COMMISSIONER OF INCOME TAX, TRIVANDRUM

v.

M/S TRANVANCORE TITANIUM PRODUCTS LTD.

DECEMBER 7, 2000

[S.P. BHARUCHA, D.P. MOHAPATRA AND Y.K. SABHARWAL, JJ.]

Surtax :

Companies (Profits) Surtax Act, 1964—Section 18—Capital—Computation of—Amount lying in Loan Redemption Reserve Account—Reserve or Provision—Held, the amount has been set aside to clear a known liability—Hence it is a provision and not a reserve—Thus it could not be excluded from capital.

Respondent-assessee obtained loan of Rs. 491 lakhs from State Government over a period from 1968 to 1983 for expansion of its plant. Amount outstanding towards principal to the State Government was Rs. 143 lakhs for the financial year 1986-87. An amount of Rs. 1 Crore was lying in 'Loan Redemption Reserve' account. In computing the capital for the purposes of the Act, the Revenue treated the amount as a provision and not a reserve and therefore excluded from capital. Commissioner (Appeals) dismissed the appeal of the assessee. Tribunal allowed the appeal of the assessee directing the Revenue to include the amount Rs. 1 crore in the capital for computation of surtax. On reference by the Revenue, High Court answered the question in favour of the assessee. Hence the appeal by the Revenue.

In appeal to this Court, Revenue contended that the amount is in nature of sinking fund for clearing an ascertained liability; that the amount was not set aside for acquiring an asset; and that the amount was a provision and not a reserve.

Allowing the appeal, the Court

HELD : 1.1. The true nature and character of an appropriation has to be determined with reference to the substance of the matter. One must have regard to the intention with which and the purpose for which the appropriation has been made, such intention and purpose being gathered from the

surrounding circumstances. If any retention or appropriation of a sum falls within the definition of 'provision', it can never be a reserve but it does not follow that if the retention or appropriation is not a 'provision', it is automatically a reserve. The fact that the amount has been set apart for redeeming liabilities makes it obvious that the intention is for clearing liabilities and not acquiring an asset. In the instant case, the Tribunal is wrong in treating the amount as 'reserve'. [467-E, F, G]

1.2. The amount of Rs. 1 crore lying in 'Loan Redemption Reserve' cannot be regarded as a 'reserve' It has to be regarded as a 'provision'. The amount was set apart to meet a loan liability. The amount set apart is less than the assessee's liabilities. It cannot be regarded as an asset. [464-B, D]

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

National Rayon Corporation Ltd. **v.** *Commissioner of Income-tax,* **(1997) 227 ITR 764;** *C.I.T.* **v.** *Century Spinning & Manufacturing Co. Ltd.,* **(1953) 24 ITR 499 and** *Metal Box Company of India Ltd.* **v.** *Their Workmen,* **(1969) 73 ITR 53, referred to.**

C.I.T. **v.** *Pieco Electronics & Electricals,* **(1987) 166 ITR 299 Cal, referred to.**

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 3825 of 1999.

From the Judgment and Order dated 18.8.98 of the Kerala High Court in I.T.R. No. 89 of 1993.

Harish N. Salve, Solicitor General, Ranbir Chandra, S.W.A. Quadri and Ms. Sushma Suri for the Appellant.

C.S. Vaidyanathan and E.M.S. Anam for the Respondents.

The Judgment of the Court was delivered by

Y.K. SABHARWAL, J. This appeal has been filed by the Revenue to challenge the correctness of the judgment and order of the High Court of Kerala dated 18th August, 1998. The case relates to assessment year 1985-86. On reference under Section 256(1) of the Income Tax Act, 1961 as applied to surtax by Section 18 of the Companies (Profits) Surtax Act, 1964 the questions that arose for consideration of the High Court were:

"(a) Whether, on the facts and in the circumstances of the case, the Appellate Tribunal is right in law in holding that the loan redemption reserve amount to Rs. 1 crore is a reserve and not a provision and is to be included in the computation of capital for the purpose of surtax? A

(b) Whether, on the facts and in the circumstances of the case and in view of the Supreme Court decision in the case of *Vazir Sultan Tobacco Co. Ltd. (132 ITR 559),* the Appellate Tribunal is right in holding so?" B

By the impugned judgment the High Court answered the questions in the affirmative, that is, in favour of the respondent-assessee and against the Revenue. C

The respondent had obtained Rs. 491 lakhs as loan from Government of Kerala from 1968 to 1983 for the expansion of the Titanium Dioxide Plant. It could repay upto March, 1987 only a sum of Rs. 115.50 lakhs. The balance of the loan outstanding as on 31st March, 1987 was Rs. 377.50 lakhs which D included a sum of Rs. 245 lakhs being overdue instalment of principal from 1983 onwards. Out of the sum of Rs. 245 lakhs outstanding, two instalments totalling Rs. 102 lakhs were repaid to the Government during June 1987 and the arrears due to the Government towards principal of the loan amount as on the date of the presentation of the annual report of the company for the E financial year 1986-87 was Rs. 143 lakhs. The assessing authority disallowed the sum of Rs. 1 crore standing in the credit side under the head 'loan redemption reserve' holding that even if it is conceded that it is an appropriation from profit by way of a fund even then it partakes the nature of the 'sinking fund' only which can be only for clearing of an ascertained liability. It further held that the fact that a sum has been set apart for F redeeming liabilities makes it obvious that the intention is for clearing a liability and not acquiring an asset. The assessing authority held the amount was a 'provision' and not a 'reserve. The appeal preferred by the respondent was dismissed on 31st January, 1990 and the assessment order was upheld by the Commissioner of Income-tax (Appeals). The Income-tax Appellate G Tribunal, however, by order dated 25th September, 1991 allowed the appeal of the assessee and directed the assessing officer to include the sum of Rs. 1 crore in the capital of the company for the purpose of surtax. The Tribunal held that there was no stipulation by the Government for the creation of loan redemption reserve; on its own volition the assessee had been creating a loan redemption reserve by making an appropriation of profit of Rs. 10 lakhs each H

A year beginning from 1970; the total reserve amount to Rs. 100 lakhs remained undisturbed till the year 1987 and in the year 1988 the same was transferred to the general reserve and that the amount appropriated was not against the profits but was from out of the profit and the loan redemption reserve did not bring into existence any fresh liability because the liability was already in existence. These are the circumstances under which the two questions noticed B above were answered by the High Court in favour of the respondent-assessee.

The point for determination is whether the loan redemption reserve amount to Rs. 1 crore is a reserve or it is a 'provision'. It may be noticed that the tribunal in its order had also relied upon the decision of the Calcutta High Court in *C.I.T.* v. *Pieco Electronics & Electricals,* (1987) 166 ITR 299. That C decision has also been referred in the impugned judgment of the High Court. The decision of the Calcutta High Court in Pieco Electronics (supra) has been overturned by this Court in *National Rayon Corporation Ltd.* v. *Commissioner of Income-tax,* (1997) 227 ITR 764. *Relying upon Vazir Sultan Tobacco Co. Ltd.* v. *Commissioner of Income-tax, A.P.,* (1981) 132 ITR 559 the Court rejected D the contention that if the redemption or appropriation of a sum out of profits and surpluses was for a unknown liability or for a liability which did not exist on the relevant date, it must be regarded as a reserve. The contention was held to be fallacious. The expressions 'provision' and 'reserve' have not been defined in the Companies (Profits) Surtax Act, 1964. After referring to the dictionary meaning of these expressions and bearing in mind the distinction E between the two concepts as known in the commercial accountancy and decision of this Court in *C.I.T.* v. *Century Spinning & Manufacturing Co. Ltd.*. (1953) 24 ITR 499 and *Metal Box Company of India Ltd.* v. *Their Workmen,* (1969) 73 ITR 53 it was held in Vazir Sultan's case (supra):

F "In other words 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 p & l 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. Bearing in mind the aforesaid broad distinction we will briefly indicate G how the two concepts are defined and dealt with by the Companies Act, 1956.

Under s.210 of the Companies Act, 1956, it is incumbent upon the board of directors of every company to lay before the annual general meeting of its shareholders, (a) the annual balance-sheet, and (b) the H profit and loss account pertaining to the previous financial year.

Section 211 (1) provides that every balance-sheet of a company shallgive a true and fair view of the state of affairs of the company as at the end of the financial year and shall, subject to the provisions of this section, be in the form set out in Pt. I of Sch. VI, or near thereto as circumstances admit or in such other form as may be approved by the Central Govt. either generally or in any particular case, while s. 211 (2) provides that every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Pat. II of Sch. VI, so far as they are applicable thereto. In other words the preparation of balance-sheet as well as profit and loss account in the prescribed forms and laying the same before the shareholders at the annual general meeting are statutory requirements which the company has to observe. The form of balance-sheet as given in Pt. I of Sch. VI contains separate heads of "Reserves and Surpluses" and "Current Liabilities and Provisions" and under the sub-head "Reserves" different kinds of reserves are indicated and under sub-head "Provisions" different types of provisions are indicated. Part III is the interpretation clause setting out the definitions of various expressions occurring in Pts I and II and the expressions "reserve", "provision" and "liability" have been defined in cl.7 thereof. Material portion of cl.7 of Pt.III runs as under:

'(1) For the purposes of Parts I and II of this Schedule, unless the context otherwise requires,-

(a) the expression 'provisions' shall, subject to sub-clause (2) of this clause, mean any amount written off 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 off 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; .....

and in this sub-clause the expression 'liability' shall include all liabilities in respect of expenditure contracted for an all disputed or contingent liabilities.

A (2) Where-

(a) any amount written off or retained by way of providing for depreciation renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

B (b) any amount retained by way of providing for any known liability;

is in excess of the amount which in the opinion of the directors, is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a 'reserve' and not C a 'provision'.

On a plain reading of cl. 7(1)(a) and (b) and cl. 7(2) above it will appear clear that though the term "provision" is defined positively by specifying what it means the definition of "reserve" is negative in form and not exhaustive in the sense that it only specifies certain D amounts which are not to be included in the term "reserve". In other words the effect of reading the two definitions together is that if any retention or appropriation of a sum falls within the definition of "provision" it can never be a reserve but it does not follow that if the retention or appropriation is not a provision it is automatically a E reserve and the question will have to be decided having regard to the true nature and character of the sum so retained or appropriated depending on several factors including the intention with which and the purpose for which such retention or appropriation has been made because the substance of the matter is to be regarded and in this context the primary dictionary meaning of the term "reserve" may F have to be availed of. But it is clear beyond doubt that if any retention or appropriation of a sum is not a provision, that is to say, if it is not designated to meet depreciation, renewals or diminution in value of assets or any known liability the same is not necessarily a reserve. We are emphasising this aspect of the matter because during the hearing G almost all counsel for the assesses strenuously contended before us that once it was shown or became clear that the retention or appropriation of a sum out of profits and surpluses was for an unknown liability or for a liability which did not exist on the relevant date it must be regarded as a reserve. The fallacy underlying the contention becomes apparent if the negative and non-exhaustive aspects of the H definition of reserve are borne in mind. Having regard to the type of

definitions of the two concepts which are to be found in cl.7 of Pt. III the proper approach in our view would be first to ascertain whether the particular retention or appropriation of a sum falls within the expression "provision" and if it does then clearly the concerned sum will have to be excluded from the computation of capital, but in case the retention or appropriation of the sum is not a provision as defined, the question will have to be decided by reference to the true nature and character of the sum so retained or appropriated having regard to several factors as mentioned above and if the concerned sum is in fact a reserve then it will be taken into account for the computation of capital."

In view of the aforestated legal position, the aspects taken into consideration by the tribunal and affirmed by the High Court that there was no stipulation by the Government for creation of loan redemption reserve; that the assessee had not kept to the schedule for repayment; that the assessee, on its own volition, had created a loan redemption reserve by making appropriation of profit of Rs. 10 lakhs each year beginning from 1970; that the total reserve amounting to Rs. 100 lakhs remained undisturbed till the year 1987 and in the year 1988 the same was transferred to general reserve and that the balance sheet showed that the amounts credited to the 'loan redemption reserve' were not invested outside the company but remained internally invested, on the facts found, were not relevant for determining as to whether the amount was an asset or provision. As held in *Vazir Sultan,* the true nature and character of an appropriation has to be determined with reference to the substance of the matter, one must have regard to the intention with which and the purpose for which the appropriation has been made, such intention and purpose being gathered from the surrounding circumstances. The *Vazir Sultan's* case (supra) also holds that if any retention or appropriation of a sum falls within the definition of 'provision' it can never be a reserve but it does not follow that if the retention or appropriation is not a 'provision' it is automatically a reserve. The fact that amount has been set apart for redeeming liabilities makes it obvious that the intention is for clearing liabilities and not acquiring an asset. Bearing in mind these aspects, it is clear that the amount in question cannot be regarded as a 'reserve'. It has to be regarded as a 'provision'. Clearly the amount was set apart to meet a loan liability. It may also be noticed that the amount set apart is less than the respondent's liabilities. It cannot be regarded as an asset. The decision in *Vazir Sultan's* case (supra) was not correctly appreciated by the High Court. In this view, the questions deserve to be answered in the negative.

A For the aforesaid reasons, we allow the appeal and answer the questions in the negative, that is, in favour of the Revenue and against the assessee, upholding the order of the assessing authority. The parties are left to bear their own costs.

B.S. Appeal allowed.