

Indian Tube Co. P. Ltd.

Vs

Commissioner of Income-Tax.

Civil Appeal No. 1254 of 1976

(K. Ramaswamy, B.P. Jeevan Reddy JJ)

14.01.1992

JUDGMENT

K. RAMASWAMY J. -

1. This appeal, by certificate under section 261 of the Income-tax Act, 1961 (for short "the Act"), granted by the Calcutta High Court (see [1981] 132 ITR 293 (Appx.), arises from a reference under section 256(1) of the Act and section 18 of the Companies (Profits) Surtax Act, 1964 (for short "the Surtax Act"), on the question of law which was answered in the negative and against the appellant thus :

"Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that a sum of Rs. 76,00,000 which was paid as dividend for the year 1962 following the general meeting dated 31st May, 1963, out of the dividend reserve of Rs. 90,00,000 as on the 1st January, 1963, was not to be taken into account for the computation of capital as on the 1st January, 1963, in pursuance of the rules of the Second Schedule to the Companies (Profits) Surtax Act, 1964 ?"

The previous year relevant to the assessment year, in relation to the paid up capital, the reserves, the debentures, etc., under rule 1 of the Second Schedule to the Surtax Act, is the calendar year 1963. The assessment year is 1964-65. The position of the capital was to be considered as on the 1st day thereof, i.e., January 1, 1963. The appellant claimed in its assessment a sum of Rs. 90,00,000 transferred to the dividend reserve as a reserve entering into capital computation. The assessing authority excluded a this sum from the computation of the capital but on appeal the Appellate Assistant Commissioner found it to be a reserve created out of amounts which had not been allowed as deduction for computing the profits of that year. Accordingly, he held that Rs. 90,00,000 was the reserve fund qualified for inclusion under rule 1(iii) of the Second Schedule to the Surtax Act. On appeal by the Revenue, the Income-tax Appellate Tribunal held that "the assessee had appropriated Rs. 14,00,000 to the dividend reserve"; Rs. 76,00,000 was taken as liability as on January 1, 1963, and as the creation of Rs. 90,00,000 was to be taken as reserve on January 1, 1963, only a sum of Rs. 14,00,000 had been transferred to the reserve account. Accordingly, the Tribunal held that a sum of Rs. 14,00,000 only would be treated as a provision and directed modification of the capital competition accordingly. On reference at the behest of the appellant, the High Court answered the question in the negative and against the assessee.

Section 4 of the Surtax Act, the charging section, postulates that, subject to the provisions contained therein, there shall be a charge on every company for every assessment year commencing on and from the 1st day of April, 1964, a tax in respect of so much of its chargeable profits of the previous

year or previous years, as the case may be, as exceeds the statutory deduction, at the rate or rates specified in the Third Schedule. Section 2(5) defines chargeable profits as the total income of an assessee computed under the Act for any previous year or years as the case may be and adjusted in accordance with the provisions of the First Schedule. Section 2(8) accords statutory deduction of an amount equal to 10 per cent. of the capital of the company as computed in accordance with the provisions of the Second Schedule or an amount of two hundred thousand rupees whichever is greater. The First Schedule gives the procedure to compute the capital of the company for the purpose of surtax. Rule 1 of the Second Schedule postulates that, subject to the other provisions contained in the Second 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 its, paid-up share capital, its reserves, if any, and other reserves as reduced by the amounts credited to such reserves as have been allowed as a deduction in computing the income of the company for the purpose is of the Indian Income-tax Act, its debentures, if any, or any borrowed amounts. The Explanation thereto provides thus :

"For the removal of doubts it is hereby declared that any amounts 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 of Balance-sheet gives in Part I of Schedule VI to the Companies Act, 1956 (1 of 1956), shall not be regarded as a reserve for the purpose of computation of the capital of a company under the provisions of this Schedule."

Section 217 of the Companies Act, 1956, enjoins the company "to attach to every balance-sheet laid before a company in general meeting. A report by its board of directors, with respect to -

- (a) the state of the company's affairs;
- (b) the amounts, if any, which it proposes to carry to any reserves in such balance-sheet; and
- (c) the amount, if any, which it recommends should be paid by way of dividend;..."

Regulation 87 of Table A of the First Schedule empowers the board to recommend any dividend and set aside, out of the profits of the company, such sums as it thinks proper as a reserve or reserves, etc.

It is found as a fact that on May 1, 1963, in respect of the accounts for the year 1962 in the directors' meeting of the assessee-company, it approved the transfer of a sum of Rs. 90,00,000 out of the profits for the year to a "Dividend Reserve Account" 12-1/2% of which amounted to Rs. 76,00,000 on the ordinary shares on the amount paid on those shares prior to December 31, 1962. On May 31, 1963, in the general meeting, the accounts were passed by the shareholders and the dividend as recommended by the directors was declared. Subsequently, the dividend was paid and it was adjusted by transferring Rs. 76,00,000 from the dividend reserve account through the profit and loss appropriation account.

In its report, the board of directors stated that the auditor's report presented the "company's affairs as on December 31, 1962, and its profits for the year ended on that date". In the balance-sheet, under the heading "Liabilities" as on December 31, 1962, under the sub-heading "Provisions" item (c)

"Proposed Dividend" shows the figure to be "nil". The Schedule forming part of the balance-sheet under the head "Reserves and Surplus" under item (e), the Dividend Reserve Account stated that the transfer from the profit and loss account was Rs. 90,00,000.

The question, therefore, is whether the sum of Rs. 90,00,000 or any part thereof would be a reserve for computing the capital as on January 1, 1963. From the above facts, it is clear that a sum of Rs. 76,00,000 earmarked by the directors' recommendation dated May 3, 1963, as dividend, was approved by the general body meeting of the shareholders on May 31, 1963, and the same was paid over to the shareholders and, in the balance-sheet, this liability was treated as on December 31, 1962, to be nil. The purpose of the Surtax Act is to impose Surtax on the profits of a company. The Act also intended to impose tax on the net profits after allowing deductions in terms of the Surtax Act and the procedure for computation thereof was indicated in the Second schedule. In the computation of the profits, the capital or reserve forming capital of the company had to be brought up for a year up to a particular date. On the facts of this case, the crucial date is January 1, 1963. If it was reasonably practicable to make up the accounts as on that date and present the same to the directors of the company as on December 31, 1962, and the balance-sheet thereof is placed before the general body meeting of the shareholders as on that date, they could have made up their minds on that date and declared the intention of appropriating the dividend or any other sums to reserves of different heads of liabilities. But the fact remains that it was not done for the obvious reason that the calculation or collection of the figures of all the items of income and expenditure of the company of the previous year ending December 31, 1962, was bound to take some time and it was not done. The fact remains that the shareholders in the general body meeting held on May 31, 1963, resolved to appropriate Rs. 76,00,000 towards dividend payable to the shareholders and, accordingly, it was appropriated and paid over. The question therefore, is whether the amount of Rs. 76,00,000 appropriated relates back as on January 1, 1963. On recommendation by the board of directors and acceptance thereof by the general body of the shareholders to pay dividend at a particular percentage, the liability came into existence and, by their act of appropriation by adjusting the reserve as against the liability, it became crystallized. There is nothing to withhold payment in specie to the respective shareholders which is merely a ministerial act. The modus operandi adopted in making the entries or the nomenclature chosen to be given are not conclusive but the heart of the matter is the nature and substance of the manner in which the company's accounts are prepared. The true nature and character of the disputed sum, therefore, must be determined with reference to the substance of the matter and not by the mere entry or nomenclature which the assessee-company had chosen to give to it. If an amount is set aside out of profits and other surpluses, not to meet any liability, contingency, commitment or diminution in the value of assets known to exist at the time of the balance-sheet, it was a reserve. The amount set aside out of profits and other surpluses to provide for any known liability of which the amount could be determined with certainty, is a provision. Creating of reserve out of the profits is stage distinct in point of fact and anterior in point of time to the stage of making a recommendation for payment of dividend by the general body of shareholders. A conjoint reading of the scheme of the Surtax Act and the Companies Act suggests that the appropriation made by the body of directors by recommending payment of dividend, in the nature of things, does not constitute a reserve. The resolution by the general body of the shareholders to declare dividend out of profits at a particular percentage crystallized into a liability, and subsequent payment relates back to the relevant date, namely, the closing of the accounting year during which the liability had arisen. Therefore, the resolution of the general body of the shareholders dated May 31, 1963, had retrospective effect inasmuch as it refers to the profits of the previous year ending December 31, 1962. Therefore, a sum of Rs. 76,00,000 worked out for the payment of dividend and appropriated by subsequent resolution was only a provision and the

residue of Rs. 14,00,000 was reserve.

In *Metal Box Co. of Indian Ltd. v. Their Workmen* [1969] 73 ITR 53, this court was concerned with whether the appropriation amounted to a reserve or provision. Dealing with the question of payment of bonus to the workmen and appropriation thereof on that account, this court held that the distinction between a provision and a reserve was, in the commercial accountancy, fairly well known. Provisions were made against anticipatory losses and contingencies were charged against profits and they had been taken into account against gross receipts in the profit and loss account and balance-sheet. On the other hand, reserves were appropriation of profits, the assets by which these were represented being retained to form part of capital employed in the business. Provisions were usually shown in the balance-sheet by deduction from the assets in respect of which those were made whereas general reserve and reserve fund were shown as part of the proprietor's interest. An amount set aside out of profits and other surpluses, not designed to meet a liability, contingency, commitment or diminution in the value of assets known to exist on the date of the balance-sheet was reserve but an amount set aside out of profits and other surpluses, to provide for a known liability of which the amount could not be determined with substantial accuracy was a provision. In *CIT v. Mysore Electrical Industries Ltd.* [1971] 80 ITR 566, a Constitution Bench of this court held that the determination of the directors to appropriate the amounts to the three items of reserve on August 8, 1963, had to be related to April 1, 1963, i.e., the beginning of the accounts for the new year and had to be treated as effective from that date and the three items had to be added to the other items for the computation of the capital of the respondent as on April 1, 1963, under rule 1 of Schedule II to the Surtax Act. In that case, the Revenue contended that since the appropriation was made after the accounting year, it would not relate back to the assessment year. Rejecting that contention, this court held that although such allocation was factually not possible on the very first day of a year, allocation on a later day should be treated as effective from that date to view of the fact that the division of undistributed profits became effective from that date. The case of *Vazir Sultan Tobacco Co. Ltd. v. CIT* [1981] 132 ITR 559 (SC) relied on by the assessee, far from helping the appellant, goes against the contention of learned counsel for the appellant, Construing section 217 of the Companies Act, 1956, and the Schedule, this court held thus (at p. 570) :

"On a plain reading of clause 7(1) (a) and (b) and clause 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 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 reserve but it does not follow that if the retention or appropriation is not a provision it is automatically a 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 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 hearing almost all counsel for the assessee 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 became apparent if the negative

and nonexhaustive aspects of the definition of reserve are borne in mind. Having regard to the type of definitions of the two concepts which are to be found in clause 7 of part 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 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."

This court, in *Hyco Products (P.) Ltd. v. CIT* [1981] 132 ITR 559, approved the ratio of the Bombay High Court in Tax Reference Case No. 5 of 1978, of *Hyco Products (P.) Ltd.*, Bombay. The question therein related to the assessment year 1974-75. The relevant previous year being the calendar year 1973 and the material date being January 1, 1973, after the accounts of the year were finalized, the directors transferred, out of the profits of Rs. 61,03,382 of that year, a sum of Rs. 29,77,000 to the general reserve. With such a transfer, the general reserve of the assessee-company as on January 1, 1973, stood at Rs. 86,07,712. (at the end of the calendar year 1972.) In the annual general meeting held on June 30, 1973, dividend of Rs. 3,10,450 was declared by the shareholders and the same was soon thereafter paid out of the said general reserve. In the surtax assessment proceedings under the 1964 Act, the assessee claimed that the entire general reserve which stood at Rs. 86,07,712 on January 1, 1973, should be taken into account while computing the capital of the assessee- company. It was negatived by the taxing officer who deducted Rs. 3,10,450 from the general reserve and the balance was added to the capital. The Appellate Assistant Commissioner and the Income-tax Appellate Tribunal confirmed the order. On a reference, the High Court upheld the order which was approved by this court.

Thus we have no hesitation to hold that though the general body of the shareholders resolved and appropriated on May 31, 1963, the dividend of Rs. 76,00,000 from the reserve of Rs. 90,00,000, it related back to the relevant assessment year and, therefore, as on January 1, 1963, Rs. 76,00,000 was a provision and cannot be computed as capital. Only Rs. 14,00,000 would be treated to be a reserve. The Tribunal and the High Court, therefore, have correctly laid down the law and it does not warrant interference. The appeal is, accordingly, dismissed, but, in the circumstances, parties are directed to bear their own costs.

Appeal dismissed.

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