

COMMISSIONER OF INCOME TAX, GUJARAT

v.

JYOTI LTD.

FEBRUARY 15, 1996

[B.P. JEEVAN REDDY AND S.B. MAJMUDAR, JJ.]

Income Tax 1961.

Companies (Profits) Surtax Act 1964—Section 256(1)/18—Surtax liability—Computation of Capital—Statutory deductions—Reserves for bad and doubtful debts and gratuity—Held—Reserves for bad and doubtful debts are part of capital because such liability cannot be ascertained—Gratuity reserves should be based upon actuarial valuation to form a part of capital—Remanded to the Surtax officer through the Tribunal for reconsideration.

The respondent assessee is a company carrying on business at Baroda. The respondent was governed by the provisions of the Surtax Act. The respondent claimed that in computing its capital base for the assessment years 1967-68 and 1968-69 gratuity reserve of Rs. 5,60,000 and reserve for doubtful debts of Rs. 85,000 should be taken into consideration. The Surtax Officer rejected the claim. Appeal before the Appellate Assistant Commissioner of Surtax was allowed. Following the decision of the Tribunal in S.T.A. Nos. 7 and 8 of 1971-72 out of the assessee's surtax assessments for the assessment years 1965-66 and 1966-67, it was held that the aforesaid reserves should be considered as part of the capital while computing the capital base for calculation of statutory deduction. Upon an appeal by the Appellant the Tribunal although confirmed the view taken by the Commissioner, referred to the High Court for its opinion the question "Whether on the facts and in the circumstances of the case, the Tribunal was correct in law in holding that reserve for doubtful debts and gratuity reserve created by the assessee were includible in computing the capital for the purpose of computing statutory deduction ?" The High Court reframed the question by the consent of both the parties as to "Whether on the facts and in the circumstances of case, the Tribunal was correct in law holding that rehabilitation reserve, reserve for doubtful debts and gratuity reserve created by the assessee were includible in computing the capital for the purpose of computing statutory deduction?"

A The reframed question was answered against the appellant and in favour of the respondent. Hence these appeals.

B Before this court, the appellants contended that so far as gratuity reserve is concerned it was assumed that merely because the respondent had not thought it fit to resort to any actuarial valuation and had styled the amount as forming part of a reserve, almost automatically, the Surtax Officer had to treat the said amount as set apart by way of a reserve and not a provision, which amounts to giving complete latitude to the respondent. If the respondent resorts to any actuarial valuation of liability to pay gratuity to its employees then it would be a provision but if the respondent does not choose to do so, by its very inaction, it could insist that the provision made for discharging the liability to pay gratuity should be treated as a reserve. Such an absolute discretion given to the respondent would denude the Surtax Officer of his statutory power and obligation to compute the correct capital base of the respondent company for the purpose of assessing the Surtax liability to the concerned company.

D Partly allowing the appeals, this court

E HELD : 1. As a clear finding of fact was reached by the Tribunal that bad debt reserve was created out of Profit and Loss Account without reference to the out-standing sundry debtors and was not created with a view to meet any anticipated liability it had to be held that the said amount which was set apart for meeting bad and doubtful debts was by way of reserve and not a provision. It was also not the Revenue's case that the amount set apart for bad and doubtful debts reserve was less than or equal to the amount necessary to be provided for meeting ascertained liability.

F On the other hand the amount appeared to be more than what was reasonably necessary to be provided for in respect of the bad and doubtful debts as the amount of bad and doubtful debts itself was not as ascertained amount. Consequently no fault can be found with the decision rendered by the authorities below and the High court that the provision of Rs. 85,000

G for doubtful debts had to be treated as reserve which could be legitimately included in computing the Capital base of the respondent assessee-company so far as the relevant assessment years were concerned.

[718-E, 719-G-H]

H *Commissioner of Income Tax, Kanpur v. Saran Engineering Co. Ltd.*
& Anr., (1986) 161 ITR 741, relied upon.

2. The assessee-company had not resorted to any actuarial valuation while creating gratuity reserve of Rs. 5,60,000. Consequently it was not possible to find out as to whether the amount set apart was required to meet the discounted value of estimated liability or was in excess thereof. It is obvious that if there was any excess amount set apart for the purpose it would be treated as a reserve which could be included in the capital base for the purpose of the Surtax Act. It is axiomatic that if discounted present value of gratuity liability on a scientific basis was arrived at by the assessee-company by resorting to actuarial valuation of such liability it would have supplied a basis for the Surtax Officer to compute the capital base by treating the said amount as a provision and that if it was further found that the amount set apart for meeting such liability was in excess of such provision then the excess amount could have been determined for being included as a reserve in the capital base. But in the absence of assessee-company undertaking such an exercise, the Surtax Officer under such circumstances could have legitimately resorted to an estimate for ascertaining the extent of provision for such contingent liability for gratuity required to be met by the assessee-company in the concerned assessment years. It would have been equally open to the Surtax Officer to call upon the assessee-company to get actuarial valuation of such liability to enable the Surtax Officer to compute the correct capital base of the company. As no such exercise was done both by the assessee-company as well as by the Surtax Officer the issue in question is remanded to the taxing authority through the Tribunal for disposal in the light of the abovesaid principles. [725-B-F]

Vazir Sultan Tobacco Co. Ltd. etc. v. Commissioner of Income Tax, A.P. Etc., (1981) 132 ITR 559, relied upon.

Metal Box Company of India Ltd. v. Their Workmen, (1963) 78 ITR 53, referred to.

CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 471-72 (NT) of 1978.

From the Judgment and Order dated 21.6.77 of the Gujarat High Court in I.T.R. No. 6 of 1976.

K.N. Shukla, Ranbir Chandra and S.N. Terdol for the Appellants.

A The Judgment of the Court was delivered by

B S.B. MAJMUDAR, J. These appeals by certificate granted on 12th December 1977 by the Gujarat High Court arise out of its judgment and order dated 21st June 1977 in Income Tax Reference No. 6 of 1976. The Commissioner of Income Tax, Gujarat is the appellant while the assessee company is the respondent. The Income Tax Appellate Tribunal, Ahmedabad referred the following question for the opinion of the High Court of Gujarat under Section 18 of the Companies (Profits) Surtax Act, 1964 [hereinafter referred to as 'the Surtax Act'] read with Section 256(1) of the Income Tax Act, 1961 :

C "Whether, on the facts and in the circumstances of the case, the Tribunal was correct in law in holding that reserve for doubtful debts and gratuity reserve created by the assessee were includible in computing the capital for the purpose of computing statutory deduction?"

D However, the Division Bench of the High Court by consent of the parties reframed the question as under :

E "Whether on the facts and in the circumstances of the case, the Tribunal was correct in law in holding that rehabilitation reserve, - reserve - for doubtful debts and gratuity reserve created by the assessee were includible in computing the capital for the purpose of computing statutory deduction ?"

F The said reframed question was answered against the Revenue and in favour of the assessee and that is how at the instance of the Revenue the present proceedings have arisen on certificate granted by the High Court.

G At the time of final hearing of these appeals the learned counsel for the appellant Commissioner of Income Tax placed for our consideration only the following aspects of the question :

1. Whether reserve for meeting doubtful debts was a reserve or a provision.

H 2. Whether gratuity reserve created by the assessee was a reserve or a provision.

So far as the aforesaid two aspects of the question are concerned we may at the outset note a few introductory facts leading to these proceedings. A

Introductory Facts

The concerned assessment years are 1967-68 and 1968-69, the previous years being calendar years 1966 and 1967 'respectively. The respondent-assessee is a company which at the relevant time was carrying on business at Baroda. The respondent was governed by the provisions of the Surtax Act. The respondent claimed that in computing its capital base for the relevant years gratuity reserve of Rs. 5,60,000 and reserve for doubtful debts of Rs. 85,000 should be taken into consideration. The Surtax Officer held that the said amounts cannot be considered for computation of capital. He accordingly excluded them from the capital computation in the assessment proceedings. Being aggrieved by the orders of the Surtax Officer the assessee carried the matter in appeal before the Appellate Assistant Commissioner of Surtax, B- Range, Baroda. The Appellate Assistant Commissioner following the decision of the Tribunal in S.T.A. Nos. 7 and 8 (Ahd.) of 1971-72 decided on 19th August 1973 which arose out of the assessee's surtax assessments for the assessment years 1965-66 and 1966-67 held that the aforesaid reserves should be considered as part of the capital while computing the capital base for calculation of statutory deduction. B C D

Being aggrieved by the order of the Appellate Assistant Commissioner the Revenue preferred appeals being S.T.A. Nos. 6 and 7 (Ahd.) of 1973-74. The Tribunal relying on its decision in S.P.T.A. No. 5 (Ahd.) of 1971-72 and S.T.A. Nos. 7-10 (Ahd.) of 1971-72 decided on 19th August 1973 confirmed the view taken by the Appellate Assistant Commissioner. Thereafter at the instance of the Revenue the aforesaid question was referred to the High Court, which as stated earlier, was reframed by the High Court. E F

We shall first deal with the question regarding the inclusion of Rs. 85,000 sought to be treated as reserve for meeting doubtful debts in the capital base of the respondent company. So far as this reserve is concerned, as noted earlier, the Appellate Assistant Commissioner as well as the Tribunal relied upon the assessments for the earlier years for the very same respondent- company for holding this reserve as includible in the capital base. The High Court also followed suit. In our view no exception can be taken to the aforesaid view of the High Court. Reasons are obvious. As G H

A noted by the Income Tax Appellate Tribunal in the present proceedings, it had already taken a similar view by its earlier order dated 19th August 1973 while considering the question of computation of capital base of respondent-assessee company itself for the previous years. The pertinent observations are found at page 25 of the Paper Book :

B "So far as Reserve for Doubtful debts is concerned, ordinarily the
C provision for doubtful debts is created with reference to the sundry
D debtors and shown as a deduction from the sundry debtors in the
E balance sheet. Such reserves, which are specifically created to write
F off the bad debts are usually in the nature of provision. In the
G instance case, the reserve was created out of P & L Account
H without reference to the outstanding sundry debtors and was not
created with a view of meeting any anticipated liability. We are
told that this amount was also written off as the General Reserve
Account in the year 1966. Having regard to the facts of the case,
we agree with the Appellate Asstt. Commissioner that the reserve
for doubtful debts was not in the nature of provision for meeting
any anticipated liability and as such should be included in the
computation of the capital base for both the years under appeal."

As a clear finding of fact was reached by the Tribunal that bad debt reserve
E was created out of Profit & Loss Account without reference to the out-
standing sundry debtors and was not created with a view of meeting any
anticipated liability it had to be held that the said amount which was set
apart for meeting bad and doubtful debts was by way of reserve and not a
provision. In the case of *Commissioner of Income-Tax, Kanpur v. Saran
F Engineering Co. Ltd. & Anr.*, (1986) 161 ITR 741. Sabyasachi Mukharji, J.
(as he then was) speaking for the Division Bench of this Court, while sitting
with R.S. Pathak, J., made the following pertinent observations in this
connection :

G "Where the liability has actually arisen or been anticipated
legitimately by the assessee though the quantum of the liability has
not been determined, a fund to meet such present liability cannot
be treated as a "reserve". A fund, however, created for payment of
a liability which had not already arisen or fallen due but is only a
provision with regard to the sum that might become liable to be
H paid is "other reserves" within the meaning of rule 1 of the Second

Schedule and should be taken into account in computing the capital of the company for the purpose of the Companies (Profits) Surtax Act, 1964." A

In connection with the question whether bad and doubtful debts reserve created by the assessee in that case was a reserve or not it was observed as under : B

"Bad and Doubtful Debts Reserve was created in 1956 through the Profit and Loss Appropriation account. The amount involved was 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 as 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 reasonably 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 the very nomenclature, this was not a reserve. The true nature of the transaction has to be examined." C D E

At page 746 of the Report applying the aforesaid principles to the case on hand it was held that in the light of the facts found so far as bad and doubtful reserves were concerned the amounts set apart must be treated as a reserve. On the facts of the present case, as noted earlier, it could not be said that there was any ascertained liability for which a provision was made by creating the aforesaid reserve for bad and doubtful debts. In the present case it was also not the Revenue's case that the amount set apart for bad and doubtful debts reserve was less than or equal to the amount necessary to be provided for meeting ascertained liability. On the other hand the amount appeared to be more than what was reasonably necessary to be provided for in respect of the bad and doubtful debts as the amount of bad and doubtful debts itself was not an ascertained amount. Consequently no fault can be found with the decision rendered by the authorities below and the High Court that the provision of Rs. 85,000 for doubtful debts had to be treated as reserve which could be legitimately included in computing the capital base of the respondent assessee company so far as H

A the relevant assessment years were concerned.

That takes us to the consideration of the question whether an amount of Rs. 5,60,000 set apart by way of gratuity for meeting the liability to pay gratuity to its employees, could be considered to be a reserve or a provision. So far as this question is concerned the Tribunal relying upon its earlier decision in case of respondent-assessee itself for the earlier assessment years noted what was decided in that earlier decision dated 19th August 1973 in paragraph 13 of that Order as under :

C "13. Keeping in mind the above decision, if we recall the facts of the case, it is clear that in the instant case, the reserve for gratuity was created as a reserve and not by means of provision against any ascertained liability. It is not disputed that the assessee company had not determined the amount credited to the aforesaid reserve account, with reference to the actuarial valuation and as such the accrual of liability would not arise, if the actuarial valuation was not ascertained. In Metal Box Company of India Ltd. case cited supra as we have stated in detail, it was not disputed that the amount of gratuity reserve was created on the basis of actuarial valuation and the liability, which actually arose during the relevant year was sought to be adjusted against this reserve. If the assessee company had made a provision against the anticipated liability of gratuity with reference to the actuarial valuation, then the department would have been correct in taking the sum as a provision and consequently disqualifying the said amount for inclusion in the computation of capital base. In the instant case, however, the facts are quite different. The amount standing to the Gratuity Reserve for the year ended 31st December, 1966 was transferred to the General Reserve Account. This was merely a reserve, which was kept back for future years without reference to any ascertained liability. The said amount in any case would be includible in computing the profits of the company. We, therefore, hold that, on the facts of the case, the contention canvassed by the assessee that the impugned amount be treated as a reserve for inclusion in the capital base has to be accepted. We, therefore, accordingly direct the Income-tax Officer to include the aforesaid amount in computation of capital base of the Company."

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The aforesaid view of the Tribunal has been accepted by the High Court. A

Learned counsel for the Revenue vehemently submitted that so far as this aspect is concerned it was assumed that merely because the assessee-company had not thought it fit to resort to any actuarial valuation and had styled the amount as forming part of a reserve, almost automatically the Surtax Officer had to treat the said amount as set apart by way of a reserve and not a provision. That this would amount to giving complete latitude to the concerned assessee-company. If the assessee-company resorts to any actuarial valuation of liability to pay gratuity to its employees then it would be a provision but if the assessee-company does not choose to do so, by its very inaction, it could insist that the provision made for discharging the liability to pay gratuity should be treated as a reserve. That such an absolute discretion given to the assessee would denude the Surtax Officer of his statutory power and obligation to compute the correct capital base of the assessee-company for the purpose of assessing the surtax liability of the concerned company. We find considerable force in the aforesaid contention of the learned counsel for the Revenue. B C D

In the case of *Metal Box Company of India Ltd. v. Their Workmen*, (1963) 73 ITR 53 a Division Bench of this Court consisting of J.M. Shelat and C.A. Vaidialingam, JJ., speaking through Shelat, J. posed two questions for consideration: E

"(1) Whether it is legitimate in such a scheme of gratuity to estimate the liability on an actuarial valuation and deduct such estimated liability in the P & L account while working out its net profits?

(2) if it is, whether such appropriation amounts to a reserve or a provision?" F

Considering these two questions the following pertinent observations were made at pages 67 and 68 of the Report :

".....In our view, an estimated liability under gratuity schemes such as the ones before us, even if it amounts to a contingent liability and is not a debt under the Wealth-tax Act, if properly ascertainable and its present value is fairly discounted is deductible from the gross receipts while preparing the P. & L. account. It is recognised in trading circles and we find no rule or direction in H

A the Bonus Act which prohibits such a practice.

B The next question is whether the amount so provided is a
C provision or a reserve. The distinction between a provision and a
D reserve is in commercial accountancy fairly well known. Provisions
E 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 (see *Spider 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)."

F The aforesaid decision was relied upon by a three member Bench of this
Court consisting of V.D. Tulzapurkar, E.S. Venkataramiah and Amarendra
Nath Sen, JJ., in the case of *Vazir Sultan Tobacco Co. Ltd. Etc. Etc. v.
Commissioner of Income-Tax, A.P. Etc. Etc.*, (1981) 132 ITR 559. In that
case this Court was concerned with a similar question which is posed for
our consideration in the present proceedings. Amongst other questions one
of the question which fell for consideration in that case was whether a
gratuity reserve created by the company was a reserve in the true sense of
G the term or was merely a provision which could not be included in the
capital base of the assessee-company for computing its surtax liability
under the Surtax Act. In this connection Tulzapurkar, J., speaking for
himself and Venkataramiah, J. made the following pertinent observations:

H "The expression "reserve" has not been defined in the Super Profits

Tax Act, 1963, or the C.(P.) S.T. Act, 1964. the dictionaries do not
make any distinction between the two concepts "reserve" and
"provision" while giving their primary meanings, whereas in the
context of those Acts a clear distinction between the two is implied.
Though the expression "reserve" is not defined, since it occurs in
taxing statutes applicable to companies only and to no other
assessable entities, the expression has to be understood in its
popular sense, that is to say, the sense or meaning that is attributed
to it by men of business, trade and commerce and by persons
interested in or dealing with companies. Therefore, the meanings
attached to the words "reserves" and "provisions" in the Companies
Act, 1956, dealing with the preparation of the balance-sheet and
the profit and loss account would govern their construction for the
purposes of the two enactments. The broad distinction between
the two is that whereas a "provision" is a charge against the profits
to be taken into account against gross receipts in the profit and
loss account, a "reserve" is an appropriation of profits, the asset or
assets by which it is represented being retained to form part of the
capital employed in the business."

It was further observed as under :

"Ordinarily, an appropriation to gratuity reserve will have to be
regarded as a provision made for a contingent liability, for, under
a scheme framed by a company, the liability to pay gratuity to its
employees on determination of employment arises only when the
employment of the employee is determined by death, incapacity,
retirement or resignation - an event (cessation of employment)
certain to happen in the service career of every employee;
moreover, the amount of gratuity payable is usually dependent on
the employee's wages at the time of determination of his employ-
ment and the number of years of service put in by him and the
liability accrues and enhances with the completion of every year
of service; but the company can work out on an actuarial valuation
its estimated liability (i.e., discounted present value of the liability
under the scheme on a scientific basis) and make a provision for
such liability not all at once but spread over a number of years. It
is clear that if by adopting such scientific method any appropriation
is made such appropriation will constitute a provision representing

A fairly accurately a known and existing liability for the year in question : if, however, an *ad hoc* sum is appropriated without resorting to any scientific basis such appropriation would also be a provision intended to meet a known liability, though a contingent one, for, the expression "liability" occurring in cl. 7(1)(a) of Part III of the Sixth Schedule to the Companies Act includes any expenditure contracted for and arising under a contingent liability; but if the sum so appropriated is shown to be in excess of the sum required to meet the estimated liability (discounted present value on a scientific basis) it is only the excess that will have to be regarded as a reserve under cl. 7(2) of Pt. III of Sch. VI to the Companies Act, 1956."

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For the aforesaid observations strong reliance was placed by the Court on the earlier judgment of this Court in *Metal Box Company's* case (*supra*). Applying this principle to the facts of the case before the Court, Tulzapurkar, J., at page 574 of the Report laid down as under :

D ".....the assessee-company did not clarify by placing material on record as to whether the appropriation of the amount was based on any actuarial valuation or whether it was an appropriation of an *ad hoc* amount, - an aspect which, as we shall presently point out, has a vital bearing on the question whether the appropriation could be treated as a provision or a reserve. In the absence of proper material touching this vital aspect, we are afraid, the issue in question will/have to be remanded to the taxing authorities through the Tribunal for disposal in the light of the well settled principles in that behalf, which we shall presently indicate."

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F On the basis of the aforesaid state of record before the Court the following directions in *Vazir Sultan Tobacco Co.'s* case (*supra*) were given at page 578 of the Report:

G "...Since in the instant case sufficient material throwing light on the above aspects of the question has not been made available, we think, it will be in the interest of justice to remand the case through the Tribunal to the taxing authority to decide the issue whether the concerned amount (Rs. 9,08,106) set apart and transferred to gratuity reserve by the assessee-company was either a provision or a reserve and if the latter to what extent? The taxing authority will

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decide the issue in the light of the above principles after giving an opportunity to the assessee-company to place additional relevant materials before it."

In the present case also almost a parallel situation has emerged. The assessee-company had not resorted to any actuarial valuation while creating gratuity reserve of Rs. 5,60,000. Consequently it was not possible to find out as to whether the amount set apart was required to meet the discounted value of estimated liability or was in excess thereof. It is obvious that if there was any excess amount set apart for the purpose it would be treated as a reserve which could be included in the capital base for the purpose of the Surtax Act. It is axiomatic that if discounted present value of gratuity liability on a scientific basis was arrived at by the assessee-company by resorting to actuarial valuation of such liability it would have supplied a basis for the Surtax Officer to compute the capital base by treating the said amount as a provision and that if it was further found that the amount set apart for meeting such liability was in excess of such provision then the excess amount could have been determined for being included as a reserve in the capital base. But in the absence of assessee-company undertaking such an exercise, it was not as if the Surtax Officer was helpless or was necessarily required to accept as gospel truth what the assessee submitted for treating the entire amount set apart as a reserve. The Surtax Officer under such circumstances could have legitimately resorted to an estimate for ascertaining the extent of provision for such contingent liability for gratuity required to be met by the assessee-company in the concerned assessment years. It would have been equally open to the Surtax Officer to call upon the assessee-company to get actuarial valuation of such liability to enable the Surtax Officer to compute the correct capital base of the company in this connection. As no such exercise was done both by the assessee as well as by the Surtax Officer the issue in question will have to be remanded to the taxing authority through the Tribunal for disposal in the light of the well settled principles in this behalf as discussed earlier by us. The course adopted by this Court in *Vazir Sultan Tobacco Co.'s* case (supra), in this connection, is therefore required to be adopted in the present case also.

In the result, these appeals are partly allowed. The reframed question is answered partly in the affirmative in favour of the assessee and against the Revenue in so far as the reserve for doubtful debts and rehabilitation

- A reserve are concerned. However, so far as the answer given by the High Court on gratuity reserve in concerned it is set aside and the issue regarding gratuity reserve is directed to be remanded through the Tribunal for re-consideration by the Surtax Officer for deciding it afresh in the light of the aforesaid principles, after giving a opportunity to the assessee-company to place additional relevant materials before him. As no one has appeared for the respondent there will be no order as to costs.
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M.K.

Appeals partly allowed.