

# **BOMBAY HIGH COURT**

Commissioner of Income-Tax

Vs.

Aryodaya Ginning and Manufacturing Co. Ltd

I.T. Ref. No. 18 of 1956

(Chagla, C.J. and Tendolkar, J.)

23.08.1956

## **JUDGMENT**

### **Chagla, C.J.**

1. The assessee is a limited company and it makes up its accounts at the end of December every year. In the statement of account for the year ended 31-12-1948 the profit for that year was shown at Rs. 28,56, 997-14-2. To this was added a sum of Rs. 37, 948-11-9 being the profit brought forward from the last year. The Directors made the following appropriations of these profits. They allocated a sum of Rs. 2,25,000/- to depreciation fund, Rs. 12,50,000/- towards provision for income-tax, corporation tax and business profits tax, Rs. 11,08,000/- to reserve fund, and Rs. 1,50,000/- to dividend reserve fund. This left a balance of Rs. 1,61,946/- and this amount they recommended should be expended in payment of dividend leaving a balance of Rs. 89,134/- which they recommended should be carried forward to next year's account. The Directors made their report on 27-4-1949. A general meeting of the shareholders was held on 27-6-1949 and they accepted the report and the recommendations of the Directors. The assessee company was assessed to business profits tax for the chargeable accounting period 1-1-1949 to 31-3-1949, and the question that arose for consideration was, what was the capital of the company for the accounting period? The company's contention was that the paid up capital should be increased by the amount of reserves which had been constituted by the recommendation made by the Directors and accepted by the shareholders and the company made this claim in respect of the three amounts of Rs. 12,50,000/-, Rs. 11,08,000/- and Rs. 1,50,000/-. The Tribunal accepted the contentions of the assessee company with regard to the reserve fund of Rs. 11,08,000/- and dividend reserve fund of Rs. 1,50, 000/-. With regard to the provision for payment of tax the view taken by the Tribunal was that that was a provision made for a liability and did not constitute a reserve, but it made a recommendation to the Income-tax Officer that if the amount set apart to meet this liability exceeded the actual liability then to the extent of the excess the amount should be treated as reserved. The Commissioner has now come on this

reference and the question that has been submitted to us for our consideration is whether the two sums of Rs. 11,08,000/- and Rs. 1,50,000/- constitute a reserve as on 1-1-1949. The rival contentions are that as this was a reserve that appears in the balance sheet as of 31-12-1948 it was a reserve on 1-1-1949 and must be taken into account in computing the capital according to the provisions of the Business Profits Tax Act. The contentions of the Commissioner on the other hand is that this reserve was not sanctioned till 27-6-1949 and therefore prior to that date it could not be looked upon as reserved.

2. Now, there is no doubt in this case that these amounts - and we will deal for the time being only with the result with regard to the amounts appropriated to the reserve fund and the dividend reserve fund - did constitute reserves. The only question is as to the date when they constituted reserves. It is undoubtedly true that the function of the Directors under the Companies Act is to make a recommendation as to how the profits should be distributed or allocated and it is the right of the shareholders ultimately to decide at a general meeting. There were profits made by this company at the end of 31-12-1948 and those profits were in the sum of Rs. 28,94,946-9-11 and these profits had to be dealt with by the Directors and in respect of them recommendations had to be made by the Directors, and the Company Law provides that dividend must be declared out of these profits after all the necessary appropriations have been made and therefore the Directors proceeded to make the appropriations and the appropriations included the taking of a sum of Rs. 11,08,000/- to the reserve fund and a sum of Rs. 1,50,000/- to the dividend reserve fund. Now, when this recommendation came before the shareholders at the general meeting, what the shareholders accepted and adopted in the form of a resolution was that these amounts should constitute reserves as of 31-12-1948. The fallacy underlying the commissioner's contention is that these amounts constituted reserves as of 27-6-1949 when the resolution was passed. Although the resolution was passed on 27-6- 1949, the resolution obviously had a retrospective effect and it referred to the profits of the year ending on 31-12-1948, to the appropriations to be made in the balance-sheet as of 31-12-1948 and the reserves that should be constituted and shown in the balance-sheet as of 31-12-1948. When we look at the balance-sheet of the year ended on 31-12-1948 these amounts are shown respectively in the reserve fund and the dividend reserve fund. Therefore, the shareholders by passing a resolution on 27-6-1949 did not decide that those amounts should constitute reserves as from that date, but they accepted the recommendation of the Directors that these amounts should constitute reserves of the company as of 31-12-1948.

3. The Advocate General says that there must be some one with the requisite authority who can decide that a certain amount should constitute reserve. The Directors under the Companies Act do not have the requisite authority only the shareholders have it, and till somebody has decided to this effect no part of the profits can become reserves. Now that proposition is perfectly sound, but in advancing that argument what is overlooked is that the body of the shareholders who are the persons with the requisite authority do not merely determine that a certain amount should constitute reserve, but they also determine and have the necessary authority for determining and

that amount should constitute reserve as from a particular date, and in this case there is no doubt that the General meeting of the share-holders was considering the accounts for the year ended 31-12-1948 and passing resolutions with regard to those accounts.

4. Reliance has been placed on two decisions by the Advocate General. In our opinion, neither of these two has any bearing on the question that we have to decide on this reference. The first is a judgment of the Supreme Court reported in *Commissioner of Income-tax, Bombay City v. Century Spinning and Manufacturing Co. Ltd*<sup>1</sup>. In that case

<sup>1</sup>(1953) 24 ITR 499

the question was whether a sum of Rs. 5,08,637/- could be called a reserve, and the Supreme Court held that the amount did not constitute a reserve. The facts there were very peculiar. This amount was earmarked by the Directors for distribution as dividend, it had never been set apart from as reserve, and the view taken by this Court, which view was not accepted by the Supreme Court, was that as that amount constituted undistributed profits they must be looked upon as having been set apart till they were actually appropriated for the purpose of payment of dividend. As we have pointed out that view was not accepted by the Supreme Court and the Supreme Court held that nobody possessed of the requisite authority had indicated on that date the manner of its disposal or destination and the fact that that amount constituted a mass of undistributed profits could not automatically make it a reserve. Therefore, it will be noticed that in this case before the Supreme Court there was no reserve at all and therefore no question arose as to when the reserve could be considered as having been constituted.

5. In other case to which reference is made, which is an unreported decision in I. T. Ref. No. 46 of 1954, D/d. 18-2-1955, the question was whether an amount of profit carried forward to the next year could constitute reserve, and we held following a decision of the Supreme Court that the amount could not be considered as reserve. There again, no portion of the profits had been earmarked for reserve, nor had the shareholders accepted the recommendation of the Directors that a particular amount should be taken to the reserve fund. In the case before us we have this distinguishing features that certain amounts have been earmarked by the Directors as reserve, and the shareholders have accepted the recommendation and passed a resolution at the general meeting.

6. On principle, too, the contention put forward by the Commissioner seems to us to be untenable. The business profits tax gives to a business man certain abatement in respect of capital utilized by the company, it also gives abatement in respect of reserves because reserves are looked upon as standing on the same footing as capital. If that be the principle underlying taxation under the business profits tax, then it is difficult to understand why a business man should not get the benefit of the reserves actually utilized by the company for the working of the company. In this case the profits were made at the end of 31-12-1948 and from 1-1-1949 the reserves were in existence and could be utilized for the working of the company as much as the

capital. If that be so, the mere fact that the shareholders passed a resolution at a later date cannot affect the merits of the question or the right of the assessee company to get the benefit of the abatement provided by the business profits tax.

7. A question has also been sought to be raised by a Notice of Motion taken out by the Commissioner, and what was sought to be argued on this Notice of Motion by the Advocate General was that the Tribunal was in error when it directed the Income-tax Officer with regard to the sum of Rs. 12,50,000/- to permit a part of it which was not utilized for meeting the liability with regard to taxation as reserve. There may be force in the Advocate-General's contention on this point, but we do not find that this contention has ever been raised by the Commissioner either on this application to the Tribunal to make a reference or in the Notice of Motion taken out before us. The question which the Commissioner suggests should be raised on the Notice of Motion is no different from the question raised by the Tribunal itself. The only virtue about the Commissioner's question is that it seeks to incorporate in the question arguments and facts which are already set out in the statement of the case. Therefore, in our opinion, the Notice of Motion taken out by the Commissioner must fail.

8. The result is that we must answer the question submitted to us in the affirmative. The Commissioner to pay the costs of the reference and also the costs of the Notice of Motion.  
Order accordingly.