Vazir Sultan Tobacco Co. Ltd. Etc. Etc vs Commlssioner Of Income-Tax Andhra ... on 25 September, 1981

Equivalent citations: 1981 AIR 2105, 1982 SCR (1) 789, AIR 1981 SUPREME COURT 2105, 1981 (4) SCC 435, 1981 TAX. L. R. 1780, (1981) 132 ITR 559, (1981) 7 TAXMAN 28

Author: V.D. Tulzapurkar

Bench: V.D. Tulzapurkar, E.S. Venkataramiah, Amarendra Nath Sen

PETITIONER:
VAZIR SULTAN TOBACCO CO. LTD. ETC. ETC.

Vs.

RESPONDENT:
COMMlSSIONER OF INCOME-TAX ANDHRA PRADESH, HYDERABAD

DATE OF JUDGMENT25/09/1981

BENCH:
TULZAPURKAR, V.D.
BENCH:
TULZAPURKAR, V.D.
VENKATARAMIAH, E.S. (J)
SEN, AMARENDRA NATH (J)

CITATION:
1981 AIR 2105 1982 SCR (1) 789
1981 SCC (4) 435 1981 SCALE (3)1483
CITATOR INFO :
RF 1986 SC 484 (13,17)
F 1986 SC1746 (6)
R 1986 SC1938 (5,13,14,16,17)

ACT:
Super Profits Tax Act, 1963 and Company's (Profits) Sur-tax Act, 1964-Rule I of Second Schedule-Scope of-"Provision" and "Reserve"-Distinction- A sum of money transferred from current profits to general reserves-Dividend paid from that fund-General reserve how calculated.

HEADNOTE:
The Super (Profits Tax) Act, 1963 and the Company's (Profits) Sur-tax Act, 1964 (the scheme and main provisions

of both of which are almost identical) impose a special tax on excess profits earned by companies. The special tax is imposed in respect of so much of a company's "chargeable profits" of the previous year as exceeded the "standard deduction"- The term "chargeable profit" is defined to mean the total income of an assessee computed under the Income Tax Act, 1961 for any previous year and adjusted in accordance with the provisions of that Act. "Standard deduction" is determined by computing the capital of a company in accordance with the rules laid down in the schedule. The material part of rule I provides that before any amount or sum qualifies for inclusion in capital computation of a company two conditions are required to be fulfilled namely: (i) that the amount or sum must be a "reserve" and (b) that it must not have been allowed in computing the company's profit for the purposes of Income Tax Acts, 1922 or 1961.

ln their respective balance sheets, the assessees had shown under the heading "current liabilities and provisions" appropriations of large sums of money for taxation, retirement gratuity and dividends and claimed that for the purposes of super profits tax these sums should be regarded as "other reserves" within the meaning of Rule 1 of Second Schedule to the Act and that for the computation of capital they should be taken into account.

Treating these sums as "provisions" and not as "reserves", the Super Profits Tax officer determined the capital and the standard deduction by excluding them from the computation of the capital. He then levied super profits tax on that portion of the chargeable profits of the previous year as exceeded the standard deduction.

While the Appellate Assistant Commissioner upheld the assessee's contention that these sums were "reserves" which should be taken into account for computing their capital, the Appellate Tribunal held that these were not "reserves" within
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the meaning of Rule l of the Second Schedule to the Act and as such could not enter into capital computation.

On reference the High Court held that the sums set apart were not "reserves and so should be excluded in the computation of the capital for the purposes of levying the super profits tax.

In Tax Reference no. 5 (a case under the Companies (Profits) Sur-tax Act, 1964) the assessee transferred from out of its current profits a large sum of money to the general reserves and paid dividend to its shareholders from out of the augmented general reserves. On the question whether for computing the capital for the purpose of sur-tax the general reserves should or should not be reduced by the sum of dividend paid, the taxing authorities and the appellate tribunal ignored this amount holding that it was not a "reserve".

None of the items of appropriation either for taxation or for retirement gratuity or for proposed dividend in the assessees' cases had been allowed in computing their profits under the Income Tax Act, 1961.

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HELD: [per Tulzapurkar & Venkataramiah, JJ]

The expressions "reserve" and "provision" have not been defined in the Act. Standard dictionaries, without making any distinction between the two concepts, use them more or less synonymously connoting the same idea. But since in the context of the legislation a clear distinction between the two is implied it is essential to know the exact connotation of the two concepts and the distinction as known in commercial accountancy. The rules for computation of capital contained in the Second Schedule to the Act proceed on the basis of the formula of capital plus reserve, a formula well known in commercial accountancy. But since they occur in a taxing statute applicable to companies only these expressions will have to be understood in the sense or meaning attributed to them by men of business, trade and commerce and by persons interested in or dealing with companies. Therefore, the meaning attached to these words in the Companies Act, 1956 would govern their construction for the purpose of these two enactments [800 C-H]

The broad distinction between the two expressions as judicially evolved by this Court is that, while 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. [801 F]

C.l.T. v. Ccntury Spinning & Manufacturiag Co., 24 ITR 499 and Metal Box Company of India Ltd. v. Their Workmen, 73 lTR 67 followed.

The Companies Act, which enjoins upon the Board of Directors of every company to lay before the annual general meeting of its shareholders an annual balance sheet and a profit and loss account, enumerates the separate heads that should be shown in the balance sheet, two of these items being "reserve' and "provision". The definitions of these two expressions given in the Act show

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that if any retention or appropriation of a sum falls within the definition of A "provision" it can never be a "reserve". But the converse is not true. If the retention or appropriation is not a "provision" that is, if it is not designated to meet depreciation, renewals or diminution in value of assets or any known liability it is not 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 purposes for which such retention or appropriation had been made.

[803 E-Fl

Having regard to the type of definitions of the two concepts, if a particular retention or appropriation of a sum falls within the expression "provision" then that sum will have to be excluded from the computation of capital. If the sum is in fact a "reserve" then it would be taken into account for the computation of capital. [804 B-C]

Where the assessee had set apart a sum of money to meet tax liability in respect of profits earned during an accounting year, which liability was not quantified, such setting apart for a known and existing liability, would be a "provision" and could not be regarded as a "reserve". [806 A-C]

Kesoram Industries and Cotton Mills Ltd.v. Commissioner of Wealth Tax (central) Calcutta, 59 ITR 767 followed.

But if provision for a known or existing liability is made in excess of the amount reasonably necessary for the purpose, such excess should be treated as reserve" and, therefore, would be includible in capital computation. [806 E]

Since the assessee (in C.A. No. 860/73) had at no stage of the proceedings before the Taxing Authorities or Appellate Tribunal or the High Court raised a plea that the provision made by it for taxation was in excess of the amount reasonably necesssary for the purpose and that such excess should be treated as a "reserve", the plea which needs investigation into facts, could not be allowed to be raised for the first time in appeal before this Court. [807 F]

Ordinarily an appropriation to gratuity reserve will have to be regarded as a provision made for a contingent liability, for, under a scheme framed by a company the liability to pay gratuity to its employee on determination of employment arises only when the employment of the employee is determined by death, incapacity, retirement or resignation-an event (cessation of employment) certain to happen in the service career of every employee. Moreover, the amount of gratuity payable is usually dependent on the employee's wages at the time of G, determination of his employment and the number of years of service put in by him and the liability accrues and enhances with completion of every year of service; but the company can work out on an acturial valuation its estimated liability (i.e. discounted present value of the liability under the scheme on a scientific basis) and make a provision for such liability not all at once but spread over a number of years. If by adopting such scientific method any appropriation is made such appropriation will constitute a provision representing fairly accurately a known and existing liability for the year in question; if however, an ad hoc sum

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is appropriated without resorting to any scientific basis such appropriation would also be a provision intended to

meet a known liability, though a contingent one, for, the expression 'liability' occurring in cl. (7)(1)(a) of Part III of Sixth Schedule to the Companies Act includes any expenditure contracted for and arising under a contingent liability: but if the sum so appropriated is shown to be in excess of the sum required to meet the estimated liability (discounted present value on a scientific basis) it is only the excess that will have to be regarded as a reserve under clause (7) (2) of Part III to the Sixth Schedule. [807 G.H; 808 A-D]

In the instant case although the assessee had urged before the authorities below that different treatment for the same item could not be given for purposes of income tax assessment and super profits tax assessment the assessee did not clarify by placing material on record as to whether appropriation was based on any acturial valuation or whether it was an appropriation of an ad hoc amount a which has a vital bearing on the question, whether the appropriation could be treated as a provision or reserve. In the absence of proper material the question should be decided by the taxing authorities whether the amount set apart and transferred to gratuity reserve by the assessee company was either a provision or a reserve and if the latter to what extent. [812 C-E]

Standard Mills Co. Ltd. v. Commissioner of Wealth-Tax, Bombay, 63, I.T.R.470 & Workmen of William Jacks & Co. Ltd. v. Management of Jacks & Co.Ltd; Madras. [1971] Supp. S.C.R. 450 followed.

Southern Railway of Peru Ltd. v. Owen [1957] A.C. 334 referred to.

The appropriations of an amount by the Board of Directors by way of providing for proposed dividend would not constitute 'provision', for, the appropriations cannot be said to be by way of providing for any known or existing liability, none having arisen on the date when the Directors made recommendation much less on the relevant date after the first day of the previous year relevant to the assessment year in question. This by itself would not convert the appropriations into "reserves". [813 E-F]

The tests and guidelines laid down by this Court in this respect are: (1) the true nature and character of the appropriation must be determined with reference to the substance in the matter, which means that one must have regard to the intention with which and the purpose for which appropriation has been made such intention and purpose being gathered from the surrounding circumstances. A mass of undistributed profits cannot automatically become a reserve. Some body possessing the requisite authority must clearly indicate that a portion thereof has been earmarked or separated from the general mass of profits with a view to constituting it either a general reserve or a specific reserve; (2) the surrounding circumstances should make it apparent that the amount so earmark ed or set apart is in

fact a reserve to be utilised in future for a specific purpose on a specific occasion; (3) a clear conduct on the part of the Directors in setting apart a sum from out of the mass of undistributed profits avowedly for the purpose of distribution of dividend in the same year would run counter to any intention of making that amount a reserve, (4) the nomenclature accorded to any particular fund which is set apart from out of the profits would not be material
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Or decisive of the matter; and (5) if any amount set apart from out of the profits A is going to make up capital fund of the assessee and would be available to the assessee for its business purposes it would become a reserve liable to be included in the capital computation of the assessee under that Act. [815 F-H, 817 G]

The relevant provisions of the Companies Act clearly show that creating reserves out of the profits is a stage distinct in point of fact and anterior in point of time to the stage of making recommendation for payment of dividend and the scheme of the provisions suggests that appropriation made by the Board of Directors by way of recommending a payment of dividend cannot in the nature of things be a reserve. [818 F-G]

Judged in the light of the above guidelines the appropriations made by the Directors for proposed dividend in the case of the concerned assessee companies did not constitute 'reserves' and the concerned amounts so set apart would have to be ignored or excluded from capital computation. [818 H]

Standard Mills Co. Ltd. v. Commissioner of Wealth-tax Bombay, 63 I.T.R.470, Metal Box Co. Of India Ltd. v. Their Workmen, 73 ITR 67, First National City Bank v. Commissioner of Income-Tax, 42 ITR 67 & Commissioner of Income- tax (Central), Calcutta v. Standard Vacuum oil Co., 59 ITR 685 followed.

Although under the Companies Act it is open to the Directors to recommend and the share-holders to approve payment of dividend from the current year's profits or from the past year's profits and on transfer of a portion of the current year's profit to the general reserve the augmented general reserve becomes a congolmerate fund, having regard to the natural course of human conduct it is not difficult to predicate that dividends would ordinarily be paid out from the current income rather than from the past savings, unless the directors in their report expressly or specifically state that payment of dividends would be made from the past savings. From the commercial point of view, if any amount is required for incurring any expenditure or making any disbursement like distribution of dividends in a current year, ordinarily the same will come out of the current income of the company if it is available and only if the sum is insufficient then the past savings will be resorted to for the purpose of incurring that expenditure or

making that disbursement. Such a course would be in accord with the common sense point of view. [822 C-F]

In the absense of express indication to the contrary the normal rule for a commercial concern would be to resort to current income rather than past savings while incurring any expenditure or making any disbursement. [822 H]

Commissioner of Income-Tax, Bombay City-l v. Bharat Bijlee Ltd. 107 ITR 30; & Commissioner of Income-Tax, Bombay City-ll v. Marrior (India) Ltd. 120 ITR Sl 2 approved.

[per A.N. Sen, J.]

The amount set apart for payment of any dividend recommended by the Board of Directors is not an amount set apart for meeting a known or existing

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liability and cannot be considered to be a "reserve" within the meaning of the Act for the purposes of computation of the capital of the company. [832 F]

The Companies Act, 1956 provides for the preparation of annual balance sheet in the prescribed form and laying it before the shareholders at the annual general meeting. Regulation 87, Table A in Schedule I contemplates that the Board may set aside out of the profits of the company certain sum as "reserve" before dividend is recommended by it. The amount recommended by the Board for payment of dividend is shown in the balance sheet under the head "provision" and not under any head of "reserve". The true nature and character of the sum so set apart must be determined with regard to the substance of the matter which in this case is that the sum set apart was never intended to constitute a "reserve' of the company. [833 F, 834G]

In law the liability for payment of dividend arises only when the share-holders accept the recommendations made by the Directors. Till then it is open to the Directors to modify or withdraw their recommendation before it is accepted by the shareholders and it is equally open to the share-holders not to accept the recommendation in its entirety. Even so, for business purposes when the Directors make any recommendation for payment of dividend and set apart any amount for this purpose the Directors intend to make a provision and do not create any reserve, as Directors know that their recomendation is generally accepted by the shareholders as a matter of course. Therefore any amount set apart for this purpose is understood by persons interested in company matters and in dealing with companies to mean a provision for the payment of dividend to the shareholders and is not understood to constitute a "reserve". [832 C-F]

Commissioner of lncome-tax Bombay City v. Century Spinning and Manufacturing Co. Ltd. [1953] 24 I.T.R. 499, Commissioner of Income Tax v. Standard Vaccum oil Co., [1966] 59 I.T.R. 685, Metal Box Co. Of Ltd. v. Their Workmen, [1963] 73 I.T.R, 53, Commissioner of Income-tax v. Mysore Electrical Industries Ltd., [1971] 80 l.T.R. 567 and Kesho Ram Industries and Cotton Mills Ltd v.Commissioner of

Wealth Tax (Central), Calcutta, [1966] 59 I.T.R. 767 referred to.

JUDGMENT:

CIVIL APPELLATE JURISDICTION: Civil Appeal No. 860 of 1973.

From the judgment and order dated the 1st September, 1972 of the Andhra Pradesh High Court at Hyderabad in R.C. No. 10 of 1971.

AND Civil Appeal No. 1614 (NT) of 1978.

Appeal by Special Leave from the judgment and order dated the 26th July, 1976 of the Calcutta High Court in l.T. Reference No.454 of 1974.

AND Review Petition No. 57 of 1980.

IN Special Leave Petition (Civil) No. 4602 of 1977 From the judgment and order dated the 11th June, 1974 of the Calcutta High Court in I.T. Reference No. 195 of 1969.

AND Tax Reference Case Nos. 2 and 3 of 1977.

Income-tax Reference under section 257 of the Income- tax Act, 1961 drawn up by the Income-tax Appellate Tribunal, Bombay Bench 'B' in R.A. Nos. 1223 and 1224 (Bom.) of 1972- AND Tax Reference Case No. S of 1978.

Income Tax Reference under section 257 of the Income Tax Act, 1961 made by the Income Tax Appellate Tribunal, Bombay Bench "D" in R.A. No. 225 (Bom.) of 1977-78 arising out of S.T.A.No. 36 (Bombay) 1 1976-77.

A. Subbarao and Y.V. Anjaneyulu for the appellant in Civil Appeal No. 860/73. E V.S. Desai, Dr. Debi Pal, Praveen Kumar and Anil Kumar Sharma for the Appellant in C.A. 1614 of 1978 and for the Petitioner in Review Petition No. 57/80.

K.G. Haji and R.J. John for the Appellant in Tax Reference Case Nos. 2 and 3 of 1977.

S.E. Dastur, S.N. Talwar and R.J. John for the Appellant in Tax Reference Case No. 5 of 1978.

S.T. Desai, J. Ramamurthi and Miss A. Subhashini for the Respondent in Civil Appeal No. 860/73.

Miss A. Subhashini for the Respondent in Civil Appeal S.C. Manehanda and Miss A. Subhashini for the Respondent in Tax Reference Nos. 2 and 3 of 1977.

S.C. Manchanda, Anil Dev Singh and Miss A. Subhashini for the Respondent in Tax Reference Case No. 5/1978.

S P. Mehta and K.J. John for the Intervener.

Dr. Debi Paul and K.J. John for the Intervener in Tax Reference Case No. 5/1978.

The following Judgments were delivered:

TULZAPUKKAR, J. In these Civil Appeals and Tax Reference Cases certain common questions of law arise for our determination and hence all these are disposed of by this common judgment. The common questions raised are whether amounts retained or appropriated or set apart by the concerned assessee company by way of making provision (a) for taxation, (b) for retirement gratuity and (c) for proposed dividends from out of profits and other surpluses could be considered as "other reserves" within the meaning of Rule I of the Second Schedule to the Super Profits Tax Act, 1963 (or Rule 1 of the Second Schedule to the Company's (Profits) Sur-tax Act, 1964) for inclusion in capital computation of the Company for the purpose of levying super profit tax ? The first three matters concerning Vazir Sultan Tobacco Co. Ltd; Hyderabad, Ballarpur lndustries, Ltd; and M/s. Bengal Paper Mills Co. Ltd; Calcutta arise under the Super Profits Tax Act, 1963 while the the Tax Reference Cases concerning M/s. Echjay Industries Pvt. Ltd. and Hyco Products Pvt. Ltd. Bombay arise under the Companies (Profits) Sur-tax Act.1 964.

Since Civil Appeal No. 860 of 1973 (Vazir Sultan Tobacco Company's case) is comprehensive and comprises all the three items of appropriation it will be sufficient if the facts in this case are set out in detail so as to understand how the questions for determination arise in these matters. Vazir Sultan Tobacco Co. Ltd. was an assessee under the Super (Profits) Tax Act, 1963. For the assess- ment year 1963-64, for which the relevant accounting period was the year which ended 30th September, 1962, for computing the chargeable profits of that year for the purpose of levy of super profits tax under the Act, the assessee company claimed that the appropriations of a) Rs. 33,68,360 for taxation, (b) Rs. 9,08,106 for retirement gratuity and (c) Rs. 18,41,820 for dividends (all of which items were shown under the heading 'current liabilities and provisions' in the concerned balance-sheet as at 30th Sept. 1962) should be regar-

ded as "other reserves" within the meaning of Rule 1 of Second A Schedule to the Act and be included while determining its capital. The Super Profits Tax officer rejected the assessee's contention as in his opinion all these items were "provisions ' and not "reserves" and as such these had to be ignored or excluded from the capital computation of the assessee company and on that basis he determined the capital, and the standard deduction and levied super profits tax on that portion of the chargeable profits of the previous year which exceeded the standard deduction. In the

appeal preferred by the assessee company against the assessment, the Appellate Commissioner upheld the assessee's contentions and held that those items were "reserves" and took them into account while computing the capital of the assessee company. In the further appeal prefer- red by the Super Tax officer, the Income Tax Appellate Tribunal accepted the Department's contention and held that these were not "reserves" within the meaning of Rule I of the Second Schedule to the Act and as such these could not enter into capital computation of the assessee company. In the Reference that was made under section 256(1) of the Income Tax Act, 1961 read with s. 10 of the Super Profits Tax Act at the instance of the assessee company the following question of law was referred to the Andhra Pradesh High Court for its opinion:

"Whether on the facts and in the circumstances of the case the provisions (a) for taxation Rs. 33,68,360,

(b) for retirement gratuity Rs. 9,08,106 and (c) for dividends Rs. 18,41,820, could be treated as 'reserves' for computing the capital for the purpose of super profits tax under Second Schedule to the Super Profits Tax Act, 1963 for the assessment year 1963-64 ?" F The High Court on a consideration of several authorities answered the question in respect of the three items in favour of the Revenue and against the assessee company and held that the three sums so set apart by the assessee company in its balance-sheet were not "reserves"

and had to be excluded in the computation of its capital for the purpose of levying super profits tax payable on the chargeable profits tor the relevant accounting year. It is this view of the High Court that is being challenged by the assessee company in the Civil Appeal No. 86() of 1973 before us.

In Civil Appeal No. 1614/1978 (Ballarpur Industries Ltd) and Review Petition No. 57 of 1980 (M/s. Bengal Paper Mills Co. Ltd.) We are concerned with only two items of appropriation being

(a) provision for taxation and (b) provision for proposed dividend and in each one of these cases the Calcutta High Court had taken the view that these two items do not constitute "reserves" and as such have to be ignored while computing the capital of the assessee company.

In Tax Reference Case Nos. 2 and 3 of 1977 (M/s Echjay Industries Pvt. Ltd.)-a case under Companies (Profits) Surtax Act, 1964, we are concerned with two items of appropriation being (a) provision for taxation (b) provision for proposed dividend for the two assessment years 1969-70 and 1970-71 and in each of the years the Taxing Authorities as also the Income Tax Appellate Tribunal Bombay have taken the view that these appropriations did not constitute "other reserves" within the meaning of Rule I of the Second Schedule to the Companies (Profit) Surtax Act, 1954 and as such were not includible in the capital computation of the assessee company but in view of a divergence of opinion between the different High Courts on the point, the Tribunal has at the instance of the assessee company made a direct Reference to this Court under s. 257 of the Income Tax Act, 1961 read with s. 18 of the Companies (Profits) Surtax Act, 1964.

In Tax Reference Case No. 5 of 1978 (Hyco Products Pvt.Ltd.)-also a case under Companies (Profits) Surtax Act, 1964 the same question pertaining to dividend alone but in a different form arose for consideration before the Taxing Authorities and the Income Tax Appellate Tribunal. It was not a case of 'proposed dividend' but the assessee company after transferring Rs. 29,77,000 out of the current year's profit amounting to Rs. 61,03,382 to General Reserves, paid out of Rs. 3,10,450 as dividend to its share-holders from such augmented General Reserves and the question was whether while computing the capital of the assessee-company for the purpose of levy of surtax the General Reserves should or should not be reduced by the aforesaid sum of Rs. 3,10,450 ? In other words, the question was whether the amount of Rs. 3,10,450 could not form part of the General Reserves on the relevant date (being 1.1. 1973) for the computation of the capital ? The Taxing Authorities as well as the Appellate Tribunal Bombay held that the said amount of Rs. 3,10,450 had to be ignored for the purpose of computation of capital for surtax purposes because it was not a reserve. The assessee company has challenged this view of the Tribunal before us in this direct Reference made to this Court under s. 257 of the Income Tax Act, 1961 read with s. 18 of the Companies' (Profits) A Surtax Act, 1964.

It may be stated that the scheme and the main provisions of the two concerned enactments are almost identical, the object of both these enactments being the imposition of a special tax on excess profits earned by companies. Under Section 4 of the 1963 Act, which is the charging provision, there shall be charged on every company for every assessment year commencing on and from 1st April, 1963, a tax, called the super profits tax, in respect of so much of its "chargeable profits" of the previous year as exceed the "standard deduction" at the rate or rates specified in the Third Schedule. Section 2(5) defines the expression "chargeable profits" to mean the total income of an assessee computed under the Income Tax Act, 1961, for any previous year and adjusted in accordance with the provisions of First Schedule, while Section 2(9) defines the expression "standard deduction" to mean an amount equal to six per cent of the capital of company as computed in accordance with the provisions of the Second Schedule, or an amount of Rs. 50,000 whichever is greater. In order to D determine "standard deduction" it becomes necessary to compute capital of the company in accordance with the rules laid down in the Second Schedule and rule 1 is relevant for our purposes, the material portion whereof runs as follows:

> "1. Subject to the other provisions contained in this Schedule, the capital of a company shall be the sum of the amounts, as on the first day of the previous year relevant to the assessment year, of its paid up share capital and of its reserve, if any, credited under the proviso (b) to Clause (vi-
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> b) of sub-section (2! of sec. 10 of the Indian Income Tax Act, 1922 or under sub section (3) of sec. 34 of the Income Tax Act, 1961, and of its other reserves in so far as the amounts credited to such other reserves have not been allowed in computing its profits for the purposes of the Indian Income Tax Act, 1922 or the Income Tax Act, 1961 .. "

It will be clear from the aforesaid provision of rule 1 that before any amount or sum qualifies for inclusion in capital computation of a company two conditions are required to be fulfilled-(a) that the

amount or sum must be a "reserve" and (b) the same must not have been allowed in computing the company's profits for the purposes of the 1922 Act or the 1961 Act. That none of the items of appropriation either for taxation or for retirement gratuity, or for proposed dividend in the concerned assessees' case had been allowed in computing the assessee's profits under the 1961 Act has not been disputed; in other words the second condition indicated above has been satisfied. The question is whether any of these items could be treated as or falls within the expression "other reserves" occurring in the said rule.

The expression 'reserve' has not been defined in the Act and therefore one would be inclined to resort to its ordinary natural meaning as given in the dictionary but it seems to us that the dictionary meaning, though useful in itself, may not be sufficient, for, the dictionaries do not make any distinction between the two concepts 'reserve' and 'provision' while giving their primary meanings whereas in the context of the legislation with which we are concerned in the case a clear distinction between the two is implied. According to the dictionaries (both oxford and Webster) the applicable primary meaning of the word 'reserve' is: "tc, keep for future use or enjoyment; to set apart for some purpose or end in view; to keep in store for future or special use; to keep in reserve", while 'provision' according to Webster means: "something provided for future." In other words according to the dictionary meanings both the words are more or less synonymous and connote the same idea. Since the rules for computation of capital contained in the Second Schedule to the Act proceed on the basis of the formula of capital plus reserves-a formula well-known in commercial accountancy, it becomes essential to know the exact connotation of the two concepts 'reserve' and 'provision' and the distinction between the two as known in commercial accountancy. Besides, though the expression 'reserve' is not defined in the Act, it cannot be forgotten that it occurs in a taxing statute which is applicable to companies only and to no other assessable entities and as such the expression will have to be understood in its ordinary popular sense, that is to say, the sense or meaning that is attributed to it by men of business, trade and commerce and by persons interested in or dealing with companies. Therefore, the meanings attached to these two words in the provisions of the Companies Act 1956 dealing with preparation of balance-sheet and profit and loss account would govern their construction for the purposes of the two taxing enactments. We might mention here that in C.l.T. v. Century Spinning and Manufacturing Company (1) this Court after referring to the dictionary meaning of the expression 'reserve' observed: "what is the true A nature and character of the disputed sum (sum allegedly set apart) must be determined with reference to the substance of the matter" and went on to determine the true nature and character of the disputed sum by relying upon the provisions of the Indian Companies Act 1913, the form and the contents of the balance-sheets required to be drawn up and Regulation 99 in Table A of the 1st Schedule.

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. Their Workmen (1) thus:

> "The distinction between a provision and a reserve is in commercial accountancy fairly well known. Provi- sions made against anticipated losses and contingencies are charges against profits and therefore, to be taken into account against gross receipts in the P. and 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 proprietor's interest. (See Spicer and Pegler's Book-keeping and Accounts, 15th Edition, page
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> 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 P and L 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 the Companies Act, 1956.

Under s. 210 of the Companies Act, 1956 it is incumbent upon the Board of Directors of every company to lay before the annual general meeting of its share-holders (a) the annual balancesheet and (b) the profits and loss account pertaining to the previous financial year. Section 211(1) provides that every balance- sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall, subject to the provisions of this section, be in the form set out in Part I of Schedule VI, or near thereto as circumstances admit or in such other from as may be approved by the Central Government either generally or in any particular case, while s. 211(2) provides that every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part Ir of r Schedule VI, so far as they are applicable thereto. In other words the preparation of balance-sheet as well as profit and loss account in the prescribed forms and laying the same before the share- holders at the annual general meeting are statutory requirements which the company has to observe. The Form of balance-sheet as given in Part I of Schedule VI contains separate heads of 'reserves and Surpluses' and 'current liabilities and provisions' and under the sub-head 'reserves' different kinds of reserves are indicated and under sub-head 'provisions' different types of provisions are indicated; Part III is the interpretation clause setting out the definitions of various expressions occurring in Parts I and Il and the expressions 'reserve', 'provision' and 'liability' have been defined in cl. 7 thereof. Material portion of cl. (7) of Part III runs as under:

> "(1) For the purposes of Parts I and II of this Sche- dule, unless the context otherwise requires:
>
> (a) the expression "provision" shall, subject to sub.

cl. (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) x x x x x x x x x and in this sub-clause the expression "liability" shall include A 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 a 'provision'."

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 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 appreciation 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 assessees strenuously contended before us that once it was shown or became clear that the retention or appreciation 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 type of definitions of the two concepts which are to be found in cl. 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 a 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.

Having thus indicated the proper approach to be adopted, we shall proceed to deal with the three items of appropriation being (a) provision for taxation, (b) provision for retirement gratuity and (c) provision for proposed dividends in the case of concerned assessee companies in these Appeals and Tax Reference Cases.

Dealing first with the item of appropriation by way of provision for taxation, which arises in Civil Appeal No. 860/1973 (Vazir Sultan Tobacco Company), Civil Appeal No. 1614 (NT)/ 1978 (Ballarpur Industries Ltd;) Review Petition No. 50/1980 (M/s. Bengal Paper Mills Co. Ltd.) and Tax Reference Cases Nos. 2 & 3/1977 (M/s Echjay Industries Pvt. Ltd;)-the common question is whether the concerned amounts appropriated or set apart by these assessee-companies from out of the profits and other surpluses by way of making provision for taxation constitute a provision or a reserve on the relevant date, being the first day of the previous year relevant to the assessment year in question ? Taking Vazir Sultan Tobacco Company's case as an illustration, for the assessment year 1963-64 the relevant accounting period was the year which ended on September 30, 1962; under Rule I of the Second Schedule to the Super Profits Tax Act, the first day of the previous year would be october 1, 1961 and. therefore, the balance-sheet of that company as on September 30, 1961 and the profits and loss account which ended on September 30, 1961 would be relevant. It cannot be disputed that on the expiry of September 30, 1961, the assessee company incurred the taxation liability in respect of the profits which it had earned during that year, though the exact amount of such liability could not be determined with substantial accuracy at that time and the same would have to be ascertained by reference to rate of taxes applicable to that year. The liability for taxation having thus arisen on the expiry of the last day of the year, the setting apart of the sum of Rs. 33,68,360 by the Board of Directors will have to be regarded as a provision for a known and existing liability, the quantification whereof bad to be done later. On principle, therefore, it seems to us clear that the item of Rs. 33,68,360 which had been set apart by the Board of Directors for taxation must be regarded as a provision and cannot be regarded as a reserve. Similar would be the position in regard to the appropriations for taxation made by the other assessee-companies mentioned earlier.

In this context a reference to this Court's decision in the case of Kesoram Industries and Cotton Mills Ltd. v. Commissioner of Wealth Tax (Central) Calcutta(') would be useful. In that case the question was whether a certain amount which had been set apart as provision for payment of income-tax and super tax was a "debt owed" within the meaning of s. 2(m) of the Wealth-Tax Act, 1957, as on March 31, 1957 which was the valuation date and as such was deductible in computing the net wealth of the appellant company. In its balance-sheet for the year ending March 31, 1957 the appellant company had shown a certain amount as provision for payment of income-tax and super-tax in respect of that year of account and this Court took the view that the expression "debt owed" within the meaning of s. 2(m) of the Wealth-Tax Act, 1957 could be defined as the liability to pay in presenti or in futuro an ascertainable sum of money and that the liability to pay income-tax was a present liability though the tax became payable after it was quantified in accordance with ascertainable data; that there was a perfected debt on the last date of the accounting year and not a contingent liability. The Court further observed that the rate was always easily ascertainable; that if the Finance Act was passed, it was the rate fixed by that Act; if the Finance Act was not yet passed, it

was the rate proposed in the Finance Bill pending before the Parliament or the rate in force in the preceding year whichever was more favourable to the assessee and that all the ingredients of a "debt" were present and it was a present liability of an ascertainable amount and that, therefore, the amount of provision for payment of income-tax and super-tax in respect of the year of account ending March 31, 1957 was a "debt H owed" within the meaning of s. 2(m) on the valuation date, namely March 31, 1957 and was as such deductible in computing the net wealth. The ratio of this decision clearly suggests that the appropriation of the amounts set apart by the assessee companies before us for taxation would constitute a provision made by them to meet a known and existing liability and as such the concerned amounts would not be includible i n capital computation.

Counsel for the assessee company in Vazir Sultan Tobacco Company's case, however, attempted to raise a further plea that the provision for taxation in the sum of Rs. 33,68,360 was an excess provision in the sense it was in excess of the amount which was reasonably necessary for the purpose of taxation and, there ore, the excess should be treated as a reserve and not a provision and in this behalf reliance was placed on cl. (7) (2) of Part III of Schedule VT and three decisions-of the Madras High Court Commissioner of Income-tax Madras v. Indian Steel Rolling Mills Ltd.(l) of the Himachal Pradesh High Court in Hotz Hotels Pvt. Ltd. v. Commissioner of Income Tax, Haryana, H.P. and Delhi(2) and of Allahabad High Court in Commissioner of Income-Tax, Delhi v. Modi Spinning and Weaving Mills(3). There could be no dispute about the principle that if provision for a known or existing liability is made in excess of the amount that would be reasonably necessary for the purpose 13: the excess shall have to be treated as a reserve and, therefore, would be includible in the capital computation but no such case was made out by the assessee company at any stage of the assessment proceedings either before the Taxing Authorities or even before the Tribunal or the High Court and in the absence of any such plea having been raised at any stage of the proceedings it will not be proper for this Court to allow the assessee company to raise such a plea, which will need investigation into facts, for the first time in its appeal before this Court. The contention is, therefore, rejected. Dealing next with the item of appropriation made for retirement gratuity, which arises only in Civil Appeal No. 860/1973 (Vazir Sultan Tobacco Co.) the question is whether the sum of Rs. 9,O8,106 appropriated or set apart by the assessee company from out of its profits and other surpluses by way of providing for retirement gratuity is a provision or a reserve on the relevant date, viz. 1.10.1961 ? Counsel for the assessee-compaoy vehemently urged before us that this appropriation had not been allowed as a deduction in the income-tax assessment proceedings of the company for the relevant assessment year on the ground that it was in the nature of a reserve and the entire sum, minus the actual payments, was added back to the income and profits of the assessee-company and if that be so, in the super profit-tax assessment it cannot be treated as a provision and excluded from capital computation. According to him there could not be two different treatments for the same item in income-tax assessment and super profit tax assessment. He pointed out that this contention was specifically urged in the appeal before the Appellate Assistant Commissioner but was wrongly rejected. He further submitted that no actuarial valuation had been undertaking but ad hoc amount was appropriate or transferred to gratuity reserve and as such the same should have been treated as a reserve and included in capital computation. On the other hand, counsel for the Revenue seriously disputed the last submission and contended that it was never the case of the assessee-company either before the Taxing Authorities or before the Tribunal or before the High Court that the appropriation was or an ad hoc sum without undertaking any actuarial

valuation. It must be observed that whereas the assessee-company did urge a contention before the lower authorities that different treatments for the same item could not be given for purpose of income-tax assessment and super profit-tax assessment, the assessee company did not clarify by placing material on record as to whether the appropriation of the amount was based on any actuarial valuation or whether it was an appropriation of an ad hoc amount an aspect which, as we shall presently point out, has a vital bearing on the question whether the appropriation could be treated as a provision or a reserve. In the absence of proper material touching this vital aspect, we are afraid, the issue in question will have to be remanded to the Taxing Authorities through the Tribunal for disposal in the light of the well settled principles in that behalf, which we shall presently indicate.

Ordinarily an appropriation to gratuity reserve will have to be regarded as a provision made for a contingent liability, for, under a scheme framed by a company the liability to pay gratuity to its employees on determination of employment arises only when the employment. Of the employee is determined by death, incapacity, retirement or resignation-an event (cessation of employment) Certain to happen in the service career of every employee; moreover, the amount of gratuity payable is usually dependent on the emp-

loyee's wages at the time of determination of his employment and the number of years of service put in by him and the liability accrues and enhances with completion of every year of service; but the company can work out on an actuarial valuation its estimated liability (i.e. discounted present value of the liability under the scheme on a scientific basis) and make a provision for such liability not all at once but spread over a number of years. It is clear that if by adopting such scientific method any appropriation is made such appropriation will constitute a provision representing fairly accurately a known and existing liability for the year in question; if, however, an ad hoc sum is appropriated without resorting to any scientific basis such appropriation would also be a provision intended to meet a known liability, though a contingent one, for, the expression 'liability' occurring in cl. (7) (1) (a) of Part III of the Sixth Schedule to the Companies Act includes any expenditure contracted for and arising under a contingent liability; but if the sum so appropriated is shown to be in excess of the sum required to meet the estimated liability (discounted present value on a scientific basis) it is only the excess that will have to be regarded as a reserve under cl. (7) (2) of Part III to the Sixth Schedule.

In the above context we might refer to one English case decided by the House of Lords and two or three decisions of this Court, which seem to lead to aforesaid propositions. In Southern Railway of Peru Ltd. v. Owen(1) an English Company operating a railway in Peru was, under the laws of that country, liable to pay its employees conpensation on the termination of their services either by dismissal or by notice or on such termination by death or efflux of contractual time. The compensation so paid was an amount equivalent to one month's salary at the rate in force at the date of determination for every year of service. In the computation of taxable income under the Income-tax Act 1918, the company claimed to be entitled to charge against each year's receipts the cost of making provision for the retirement payments which would ultimately be thrown on it, calculating the sum required to be paid to each employee if he retired without forfeiture at the close of the year and (; setting aside the aggregate of what was required in so far as the year had

contributed to the aggregate. The House of Lords rejected the deductions on the ground that in calculating the deductions the company had ignored the factor of discount. But, their Lordships recognised the principle that the company was entitled to charge, against each year's receipts, the cost of making the provision for the retirement which would ultimately be payable as the company had the benefit of the employee's services during that year provided the present value of the future payments could be fairly estimated. Lord MacDermott observed at page 345 as follows:

> ".... as a general proposition it is, I think right to say that, in computing his taxable profits for a particular year, B a trader, who is under a definite obligation to pay his employees for their services in that year an immediate payment and also a future payment in some subsequent year, may properly deduct, not only the immediate payment but the present value of the future payment, provided such present value can be satisfactorily determined or fairly estimated."

In Standard Mills Co. Ltd. v. Commissioner of Wealth- Tax, Bombay (1) the question for decision was whether an estimated liability under gratuity schemes framed under industrial awards amounted to 'debts' and could be deducted while computing the net wealth of the assessee-company under the Wealth Tax Act. This Court held in view of the terms of s. 2 (m) of that Act, that as the liability lo pay gratuity was not in praesenti but would arise in future on determination of the service, i. e. On the retirement, death or termination, the estimated liability under the schemes would not be a 'debt' and, therefore, could not be deducted while computing the net wealth. The House of Lords decision in the case of Southern Rly. Of Peru Ltd. (supra) was distinguished by this Court as having no relevance to the question before it on the ground that the House of Lords in that decision was concerned in determining the deductibility of the present value of a liability which may arise in future in the computation of taxable income for the relevant year under the income-tax laws. It will thus appear that this Court was of the view that though such a liability is a contingent liability and, therefore, not a 'debt' under s. 2(m) of the Wealth-Tax Act it would be deductible under the Income Tax Act while computing the taxable profits; in other words different considerations would apply to cases arising under the Wealth-Tax Act and the Income-Tax Act.

In Matal Box Co's case (supra) this Court was concerned with the nature of liability under a scheme of gratuity in the context of the Payment of Bonus Act, 1965 and the question related to a sum of Rs. 18.38 lakhs being the estimated liability under the two gratuity schemes framed by the company, which was deducted from the gross receipts in the P & L Account, it being contended on behalf of the workmen that such deduction was not justified while determining the 'available surplus' and the 'allocable surplus' for payment of bonus to them under the Payment of Bonus Act, 1965. The Court rejected the contention and adverting to the decision of House of Lords in the case of Southern Rly. Of Peru Ltd. (supra) held that an estimated liability under gratuity schemes even if it amounted to a contingent liability and was not a 'debt' under the Wealth Tax Act, if properly ascertainable and its present value was fairly discounted was deductible from the gross-receipts while preparing the P & L Account. The material portion of the head-note appearing at page 54 of the report runs thus:

> "Contingent liabilities discounted and valued as necessary, can be taken into account as trading expenses if they are sufficiently certain to be capable of valuation and if

> profits cannot be properly estimated without taking them into consideration. An estimated liability under a scheme of gratuity if properly ascertainable and its present value is discounted, is deductible from the gross receipts while pre paring the P & L account. This is recognised in trade circles and there is nothing in the Bonus Act which prohibits such a practice. Such a provision provides for a known liability of which the amount can be determined with substantial accuracy. It cannot, therefore, be termed a "reserve". Therefore, the estimated liability for the year on account of a scheme of gratuity should be allowed to be deducted from the gross profits. The allowance is not restricted to the actual payment of gratuity during the year."

At page 62 of the Report this Court observed thus:

> "Two questions, therefore, arise: (I) whether it is legitimate in such a scheme of gratuity to estimate the liability on an actuarial valuation and deduct such estimated liability in the P & L Alc while working out its net profits; (2) if it is, b whether such appropriation amounts to a reserve or a provision?.. In the case of an assessee maintaining his accounts on mercantile system, a liability already accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, re-
>
> gard being had to the accepted principle of commercial A practice and accountancy . It is not as if such deduction is permissible only in case of amounts actually expended or paid. Just as receipts, though not actual receipts but accrued due, are brought in for income-tax assessment, so also liabilities accrued due would be taken into account while working out the profits and gains of the business".

Again at page 64 of the Report this Court observed thus:

> "In the instant case the question is not whether such estimated liability arising under the gratuity schemes amounts to a debt or not. The question that concerns us is whether while working out the net profits, a trader can pro vide from his gross receipts his liability to pay a certain sum for every additional year of service which he receives from his employees. This, in our view, he can do if such liability is properly ascertainable and it is possible to arrive at a proper discounted present value. Even if the n liability is a contingent liability, provided its discounted present value is ascertainable, it can be taken into account. Contingent liabilities discounted and valued as necessary can be taken into account as trading expenses if they are sufficiently certain to be capable of valuation and if profits cannot be properly estimated without taking them into account."

In the case of Workmen of William Jacks . Co. Ltd. v. Management of Jacks & Co. Ltd. Madras (1) another decision under the Payments of Bonus Act, 1965, this Court, after referring to the distinction pointed out in Metal Box Co's case between the two concepts 'provision' and 'reserve' has observed on page 547 as follows:

> "The provision for gratuity, furlough salary, passage, service and commission, in the present case was all made in respect of existing and known liabilities though in some cases the amount could not be ascertained with accuracy. It was not a case where it was an anticipated loss or anticipated expenditure which would arise in future. Such provision is therefore not a reserve at all and cannot be added back under item 2 (c) of the Second Schedule."

In the above case also the Court was concerned with the question whether particular provision made for gratuity, furlough salary, passage, etc. was a reserve or a provision for the purpose of Second Schedule to the Payment of Bonus Act, 1965. At page 546 of the report the Court has categorically observed that all these items, namely, gratuity furlough salary, passage, service, commission, etc. were clearly in respect of liabilities which had already accrued in the years in which the provision was made and were not in respect of anticipated liabilities which might arise in future and, therefore, the Court held that the said provision was not a reserve but a provision.

From the aforesaid discussion of the case law it seems to us clear that the propositions indicated by us earlier clearly emerge. Since in the instant case sufficient material throwing light on the above aspects of the question has not been made available, we think, it will be in the interest of justice to remand the case through the Tribunal to the taxing authority to decide the issue whether the concerned amount (Rs. 9,O8,1061-) set apart and transferred to gratuity reserve by the assessee company was either a provision or a reserve and if the latter to what extent? The taxing authority will decide the issue in light of the above principles after giving an opportunity to the assessee company to place additional relevant materials before Turning to the last item of appropriation by way of provision for proposed dividends, which arises in all these matters (except in Tax Reference Case No. 511978 of Hyco Products Pvt. Ltd.) the common question is whether the concerned amount appropriated or set apart by the assessee- companies from out of the profits and other surpluses by way of making provision for 'proposed dividends' constituted a provision or a reserve on the relevant date ?

It is true that under s. 27 of the Companies Act, 1956 the Directors can merely recommend that a certain sum be paid as dividend but such recommendation does not result in any obligation or liability; the obligation or liability to pay the dividend arises only when the share-holders at the annual general meeting of the company decide to accept the recommendation and pass a resolution for declaration of the dividend. It is therefore open to the directors to withdraw or modify their recommendation at any time before the shareholders accept the same and it is equally open to the shareholders not to accept the recommendation at all or to declare a dividend of an amount lesser than that recommended by directors. In Kesoram Industries case (supra) this Court has clarified the aforesaid legal A position by observing at page 772 of the report, thus:

> "The directors cannot distribute dividends but they can only recommend to the general body of the company the quantum of dividend to be distributed. Under section 217 of the Indian Companies Act, there shall be attached to every balance-sheet laid before a company in general meeting a report by its board of directors with respect to, interalia, the amount, if any, which it recommends to be

> paid by way of dividend. Till the company in its general body meeting accepts the recommendation and declares the dividend, the report of the directors in that regard is only a recommendation which may be withdrawn or modified as the case may be. As on the valuation date (under the Wealth Tax Act) nothing further happened than a mere recommendation by the directors as to the amount that might be distributed as dividend, it is not possible to hold that there was any debt owed by the assessee to the share holders on the valuation date."

All that follows from above is that in the instant cases the appropriations of the concerned amounts by the Board of Directors by way of providing for proposed dividend would not constitute 'provisions' for, the appropriations cannot be said to be by way of providing for any known or existing liability, none having arisen on the date when the directors made the recommendation much less on the relevant date being the first day of the previous year relevant to the assessment year in question. But as stated earlier this by itself would not automatically convert the appropriation into 'reserves', regard being had to the negative and non- exhaustive character of the definition of 'reserve' given in cl. 7 (I)(b) of Part III of the Sixth Schedule to the Companies A ct. The question whether the concerned amounts in fact constituted 'reserves' or not will have to be decided by having regard to the true nature and character of the sums so appropriated depending on the surrounding circumstances particularly the intention with which and the purpose for which such appropriations had been made.

We have already indicated that according to the dictionaries (both oxford and Webster) the applicable meaning of the word 'reserve' is: "to keep for future use or enjoyment; to set apart for some purpose or end in view; to keep in store for future or special use; to keep in reserve." In other words, the word 'reserve' as a noun in ordinary parlance would mean "something which is kept for future use or stored up for something or set apart for some purpose". It cannot be disputed that a reserve may be a general reserve or specific reserve and all that is required is that an amount should be kept apart for some purpose, either general or specific. Eeven so the question is whether the earmarking of a portion of pro fits by the board of directors of a company avowedly for the purpose of distributing dividend would fall within the expression 'reserve' occurring in rule T of the Second Schedule to the Super Profits Tax Act, 1963? For this purpose certain tests indicated in some decisions of this Court will have to be considered: The first decision of this Court in that behalf is the decision in Century Spinning and Manufacturing Company's ease (supra). In that case the material facts were these: For the year ending 31st December, 1946, the profit of the assessee-company, whose accounting year was the calendar year, was a certain sum according to the profit and loss account. After making provision for depreciation and taxation, the balance of Rs. 5,08,637 was carried to the balance sheet. This sum was not allowed in computing the profits of the assessee for the purposes of income tax. On 28th February, 1946, the Board of directors recommended out of that amount the sum of Rs. 4,92,426 should be distributed as dividend and the balance of Rs. 16,211 was to be carried forward to the next year's account. This recommendation was accepted by the share- holders in their meeting on 3rd April, 1946, and the amount was shortly afterwards distributed as dividend. In computing the capital of the assessee company on 1st April, 1946, under the Business Profits Tax Act, 1947, the assessee claimed that the sum of Rs. 5,08,637 and the profit earned by it during the period 1st January, 1946 to 1st April, 1946, should be treated as "reserves"

for the purpose of rule 2(1) of Schedule IT. The High Court held that the sum of Rs. 5,08,637 must be treated as a reserve for the purpose of rule 2, but the profit made by the assessees during the period 1st January, 1946 to 1st April, 1946 could not be included in the reserves. On appeal to this Court, it was held that the sum of Rs. 5,08,637 as well as the profits earned by the assessee during the period 1st January, 1946 to 1st April, 1946 did not constitute "reserves" within the meaning of rule 2 (1) of Schedule II. After noting that the expression 'reserve' had not been defined in the Business Profits Tax Act, 1947 and after noting dictionary meanings of that expression the Court observed:

> " What is the true nature and character of the disputed A sum must be determined with reference to the substance of the matter and when this is borne in mind, it follows that the 1st of April, 1946 which is the crucial date, the sum of Rs. 5,08,637 could not be called a reserve for nobody possessed of the requisite authority had indicated on that date the manner of disposal or distination. On the other hand, B on the 28th February, 1946 the directors clearly earmarked it for distribution as dividend and did not make it a reserve. Nor did the company in its meeting of 3rd April, 1946 decide that it was a reserve. It remained on the 1st of April, as a mass of undistributed profits which were available for distribution and not earmarked as "reserve". On the 1st of January, 1946 the amount was simply brought from the profit and loss account to the next year and nobody with any authority on that date made or declared a reserve. The reserve may be a general reserve or a specific reserve, but there must be a clear indication to show whether it was a reserve either of the one or the other kind. The fact that it constituted a mass of undistributed profits on the 1st Jan. 1946 cannot automatically make it a reserve. On the 1st April, 1946 which is the commencement of the chargeable accounting year, there was merely a recommendation by the directors that the amount in question should be distributed as dividend. Far from showing that the directors have made the amount in question a reserve it shows that they had decided to earmark it for distribution as dividend."

The decision clearly lays down that the true nature and character of the appropriation must be determined with reference to the substance of the matter; obviously this means that one must have regard to the intention with which and the purpose for which appropriation has been made, such intention and purpose being gathered from the surrounding circumstances. In that behalf the following aspects mentioned in the judgment provide some guidelines: (a) a mass of undistributed profits cannot automatically become a reserve and that somebody possessing the requisite authority must clearly indicate that a portion thereof has been earmarked or separated from the general mass of profits with a view to constituting it either a general reserve or a specific reserve, (b) the surrounding circumstances should make it apparent that the amount so ear-marked or set apart is in fact a reserve to be utilised in future for a specific purpose and on a specific occasion, and (c) a clear conduct on the part of the directors in setting apart a sum from out of the mass of undistributed profits avowedly for the purpose of distribution as dividend in the same year would run counter to any intention of making that amount a reserve. It was because these aspects obtained in the case that this Court took the view that neither the sum of Rs. 5,08,637 nor the profits earned by the assessee during the period 1st January, 1946 to 1st April 1946 constituted "reserve" within the

meaning of Rule 2(1) of Second Schedule of the Business Profits Tax Act, 1947.

Two more decisions of this Court one in First National City Bank v. Commissioner of Income-Tax (1) and the other in Commissioner of Income-Tax (Central), Calcutta v. Standard Vacuum oil Co.(2) which provide two more guidelines, may now be considered. In both these cases the Court was concerned with the question whether the amount set apart as "undivided profit" or set apart as "earned surplus" in accordance with the system of accountancy which obtained in the United States amounted to a reserve liable to be included in the capital computation under rule 2 of Schedule II of the Business Profits Tax Act, 1947. In both the cases the assessees were non-resident companies and followed the system of accounting that obtained in the American commercial world. In the first case Justice Kapur, speaking for the court, pointed out the difference between the two system of accounting at Page 23 of the Report thus:

> "In India at the end of an year of account the unallocated profit or loss is carried forward to the account of the next year, and such unallocated amount gets merged in the account of that year. In the system of accounting in the USA each year's account is self- contained and nothing is carried forward. If afteral locating the profits to diverse heads mentioned above any balance remains, it is credited to the "undivided profits" which become part of the capital fund. If in any year as a result of the allocation there is loss the accumulated undivided profits of the previous years are drawn upon and if that fund is exhausted the banking company draws upon the surplus. In its very nature the undivided profits are accumulation of amounts of residue on hand at the end of the year of successive periods of accounting and these amounts are by the prevailing accounting practice and the Treasury directions regarded as a part of the capital fund of the banking company.' After quoting with approval the above observations, Mr. A Justice Shah in Standard Vacuum Oil Co.'s case went on to observe at page 695 of the report as follows:
>
> "It is true that the court in that case was dealing with a case of a banking company but the characteristics noted are not peculiar to the accounts of a banking company; they are applicable with appropriate variations to the accounts of all companies in which different nomenclatures are used in the accounts to designate the residue on hand as 'surplus', ' undivided profits' or 'earned surplus'. Where the balance of net profits after allocation to specific reserves and payment of dividend are entered in the account under the caption 'earned surplus', it is intended thereby to designate the fund which is to be utilised for the purpose of the business of the assessee. Such a fund may be regarded according to the Indian practice as 'general reserve") This Court in the first case held that the amount designated as "undivided profits" which was available for continuous future use of the business for the bank was a part of the reserve and had to be taken into account while computing the capital under rule 2(1) of Schedule II of the Business Profits Tax Act; similarly, in the second case the Court held that the amount which had been allocated to "earned surplus" which was intended for the purpose of the business of the assessee company and was used in subsequent years in business, represented "reserves" within the meaning of rule

2 of Schedule II of the Business Profits: Tax. From these two decisions two aspects emerge very clearly. In the first place, the nomenclature accorded to any particular fund which is set apart from out of the profits would not be material or decisive of the matter and secondly, having regard to the purpose of rule of 2 of Schedule II of the Business Profits Tax Act, 1947, if any amount set apart from out of the profits is going to make up capital fund of the assessee and would be available to the assessee for its business purposes, it would become a reserve liable to be included in the capital computation of the assessee under that Act.

The provisions of the Companies Act 1956 also lend support to the proposition that an appropriation for proposed dividend would not amount to a reserve. Section 217(1) runs thus:

> "217(1) There shall be attached 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,
>
> (c) the amounts, if any, which it recommends should be paid by way of dividend;
>
> (d) ..... "

Regulation 87 of Table A in the First Schedule runs thus:

> "87(1) The Board may, before recommending any dividend, set aside out of the profits of the company such sums as it thinks proper as a reserve or reserves which shall, at the discretion of the Board, be applicable for any purpose to which the profits of the company may be properly applied, including provision for meeting contingencies or for equalising dividends; and pending such application may at the like discretion, either be employed in the business of the company or be invested in such investments (other than shares of the company) as the Board may, from time to time, think fit.
>
> (2) The Board may also carry forward any profits which it may think prudent not to divide, without setting them aside as a reserve."

The aforesaid provisions read together clearly show that creating re serves out of the profits is a stage distinct in point of fact and anterior in point of time to the stage of making recommendation for payment of dividend and the scheme of the provisions suggests that appropriation made by the Board of Directors by way of recommending a payment of dividend cannot in the nature of things be a reserve.

If regard be had to the guide-lines indicated above as well as the provisions of the Companies Act 1956 specified above we are clearly of the opinion that the appropiations made by the directors for proposed dividend in the case of the concerned assessee-companies do not constitute 'reserves' and the concerned amounts so set apart would have to be ignored or excluded from capital computation.

Since we have reached the aforesaid conclusion on first principles and on the basis of the guidelines discussed above it is unnecessary for us to go into or discuss the scope and effect of the Explanation to Rule 1 in Second Schedule to The Companies (Profits) Sur-tax Act, 1964 though it seems to us prime facie that the Explanation, being clarifacatory in nature is declaratory of the existing legal position.

Dealing with the last case of Hyco Products Pvt. Ltd. Bombay (Tax Reference Case No. 5 of 1978), where the question pertaining to dividend but in a different form arises for consideration, the admitted facts may briefly be stated. The question relates to the Assessment Year 1974-75, the relevant previous year being calendar year 1973 and the material date being 1.1.1973. After the accounts of the calendar year 1972 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 tranfer the General Reserve of the assessee company as on 1.1.1973 stood at Rs. 86,07,712. At the end of the calendar year, 1973 admittedly the directors did not make any provision for 'proposed dividend' in its accounts but there was note on the Balance Sheets to the following effect:-

> "The directors have recommended dividend for the year 1972 at the rate of Rs. 10/- per share free of tax. The dividend, if approved by the share-holders at the forth-coming Annual General Meeting, will be paid out of General Reserve and no separate provision has been made therefor in the accounts."

At the Annual General Meeting held on June 30, 1973 dividend of Rs. 3,10,450 was declared by the share-holders 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 as Rs. 86,07,712 as on 1.1.1973 should be taken into account while computing the capital of the assessee company. But the taxing officer reduced the general reserves by the aforesaid sum of Rs. 3,10,450 and only the balance of Rs. 82,97,262 was added in computing the capital. The Appellate Assistant Commissioner as well as the Income-Tax Appellate Tribunal, Bombay confirmed the order of the Taxing officer. The Tribunal took the view that though it was not a case of 'proposed dividend' since the amount actually paid out as dividend was a smaller sum than the amount transferred from out of profits to the General Reserve that amount could not form part of the reserve and therefore the General Reserve as reduced by Rs. 3,10,450 was properly taken into account for the purpose of computation of the capital as on the relevant date. At the instance of the assessee the Tribunal has referred the following question of law directly to this Court for its opinion under s. 257 of the Income Tax Act 1961 read with s. 18 of the Companies (Profits) Sur-tax Act, 1964:

> "Whether on the facts and in the circumstances of the case the Tribunal was justified in excluding a sum of Rs. 3,10,450 representing the dividends declared for the calendar year 1972 from the General Reserves on the opening date of the previous

year while computing the capital under the Second Schedule of the Companies (Profits) Sur-tax Act, 1964 for the assessment year 1974-75?"

Counsel for the assessee-company contended that after con ceding that this was not a case of "proposed dividend"

the Tribunal erred in holding that the sum of Rs 3,10,450 representing the dividends paid out from the General Reserve was liable to be excluded while computing the capital of the company as on 1.1.1973 for purposes of sur-tax assessment under the 1964 Act. According to him under s. 205(1) of the Companies Act, 1956 dividend can be paid from out of the current year's profits or profits of any previous financial year or years and there is no presumption in law or in commercial accounting that a dividend has to be paid either from the current year's profits or from the past year' s profits. He further urged that once from out of the current year's profit a certain sum is transferred to the General Reserve it merges into the latter and the General Reserve so augmented becomes a conglomerate fund and if out of such conglomerate fund any sum is recommended or paid out as dividend it will be difficult to say that such payment has come out of the portion of current year's profits that has been transferred and merged and there is no reason why the principle 'Last-in, First-out' should be invoked for drawing the inference that the payment has been made out of the current year's profits. He pointed out that such a principle was applied by the Bombay High Court in two decisions, namely, Commissioner of Income-Tax, Bombay City-l v. Bharat Bijlee Ltd.(1) and Commissioner of Income Tax, Bombay City- ll v. Marrior (India) Ltd.(2) but urged that there was no warrant for it. In support of his contention that the entire A General Reserve of Rs. 86,07,712 without any deduction should have been taken into account while computing the capital of the assessee-company, counsel relied upon a decision of the Andhra Pradesh High Court in Super Spinning Mills Ltd. v. Commissioner of Income Tax, Hyderabad(l).

Alternatively counsel pointed out that as far as stock valuation is concerned a question often arises whether the stock on hand at the end of the year is to be valued at the closing price or at the initial purchase price and in 'Advanced Accounting' by R. Keith Yorston and E. Bryan Smyth (a treatise on the principles and practice of accounting in Australia) three methods of valuing the closing stock have been indicated at pages 441 and 442 of Vol. II (5th Edn.) of the treatise, namely, (a) First-in First-out, (b) Last-in First-out and (c) Average Cost. In regard to these three methods the authors have stated thus .

(a) First-in First-out The assumption underlying this method is that the oldest stock is used or issued first or that sales are made in the order in which the goods are purchased or produced. If there are several lots of goods at different prices, they are regarded as being exhausted in the order of purchase. On a rising market this would write off the lower-priced lots first, and on a falling market the higher-priced lots would go first."

(b) "Last-in First-out.

This method assumes that the items of stock purchased are the first to be issued or sold and thus the stock remaining is valued at the cost of the earlier purchase."

(c) Average Cost.

On this basis issues of stocks are valued at the weighted average cost of the stock on hand at the beginning and of the purchases, less any issues already made."

Counsel for the assessee urged that for determining whether the entire General Reserve of Rs. 86,07,712 or reduced General Reserve of Rs. 82,97,262 should be taken into account for capital computation either the 'First-in First- out' principle should be adopted; if not, only a proportionate deduction should be made and the balance should be held to be includible in capital computation, particularly because the payment of dividend has been from a conglomerate fund.

It is not possible to accept either of these contentions urged by counsel for the assessee-company. It is true that under s. 205(1) a of the Companies Act, 1956 it is open to the directors to recommend and the share-holders to approve payment of dividends either from the current year's profits or from the past year's profits. It is also true that on transfer of a portion of current year's profits to the General Reserve the augmented General Reserve becomes a conglomerate fund but having regard to the natural course of human conduct of hard-headed men of business and commerce it is not difficult to predicate that the dividends would ordinarily be paid out from the current income rather than from the past savings unless the directors in their report expressly or specifically state that payment of dividends would be made from the past savings. From the commercial point of view if any amount is required for incurring any expenditure or making any disbursement like distribution of dividends in a current year, then ordinarily the same will come out of the current income of the company if it is available and only if the same is insufficient then the past savings will be resorted to for the purpose of incurring that expenditure or making that disbursement; such a course would be in accord with the common sense point of view. We may point out that this aspect of the matter was not considered by the Andhra Pradesh High Court in Super Spinning Mills Ltd. case (supra) and the view of the Bombay High Court in the case of Bharat Bijlee Ltd. (supra) and Marrior (India) Ltd. (supra) commends itself to us. Even in regard to the question of valuing the closing stock the learned authors of the treatise referred to by the counsel for the assessee-company merely indicate three methods for such valuation and it will be open to a commercial concern to avail of any one method. In our view in the context of the question whether while incurring any expenditure or making any disbursement a commercial concern will resort to current income or past savings, the normal rule, in the absence of express indication to the contrary, would be to resort to the current income rather than past savings.

In our view, therefore, the Tribunal was right in excluding the sum of Rs. 3,10,450 from the General Reserves while computing the capital of the assessee-company for the assessment year]974-75, in the absence of express indication to the contrary.

In the result Civil Appeal No. 1614(NT) of 1978 and Review Petition No. 57 of 1980 are dismissed. Civil Appeal No. 860 of g 1973 is partly allowed and the issue whether the appropriation for retirement gratuity is a reserve or not is remanded to the Taxing Authority and the rest of the appeal is dismissed. In Tax Reference Cases Nos. 2 and 3 of 1977 and No. S of 1978 the questions referred to us are answered in favour of the Department and against the assessee-companies. Each party will bear its own costs in all the matters.

AMARENDRA NATH SEN, J. At the outset I wish to observe that I have been somewhat diffident in hearing these matters. I felt a little embarrassed as I found that as a Judge of the High Court at Calcutta, I had an occasion to consider some of the questions in the case of Braithwaite and Co. (India) Ltd. v. Commissioner of. Income- Tax, West Bengal, (I) (Income Tax Reference No. 262 of 1969). As I have already considered some of the questions and have expressed my views on the same in the judgment delivered by me in the said reference, I was wondering whether I should hear these appeals. The members of the Bar, however, represented to me that they had not only no objection to my hearing these appeals but they also wanted me to hear these appeals. They further represented that most of the Judges of this Court had on some occasion or other considered these questions. They further stated that if I would decline to take up these matters not only the members of the Bar who had come from various parts of the country for these appeals would be seriously inconvenienced; but also the litigant public who had been waiting for years for the hearing of these matters would be prejudiced. It was further pointed out to me that the judgment which was delivered by me was not under appeal and further it would appear from the judgment which I had earlier delivered in Braithwaite matter, there was in fact a concession made by the learned counsel appearing on behalf of the assessee that the said case was covered by the decision of the Supreme Court in the case of Commissioner of Income-tax Bombay City v. Century Spinning and Manufacturing Co. Ltd. (') The learned counsel appearing on behalf of the parties further represented to me that the earlier judgment was delivered by me as a Judge of the High Court and it was always open to me to reconsider ' my view, particularly as a Judge of this Court after hearing the submissions to be made by the learned counsel appearing on behalf of the parties. In view of the aforesaid representations and submissions made by the learned lawyers, I was persuaded to hear these appeals with my learned brothers to avoid inconvenience not only to the lawyers but to the litigant public. I have also had no doubt in my mind that if I felt after hearing the submissions made by the learned counsel appearing on behalf of the parties in these appeals, that the earlier judgment delivered by me was wrong and incorrect, I would have no hesitation in reconsidering my earlier decision.

I do not propose to set out the facts of this case at any length in this judgment. The facts have been fully and correctly set out in the judgment of my learned brother Tulzapurkar, J. My learned brother in his judgment has also dealt with the various arguments which were advanced from the Bar and has also considered the decisions which were cited.

I propose to notice only some of the decisions which, to my mind, are particularly important for decision of the question whether the provision made in the balance-sheet for payment of dividend to the share-holders recommended by the Board of Directors constituted a 'reserve' and the amount, so set apart, should be taken into account, in computing the capital of the company for the purpose of

Super-Profits Tax Act, 1963. It may be noted that in the Act itself the expression 'reserve' has not been defined.

In the case of Commissioner of Income-tax, Bombay City v. Century Spinning and Manufacturing Co. Ltd. (supra), this Court had the occasion to consider the meaning of the word 'reserve' while dealing with a case under Business Profits Tax Act (XXI of 1947). In this Act also, there were similar provisions with regard to computation of the capital of the Company and the assessee had claimed that the amount recommended by the Board of Directors and earmarked for payment of the dividend to the share-holders should be treated as 'reserve' and should be taken into consideration in computing the capital of the assessee. The Supreme Court observed at pp. 503-504 as follows :-

> "The term 'reserve' is not defined in the Act and we must resort to the ordinary natural meaning as understood in common parlance. The dictionary meaning of the word 'reserve' is :-
>
> "1 (a) To keep for future use or enjoyment; to store up for some time or occasion; to refrain from using or for enjoying at once.
>
> (b) To keep back or hold over to a later time or place or for further treatment.

6. To set apart for some purpose or with some end in view; to keep for some use.

II. To retain or preserve for certain purposes (oxford Dictionary, Vol . VIII, P. 513.) In Webster's New International Dictionary Second Edition, page 2118 'reserve' is defined as follows:

> 1. To keep in store for future or special use; to keep in reserve; to retain, to keep, as for oneself.
>
> 2. To keep back; to retain or hold over to a future time or place.
>
> 3. To preserve."

The Supreme Court further observed at p. 504: "What is the true nature and character of the disputed sum, must be determined, with reference to the substance of the matter?"

> The Supreme Court held at p. 504-505 as follows :-
>
> "A reserve in the sense in which it is used in rule 2 can only mean profit earned by a company and not distributed as dividend to the shareholders but kept back by the directors for any purpose to which it may be put in future. Therefore, giving to the 'reserve' its plain natural meaning it is clear that the sum of Rs. 5,08,637 was kept in reserve by the company and not distributed as profits and subjected to taxation. Therefore, it satisfied all the requirements of rule 2. The Directors had no power to distribute the sum as dividend. They could only recommend as indeed they did, and

> it was upto the shareholders of the company to accept that recommendation in which case alone the distribution could take place. The recommendation was accepted and the dividend was actually distributed. It is, therefore, not correct to say that the amount was kept back. The nature of the amount which was nothing more than the undistributed profits of the Company, remained unaltered. Thus the profits Lying unutilised and not specially set apart for any purpose on the crucial date did not constitute reserves within the meaning of Schedule II, rule 2(1)."

The Supreme Court also referred to S.l31 (a) and 132 of the Indian Companies Act. Referring to these sections the Supreme Court observed at p. 505 as follows:

> "Section 131 (a) enjoins upon the directors to attach to every balance sheet a report with respect to the state of company's affairs and the amount if any which they recommend to be paid by way of dividend and the amount, if any, which they propose to carry to the reserve fund, general reserve or reserve account. The latter section refers to the contents of the balance sheet which is to be drawn up in the Form marked in Schedule III. This Form contains a separate head of reserves. Regulation 99 of the Ist Schedule. Table A, lays down 'that the directors may, before recommending any dividend set aside out of the profits of the company such sums as they think proper as a reserve or reserves which shall, at the discretion of the directors, be applicable for meeting contingencies, or for equalising dividends, or for any other purpose to which the profits of the company may be properly applied.. ' The Regulation suggests that any sum out of the profits of the company which is to be made asa reserve or reserves must be set aside before the directors recommend any dividend. In this case the directors while recommending dividend took no action to set aside any portion of this sum as a reserve or reserves. Indeed, they never applied their mind to this aspect of the matter. The balance sheet drawn up by the assessee as showing the profits was prepared in accordance with the provisions of the Indian Companies Act. These provisions also support the conclusion as to what is the true nature of a reserve shown in a balance sheet."

In the case of Commissioner of Income Tax v. Standard Vacuum oil Co. (1) this Court had occasion to consider the decision in the case of Commissioner of Income-tax v. Century Spinning and A Manufacturing Co. Ltd. (supra). Dealing with the said decision of this Court held at p. 697-98 as follows :-

> "The Court was dealing in this case with the accounts of an Indian Company, the balance-sheet of which was prepared according to the provisions of the Indian Companies Act, 1913. Regulation 99 of the First Schedule, Table A, required that reserves must be set apart before the directors recommended any dividend but out of the profits of the company no amount was set apart towards reserves before the directors recommended payment of dividend to the shareholders. The identity of the amount remaining on hand at the foot of the profit and loss account was not preserved. rt is on these facts that the court held that there was no allocation of the

> amount to reserve and from the mere fact that it was carried forward in the account of the next year and ultimately applied in payment of dividend, it could not be said to be specifically set apart for any purpose at the relevant date, i. e. the end of the year of account."

This Court then proceeded to hold at p. 697-98 as follows :-

> "We are in this case dealing with a foreign company and the system of accounting followed by the company is different in important respects from the system which obtains in India. Companies in India maintain diverse types of reserves: such as capital reserve, reserve for redemption of debentures, reserve for replacement of plant and machinery, reserve for buying new plant to be added to the existing ones, reserve for bad and doubtful debts? reserve for payment of dividend and general reserve. Depreciation reserves within the limit prescribed by the Income-tax Act or the Rules thereunder is the only reserve which is a permissible allowance in the computation of taxable profits. In its ordinary meaning the expression 'reserve' means something specifically kept apart for future use or for a specific occasion."

In the case of Metal Box Company of India Ltd. v. Their Workmen, (1) this Court while dealing with a case under the pay-

ment of Bonus Act, 1965 had occasion to consider the expression 'reserve' and its meaning for the purpose of the said Act. This Court held at p. 67-68 as follows :-

> " The next question is whether the amount so provided is a provision or a reserve. This 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 asset by which they are represented being retained in 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 proprietor's interest (see Spicer and Pegler's Book-keeping and Accounts, 15th Edn. page 42). An amount set aside out of profits and other surpluses, not designed to meet a liability, contingency, commitment or diminution in value of assets known to exist at the date of the balance-sheet is a reserve but an amount set aside out of profits and other surpluses to provide for any known liability of which the amount cannot be determined with substantial accuracy is a provision; (see William Pickles Accountancy, Second Edn. p. 192; Part III, clause 7, Schedule VI to the Companies Act, 1958, which derives provision and reserve."

In the case of Commissioner of Income-tax v. Mysore Electrical Industries Ltd.(1) the facts were briefly as follows:-

Out of the profits of the company for the accounting period ending March 31, 1963. the Directors of the company appropriated the following amounts towards reserves on August 8, 1963: (i) Rs. 2,56,000 as plant modernisation and rehabilitation reserve: (ii) Rs. 89,557 as development rebate reserve. The question was whether these amounts could be included in computing the capital of the respondent as on April 1, 1963 under rule 1 of Schedule II to the Companies (Profits) Sur-tax Act, 1964. for the purpose of the statutory deduction for the assessment year 1961-65, The contention of the department was that since the appropriations were made on 8th August, 1963 they could not be treated as components of capital as on the first day of the previous year i.e. 1st April, 1963. Negativ-

ing the contention of the department, this Court held that the determination of the Directors to appropriate the amounts of the three items of reserve on 8th August, 1963 had to be related to first April, 1963, viz., the beginning of the accounts for the new year, and had to be treated as effective from that day and the said three items had to be added to the other items for computation of the capital of the company as on first April, 1963 under rule 1 of Schedule II to the Companies (Profits) Sur-tax Act, 1964. It may be noted that in this case before the trial court a claim had been made by the company that a sum of Rs. 3,15,000 representing dividend reserve was to be considered in computing the assessee's capital for the purpose of Companies (Profits) Sur-tax Act, 1964 and the High Court had rejected this claim. As against the rejection of this claim by the High Court, no appeal had been preferred by the assessee to the Supreme Court. The Supreme Court while considering the three items which came up for consideration before it held, as already noted, that the decision of the directors to appropriate the amounts to these three items of reserve on 8th August, 1963 had to be related to 1st April, 1963 and this Court observed at pp. 560-570 as follows:-

"It is well known that the accounts of the company have to be made up for a year up to a particular day. In this case that day was the 31st March, 1963. If it was reasonably practicable to make up the accounts up to the 31st March, 1963, and present the same to the directors of the respondent on April 1, 1963, they could have made up their minds on that day and declared their intention of appropriating the said and other sums to reserves of different kinds. But the fact that they could not do so for the simple reason that the calculation and collection of figures of all the items of income and expenditure of the company for the year ending March 31, 1962, was bound to take some time cannot make any difference to the nature or quality of the appropriation of the profits to reserves as determined by the directors after the first of April, 1963. Their determination to appropriate the sums mentioned to the three separate classes of reserves on the 8th August, 1963, must be related to the 1st of April, 1963, i.e., the beginning of the accounts for the new year and must be treated as effective from that day".

Relying on the aforesaid decisions and also many other decisions of the various High Courts which have been considered by my learned brother Tulzapurkar, J. in his judgment, the learned counsel

for the assessee has argued that the word 'reserve' which has not been defined in the Act, has to be understood in its ordinary meaning as laid down by the Supreme Court in the case of Century Spinning Mills Ltd. The further argument is that the recommendation for dividend by the directors of the Company does not create any kind of liability, immediate or future. It is argued that the obligation to pay the dividend only arises when the shareholders at the Annual General Meeting of the Company decided to accept the recommendation of the Directors and pass a resolution for declaration of dividend. It is submitted that it is open to the Directors to withdraw or modify the recommendations made by them any time before the shareholders accept the recommendations and in support of this contention reference is made to the decision of this Court in the case of Keshoram Industries and Cotton Mills Ltd. v. Commissioner of Wealth Tax (Central), Calcutta (I) and n reliance is placed on the following observations at p. 772 :-

> "The directors cannot distribute dividends but they can only recommend to the general body of the company the quantum of dividend to be distributed. Under section 217 of the Indian Companies Act, there shall be attached to every balance-sheet laid before a company in general meeting a report by its board of directors with respect to, inter alia, the amount. if any, which it recommends to be paid by way of dividend. Till the company in its general body meeting accepts the recommendations and declares the dividend, the report of the directors in that regard is only a recommendation which may be withdrawn or modified as the case may be. As on the valuation date nothing further happened than a mere recommendation by the directors as to the amount that might be distributed as dividend, it is not possible to hold that there was any debt owed by the assessee to the share holders on the valuation date."

It is further argued that it is open to the share-holders to accept the i recommendations in its entirety or to modify the same by deciding to declare dividend at a rate lower than the one recommended by the directors. It is, therefore, contended that the recommendation of the directors for payment of dividend does not have the effect of creating any kind of liability and there is no debt owed by the company by virtue of the said recommendations. It has been submitted that the decision of this Court in the case of Mysore Electrical Industries Ltd. (supra) is of no assistance and the said decision does not lay down that in the event of the share holders' acceptance of recommendation made by the directors for the distribution of dividend to the share-holders of the company, the liability for payment of the dividend will also relate back; and the doctrine of relation-back applies only in respect of items which the directors are competent to decide for themselves, in view of the process involved in the preparation of accounts of the company.

The main argument advanced on behalf of the Revenue is that any amount which may be set apart for payment of dividend r recommended to be paid by the Directors cannot constitute 'reserve' within the meaning of the Act.

The argument advanced on behalf of the assessee appears to be sound; but to my mind the said arguments are not sufficiently convincing to lead the Court to the conclusion that the amount set apart for payment of dividend recommended by the Board of Directors can constitute 'reserve'

within the meaning of the Act for the purpose of computation of the capital of the Company.

The word 'reserve' has not been defined in the ACT. In the absence of any such definition the word has to be understood in its ordinary sense. It is, however, to be remembered that the word 'reserve' in the instant case occurs in a taxing statute specially applicable to Companies only. The word 'reserve' should be so construed as to give the said word the meaning in which it is ordinarily understood by persons interested in Companies or in dealing with Companies. In other words, the word 'reserve' for the purpose of this Act should be understood in the sense in which it is understood in company circles and by persons interested in Companies and in dealing with Companies. It may be noticed that while considering the true meaning and true nature of 'reserve', the Supreme Court in the case of Commissioner of Income Tax v. Century Spinning and Manufacturing Co. Ltd. (supra) has referred to S. 131 (a) and 132 of the Indian Companies Act, to the Form marked in Schedule III in which balance sheet of the Company has to be prepared and also to Regulation 99 of the First Schedule, Table A. I have earlier quoted the relevant observations of the Supreme Court.

It is, no doubt, true that the re commendations of the Directors for payment of any dividend does not create any kind of liability for the payment of the said amount. The liability for payment of any amount by way of dividend only arises when the share-holders accept the recommendations and a dividend is declared at the annual general meeting of the Company. It is open to the Directors to modify or withdraw the recommendation with regard to the payment of dividend before the said recommendation is accepted by the share- holders. It is also open to the share-holders not to accept the recommendation of the Directors in its entirety and to modify the same. The legal liability for the payment of any dividend only arises after the share-holders at the annual general meeting have decided to declare a dividend on the basis of the recommendations of the Directors or on the basis of any modification thereof. The liability for the payment of dividend only arises after the dividend has been declared by the share-holders at the annual general meeting and this liability does not relate back to 3 any earlier date on the basis of the recommendations of the directors. as the directors do not enjoy any power of declaring the b dividend. The amount that may be set apart for payment of any dividend on the basis of the recommendations made by the Directors, cannot be considered to be an amount set apart for meeting a known or existing liability.

Though the amount which is set apart for payment of any dividend recommended by the Board of Directors is not an amount set apart for meeting any known or existing liability, yet the said amount so set apart cannot be considered to be a 'reserve' within the meaning of the Act for the purpose of computation of the capital of the Company.

S. 210 of the Companies Act, 1956 specifically provides that at every annual general meeting of a Company the Board of Directors of a Company shall lay before the Company the balance sheet of the Company and also the Profits and Loss account. S. 211 further provides that every balance sheet of a Company shall give a A true and fair view of the state of affairs of the Company as at the end of the Financial Year and shall, subject to the provisions of the section, be in the form set out in Part I of Schedule VI, or as near thereto as circumstances admit or in such other form as may be approved by the Central Government either generally or in a parti- cular case. The preparation of a balance sheet in the prescribed form and laying the same before the share-holders at the annual meeting are

statutory requirements which the Company has to observe.

Regulation 87 of Table A in Schedule I provides:

> "(1) The Board may, before recommending any dividend, set aside out of the profits of the Company such sums as it thinks proper as a reserve or reserves which shall, at the discretion of the Board, be applicable for any purpose to which the profits of the Company may be properly applied, including provisions for meeting contingencies or for equalising dividends;

and pending such application, may at the like discretion, either be employed in the business of the company or be invested in such investments (other than shares of the Company) as the Board may from time to time, think fit.

(2) The Board may also carry forward any profits which it may think prudent not to divide. without setting them aside as a reserve".

This Regulation contemplates that the Board may set aside out of the profits of the Company such sums, as it thinks proper, as a reserve or reserves which shall, at the discretion of the Board, be applicable for any purpose to which the profits of the Company may be properly applied including the provisions for meeting contingencies or for equalising the dividends, before recommending any dividend. In other words, the sums out of the profits of the Company have to be set apart as reserve before any dividend is recommended by the Board; and the recommendation of the Board for payment of dividend comes only after the creation of reserve. The amount that may, therefore, be set apart for payment of dividend recommended by the Board is an amount which is set apart after the Board had created the reserve. The form of balance sheet referred to in S. 211 of the Companies Act, 1956 is appended in Part I of Schedule VI of the Statute. In the statutory form there are various heads including heads of various kinds of reserves and also of provisions. In the balance sheet of the Company which has necessarily been prepared in accordance with the provisions of the statute and in the form prescribed, the amount recommended by the Board for payment of dividend has been shown under the head provisions and not under any head of reserves. It is, no doubt, true that the true nature and character of the sum so set apart must be determined with regard lo the substance of the matter. The substance of the matter clearly appears to be that the amount is set apart for payment of dividend recommended by the Board to be paid to the share-holders and the said amount is never intended to constitute a reserve of the Company. Indeed a provision is made for payment of the said amount to the share-holders by way of dividend on the basis of the recommendation made by the Directors. Though in law the recommendation made by the Directors for payment of dividend to share-holders does not create any liability for the payment of dividend and liability only arises when the shareholders accept the said recommendation, and though in law it may be open to the Board to modify or withdraw the recommendation with regard to the payment of dividend before the acceptance by the share-holders and it may also be open to the share-holders not to accept the said recommendation in its entirety and to modify the same, yet, for business purposes, when the directors make any recommendation for payment of dividend and set apart any amount for the payment of dividend so recommended, the directors intended to make a provision

for the payment of dividend recommended by them and not to create any reserve, as the Directors very well know that the recommendation made by them with regard to the payment of dividend is not normally up-set by the share- holders and it is generally accepted by the share-holders, as a matter of course. Any amount set apart by the Directors for payment of dividend to the share-holders recommended by them, is understood by persons interested in company and in dealing with companies to mean a provision for the payment of dividend to the share-holders and is not understood to constitute a reserve. In my opinion, this true nature and character of the sum so set apart are reflected in the provisions of the Companies Act and more particularly in the manner of preparation of the balance-sheet of the Company. I am, therefore, of the opinion that the amount set apart for the payment of any proposed dividend on the basis of the recommendation of A the Directors cannot constitute reserve for the purpose of computation of the capital of the Company. The view that I have taken, to my mind, appears to be in accord with the view earlier expressed by this Court in the decisions to which I have already referred.

On the other questions, I entirely agree with the view expressed by my learned brother Tulzapurkar, J. and I agree with the order proposed by him.

C.A. No. 1614(NT)/78, Review Petition No. 57180 and Tax Reference Cases Nos 2&3/77 and 5/1978 dismissed.

P.B.R. C.A. No. 860/73 partly allowed.