

A COMMISSIONER OF INCOME TAX (CENTRAL-II), CALCUTTA
v.
M/S. DUNCAN BROTHERS AND CO. LTD., CALCUTTA

FEBRUARY 13, 1996

B [J.S. VERMA, S.P. BHARUCHA AND SUJATA V. MANOHAR, JJ.]

Super Profits Tax Act, 1963/Companies (Profits) Surtax Act, 1964 :

C *Clause (ii) of Rule 1 of the Second Schedule/Rule 2(ii) of the Second Schedule—Provision for taxation—Whether could be deducted from the cost of excluded investments so as to augment the capital base—Held : No.*

Circulars—Central Board of Revenue—Circular No. I.P. (XV- 5) of 1968 dated 23-1-1968—Applicability of.

D *Words & Phrases :*

'Fund'—Meaning of.

E For the assessment year 1963-64, the assessee company claimed for the purposes of Super Profits tax Act, 1963 in the computation of its capital, a provision for taxation made by it should be treated as a part of its capital or as a deduction from the cost of investment. For the assessment year 1964-65, the assessee made a similar claim in respect of a provision for taxation made by it. This claim was made under the provisions of the Companies (profits) Surtax Act, 1964. The Appellate
F Assistant Commissioner of Income tax held that the provision for taxation cannot be considered as a reserve but was to be deducted from the cost of investments in computing the capital based of the company.

G On appeal, the Tribunal held that the provisions for taxation made in the said two assessment years was not a reserve which could form part of the capital of the company; that the provisions for taxation was neither a fund nor a surplus but a "perfected debt" and as such it would not qualify for a deduction as claimed by the assessee. The Tribunal made a Reference to the High Court. Of the three questions referred to it, the High Court
H answered the first question viz. whether the Tribunal was right in holding that 'provision for taxation' was not a reserve to form part of the capital,

in favour of the Revenue. As regards the other two questions as to whether the company was entitled to the benefit of deduction of the amount of 'Provision for Taxation' from its cost of investments, in respect of assessment years 1963-64 and 1964-65, the High Court answered in favour of the assessee. Against this, the Revenue has come in appeal.

The Respondent-assessee contended that while the capital involved in the investment in shares had been deducted in the computation of its Capital, the amount of such capital deducted should be reduced by the amount of "any fund, any surplus and any reserve" in terms of clause (ii) of Rule 1 of the Second Schedule of the Super Profits tax Act, 1963 and the corresponding clause of Rule 2(ii) of the Second Schedule of the Companies (Profits) Surtax Act, 1964.

Allowing the Revenue's appeal, this Court

HELD : 1.1. Since the Second Schedule to both the Acts viz., Super Profits Tax Act, 1963 and Companies (Profits) Surtax Act, 1964 pertains to computing the capital of a company for the purposes of tax under these Acts, the terms used in the Second Schedule need to be interpreted in the context of the balance sheet of a company and its profit and loss account which will necessarily have to be looked at to ascertain the company's capital and its profits. The terms used must, therefore, be read in the light of the provisions of the Companies Act and how these terms are understood in accounting parlance. [499-C-D]

1.2. In the instant case there is no systematic accumulation of cash or any separation of assets to meet future tax liabilities. There is only an accounting entry of an exact sum being earmarked for payment of tax liability arising at the end of the current accounting years. Such a provision cannot be considered as a fund. [500-G-H]

1.3. Circular No. I.P. (XV-5) of 1968 dated 23rd of January, 1968, issued by the Central Board of Revenue and relied on by the assessee deals with the treatment of an amount standing to the credit of "reserve for unexpired risks" held by General Insurance Companies. But it is of no assistance in the present case. In the first place, the provision for taxation made is very different in nature from the reserve for unexpired risks referred to in the circular. The reserve in that case represented a sum of

A money which would be available to the insurance company for payment or discharge of unexpected claims that may arise in respect of policies which extend beyond the accounting year. The provision for taxation in the present case, however, is set apart to meet a specific liability which would arise at the end of the current accounting year. It cannot, in any manner, be compare to a fund of the kind referred to in the circular of the Board. [501-A-B; E-F]

1.4. The Board has considered the etymological meaning of "fund" in considering a reserve to meet future unexpired risks. A sum of money set apart to meet such unforeseen risks was considered as a fund. A provision for taxation of the kind in question is not a fund either etymologically or in accounting parlance. The more relevant meaning of the term "fund" in the context of the two Acts is what that terms is commonly considered to connote when used in a balance sheet or profit and loss account of a company. A specific provision for an ascertained liability is not a fund within the meaning of that terms in the rules in question. [501-G-H; 502-A]

Vazir Sultan Tobacco Co. Ltd. v. Commissioner of Income-Tax, 132 ITR 559 and *Duncan Brothers & Co. Ltd. v. Commissioner of Income-Tax, Central, Calcutta*, 128 ITR 302, referred to.

E *Dictionary for Accountants, 4th Edition by Eric L. Kohler*, pages 204 to 208, referred to.

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 595 of 1978.

F From the Judgment and Order dated 24.12.76 of the Calcutta High Court in I.T.R. No. 642 of 1972.

S.N. Terdol for the Appellant.

G S.N. Gupta for the Respondent.

The Judgment of the Court was delivered by

MRS. SUJATA V. MANOHAR, J. This is an appeal from a decision of the Calcutta High Court in a Reference made to it under Section 256(1) of the Income-Tax Act, 1961.

The assessee is a company and the accounting years involved are the years ending on 31.12.1962 and 31.12.1963 relevant to the assessment years 1963-64 and 1964-65 respectively.

For the assessment year 1963-64, the assessee claimed that for the purposes of Super Profits Tax Act, 1963, in the computation of its capital, a provision for taxation made by it to the tune of Rs. 16,48,888 should be treated either as a part of its capital under Rule 1 of the Second Schedule to the Super Profits Act, 1963 or in the alternative as a deduction from the cost of investment under Clause (ii) of Rule 1 of the Second Schedule to the Super Profits Tax Act, 1963.

For the assessment year 1964-65, the assessee made a similar claim in respect of a provision for taxation made by it to the tune of Rs. 17,52,920. For this assessment year the relevant provisions which were applicable were under the Companies (Profits) Surtax Act, 1964.

The claim of the assessee was disallowed by the Income-Tax Officer. In appeal before the Appellate Assistant Commissioner for the assessment year 1963-64, the Appellate Assistant Commissioner held that as the provision for taxation was only an amount set apart to meet the liability for taxation which would accrue on the last day of the accounting year, it could not be treated as a reserve and be included in the capital of the assessee under the Super Profits Tax Act, 1963. He, however, accepted the alternative contention of the assessee that the provision for taxation fell within Clause (ii) of Rule 1 of the Second Schedule to the Super Profits Act, 1963 and it should be deducted from the cost of investments in computing the capital based of the assessee-company under the Super Profits Tax, 1963.

For the assessment year 1964-65, the Appellate Assistant Commissioner similarly held that the provision for taxation cannot be considered as a reserve but it was to be deducted from the cost of investments under Rule 2(ii) of the Second Schedule to the Companies (Profits) Surtax Act, 1964.

The matter was taken in appeal before the Tribunal which came to the conclusion that the provision for taxation made in the two assessment years was not a reserve which would form a part of the capital of the company. It further held that the provision for taxation was also neither a

A fund nor a surplus. It was a provision against a "perfected debt" and as such it would not qualify for a deduction as claimed by the assessee company.

B The Tribunal made a Reference to the High Court under Section 256(1) of the Income Tax Act 1961. The questions of law which arose for determination were as follows :

For the assessment Year 1963-64

C "(1) Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding that 'provision for Taxation' is not a reserve as to form part of the capital under Rule-1 of the Second Schedule to the Super Profits Tax Act, 1963?

D (2) If the answer to the above question is in the affirmative, whether on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding that in the computation of capital the company was not entitled to the benefit of deduction of the amount of 'provision for taxation' from its cost of investments in terms of clause (ii) of Rule - 1 of the Second Schedule to the Super Profits Tax Act, 1963?"

E *For the Assessment Year 1964-65*

F "Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that in the computation of capital the company was not entitled to the benefit of deduction of 'Provision for Taxation' from its cost of investments in terms of Clause (ii) of Rule -2 of the Second Schedule of the Companies (Profits) Surtax Act, 1964?"

G The Calcutta High Court has answered Question No. 1 for the assessment year 1963-64 in the affirmative in favour of the revenue. It has answered Question No. 2 for the assessment year 1963-64 and the question for the assessment year 1964-65 in the negative and in favour of the assessee. The revenue has come in appeal before us from the above decision of the Calcutta High Court. The assessee has not filed an appeal
H before us in respect of the decision of the Calcutta High Court on Question

No. 1 for the assessment year 1963-64.

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The only issue before us is whether the provision for taxation can be deducted from the cost of excluded investments and would, therefore, augment the capital base of the company for the purposes of the Super Profits Tax Acts, 1963 and the Companies (Profits) Surtax Act, 1964. Under both the Act, the tax is levied on the chargeable profits of the company as exceed the standard deduction or the statutory deduction. Such deduction has to be worked out at the prescribed percentage of the capital of the assessee company. The computation of capital for the purposes of these two Acts has to be made in accordance with the provisions of the Second Schedule in both these Acts. The Second Scheduled to the Super Profits Tax Act, 1963 consists of three rules while the second Schedule to the Companies (Profits) Surtax Act, 1964 consists of four rules. The relevant rules under both these Acts for our purposes are as follows :

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The Super Profits Tax Act, 1963
The Second Schedule

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Rules for computing the capital of a company for the purposes of Super Profits Tax :

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"Rule 1: Subject to the other provisions contained in this Schedule, the capital of a company shall be the sum of the amounts, as on the first day of the previous year relevant to the assessment year, of its paid-up share capital and of its reserve,..... and of its other reservesdiminished by the amount by which the cost to it of the assets the income from which in accordance with clause (iii) or clause (vi) or clause (viii) of rule 1 of the First Schedule is not includible in its chargeable profits, exceeds the aggregate of --

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(i) any money borrowed which remains outstanding; and

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(ii) the amount of any fund, any surplus and any such reserve as is not to be taken into account in computing the capital under this rule.

....."

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A *The Companies (Profits) Surtax Act, 1964*
The Second Schedule

"Rules for computing the capital of a company for the purposes of surtax :

B 1. Subject to the other provisions contained in this Schedule, the capital of a company shall be the aggregate of the amounts, as on the first day of the previous year relevant to the assessment year, of -

C (i) its paid-up share capital;

(ii) its reserves.....

D 2. Where a company owns any assets the income from which in accordance with clause (iii) or clause (vi) or clause (viii) of rule 1 of the First Schedule is required to be excluded from its total income in computing its chargeable profits, the amount of its capital as computed under rule 1 of this Schedule shall be diminished by the cost to it of the said assets as on the first day of the previous year relevant to the assessment year in so far as such cost exceeds the aggregate of -

E (i) any moneys borrowed.....

(ii) the amount of any fund, any surplus and any such reserve as is not to be taken into account in computing the capital under rule 1....."

F In the present case, the assessee has earned income from dividends as envisaged in Clause (viii) of Rule 1 of the Second Schedule. The assessee contends that while the capital involved in the investment in shares has been deducted in the computation of its capital the amount of such capital deducted should be reduced by the amount of "any fund, any surplus and any reserve" in terms of Clause (ii) of Rule 1 of the Second Schedule of the Super Profits Tax Act, 1963 and the corresponding clause of Rule 2(ii) of the Second Schedule of the Companies (Profits) Surtax Act, 1964. It is contended that the provision made for taxation should be regarded as a reserve and should thus be included straightaway in the computation of capital or otherwise, it should be deducted from the cost of investment in

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the shares which are deducted from the computation of capital. In view of the decision of this Court in *Vazir Sultan Tobacco Co. Ltd. v. Commissioner of Income Tax*, (132 ITR 559 at 572), a provision made to meet the tax liability of the current accounting year cannot be considered as representing a reserve. We, however, have to consider the alternative submission that it should be treated as a fund, and, therefore, should be deducted from the cost of the assets required to be excluded from the capital of the company.

Since the Second Schedule to both these Acts pertains to computing the capital of a company for the purposes of tax under these Acts, the terms used in the Second Schedule need to be interpreted in the context of the balance sheet of a company and its profit and loss account which will necessarily have to be looked at to ascertain the company's capital and its profits. The terms used must, therefore, be read in the light of the provisions of the Companies Act and how these terms are understood in accounting parlance. The form of the balance sheet of a company prescribed under Schedule VI to the Companies Act, 1956, under the column "reserves and surplus" contains a note to the following effect :

"The word 'fund' in relation to any 'Reserve' should be used only where such Reserve is specifically represented by earmarked investments."

The juxtaposition of funds with surplus and reserves clearly refers to accounting language and the manner in which these three terms are understood in accounting practice. Our attention is also drawn to the term "fund" as described in the Dictionary for Accountants, 4th Edition by Eric L. Kohler, pages 204 to 208 as set out in the judgment of the Calcutta High Court in *Duncan Brothers & Co. Ltd. v. Commissioner of Income-Tax, Central, Calcutta*, 128 ITR 302 at 311 which is as follows :

"Fund. 1. An asset or group of assets within any organization, separated physically or in the accounts or both from other assets and limited to specific uses. Examples : a petty-cash or working fund; a replacement-and-renewal fund; an accident fund; a contingent fund; a pension fund.

2. Cash, securities, or other assets placed in the hands of a trustee, principal or income or both being expended in accordance with

A the terms of a formal agreement. Examples: a trust fund created by a will; an endowment fund; a sinking fund.

3. (government accounting) A self-balancing group of accounts — asset, liability, revenue and expense — relating to specified sources and uses of capital and revenue.

B

4. pl. Current assets less current liabilities (on an accrual basis) : working capital; a term used in flow statements.

5. pl. = cash.

C

v.t. 1. To convert currently maturing liabilities into a long-term loan.

2. To provide for the ultimate payment of a liability by the systematic accumulation of cash or other assets in a separate account or trust.

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A special revenue fund is created for taxes and other revenues levied or set aside for specified purposes. For example, if a separate tax is authorised for schools, a special revenue fund is set up to account for its disposition. The accounting principles, procedures, and financial statements of a special-revenue fund resemble those of the general fund.....

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Other Funds.

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A balance-sheet combining a group of related funds should indicate the amount of assets, liabilities, reserves and surplus applicable to each fund within the group. The revenues and expenditures of each fund must likewise be kept independent, and the revenues of one fund should not be used to meet the expenditures of another without legal authority or opinion behind the action."

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In the present case there is no systematic accumulation of cash or any separation of assets to meet future tax liabilities. There is only an accounting entry of an exact sum being earmarked for payment of tax liability arising at the end of the current accounting year. Such a provision

H cannot be considered as a fund.

The assessee has relied upon a Circular No. I.P. (XV-5) of 1968 dated 23rd of January, 1968, issued by the Central Board of Revenue. The circular deals with the treatment of an amount standing to the credit of "reserve for unexpired risks" held by General Insurance Companies. The circular, *inter alia*, states as follows :

"The Board are advised that, while the 'reserve for unexpired risks' cannot be regarded as a 'reserve' or 'surplus', it would qualify for being considered as a 'fund' within the meaning of rule 2(ii) of the said Second Schedule. The term 'fund', it will be observed, has not been defined in the Companies (Profits) Surtax Act, 1964. As such, it is to be given its ordinary meaning as understood in common parlance. Etymologically, 'fund' means a sum of money available for the payment or discharge of liabilities. As the 'reserve for unexpired risks' clearly represents a sum of money available to the company for payment or discharge of unexpected claims that may arise in respect of policies which extend beyond the relevant accounting year, the amount standing to the credit of this account can be regarded as a fund"

This circular, however, is of no assistance in the present case. In the first place, the provision for taxation made in the present case is very different in nature from the reserve for unexpired risks referred to in the circular. The reserve in that case represented a sum of money which would be available to the insurance company for payment or discharge of unexpected claims that may arise in respect of policies which extend beyond the accounting year. The provision for taxation in the present case, however, is set apart to meet a specific liability which would arise at the end of the current accounting year. It cannot, in any manner, be compared to a fund of the kind referred to in the circular of the Board.

The assessee, however, has submitted that the circular of the Board has taken the meaning of the term "fund" in its literal or etymological sense. Hence it must be applied to any sum of money available to the company including a provisions for taxation. The argument has no merit. The Board has considered the etymological meaning of "fund" in considering a reserve to meet future unexpired risks. A sum of money set apart to meet such unforeseen risks were considered as a fund. We fail to see how the circular helps the assessee in the case before us. A provision for taxation of the

- A kind in question is not a fund either etymologically or in accounting parlance. The more relevant meaning of the term "fund" in the context of the two Acts is what that term is commonly considered to connote when used in a balance sheet or profit and loss account of a company. A specific provision for an ascertained liability is not a fund within the meaning of that term in the rules in question.
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In the premises, Question No. 2 for the assessment year 1963-64 and the question for the assessment year 1964-65 has to be answered in the affirmative and in favour of the revenue. The appeal is accordingly allowed. In the circumstances, however, there will be no order as to costs.

C
G.N.

Appeal allowed.