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INDIAN TUBE CO. (P) LTD.

v.

COMMISSIONER OF INCOME-TAX, CALCUTTA

JANUARY 14, 1992

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[K. RAMASWAMY AND B. P. JEEVAN REDDY, JJ.]

Companies (Profit) Sur Tax Act, 1964 Sections-2 (b), 4, 18—Payment of dividend—Recommendation of Board of Directors—Whether reserve—Whether to be taken into consideration for computation of capital.

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This appeal arises out of proceedings initiated to compute the capital of the appellant-company for the purpose of Sur-tax. The previous year relevant to the assessment year of the paid up capital, the reserve, the debentures etc. under Rule 1 of Second Schedule to the Sur-tax 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 of January, 1963. In this connection it may be mentioned that the Directors of the appellant-assessee's company at their meeting held on 1.5.1963 approved the transfer of a sum Rs. 90,00,000 out of the profits for the 1962 year to a 'Dividend Reserve Account', 12½% which amounted to Rs. 76,00,000 on the ordinary shares on the amount paid on those shares prior to 31.12.1962. On 31.5.1963 in the general meeting the accounts were passed by the share-holders 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. The question therefore arose whether a sum of Rs. 90,00,000 or any part thereof would be reserve for computing the capital as on 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 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. He therefore held that Rs. 90,00,000 was the reserve fund qualified for inclusion under Rule I (III) of the Second Schedule to the Sur-tax Act. On appeal by the Revenue, the Income-tax Appellate Tribunal held that "the assessee had appropriated Rs. 76,00,000 out of the Year's profit and transferred the balance of Rs. 14,00,000 to the dividend reserve" : Rs. 76,00,000 was taken as liability as on 1.1.1963 and as the creation of Rs. 90,00,000 was

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to be taken as reserve on 1.1.1963, only a sum of Rs. 14,00,000 has been transferred to the reserve account. Accordingly the Tribunal held that a sum of Rs. 14,00,000 would only be treated as a reserve and directed modification of the capital computation. On a reference under section 256(1) of the Income-tax Act and Section 18 of the companies (Profits) Sur-tax Act, 1964 at the behest of the appellant, the High Court answered the question in the negative and against the assessee. Hence this appeal by certificate under Section 261 of the Income-Tax Act, 1961.

Dismissing the appeal, this Court,

HELD : A conjoint reading of the scheme of the Sur-tax Act and the Company's Act suggests that the appropriation made by the Board of Directors by recommending payment of dividend, in the nature of things does not constitute a reserve. [28B]

If an amount is satisfied out of profits and other surpluses, not to meet the 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 profit for any known liability for which the amount could be determined with certainty, it is a provision. [27H]

Creating of reserve out of the profit is a stage distinct in point of fact and anterior in point of time to the stage of making recommendation for payment of dividend by the general body of the shareholders. [28A]

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 be given. [27G]

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. [28C]

Though the general body of the shareholders resolved and appropriated on May 31, 1963 of 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 1st January, 1963, Rs. 76,00,000 was provision and cannot be computed as capital. Only Rs. 14,00,000 would be treated to be reserve. [30F-G]

Metal Box Co. of India Ltd. v. Their Workmen; 73 I.T.R. 53; Commis-

A. *sioner of Income-tax, Mysore v. Mysore Electrical Industries Ltd., 1971 (80) I.T.R. 566; Hyco Products (P) Ltd. v. Commissioner of Income-tax, Bombay, referred to.*

Vazir Sultan Tobacoo Co. Ltd. v. Commissioner of Income-tax, A.P. [1981] 132 I.T.R. 559, not applicable.

B CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1254 (NT) of 1976.

From the Judgment and Order dated 23.8.1974 of the Calcutta High Court in Income Tax Reference No. 241 of 1970.

C Janaki Ramachandran, R. Ayyam Perumal and D.N. Gupta for the Appellants.

D Dr. V. Gauri Shankar, P. Parmeshwaran, S. Rajappa and Ms. A. Subhashini for the Respondents.

The Judgment of the Court was delivered by

E K. RAMASWAMY, J. This appeal, by certificate under Section 261 of the Indian Income-tax Act 1961 (for short 'the Act') granted by the Calcutta High Court, arises from a reference under Section 256 (1) of the Act and Section 18 of the Companies (Profits) Sur-tax Act, 1964 (for short 'Sur-tax Act') on the question of law which was answered in negative and against the appellant thus :

F "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) Sur-tax Act 1864."

G The previous year relevant to the assessment year, of the paid up capital, the reserve, the debentures etc. under Rule 1 of Second Schedule to the Sur-tax 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. 1.1.1963. The appellant claimed in its assessment a sum of Rs. 90,00,000 transferred to the dividend reserve as a reserve entering into capital compu-

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tation. The assessing authority excluded this sum from the computation of the capital but on appeal the Appellate Asstt. 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 Sur-tax Act. On appeal by the Revenue, the Income-tax Appellate Tribunal held that "the assessee had appropriated Rs. 76,00,000 out of the year's profit and transferred the balance of Rs. 14,00,000 to the dividend reserve" : Rs. 76,00,000 was taken as liability as on 1.1.1963 and as the creation of Rs. 90,00,000 was to be taken as reserve on 1.1.1963 only a sum of Rs. 14,00,000 has been transferred to the reserve account. Accordingly the Tribunal held that a sum of Rs. 14,00,000 would only be treated as a provision and directed modification of the capital computation 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 Sur-tax Act, the charging section postulates that, subject to the provision 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 a 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, 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 Rs. 200 thousands whichever is greater. The First Schedule provides the rules for computation of the chargeable profits. The Second Schedule gives the procedure to compute the capital of the company for the purpose of sur-tax. 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 reserve, 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 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 amount 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

A year which is of the nature of item (5) or item (6) or item (7) under the heading "Reserves and Surplus" of any item under the heading "Current Liabilities and Provisions" in the column relation to "Liabilities" in the "Form of Balance Sheet" given in Part I of the Schedule VI to the Companies Act, 1956 (I) 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".

B Section 217 of the Companies Act, 1956 enjoins the company to attach to every balance sheet laid before a company general meeting, a report by its Board of Directors, with respect to :

- C (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
- D (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 set aside, out of the profits of the company, such sum as it thinks proper as a reserve or reserves etc.

E It is found as a fact that on 1st May, 1963 in respect of the accounts for the year 1962 in the Director's 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% which amounted to Rs. 76,00,000 on the ordinary shares on the amount paid on those shares prior to 31st December, 1962. On 31st May, 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.

G In its report, the Board of Directors stated that the Auditor's Report presented the 'company affairs as on 31st December, 1962 and its profits for the year ended on that date'. In the balance sheet under the heading 'Liabilities' as on 31st December, 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 'Reserve and Surplus' under item (e) the Dividend Reserve Account stated that from the transfer of a Profit and Loss Account was Rs. 90,00,000.

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The question, therefore, is whether a sum of Rs. 90,00,000 or any part thereof would be reserve for computing the capital as on January 1, 1963. From the above fact, it is clear that a sum of Rs. 76,00,000 earmarked by the director's 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 Sur-tax Act is to impose Sur-tax on the profits of a company. The Act also intended to impose tax on the net profits after allowing deductions in terms of the Sur-tax Act and the procedure for computation thereof was indicated in the 2nd schedule. In the computation, the profits, the capital or reserve forming capital of the company, had to be excluded. It is well known that the accounts of the company have to be brought up for a year upto a particular date. On the facts of this case the crucial date is 1.1.1963. 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 their 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 crystallised. There is nothing to withhold payment in species to the respective shareholders which is merely a ministerial act. The modes operandi adopted in making the entries or 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 of nomenclature which the assessee company had chosen to be given. If an amount is satisfied out of profits and other surpluses, not to meet the liability, contingency, commitment or diminution in the value of asset known to exist at the time of the balance sheet, it was a reserve. The amount set aside out of profits and

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A other surpluses to profit for any known liability for which the amount could be determined with certainty, it is a provision. Creating of reserve out of the profit is a stage distinct in point of fact and anterior in point of time to the stage of making recommendation for payment of dividend by the general body of the shareholders. A conjoint reading of the scheme of the Sur-tax Act and the Company's Act suggests that the appropriation made by the Board of
B 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 make dividend out of profits at a particular percentage crystallised into a liability, and subsequent payment relates back to the relevant date, namely, closing of the accounting year during which the liability had arisen. Therefore, the resolution of the general body of the shareholders dated May 31,
C 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.

D In *Metal Box Co. of India Ltd. v. Their Workmen*, 73 I.T.R. 53 this Court was concerned whether appropriation amounted to 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 commercial accountancy fairly well known. Provisions were made against anticipatory losses and contingencies were charged against profit and they had been taken into account against
E 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 their business. provisions were usually shown in the balance sheet by deduction from the asset in respect of which those were made whereas general reserve and
F reserve fund were shown as part of proprietor's interest. An amount set aside out of profits and other surpluses, not designed to meet a liability, contingency, commitment or diminution in valuation of asset known to exist on the date of the balance sheet was a reserve but an amount set aside out of profits and other surpluses, was provided for known liability for which the amount could not be determined with substantial accuracy was a provision. In
G *Commissioner of Income-tax, Mysore v. Mysore Electrical Industries Ltd.*, 1971 (80) I.T.R. 566 a constitution bench of this Court held that the determination of the directors to appropriate the accounts 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 in 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
H computation of the capital of the respondent as on April 1, 1963 under Rule

1 of Schedule II of the Sur-tax 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 but allocation on a later day should be treated as effective from that date in view of the fact that the division of undistributed profits became effective from that date. The case of *Vazir Sultan Tobacco Co. Ltd. v. Commissioner of Income-tax, A.P.* 1981 [132] ITR 559, relied on by the assessee, far from helping the appellant, goes against the contention of the learned counsel for the appellant. Construing Section 217 of the Company's Act 1956 and the Schedule this Court held thus :

“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 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 reserve and the question 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 the 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 becomes apparent if the negative and non-exhaustive 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 cl. 7 of Pt. III the proper

A 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".

C This Court in *Hyco Products (P) Ltd. v. C.I.T. Bombay* (supra) approved the ratio of the Bombay High Court in Ref. Case No. 5 of 1978 of *Hyco Products (P) Ltd., Bombay*. The question therein relates to the assessment year 1974-75. The relevant provision being the calendar year 1963 and the material date being January 1, 1973 after the accounts of the year were finalised, 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. 36,07,712 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 Sur-tax assessment proceeding under the 1964 Act the assessee claimed that the entire general reserve which stood at Rs. 86,07,712 as 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 Commissioner and the Income-tax Appellate Tribunal confirmed the order. On reference, the High Court upheld the order which was approved by this Court.

F Thus we have no hesitation to hold that though the general body of the shareholders resolved and appropriated on May 31, 1963 to 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 1st January 1963 Rs. 76,00,000 was provision and cannot be computed as capital. Only Rs. 14,00,000 would be treated to be reserve. The Tribunal and the High Court, therefore, 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.