Delhi High Court
Bharat General Reinsurance Ltd. vs Commissioner Of Income Tax on 11 September, 2001
Equivalent citations: (2001) 170 CTR Del 629, 2002 256 ITR 587 Delhi
Author: A Pasayat
Bench: A Pasayat, D Jain
JUDGMENT Arijit Pasayat, C.J.

1. Accepting the prayer of the assessed for reference in terms of Section 18 of the Companies (Profits) Surtax Act, 1964 (in short "the Act"), read with Section 256(1) of the Income-tax Act, 1961 (in short "the I. T. Act"), the following question has been referred for the opinion of this court by the Income-tax Appellate Tribunal, Delhi Bench (in short "the Tribunal") :

"Whether, on the facts and in the circumstances of the case, the reserve on account of retrocessions ceded by the company could form a part of capital and/or reserve of the assessed-company under the Second Schedule to the Companies (Profits) Surtax Act, 1964 ?"

2. The dispute relates to the assessment year 1971-72.

3. The factual position in a nutshell is as follows :

The assessed (hereinafter referred to in short as "BG") at the relevant point of time was engaged in the business of general reinsurance of fire, marine, motor and miscellaneous policies. Reinsurance is made by ceding a part of the premium by the original insurer to the reinsurer for sharing the risk. The reinsurer, in its turn, may give off a share of cession which has been ceded to it. If it does so, the transaction is called retrocession and the reinsurer so accepting the share in the cession is called retrocessionaire. In the instant case, the asses-see is a reinsurer and the Calcutta Insurance Ltd. (in short "CI") is its retrocessionaire. Under an agreement entered into between the assessed and CI, the former was entitled to retain 40 per cent, out of the premium credited by it in each quarter to CI for creating a premium reserve deposit on which assessed was to pay interest to CI. In its return filed, the assessed claimed that Rs. 57,62,002 included in its balance-sheet as on December 31,1969, under the heading "Reserve held on account of retrocessions ceded by the company" should be included in the computation of the capital base. The Assessing Officer did not accept the claim. The assessed filed an appeal before the Appellate Assistant Commissioner (in short the "AAC"). The said authority held that the reserve had been created by allowing a corresponding deduction while computing the income of the company for the purpose of the Income-tax Act and as such the reserve could not be allowed in view of the specific prohibition contained in Rule l(iii) of the Second Schedule to the Act. The assessed carried the matter in appeal before the Tribunal. It was the assessed's stand that the Appellate Assistant Commissioner's view was erroneous as the Assessing Officer was required under Rule 5 of the First Schedule to the Income-tax Act to accept the balance of the profits disclosed by the annual account of a general insurance company, which are required to be prepared under the Insurance Act, 1938, and to be furnished to the Controller of Insurance subject to annual adjustments as were permissible under the said Rule 5.

4. The Tribunal with reference to the factual position came to hold that the amount in question is not a part of either the assessed's own capital or reserves. It is the amount due to CI on which interest is payable by the assessed. Accordingly, it was concluded that the amount stands on the same footing as any other item of liability. Therefore, there was no question of its inclusion in the computation of the capital.

5. On being moved for reference the question as set out above has been referred for the opinion of this court. We have heard learned counsel for the parties. The stand vis-a-vis Rule 5 of the First Schedule to the Income-tax Act was again pressed into service by learned counsel for the assessed. Learned counsel for the Revenue, on the other hand, submitted that the reserve in question had been created by excluding from the premium receipts of the assessed certain amounts payable by it to the retrocessionaire and hence the view of the Tribunal is correct. It was further submitted that the Explanation to Rule 1 of the Second Schedule applied to the case of the assessed because the Explanation refers to reserves or surplus, which are of the nature of item (5) or item (6) or item (7) under the head "Reserves and surplus" or of any item under the heading "Current liabilities and provisions" in the column relating to liabilities in the form of balance-sheet given in Part I of Schedule VI to the Companies Act, 1956.

6. We find that rule 1 of the Second Schedule to which reference has been made by learned counsel for the parties reads as follows :

"THE SECOND SCHEDULE [See Section 2(8)] RULES FOR COMPUTING THE CAPITAL OF A COMPANY FOR THE PURPOSES OF SURTAX

1. Subject to the other provisions contained in this Schedule, the capital of a company shall be the aggregate of the amounts, as on the first day of the previous year relevant to the assessment year, of-

(i) its paid-up share capital,

(ii) its reserves, if any, created under proviso (b) to Clause (vi) of Subsection (2) of Section 10 of the Indian Income-tax Act, 1922 (11 of 1922), or under Sub-section (3) of Section 34 of the Income-tax Act, 1961 (43 of 1961) ;

(iii) its other reserves as reduced by the amounts credited to such reserves as have been allowed as a deduction in computing the income of the company for the purposes of the Indian Income-tax Act, 1922 (11 of 1922), or the Income-tax Act, 1961 (43 of 1961) . . .

Explanation--For the removal of doubts it is hereby declared that any amount standing to the credit of any account in the books of a company as on the first day of the previous year relevant to the assessment year which is of the nature of item (5) or item (6) or item (7) under the heading 'Reserves and surplus' or of any item under the heading 'Current liabilities and provisions' in the column relating to 'Liabilities' in the 'Form of balance-sheet' given in Part I of Schedule VI to the Companies Act, 1956 (1 of 1956), shall not be regarded as a reserve for the purposes of computation of the capital of a company under the provisions of this Schedule."

7. The apex court had occasion to deal with the question as to the difference between the "reserve" and "provision" in National Rayon Corporation Ltd. v. CIT [1997] 227 ITR 764. The basic principle is that an amount set apart to meet a known liability cannot be regarded as "reserve". "Provision" and "reserve" have been defined in Part III, Schedule VI to the Companies Act, 1956. It reads as follows (page 768) :

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

(a) the expression 'provision' shall, subject to Sub-clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy ;

(b) the expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability :"

8. In Vazir Sultan Tobacco Co. Ltd. v. CIT [1981] 132 ITR 559, the Supreme Court had also occasion to deal with the question. It was held that "provision" and "reserve" are not defined in the Act, therefore, the two concepts which are fairly well known in commercial accountancy and which are used in the Companies Act, 1956, dealing with preparation of balance-sheets and profit and loss accounts will have to be gathered from the meaning attached to them by the Companies Act, 1956, itself. It was pointed out that even if a sum of money which had been set apart for a certain purpose was held not to be a "provision", it did not automatically follow that it would be a "reserve". In the prescribed form of balance-sheet under the heading "Reserves and surpluses" seven types of reserves have been shown :

"(1) Capital reserves ;

(2) Capital redemption reserve ;

(3) Share premium account;

(4) Other reserves ;

(5) Surplus, i.e., balance in profit and loss account;

(6) Proposed additions to reserves ;

(7) Sinking funds."

9. For the purpose of computation of capital of a company under the Act, items Nos. (5), (6) and (7) are not be treated as reserves. The Second Schedule to the Act lays down the rules for computation of the capital. Rule 1, as noted above, contains an Explanation that any amount retained by way of

providing for a known liability will not be "reserve". The Explanation to Rule 1 of the Second Schedule to the Act takes this principle to its logical conclusion by providing that even a sinking fund, which has to be shown as a reserve in the prescribed from of balance-sheet will not be treated as "reserve" for the purpose of computation of capital. A similar view has been expressed in CIT v. South India Corporation Ltd. [2000] 242 ITR 114 (Ker) (sic).

10. In view of the aforesaid legal position view of the Tribunal is in order. The question referred is therefore answered in the negative, in favor of the Revenue and against the assessed.

11. Reference is accordingly disposed of.