

National Rayon Corporation Ltd vs The Commissioner Of Income Tax on 29 July, 1997

Equivalent citations: AIR 1997 SUPREME COURT 3487, 1997 AIR SCW 3579, 1997 (4) COM LJ 13 SC, (1997) 7 JT 372 (SC), 1997 (7) SCC 56, (1997) 93 TAXMAN 754, 1997 (7) JT 372, 1997 (5) SCALE 415, (1997) 4 COM LJ 13, (1997) 7 SUPREME 396, (1997) 227 ITR 764, (1997) 5 SCALE 415, (1997) 140 TAXATION 537, (1997) 142 CURTAXREP 202

Bench: Suhas C. Sen, K. T. Thomas

PETITIONER:

NATIONAL RAYON CORPORATION LTD.

Vs.

RESPONDENT:

THE COMMISSIONER OF INCOME TAX

DATE OF JUDGMENT: 29/07/1997

BENCH:

SUHAS C. SEN, K. T. THOMAS

ACT:

HEADNOTE:

JUDGMENT:

(WITH C.A NOS. 2/95, 198/89, 432/89, 433/89 AND 2970/81) J U D G M E N T SEN, J.

The point that falls for determination in this case is whether a sum of Rs. 79 lakhs representing Debenture Redemption Reserve was includible in computing the capital of the assessee Company for the purpose of Companies (Profits) Surtax Act, 1964.

The High Court took the view that the amount set apart to redeem the debentures has to be treated as 'provision' and not as 'reserve'. The facts stated by the High Court in this regard are as follows:

"From the balance-sheets for the said periods, we find that in the calendar year 1965, the development rebate reserve was Rs. 79,00,000. However, in the next calendar year 1966, which is relevant to the assessment year 1967-68, the figure of debenture redemption reserve has gone up to Rs. 1,12,00,000. A perusal of the balance-sheet further shows that the assessee company had floated an actually issued 6 1/2 per cent secured redeemable mortgage debentures, as pointed out earlier, against the security of land, buildings and machinery of the company and a floating charge on the undertaking. None of these debentures appear to have been redeemed during the relevant previous years. There is no dispute regarding any of these facts. In these circumstances, it clearly appears to us that the debenture redemption reserve must be regarded as a provision made by the assessee company to enable it to redeem the said debentures when they became due for redemption. Since the aggregate amount of such debentures is much larger than the amount of the debenture redemption reserve, we fail to see how it can be said that there was any excess as such in this appropriation which could be taken as reserve. It is true that all the debentures had not become redeemable during the relevant previous years, but that does not make any difference because an amount set aside to meet a future liability, which was certain to come into existence, as in this case, must be regarded as a provision and not as a reserve."

We are of the view that the High Court has come to a correct conclusion. The basic principle is that an amount set apart to meet a known liability cannot be regarded as 'Reserve'. 'Provision' and 'Reserve' have been defined in Part III, Schedule VI of the Companies Act itself:

"7. (1) For the purposes of Part I and II of this Schedule, unless the context otherwise requires,-

(a) the expression "provision"

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;

(c) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account; and the expression revenue reserve shall mean any reserve other than a capital reserve;

and in this sub-clause the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities. (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) 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 as a provision.

The definition clearly indicates that if an amount is retained by way of providing for any known liability that amount shall not be treated as reserve. Clause 7(2)(b) makes it clear that only an amount which is in excess of what is reasonably necessary for meeting a known liability shall be treated as reserve and not as provision. The directors will have to form an opinion as to what is reasonably necessary for meeting the known liability of a Company. The opinion of an accountant or an auditor or a lawyer is quite immaterial for this purpose.

The finding of fact in this case is that the amount set apart for redemption of debentures is less than the Company's liability on this account. Therefore, the answer to the question raised must be that the amount of Rs. 79 lakhs representing Debenture Redemption Reserve cannot be included in the capital of the Company for the purpose of Surtax assessment. The facts stated in the judgment of the High Court go to show that the amount was not larger than the amount which had to be paid for redemption of the debentures. Therefore, there is no question of any excess provision in this case.

In the case of Vazir Sultan Tobacco Co. Ltd. V. Commissioner of Income Tax, A.P., 132 I.T.R. 559, it was held that 'provision' and 'reserve' had not been defined under the Companies (profits) Surtax Act, 1964. Therefore, the two concepts 'reserve' and 'provision' which are fairly well known in commercial accountancy and which are used under the Companies Act dealing with preparation of Balance Sheets and Profit and Loss Accounts, will have to be gathered from the meaning attached to them by the Companies Act itself. Moreover, in Vazir Sultan's Case, it was pointed out that even if a sum of money which had been set apart for a certain purpose was held not to be a 'provision', it did not automatically follow that it would be a reserve. It was held:

"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 re 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 surplus 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."

It has been contended by Shri T.A. Ramachandran on behalf of the assessee that what is set apart for meeting the current year's known or estimated liability will be 'provision'. An amount set apart for future use will not be 'provision'. This argument is without any merit. It goes against the very definition of 'provision' and 'reserve' provided by the Companies Act. In the form of Balance Sheet in Schedule VI of the Companies Act provisions have to be made, inter alia, for Contingencies, Provident Fund Scheme, insurance, Pension and Staff benefit schemes. Amounts set apart for the aforesaid purposes will mostly be for future use. Question of payment of pension or provident fund can only arise when an employee retires.

Mr. Ramachandran advanced another argument that there was no present liability to pay any amount to the debenture-holders. That liability will arise only when the amount falls due for payment. Therefore, there was no existing liability for redeeming the debentures in the relevant year of account.

We are unable to uphold this argument. The liability to repay arises the moment the money is borrowed. The amount borrowed may be repayable immediately or in future. The date of repayment of loan may be deferred by agreement but the obligation or the liability to repay will not cease on that account. The obligation is a present obligation; *Debitum in Praesenti, solvendum in futuro*. This aspect of the matter was explained in the judgment of this Court in *Kesoram Industries and Cotton Mills Ltd., v. The Commissioner of Wealth Tax (Central), Calcutta*, A.I.R. 1996 SC 1370.

By issuing the debentures, the company had taken a loan against the security of its assets. This loan may not be repayable in the year of account. But the obligation to pay the loan is a present obligation. Any money set apart in the accounts of the company to redeem the debentures must be treated as moneys set apart to meet a known liability. The debentures will have to be shown in the Company's Balance Sheet of the year as 'Liability'.

In the case of *Commissioner of Income Tax vs. Peico Electronics 7 Electricals*, 166 ITR 299, the Calcutta High Court held that the debenture redemption reserve will have to be treated as a 'reserve' and not 'provision' because, none of the debentures became redeemable during the accounting period. The liability to redeem the debentures was a future liability. The debentures had been separately shown in the balance sheet as a liability. The reserve had been created by appropriation of profits and not by way of a charge on revenue.

We are of the view that this approach is erroneous and overlooks the definitions of 'provision' and 'reserve' given in the Companies Act. The debentures were nothing but secured loans. Merely because, the debentures were not redeemable during the accounting period, the liability to redeem the debentures did not cease to exist. It was redeemable or repayable at a future date. But it was a known liability. In the form of balance sheet prescribed by the Act in Schedule VI, the secured loans have to be shown under the heading 'liabilities'. Secured loans have to be shown under the heading 'liabilities'. Secured loans include (1) debentures, (2) loans and advances from banks, (3) loans and advances from subsidiaries and (4) other loans and advances. The secured loans might not be immediately repayable, but the liability to repay these loans was an existing liability and has to be shown in the Company's Balance Sheet for the relevant year of account as a liability. Amount set

apart to pay these loans cannot be 'reserve'. The interpretation clause of the Balance Sheet in Schedule VI of the Companies Act specifically lays down that reserves shall not include any amount written off retained by way of providing for a known liability.

The Delhi High Court in the case of Commissioner of Income Tax v. Modi Industries Ltd. (No.2), 197 ITR 655 also took the view that the amount set apart out of profits to redeem the debentures had to be treated as reserves because, there was no liability in the current year to redeem the debentures.

We are unable to agree with this view for the reasons given earlier in the judgment.

Apart from this, the argument that found favour with the Courts in the cases of Peico Electronics & Electricals and Modi Industries Ltd. (supra) that if the retention or appropriation of a sum 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', was specifically rejected by this Court in Vazir Sultan's Case (supra). This argument of the assessee was held to be fallacious (Page 571 of the report).

There is another aspect of this case. In the prescribed form of Balance Sheet, under the heading "RESERVES AND SURPLUSES" seven types of reserves have to be shown:

- (1) Capital Reserves, (2) Capital Redemption Reserve, (3) Share Premium Account
- (4) Other reserves, (5) Surplus, i.e., balance in profit and loss account. (6) Proposed additions to reserves. (7) Sinking funds.

However, for the purpose of computation of capital of a company under the Companies (Profits) Surtax Act, 1964, items 5, 6 and 7 will not be treated as Reserves. The Second Schedule of the Surtax Act lays down the rules for computation of the capital. Rule 1 contains an Explanation to the following effect:

"Explanation, - 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 1st 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" given in Part I of Schedule VI to the Companies Act, 1956 (1 of 1956), shall not be regarded as a reserve for the purposes of computation of the capital of a company under the provisions of this Schedule."

In Batliboi's advanced Accountancy, 27th Edn. p.678, the nature of a Sinking Funds is explained as under;

"Sinking Fund. - A Sinking Fund is a fund created with the object of providing means for the redemption of liabilities like debentures or any other loan. It is formed by setting aside, half yearly or yearly, a fixed sum of money for a definite period, such

sum to be invested at compound interest, so that at the end of the period, the annual amounts, with accumulations of interest, will be sufficient to discharge a prescribed loan. In such a case, the amount set aside should not be debited to Revenue Account but to a Net Revenue Account or Profit and Loss Appropriation Account, as being rather in the nature of an allocation of profits than a charge against them."

A Sinking Fund created for redemption of debentures will not be treated as Reserve even though (1) it has to be shown as "Reserve" in the Balance Sheet and (2) the amount kept in this fund is in the nature of allocation of profits and not a charge against them. It is difficult to see, in the context of this rule in the Second Schedule, why a Debenture Redemption Reserve is to be treated as "Reserve" on the ground that the amounts set apart for redemption of debentures are not in the nature of a charge against profits but merely appropriation of profit. In *Peico Electronics & Electricals Case* (supra), one of the grounds which weighed with the Court was the argument that the Sinking Fund has to be utilised by making investments and did not form part of the working capital of the Company but the amount lying to the credit of Debenture Redemption Reserve was available to the Company to be used as working capital.

We fail to comprehend this distinction. What has to be computed under Rule 1 of the Second Schedule of the Surtax Act is the capital of the Company and not its working capital. The amount shown as Sinking Funds may be invested in a fruitful way so that the principal and gains from the investments taken together will enable the Company to pay off its debts. Investment of monies standing to the credit of the Sinking Fund is nothing but utilisation of the Company's assets for the discharge of its liabilities. There is no rational explanation why a Sinking Fund for redemption of debentures will not be a reserve but a Debenture Redemption Reserve created with the same purpose will be treated as reserve and included in computation of capital of the Company for surtax purposes. A construction which leads to absurdity should be avoided.

The basic principle is that any amount retained by way of providing for a known liability will not be 'reserve'. Explanation to Rule 1 of the Second Schedule of the Surtax Act takes this principle to its logical conclusion by providing that even a Sinking Fund, which has to be shown as a reserve in the prescribed form of balance Sheet, will not be treated as 'Reserve' for the purpose of computation of capital.

It is further to be noted that the surplus and unallocated balance in the Profit and Loss Account has been specifically excluded from "reserves" for computation of capital under the Surtax Act. Therefore, availability of the amount for utilisation as working capital of the Company or for distribution of dividend cannot be a criterion for deciding whether a particular amount retained from the profits of the Company will be treated as its reserve or not.

In the premises, we are of the view that the judgment under appeal; was rightly decided. We are unable to uphold the contrary decisions in the cases of *Peico Electronics & Electricals* and *Modi Industries Ltd.* (supra).

This appeal is, therefore, dismissed. There will be no order as to costs.

CIVIL APPEAL NOS.2/95, 198/89, 432/89 AND 433/89 Appeals are dismissed in view of the above decision. There will be no order as to costs.

In this appeal, we are concerned with the following question;

"Whether on the facts and in the circumstances of the case, the sums of Rs. 38,98,970/- and Rs. 6,66,159/- constituted reserve and was required to be taken into account in the computation of the capital under the Super Profits Tax Act, 1963"

However, we are concerned in this appeal only with the amount of Rs. 6,66,159/- which was appropriated to gratuity reserve. The question is whether this should be treated as reserve or provision. The point is well settled by the decision of this Court in the case of Vazir Sultan (supra). The answer to the question will be that the amount of Rs. 6,66,159/- will have to be treated as provision and not reserve. We answer the question accordingly. The order of the High Court to the above extent is set aside.

A point has been taken on behalf of the respondents that the amount was more than what was actually required to be set apart as liability for gratuity. We are not expressing any opinion as to that because that is a question of fact. It does not appear from the High Court's order or the question raised that this point was at all in issue before the Court or the Tribunal.

The assessee can raise this question, it can lawfully do so, before the Tribunal. The appeal is allowed.