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Calcutta High Court

Case No: Income Tax Reference No. 205 of 1971

Commissioner of Income Tax and Super Profit Tax		APPELLANT
	Vs	
Indian Standard Wagon Co.		RESPONDENT

Date of Decision: Feb. 20, 1978

Citation: 82 CWN 669

Hon'ble Judges: Sudhindra Mohan Guha, J; Sabyasachi Mukharji, J

Bench: Division Bench

Advocate: Balai Pal and B.K. Nahar, for the Appellant;D. Pal and P.K. Pal, for the Respondent

Judgement

Sudhindra Mohan Guha, J.

The point involved in this case is whether certain amount set apart for payment of gratuity to the retiring labourers would be a "provision" or "reserve" for the purpose of capital computation under the Second Schedule of the Super Profit Tax Act 1963. The reference in question arises from the assessment proceedings under the Super Profit Tax Act, 1963 for the assessment year 1963-64. The relevant previous year ended on 31st March, 1963. Under the aforesaid Act tax should be levied on the charge of its profits of the previous year in accordance with the rates set out in the Third Schedule to that Act. "Chargeable Profits" mean the total income of the assessee computed under the income tax Act, 1961 for any previous year and adjusted in accordance with the provisions of the First Schedule. The Super Profits Tax is levied only on the balance remaining after adjustment of the balance-sheet deduction against the chargeable profits.

2. The assessee is a company carrying on the business of building railway wagons. In the assessment year 1963-64 a sum of Rs. 19, 57, 258/- appeared as provision for labour retire in gratuity, as on 1st April, 1962, the relevant date and it continued in the balance-sheet as on 31st March, 1963 and 31st March, 1964 with some slight modification covering some actual payments made therefrom. The assessee claimed

the said amount as a reserve before the assessing authority for inclusion in the capital computation. The Assessing Authority however, took the view that a ''reserve'' would consist of funds which were not incumbared and not assigned and specifically set apart for meeting as at the date of the balance-sheet. The Assessing Authority accordingly, opined the said amount was meant to be used for the specific contingency already foreseen though not quantified. So, the claim preferred by the assessee was disallowed.

3. There was an appeal before the Appellate Assistant Commissioner who also held that it was an amount set apart for disbursement against a known liability and that it was only a ''provision'' and not a ''reserve''.

4. The assessee preferred an appeal to the Tribunal. It was contended on behalf of the assessee that the payment to the employees was circumscribed by certain conditions and as the amount was not payable merely because a person retired, it could not have been taken as a mere provision. The contention of the appellant assessee was upheld by the Tribunal holding that the gratuity payable was circumscribed by conditions and that no person was absolutely or unconditionally entitled to it. In short, it was held by the Tribunal that the sum set apart was only a ''reserve'' and not a mere ''provision''.

5. On the aforesaid facts, the following question of law is referred for opinion :--

Whether, on the facts and in the circumstances of the case, the sum of Rs. 19,57,268/- shown by the assessee in its accounts as ''provision for labour retiring gratuity'' was a reserve so as to be eligible for inclusion in the capital computation under the Second Schedule to the Super Profit Tax Act, 1963.

6. The expression ''reserve'' has not been defined in the Super Profits Tax Act, 1963. But is is admitted case of both the parties that there is a clear cut distinction between a ''provision'' and a ''reserve''. If any amount is retained by way of providing for "any known liability of which the amount cannot be determined with substantial accuracy, the same will have to be regarded as ''provision'' and consequently if any amount is retained which is not designated by way of providing for any known liability the same could be regarded as ''reserve''. In elaborating the arguments in support of such distinction Mr. Pal, the learned Counsel for the revenue, refers to the decision of Supreme Court in Metal Box Company of India Ltd. Vs. Their Workmen, at page 67. Their Lordship observe as follows :--

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 profits and loss 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 (see Spicer and Plegler''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).

7. Mr. Pal argues that in this case certain amount was set apart out of the profits and surpluses for payment of gratuity, a known liability the amount of which of course, could not be determined with substantial accuracy. He also relies upon the interpretation of the words ''reserves'' and ''provisions'' as had been denned by rule 7 in Part III of Schedule VI of the Companies Act 1956 as hereunder :--

Rule 7(1) (a) - The expression ''provision'' shall subject to sub-clause (2) of this clause mean any amount written of or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(b) the expression ''reserve'' shall not, subject as aforesaid include any amount written of or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability.

8. It is contended that the amount set apart for gratuity was certainly a liability on the date of the balance-sheet. The company was under an obligation to make payment of gratuity to the retiring workers or deceased ones, according to the length of service. So the liability was known, though not the exact amount. Reliance is placed on a decision of the Division Bench of Andhra Pradesh High Court in Vazir Sultan Tobacco Co. Ltd. Vs. Commissioner of Income Tax, . The decision was followed by the full Bench of that High Court in Hyderabad Asbestos Cement Products Ltd. Vs. Commissioner of Income Tax, . Elaborating his arguments to show the distinction Mr. Pai takes us through decision of Bombay High Court in Shree Ram Milis Ltd. Vs. Commissioner of Income Tax, Bombay City-I, . It is observed therein that an amount set aside out of profits and other surpluses nor 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. On this principle it is argued that the sum of Rs. 19,57,258/- set apart for labour retiring gratuity could not be included in the capital computation. The amount set apart for specific contingency already foreseen though not quantified could not be accepted as a reserve. Dr. Pal appearing for the assessee, on the other hand, contends that the

question of payment of gratuity arises if and when the employment of the employee is determined by death, incapacity, retirement or resignation. So, according to him this is a contingent liability which could not be foreseen. This liability does not exist in praesenti it is contingent upon the determination of employment. The decision of the Supreme Court in Standard Mills Co. Ltd. Vs. Commissioner of Wealth-tax, Bombay City, is referred to show the nature of liability. To meet the arguments of Mr. Pal, learned Counsel for the Revenue regarding definition of ''reserves'' and ''provisions'' under the Companies Act 1956. Dr. Pal refers to the decision of the Madras High Court in Commissioner of Income Tax Vs. Indian Steel Rolling Mills Ltd., wherein it is pointed out that the manner in which the balance-sheet of a company has been prepared will not decide the question as to whether an amount is really a ''reserve'' or not for the purpose of the Super Profits Tax Act, 1963. According to the Madras. High Court though there is a distinction between a ''reserve'' and a ''provision'' in the Companies Act, 1956 that distinction cannot be imported into the meaning of the word ''reserve'' in Rule 1 of the Second Schedule of the Super Profits Tax Act, the term therein mean a sum specifically set aside for future use for a specific occasion before the distribution of dividends to the share-holders and it must be a specified sum for a specific use.

9. Next Dr. Pal distinguishes the facts in Metal Box Company of India Ltd. Vs. Their Workmen, from the facts and circumstances of the case in hand. It is stated that therein the Supreme Court was concerned with the nature of liability and of the scheme of gratuity in connection with the payment of Bonus Act, 1965, not the payment of gratuity on determination of relationship of employer and employee. In that case the Company''s accounting year was from 1st April to 31st March of the following year and its books of account were maintained on the mercantile system of accounting. The company computed the amount of bonus payable to its employees under the payment of Bonus Ordinance which was promulgated on 29th May, 1965 and furnished on 5th July, 1965, copies of its computation to the three respondents unions repaying its employees. The available surplus and allocable surplus, according to this computation were Rs. 49.96 lakhs and 29.98 lakhs respectively. On the basis the company declared the bonus at 13.28 per cent of the total wages paid to the employees. The employees disputed the computation. They also challenged the deduction of interest on the reserves. It was held by the Supreme Court in that case that the Second Schedule of the payment of Bonus Act, 1965 required the adding back to the net profit shown in the profit and loss account; the amount of depreciation deducted in that account while computing the gross profits. Similarly, the Second Schedule of the Bonus Act required that the gross profits should be determined by adding back the development rebate "to the extent charged to profit and loss account". Thus, according to Dr. Pal the decision in Metal Box case would be of little assistance in coming out to the decision in the present case.

10. In reply to the decision of Bombay High Court in Shree Ram Milis Ltd. Vs. Commissioner of Income Tax, Bombay City-I, Dr. Pal contends that in that case payment of gratuity was not in issue. But the question was whether (1) provision for taxation and (2) provision for proposed dividend, could be included in the computation of its capital under the Second Schedule of the Super Profits Tax Act, 1963. While concluding his arguments he refers to the decision of the Division Bench of the Bombay High Court in Commissioner of Income Tax, Bombay-II Vs. Forbes Forbes Campbell and Co. Ltd., . In view of the principles enunciated by the Supreme Court in the case of Metal Box Company of India Ltd. Vs. Their Workmen, and in the case of The Workmen of William Jacks and Co. Ltd., Madras, Represented by the William Jacks and Company Employees'' Union Vs. Management of William Jacks and Co. Ltd., Madras, , the learned Judges in this case were not prepared to accept the view taken by the Andhra Pradesh High Court i. e., Vazir Sultan Tobacco Co. Ltd. Vs. Commissioner of Income Tax, . It was held that there was no approved gratuity scheme framed as such by the assessee company until appropriation to the gratuity reserve was made and while appropriating the amounts to gratuity reserve ad hoc amounts were appropriated or transferred to that reserve without undertaking any actual valuation. No attempt was made to estimate the present liability that would arise as a result of either retirement, death or superannuation or anything which may require the company to undertake a recourse to gratuity reserve and as such the amount had been regarded as amounts not set apart to meet any known or existing liability and as such was to be regarded as reserve and was includable in computing the capital of the assessee company under rule 1 (iii) of Schedule II of the Companies (Profits) Surtax Act, 1964, for the purpose of surtax.

11. In order to find whether certain amount set apart was ''reserve'' or ''provision'', the true nature of the amount could be taken into account and not the mere description by the assessee. It is rightly pointed out in the case reported in Shree Ram Mills Ltd. v. Commissioner of income tax, Bombay City-1 27 at 40 that two things must co-exist before the amount can be treated as reserve namely, (a) that the amount must be separated from the general mass of profits and (b) that it should be apparent from the surrounding circumstances that it is in fact, a reserve and not an amount for distribution as dividend. Having regard to this principle there will be no justification to hold that the sum of Rs. 19,57,258/- set apart in this case was kept for distribution as dividend.

12. We like to point out in this connection that the Bombay High Court in the case 107 ITR 38 appears to have laid down the correct position in law. We are fully in agreement with the views and observations of their Lordships. Similarly point also arose in I. T. Ref. 371 of 1970 Commissioner of income tax and Super Profits Tax, West Bengal-1, Calcutta v. Burn & Co., Calcutta, which came up for hearing before us. My Lord Sabyasachi Mukharji, J. speaking for the Court also answered the point in favour of the assessee holding similar views.

So, in view of foregoing findings and reasonings we answer the question in the affirmative and in favour of the assessee.

Each party to pay and bear its own costs.

Sabyasachi Mukharji, J.

I agree.