b) Rehabilitation reserve—Rs.40,00,000
- (c) Forfeited Dividend reserve—Rs.96,374

The Income-tax Officer did not include any of the said 'reserves' in the capital of the assessee-company on the basis that these did not represent reserve in the real sense. On appeal, the Appellate Assistant Commissioner held that the Rehabilitation reserve and Forfeited Dividends reserve represented reserves but the investment reserve account did not constitute real reserve. Both the assessee as well as the revenue went up in appeal before the Tribunal. The Tribunal disposed of these appeals by a similar order along with two similar appeals relating to the assessment year 1963-64 which arose out of proceedings under the Super Profits Tax Act, 1963. The Tribunal held that all the three accounts represented reserves for the purposes of assessment under the Super Profits Tax Act, 1963. The Tribunal was further of the view that all the three represented reserves for the purposes of assessment under the Super Profits Tax Act, 1963 and as the principle involved was the same as under the Companies Profits (Surtax) Act, 1964, the Tribunal held that the accounts in question represented reserves under the latter Act also. At the instance of the Commissioner, reference was made to the High Court for the assessment year 1964-65 on the following questions:

"1. Whether, on the facts and in the circumstances of the case, the tribunal was right in arriving at its decision by applying the principles laid down in the second schedule to the Super Profits Tax Act, 1963, instead of the provisions of the second Schedule to the Companies Profits (Surtax) Act, 1964, for computation of capital of the assessee company for the assessment year 1964-65.

2. Whether, on the facts and in the circumstance of the case, the tribunal was right in holding that (a) Investment Reserve (b) Rehabilitation reserve (c) Forfeited Dividend Reserve were includable in the capital computation of the company in accordance with the second schedule to the Companies Profits (surtax) Act, 1964."

A The High Court noted that in the connected reference No. 196 of 1971—*Commissioner of Income-tax v. Elgin Mills Company Ltd.* (decision dated 19th July, 1973)) arising out of proceedings under the Super Profits Tax Act, 1963, it had already held that these accounts in question constituted reserve in the real sense and as such should be taken into consideration in determining the standard deductions under section 9(2) of the Act, 1963. It was not disputed before the High Court that if the present reference had been under the Super Profits Tax Act, 1963, the accounts in question would have to be held as reserves by the High Court in view of its previous judgment. But it was contended that the provisions of the Companies Profits (Surtax) Act, 1964 were different from the provisions of the Super Profit Tax Act, 1963. The High Court did not accept this contention. The High Court was of the view that under both the Acts, charging sections (section 4) were identically worded except that the expression "standard deduction" in Super Profits Tax Act, 1963 had been replaced by the expression "statutory deductions" in the Companies Profits (Surtax) Act, 1964. Under both Acts these deductions had to be computed with reference to the capital employed in the assessee company. Under both the Acts reserves of the company were to be treated as its capital and the only difference was in the second schedule to the Companies (Profits) Surtax Act, 1964, an explanation had been added. The said explanation was to the following effect:

E "For the removal of doubts it is hereby declared that any amount standing to the credit of any account in the books of a company as on the first day of the previous year relevant to the assessment year which is of the nature of item (5) or item (6) or item (7) under the heading "RESERVES AND SURPLUS" or of any item under the heading "CURRENT LIABILITIES AND PROVISIONS" in the column relating to "Liabilities" in the Form "Balance-Sheet" given in part I of Schedule VI to the Companies Act, 1956 (I of 1956), shall not be regarded as a reserve for the purposes of computation of the capital of a company under the provision of this schedule."

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H This explanation, the High Court noted, merely clarified what was implicit in the Super Profit Tax Act, 1963. Item No. 5 in the prescribed Balance Sheet under the Companies Act is "Surplus" i.e. Balance in profit and loss account after providing for proposed alloca-

tions, namely, Dividend, Bonus, or Reserves. Item No. (6) was "Proposed additions to Reserves" and item No. (7) was "Sinking Funds". The Accounts mentioned in the explanation would not form a reserve for the purposes of the computation of capital of a company. In any case the High Court was of the view that none of the accounts in dispute fell under the heading "current liabilities". It was contended before the High Court on behalf of the revenue that any amount credited to those accounts during the relevant previous year would fall in item No. 6 viz. proposed additions to reserves. The High Court found that there were no additions to those funds during the relevant previous year inasmuch as the amount standing in those accounts were being brought forward from year to year. In those circumstances the Tribunal was right in deciding the question with regard to the admissibility of the three accounts in question on the principle application to Super Profits Tax Act, 1963. This Court in *Vazir Sultan Tobacco Co. Ltd. v. Commissioner of Income Tax*, [1981] 132 I.T.R. 559 held that the expression "reserve" in Super Profits Tax Act, 1963 and the Companies Profits (Surtax) Act, 1964 are in *pari materia*.

On merits, it was agreed that the points were covered by the previous decision of the High Court in the case of *Commissioner of Income-tax, Kanpur v. British India Corporation (P) Ltd.*, 92 I.T.R. 38. Accordingly, the High Court answered both the questions in the affirmative and in favour of the assessee. This appeal arises out of the said decision of the High Court. In *Commissioner of Income-tax, Kanpur v. British India Corporation (P) Ltd.* (supra), the High Court noted the distinction between 'provision' and 'reserves' and observed that when an amount was set apart for a future liability, it was called a reserve and when it was set apart to meet an existing liability, it was called a provision. The High Court was of the view that the Tribunal in that case was right in holding that capital reserve, stocks and stores reserves, bad and doubtful debts reserves, obsolescence reserve, loans and insurance reserves and investment reserves were to be included in the computation of capital. The Tribunal was not right in including, according to the High Court, forfeited money reserve as the assessee had been transferring to this account dividends which had not been collected by the share holders after they had been declared, and as and when the shareholders made a claim, made payments and debited the same to the account. The High Court, therefore, was of the view that this account represented a provision in respect of an existing liability.

The High Court in Income-Tax Reference No. 196 of 1971 had to

A deal with investment reserve account, rehabilitation reserve account, capital reserve account and depreciation reserve account and held that these were reserves but the account maintained as dividend account did not represent reserve.

B The High Court in its judgment noted that on the 19th July 1973 relying on other judgment in Income-Tax Reference No. 200 of 1917 *Commissioner of Income-Tax v. The Saran Engineering Co. Ltd.* had answered the question by saying that the aforesaid items were reserves. This is the subject matter of civil appeal No. 1599 of 1974 which will also be disposed of by another judgment of this Court.

C Civil Appeal No. 1665 of 1974 and Civil Appeal No. 145 of 1976 which arose out of the Income-Tax Reference No. 196 of 1971 have been heard together and are being disposed of by this judgment.

D In this connection it would be desirable to dispose of Civil Appeal No. 145 of 1976 separately first. It was submitted that the assessee had shown capital of Rs.2,63,79,218 which included the aforesaid reserves including investment reserves, rehabilitation reserve, capital reserve, depreciation reserve and forfeited dividends. The submission on behalf of the revenue by Sree Dalip Singh was that the amount of Rs.85 lakhs in the relevant year as investment reserve was set apart by the assessee company to meet the liabilities of its Bombay Subsidiaries, M/s Madhav Mills Ltd. and Calico Processors Ltd. which were known to the assessee on the date of the balance-sheet. The Directors' report, according to the revenue, left no room for doubt that these were anticipated losses of the assessee company in the form of the investments made in its Bombay subsidiaries known at the date of the balance sheet. These were liabilities, according to Sree Singh actually staring in the face of the assessee company when it prepared the balance sheet. The Tribunal had held that it was a reserve because it was formed by transfer of the amount from capital/General reserve. This according to the revenue, could not be accepted. Revenue submitted that it was a common ground that originally the amount was set apart out of the undistributed mass of profits and therefore the moment it was taken out of the capital or general reserve, it ceased to be a capital or general reserve, and but for its being set apart to meet the liabilities of its subsidiaries, it had again gone back and formed part of the undistributed mass of profits and thereby assumed its original character. It was submitted that the reserve in order that it might be so called in the real sense of the term must come out of the profits of the

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company. But if reserves were constituted out of assets which were sold or by any other means it would be difficult to term the amounts shown as reserve. It was submitted that the investments by the assessee company in the Bombay subsidiaries were in the nature of bad and doubtful debts. Therefore, these were dead losses of the assessee company as the holding company, and these amounts were ultimately bound to be written off and according to the revenue's submission, the substance of the matter clearly was that the amount of Rs.85 lakhs though shown as a reserve, was, in fact, a provision to meet the anticipated losses or bad and doubtful debts in the shape of investments in the two subsidiaries aforesaid which were shown at the date of the balance sheet.

For the assessee Sree Salve drew our attention to the distinction between reserve and provision which has been discussed in the decision of this Court in *Metal Box Co. Ltd. v. Their Workmen*, 73 I.T.R. 53 at 67-68.

According to the revenue, the nature and object of the subsidiary companies have to be kept in view and the practical result, revenue contended before us, was that the shareholders of the holding company whose share capital had been employed for the floatation of the subsidiary companies had not only no power to control the dealings of the subsidiary companies but in fact had no knowledge of, nor any right to the knowledge of or dealings of the subsidiary companies.

The expressions 'Provision' and 'Reserve' are defined in Schedule VI Part III to the Companies Act, 1956. In the decision of this Court in *Vazir Sultan's case* (supra) it has been held that a provision was meant to provide for any known liability and the substance of the matter had to be kept in view. It was further submitted by Sree Singh that the depreciation reserve could not be considered to be reserve in the real sense at all. Forfeited dividends reserve of Rs.1,08,771 had to be a provision.

On the other hand, on behalf of the revenue, it was submitted that in order to constitute reserve, there must be an appropriation of profits current or accumulated and not a charge against the profits for the year. The conduct must bear out the intention to create a reserve. It must not be to set apart to meet any known liability, a liability known but existing on the date of the balance-sheet. The explanation 'reserve' has been defined in the text books of Accountancy which has been noted by this Court. It was urged that it could not be disputed

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- A that reserve might be general or specific reserve, what was required was that amount should be kept apart for one or the other purpose either general or specific. The distinction between provision and reserve must be found out bearing in mind main features of the reserve.
- B These are (1) It must be an appropriation of profits, current or accumulated and not a charge against the profits for the year. (2) The conduct of the parties must bear out that intention. (3) It must not be set apart to meet any known liability—a liability known to exist on the date of the balance sheet. Reference in this connection may be made to the observations of this Court in *Vazir Sultan*'s case (*supra*) at pages 569-70. The Calcutta High Court in *Commissioner of Income Tax v. Eyre Smelting Private Ltd.*, 118 I.T.R. 857, noted the characteristics of 'provisions' as well as 'reserves'. It held, *inter alia*, that provisions were made against anticipated losses and contingencies, it held further that an amount set aside of the profits designed to meet a contingency or liability or commitment or diminution in the value of the assets known to exist would be a reserve, and an amount set aside to provide for a known liability to which the amount cannot be determined with substantial accuracy would be a provision. The said High Court differed from the decision of the Allahabad High Court in *British India Corporation (P) Ltd.* (*supra*) in respect of 'bad and doubtful debts.' Whether in respect of bad and doubtful debts the account could be treated as reserve or provision would depend upon the facts and circumstances of the case.
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The distinction between 'provision' and 'reserve' has been clarified by this Court in *Metal Box Company of India Ltd. v. Their Workmen* (*supra*) at pages 67-68 which states as follows:

- F "The next question is whether the amount so provided is a provision or a reserve. The distinction between a provision and a reserve is in commercial accountancy fairly well known. Provisions made against anticipated losses and contingencies are charges against profits and, therefore, to be taken into account against gross receipts in the P. & L. account and the balance-sheet. On the other hand, reserves are, appropriations of profits, the assets by which they are represented being retained to form part of the capital employed in the business. Provisions are usually shown in the balance-sheet by way of deductions from the assets in respect of which they are made whereas general reserves and reserve funds are shown as part of the proprietor's interest
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(see Spicer and Pegler's Book-keeping and Accounts, 15th Edition, page 42). An amount set aside out of profits and other surpluses, not designed to meet a liability, contingency, commitment or diminution in value of assets known to exist at the date of the balance-sheet is a reserve but an amount set aside out of profits and other surpluses to provide for any known liability of which the amount cannot be determined with substantial accuracy is a provision: (see William Pickles Accountancy, second edition, p. 192; Part III, clause 7, Schedule VI to the Companies Act, 1956: which defines provision and reserve)."

This Court in *Commissioner of Income Tax (Central) Calcutta v. Standard Vacuum Oil Co.*, 59 I.T.R. 685 at 698, observed that the ordinary meaning of the expression reserve was something specifically kept apart for further use or for specific occasion. The observations made therein will have to be understood in the light of the subsequent decisions of this Court in *Metal Box* (supra) and *Vazir Sultan* (supra).

This Court in *Vazir Sultan Tobacco Co. Ltd. etc. v. Commissioner of Income-tax etc.* (supra) considered the expression 'reserve' in the Super Profits Tax Act, 1963 and Companies (Profit) Surtax Act, 1964. It is not necessary to set out all the conclusions of this Court.

Our attention was drawn to Datta's *On the Company Law* (Third Edition) at page 421. "Reserves" consist of appropriations from profits and other surplus and retained for future use. This, however, does not include any amount which had been kept to meet any liability or diminution in value of assets known to exist as on the date of the balance sheet. The essence and substance of the matter has to be kept in view.

As reiterated before, the distinction between 'provision' and 'reserve' is while the 'provision' is a charge of profits which are taken into account in the gross receipt of Profits & Loss Account, 'reserve' is an appropriation of profit to provide for the asset which is represented.

Keeping these tests and the facts of these appeals in mind, we must hold that the conclusion of the High Court in Civil Appeal No. 1665 of 1974 holding that the investment reserve and rehabilitation reserve were reserves and were entitled to be treated so under the relevant Act is right. But in the facts of the case, the High Court was

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A not right in holding that the forfeited dividend reserve was reserve and question No. 2 also in the affirmative. It should have followed in this respect its previous decision in respect of forfeited dividend reserve in *Commissioner of Income-Tax v. British India Corporation* (supra). The appeal, therefore fails, except on the point of "Forfeited Dividend Reserve."

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In Civil Appeal No. 145 of 1976, we are concerned with five items as mentioned i.e. investment reserve, rehabilitation reserve, capital reserve, depreciation reserve and forfeited dividends and in view of the facts found, we are of the opinion that first four items constituted reserves and were entitled to be treated as such under the

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Act and the forfeited dividends did not represent reserve. This appeal accordingly fails in view of the facts found by Tribunal and reiterated by the High Court and the principles applicable as mentioned hereinbefore. The High Court in its order had excluded "Forfeited dividend account" from the reserve. The High Court was right in so doing.

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In the facts and circumstances of the case, the parties will pay and bear their own costs in both the appeals.

CA 1665/74 allowed in part.

M.L.A.

CA 145/76 dismissed.