SUPREME COURT OF INDIA

Commissioner of Income Tax, New Delhi

Vs

Oriental Fire and General Insurance Company Limited

Appeal (Civil) 2741 of 2007; Civil Appeal No. 2741 of 2007 [Arising Out of S.L.P. (Civil) Nos. 1008-1010 of 2005] W I T H Civil Appeal Nos. 2742, 2743, 2744, 2745 of 2007 [Arising Out of S.L.P. (Civil) Nos.2037 of 2005, 5350, 5351 and 10820 of 2006]

(Markandeya Katju and S. B. Sinha, JJ)

18.05.2007

JUDGMENT

S. B. SINHA, J.

1. Leave granted in all the Special Leave Petitions.

2. Respondent is a subsidiary to the General Insurance Corporation of India. It is wholly a government owned company engaged in the business of general insurance. It is an income-tax asessee. Its affairs, indisputably, are governed by the provisions of the Insurance Act, 1938(for short, 'the 1938 Act). For the assessment years 1974-75, 1975-76 and 1978-79, it filed its income tax returns. Such returns were filed relying on or on the basis of the annual accounts furnished by it before the Controller of Insurance.

3. The Assessing Officer opined that Respondent was not entitled to any deduction in respect of the provisions of taxation by way of "reserve for bad and doubtful debts" and "entertainment allowance". The Commissioner (Appeals), however, in respect of the assessment year 1974-75 allowed various deductions and the order of the Assessing Officer disallowing certain expenditure

was set aside by orders dated 09.02.1979 and 09.09.1980.

4. Both the orders were questioned by the Revenue before the Income Tax Appellate Tribunal (for short, 'the Tribunal). By reason of an order dated 30.11.1981, the Tribunal held that the Assessing Officer was not correct in refusing to accede to the deductions under the aforementioned heads claimed by the assessee.

5. The following questions of law were referred to the High Court under Section 256 of the Income Tax Act, 1961(for short, 'the 1961 Act').

"1. Whether on the facts and in the circumstances of the case, and on a true interpretation of section 44 of theIncome Tax Act, 1961read with Rule 5 of the First Schedule to the said Act, the Tribunal was right in confirming the addition of the following amounts to the Balance of profits disclosed by the annual accounts of the assessee Insurance Company

i) Tax deducted at sourceRs.76, 74, 713/-ii)Provision for taxationRs.6, 57, 00, 000/-.TotalRs.7, 33, 74, 713/-

(This question is referred at the instance of the assessee for the assessment year 1974-75)

2. Whether on the facts and in the circumstances of the case, the Tribunal was correct in law in holding that reserve for bad and doubtful debts cannot be added to the Balance of profit disclosed in the annual accounts of the assessee insurance company ?

(This question is referred at the instance of Revenue for the assessment year 1974-75)"

6. The High Court, however, by reason of the impugned judgment answered the said reference in favour of the respondent and against the Revenue. Indisputably, the question as to whether the respondent was entitled to deductions under the head "Entertainment Allowance" is not in question before us.

7. Mr. Mohan Parasaran, the learned Additional Solicitor General appearing on behalf of the Revenue, would submit that the terms 'provision' and 'reserve' connote two different meanings, and, thus, there cannot be any provision for "bad and doubtful debts" and in that view of the matter, the High Court committed a serious error in passing the impugned judgment.

8. The Assessing Authority, the learned counsel would point out, has assigned sufficient and cogent reason for arriving at its decision. It was furthermore argued that the provisions for tax cannot be claimed to be an expenditure and in that view of the matter the Assessing Officer in regard to the

concept of provision for tax was entitled to invoke its jurisdiction in arriving at a finding as to whether the assessee was entitled to the deductions claimed by it or not.

9. Mr. M.S. Syali, the learned Senior Counsel appearing on behalf of the assessee, on the other hand, would support the impugned judgment.

10. Determination of liability of income tax under the provisions of the 1961 Act for the purpose of computation of income of an assessee, inter alia, for carrying on business in insurance is governed by Section 44 thereof and Rule 5(a) of the First Schedule appended thereto, which read as under :

"S.44.-Notwithstanding anything to the contrary contained in the provisions of this Act relating to the computation of income chargeable under the head "Interest on securities", "Income from house property, capital gains or Income from other sources, or in sections 28 to 43 A, the profits and gains of any business of insurance, including any such business carried on by a mutual insurance company or by a cooperative society, shall be computed in accordance with the rules contained in the First Schedule."

"Rule 5(a).- The profits and gains of any business of insurance other than life insurance shall be taken to be the Balance of the profits disclosed by the annual accounts, copies of which are required under the Insurance Act, 1938(4 of 1938) to be furnished to the Controller of Insurance, subject to the following adjustments :

(a) Subject to the other provisions of this rule, any expenditure or allowance which is not admissible under the provisions of Sections 30 to 43A in computing the profits and gains of a business shall be added back."

11. Section 44 contains a non obstante clause. It provides for a special mode in which the assessee carrying on business, inter alia, in general insurance should be assessed.

12. The reason for it is not far to seek as the matter relating to "carrying on business" in General Insurance is covered by the 1938 Act. By reason of Section 11 of the 1938 Act every insurer is required to prepare : (a) Balance Sheet; (b) Profit and Loss Account ; and (c) a revenue account; at the expiry of each calendar year wherefor special forms are prescribed. Their Balance Sheets and Profit and Loss Accounts etc. are audited by the auditors. Prudential regulation in the context of insurance business has seminal importance as it caters to its very nature, which entails pooling of risk. Acturial oversight involves keeping a tab on 'financial condition' of companies, valuation of liabilities, inter alia, with regard to which investigation is required to be made at intervals of not less two years from the date they are submitted before the Controller of Insurance. The said authority has a wide jurisdiction. It may take evidence and order revaluation as also investigate into the affairs of the insurance company. The statute provides for checks and balances. It mandates as to the kind of investments which the insurer must make. The provisions of the 1938 Act and the regulations framed thereunder provide for the details in which the accounts are to be maintained.

13. Insurance companies in view of the provisions of the said Act, however, are dealt with also under the 1961 Act differently. Section 44 thereof, as noticed hereinbefore, begins with a non-obstante clause. The jurisdiction of the Income Tax Officer in passing the orders of assessment is limited. Keeping in view the fact that the business carried out by the assessee is not governed by the ordinary principles applicable to business computation as laid down in Section 10 of the 1961 Act; the insurance companies do not compute their profits annually in the manner laid down therein.

14. A bare perusal of Rule 5(a) of the 1961 Act would categorically demonstrate that ordinarily the annual accounts furnished before the Controller of Insurance would be taken to be the balance of the profits disclosed thereby. The same, however, is subject to the adjustments mentioned therein, namely, any expenditure or allowance which is not admissible under the provisions of Sections 30 to 43A in computing the profits and gains of the business. If the said provision is found to be applicable, the amount may be added back.

15. The rules lay down as to how the Income Tax Officer must proceed in the matter if he finds any inaccuracy in the said accounts.

16. The question came up for consideration before this Court in relation to business of life insurance in Life Insurance Corporation of India. v. Commissioner of Income Tax, Delhi & Rajasthan [illegible]. Therein, this Court had the occasion to consider the relevant provisions of the 1938 Act as also the 1961 Act. In respect of business of insurance other than life insurance, a matter fell for consideration in Pandhyan Insurance Co. Ltd. v. Commissioner of Income-Tax, Madras [illegible], wherein it was categorically held that the rules do not empower the Income Tax Officer to adjust the accounts on the basis of revaluation made by him or to correct the discrepancy between what is entered into the accounts and what is fact.

17. In Commissioner of Income-Tax, West Bengal, Calcutta v. Calcutta Hospital and Nursing Home Benefits Association [illegible]pplication of Rule 6 to the Schedule appended to the Income Tax Act came up for consideration of this Court, wherein the law was laid down in the following terms :

"11. The Section adopted the device of a deeming provision. The profits arising from the transactions of a company or society with its members were deemed to be profits arising from transactions with non-members Parliament assumed that the latter were taxable. As this hypothesis was wrong Parliament failed in its objective. But the Indian Legislature did not adopt any deeming device. It defined income to include profits of any business of insurance carried on by a mutual insurance association. What are those profits is then explained by reference to the Schedule. The effect of this in substance is to incorporate Rule 6 into the definition. If the legislature had defined income to include profits of insurance earned on by a mutual insurance association computed according to Rule 6, very little would have remained arguable."

18. There cannot be any doubt whatsoever, as was submitted by the learned Additional Solicitor

General, that there exists a distinction between a 'provision' and 'reserve'. It was so held in Vazir Sultan Tobacco Co. Ltd., Hyderabad etc. v. Commissioner of Income Tax, Andhra Pradesh, Hyderabad etc. [illegible] in the following terms:

"9. The distinction between the two concepts of reserve and provision is fairly well known in commercial accountancy and the same has been explained by this Court in Metal Box Company of India Ltd. v. Workmen thus:

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 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 proprietors interest. (See Spicer and Pegler: Book- keeping and Accounts, 15th Edn., p. 42.) 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 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. Bearing in mind the aforesaid broad distinction we will briefly indicate how the two concepts are defined and dealt with by Companies Act, 1956."

19. Our attention, in this behalf, has also been drawn by the learned Additional Solicitor General to State Bank of Patiala, Patiala v. Commissioner of Income Tax,

Patiala [illegible] 7, wherein Paripoornan, J. speaking for a Division Bench noticed :

"12. A fair reading of the above decisions would go to show that if the transfer of amount is made ad hoc, when there is no known or anticipated liability, such fund will only be treated as reserve. In this case, substantial amounts were set apart as reserves. No amount of bad debts was actually written off or adjusted against the amount claimed as reserves. No claim for any deduction by way of bad debts were made during the relevant assessment years. The assessee never appropriated any amount against any bad and doubtful debts. The amounts throughout remained in the account of the assessee by way of capital and the assessee treated the said amounts as reserves and not as provisions designed to meet liability, contingency, commitment or diminution in the value of assets known to exist at the relevant dates of Balance-sheets. These facts have been found by the Tribunal. On the facts, the amount set apart as reserves cannot be said to be so earmarked, when any liability has actually arisen or was anticipated by the assessee. It cannot be said either, that the amounts set apart out of the profits were designed to meet any known liability, that existed at the date of the Balance-sheet. Tested in the light of the decisions of this Court, referred to hereinabove, it appears to us, that the amounts set apart towards bad and doubtful debts in these cases are reserves qualifying for appropriate relief under Rule 1(xi)(b) of the First Schedule and Rule 1(iii) of the Second Schedule of the Act."

20. The said decision was rendered in a case involving the Companies (Profits) Surtax Act, 1964. It

was decided on the fact situation obtaining in that case.

21. Section 36(1)(vii) of the Act lays down the following conditions for allowance of a claim for a bad debt :

i) It must be a proper debt, or a part thereof;

ii) It must be of a revenue nature as contra distinguished from that of capital nature;

(a) It has been taken into account in computing the income of the assessment of that previous year or of an earlier previous year, or

(b) Represents money lent in the ordinary course of the business of banking.

iii) Which is established to have become a bad debt in the previous year; and

iv) Has been written off as irrecoverable in the accounts of the assessee for the previous year.

22. We are, however, of the opinion that it is not necessary for us to dwell further upon the said question, inasmuch as a distinction between a 'provision' and 'reserve' had been kept in mind by the authorities under the 1961 Act as also the High Court. Every provision, however, needs not be an expenditure, as the same may represent a liability.

23. While calculating the profit and loss, what is primarily necessary to be taken into account is the gross profit. The amount of income tax payable for the said purpose would not come within the purview of the definition of the term 'expenditure'. It was so held in Ashton Gas Company v. Attorney General and Others 1906 AC 10in the following terms:

"My Lords, so presented, the case appears to me to be perfectly clear. The fallacy has been in arguing as if you can deduct from the income tax which you have got to pay something which alters what is the real nature of the profit. Now the profit upon which the income tax is charged is what is left after you have paid all the necessary expenses to earn that profit. Profit is a plain English word; that is 2what is charged with income tax. But if you confound what is the necessary expenditure to earn that profit with the income tax, which is a part of the profit itself, one can understand how you get into the confusion which has induced the learned counsel at such very considerable length to point out that this is not a charge upon the profits at all. The answer is that it is. the income tax is a charge upon the profits; the thing which is taxed is the profit that is made, and you must ascertain what is the profit that is made before you deduct the tax you have no right to deduct the income tax before you ascertain what the profit is. I cannot understand how you can made the income tax part of the expenditure"

24. Yet again in Allen (H.M. Inspector of Taxes) v. Farquharson Brothers and Company [XVII Tax Cases 54], it was held :

"Now it is not necessary for me to discuss, and I do not need to discuss, in detail or, indeed, at all, although my attention was properly called to it by counsel, the exact nature of the Income Tax and its distinction from Excess Profits Duty. The distinction, of course, is perfectly familiar and, in a general way, is recollected by anybody who has ever had anything to do with these things. Income Tax is not a deduction before you arrive at the profits; it is a part of the profits. It is, as has been expressed by some well-known person I cannot remember who, but it does not matter the Crown's share of the profits. Excess Profits Duty was quite a different sort of thing. That was a deduction, the sum to be deducted before you arrived at the profits for the purpose of computation, with the result that you deducted the Excess Profits Duty in arriving at the computation and then if, as sometimes happened, later on, some Excess Profits Duty was got back, that Excess Profits Duty had to be brought in."

25. The said principle has been applied by this Court in Bharat Commerce & Industries Ltd. v. Commissioner of Income Tax, Central-II [illegible] 7, stating :

"6. The expenses in that case were incurred for a very different purpose from the purpose for which the assessee has paid interest in the present case. When interest is paid for committing a default in respect of a statutory liability to pay advance tax, the amount paid and the expenditure incurred in that connection is in no way connected with preserving or promoting the business of the assessee. This is not expenditure which is incurred and which has to be taken into account before the profits of the business are calculated. The liability in the case of payment of income tax and interest for delayed payment of income tax or advance tax arises on the computation of the profits and gains of business. The tax which is payable is on the assessees income after the income is determined. This cannot, therefore, be considered as an expenditure for the purpose of earning any income or profits. The ratio of Birla Cotton Mills[illegible]s case is not applicable in the present case."

26. It is, therefore, evident that the provision of income tax being not an expenditure, the Assessing Officer could not have exercised its jurisdiction in relation thereto.

27. Reliance has been placed by the learned Additional Solicitor General on Madras Motor & General Insurance Co. Ltd. v. Commissioner of Income Tax, Madras [illegible] 1977 Indlaw MAD 100. In the said decision also, the Madras High Court categorically held that the provision for payment of income-tax is a liability and not an expenditure. The question again came up for consideration recently in General Insurance Corporation of India v. Commissioner of Income Tax, Bombay [illegible] 4wherein this Court rejected the contention of the learned counsel for the assessee therein, in the fact situation obtaining in that case, opining :

"19. There is another approach to the same issue. Section 44 of the Income Tax Act read with the rules contained in the First Schedule to the Act lays down an artificial mode of computing the

profits and gains of insurance business. For the purpose of income tax, the figures in the accounts of the assessee drawn up in accordance with the provisions of the First Schedule to the Income Tax Act and satisfying the requirements of the Insurance Act are binding on the assessing officer under the Income Tax Act and he has no general power to correct the errors in the accounts of an insurance business and undo the entries made therein."

28. Section 40(a)(ii) of the 1961 Act, it will bear repetition to state, provides for a non-obstante clause. It is of wide magnitude. Sections 32 to 38 of the 1961 Act refer to expenditure admissible under the Act. Section 40, however, seeks to make an exception thereto stating that some expenditures would not be allowed. Section 40(a)(ii), however, does not say that the income-tax would be an expenditure. It does not provide as to how a total income of a person should be computed. It provides for other types of taxes. The said provision has, therefore, no application in the instant case.

29. So far as the question of 'bad and doubtful claims' is concerned, again the same is not an expenditure. Section 36(1)(vii) of the Act whereupon the learned Additional Solicitor General placed strong reliance, cannot be said to have any application whatsoever in the instant case. It is not relevant for computing the profit under the 1961 Act. In any event, Section 44 of the Act provides for a non -obstante clause and, thus, would prevail over the former.

30. For the reasons aforementioned, we find no merit in these appeals, which are dismissed accordingly with costs. Counsel's fee is assessed at Rs. 10, 000/- in each case.