

PETITIONER:
STATE BANK OF PATIALA, PATIALA

Vs.

RESPONDENT:
THE COMMISSIONER OF INCOME-TAX, PATIALA

DATE OF JUDGMENT: 15/03/1996

BENCH:
N.P. SINGH, S.P. BHARUCHA

ACT:

HEADNOTE:

JUDGMENT:

J U D G M E N T

Paripoornan, J.

Leave granted in all the special leave petitions.

2. These are all connected cases. The matter arises under the Companies (Profits) Surtax Act, 1964 (hereinafter referred to as the Act). The parties in all the appeals are the same. The appellant in the appeals is "The State Bank of Patiala" and the respondent is the "Commissioner of Income Tax, Patiala". The Civil Appeals filed from Special leave petitions (C) Nos. 2392-95 of 1993 are the main cases. They relate to four assessment years - 1971-72, 1972-73, 1973-74 and 1975-76. The appellant-assessee set apart amounts as "reserve" for "bad and doubtful debts" in all the years. A claim was laid that such sums qualified as reserves for the purpose of Rule 1 (xi) (b) of the First Schedule and Rule 1 (iii) of the Second Schedule of the Act and such sums, representing reserves, should be included in the capital of the appellant for appropriate relief. The Income Tax Officer rejected the claim. In appeal, the Income Tax Appellate Tribunal allowed the plea of the assessee. The Income Tax Appellate Tribunal, by its detailed order dated 23.1.1980, upheld the plea of the assessee and held that the amounts set apart as reserves are entitled for appropriate relief under Rule 1 (xi)(b) of the First Schedule and Rule 1(iii) of the Second Schedule of the Act. On motion by the Revenue the Appellate Tribunal referred the following questions of law for the decision of the High Court of Punjab and Haryana, which were numbered as Income Tax Reference Nos. 235 to 238 of 1980 :

"i) Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in holding that the amounts provided by the assessee for bad and doubtful debts in the balance sheets of the relevant previous years qualified as reserves for the purpose of clause xi (b) of Rule 1 of the First Schedule

to the Companies (Profits) Sur-tax Act, 1964 and consequently allowing yearwise deduction as under:

1971-72	Rs. 7,00,000/-
1972-73	Rs. 13,78,000/-
1973-74	Rs. 22,11,000/-
1975-76	Rs. 15,98,000/-

- ii) Whether on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in holding that the amounts of Rs.15,53,576/-, Rs.27,21,641/-, Rs.29,91,641/- and Rs.47,16,641, provided for bad and doubtful debts as at the beginning of the relevant accounting year respectively for the assessment years 1971-72, 1972-73, 1973-74 and 1975-76 qualified as a reserve for inclusion in the capital of the assessee under Second Schedule of the companies {Profits} sur-tax, Act,1964." (emphasis supplied)

By a detailed judgment dated 27.7.1992 the High Court took the view that on the facts and circumstances of the present case, sums of money set apart by the assessee as reserves are really "provisions" and not "reserves" and so, such sums are not entitled to the relief granted by the Appellate Tribunal. It is, thereafter the assessee moved this Court by special leave petition Nos. 2392-95 of 1993 and obtained special leave in the four cases. The judgment of the High Court is reported as Commissioner of Income Tax vs. State Bank of Patiala (203 ITR 150).

3. Special leave petitions (C) Nos. 27543-5Q of 1995 relate to the same assessee and eight assessment years are involved therein - 1979-80 to 1987-88 except 1985-86. For those years, identical claim put forward by the appellant-assessee was rejected by the Income Tax Officer. In appeal, CIT allowed the claims. In the meanwhile, the decision of the High Court for the previous four years, i.e., 1971-72, 1972-73, 1973-74 and 1975-76 had been rendered and so the Tribunal, following the decision of the High Court, held against the assessee. The plea of the assessee to refer the matter either to the appropriate High Court or to this Court was disallowed. The assessee has filed special leave petitions in this Court directly against the aforesaid order of the Appellate Tribunal.

4. Special leave petition (C) No. 27551 of 1995, relating to the same assessee and involving consideration of the same question, relates to the assessment year 1985-86. The Appellate Tribunal finally decided against the assessee following the earlier decision of the High Court reported in 203 ITR 150. The attempt to get the matter referred to the High Court was unsuccessful and so the assessee filed the special leave petition in this Court against the order of the Appellate Tribunal.

5. All the 13 appeals involve consideration of the same question between the same parties. So, they were heard together and are disposed of by this common judgment.

6. We heard counsel for the appellant-assessee, Mr. A. Subba Rao, and counsel for the respondent Revenue, Mr. B.S. Ahuja.

7. The statutory provisions, relevant for our purpose, are mentioned hereinbelow:

The Companies (Profits) Surtax Act
1964 {Act 7 of 1964}

"2(5) 'chargeable profits' means the total income of an assessee computed under the Income-tax Act, 1961 for any previous year or years, as the case may be, and adjusted in accordance with the provisions of the First Schedule;

xxxx xxxx xxxx xxxx

(8) "Statutory deduction" means an amount equal to fifteen per cent of the capital of the company as computed in accordance with the provisions of the Second Schedule, or an amount of two hundred thousand rupees, whichever is greater:

Provided that where the previous year is longer or shorter than a period of twelve months, the aforesaid amount of fifteen per cent or, as the case may be, of two hundred thousand rupees shall be increased or decreased proportionately:

Provided further that where a company has different previous years in respect of its income, profits and gains, the aforesaid increase or decrease, as the case may be, shall be calculated with reference to the length of the previous year of the longest duration; and

(9) all other words and expressions used herein but not defined and defined in the Income-tax Act shall have the meanings respectively assigned to them in that Act."

"4. Charge of tax. - Subject to the provisions contained in this Act, there shall be charged on every company for every assessment year commencing on and from the first day of April, 1964 [but before the first day of April, 1988], a tax (in this Act referred to as the surtax) in respect of so much of its chargeable profits of the Previous year or previous years, as the case may be, as exceed the statutory deduction, at the rate or rates specified in the Third Schedule."

"THE FIRST SCHEDULE"

(See Section 2(5))

RULES FOR COMPUTING THE CHARGEABLE
PROFITS

In computing the chargeable profits of a previous year, the

total income computed for that year under the Income Tax Act shall be adjusted as follows:

1. Income, profits and gains and other sums falling within the following clauses shall be excluded from such total income, namely:

xxxx xxxx xxxx

(xi) in the case of a banking company

(a) any sum which during the previous year is transferred by it to a reserve fund under subsection (1) of section 17 of the Banking Companies Act, 1949 or is deposited by it with the Reserve Bank of India under sub-clause (ii) of clause (b) of sub-section (2) of section 11 of that Act, not exceeding the amount required under the aforesaid provisions to be so transferred or deposited, as the case may be, or

(b) any sum transferred by it during the previous year to any reserves in India including reserves not shown as such in its published balance sheet in so far as the sums transferred to such reserves are attributable to income chargeable to tax under the Income-tax Act and have not been allowed as a deduction in computing its total income under that Act and in so far as the aggregate of such sums does not exceed the highest of the aggregate of such sums, if any, so transferred during any one of the three years prior to the previous year, whichever is higher;

xxx xxx xxx
[Explanation - Notwithstanding anything contained in any clause of this rule, the amount of any income or profits and gains which is required to be excluded from the total income under that clause shall be only the amount of such income or profits and gains as computed in accordance with the provisions of the Income-tax Act (except Chapter VIA thereof), and in a case where any deduction is required to be allowed in respect of any such income or profits and gains under the said Chapter VIA, the amount of such income or profits and gains computed as aforesaid as reduced by the amount

oi such deduction.]"

"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)

(ii)

(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 or the Income-tax Act, 1961;

(emphasis supplied)

8. The facts of these cases are not in dispute. As stated by the High Court the sole point, which falls for consideration, is whether the amounts set apart by the assessee during each assessment year for "bad and doubtful debts" in the balance sheets of the relevant period constitute "reserve" as contemplated by Rule 1 (xi) (b) of the First Schedule and Rule 1 (iii) of the Second Schedule to the Act? The Act has levied a charge on every company for every assessment year - a tax called sur-tax - in respect of so much of its chargeable profits of the previous years as exceed the Statutory deduction at the rates specified in the Third Schedule. In determining the chargeable profits Rule 1 (X1) (b) of the First Schedule mandates that in the case of a banking company any sum transferred by it during the previous year to any reserves in India including the reserves not shown as such in its published balance sheets in so far as the sums transferred to such reserves are attributable to income chargeable to tax under the Income tax Act and have not been allowed as a deduction in computing its total income under the Act, shall be excluded. The tax is levied, on the chargeable profits, which excluded the statutory deduction at the rates specified in the Third Schedule. As per section 2(8) of the Act statutory deduction is defined to mean an amount equal to ten per cent of the capital of the company as computed in accordance with the provisions of the Second Schedule. Rule 1 of the Second Schedule mandates that the capital of the company shall be the aggregate of the amounts taking within its total its other reserves as specified in Rule 1(iii) of the Second Schedule.

9. If the sums set apart in the balance sheets are only "provisions" the assessee will not be entitled to the relief claimed by it. If, on the other hand, the sums set apart are "reserves" within the meaning of the Act assessee will be entitled to appropriate relief. After referring to the relevant decisions, dealing with the reserves and provisions, the Income Tax Appellate Tribunal posed the question thus:

" in order to constitute a reserve a particular amount set aside out of the profits and other surpluses, not designed to meet a liability, contingency, commitment or

diminution in the value of assets known to exist at the date of the balance sheets, is a reserve. In other words, if the amount set apart is designed to meet a liability, contingency, commitment or results in diminution in value of assets, it would be a provision and not a reserve. We have to apply this test here "

In paragraphs 20 to 22 of its order, the Appellate Tribunal entered the following findings:

"We find that the assessee has not written off or adjust(ed) these amounts provided as reserves and doubtful debts in its profit and loss account that these amounts have not been allowed as a deduction computing the income of the company for purposes of Income-tax Act, that these amounts have remained employed in the business of the assessee by way of capital and the assessee has in fact treated these amounts as reserves and not as provisions designed to meet a liability, contingency, commitment, or diminution in the value of assets known to exist at date of relevant balance sheets. We, therefore, hold that these are amounts which constitute reserve for clause liii) of rule 1 of the Second Schedule to the Companies (Profits) Surtax Act, 1964."

"In fact it has been clarified by the learned Counsel for the assessee, and it has not been controverted by the revenue, that in none of the years under appeal the assessee appropriated any amounts against bad and doubtful debts. The reserves stood as they were in each year and therefore, would constitute reserve within the meaning of rule 1(xi)(b) of the Second Schedule to the Companies (Profits) Sur-tax Act, 1964."

(emphasis supplied)

In paragraph 24 of its order the Tribunal concluded thus:

"We also find that no amount on account of bad debts was factually written off or adjusted by the assessee against these amounts claimed as reserves, that in fact the assessee also did not make a claim for any deduction for any of the assessment years under consideration on account of bad debts, that no such claim was either made or allowed by the Income-tax Officer, that the assessee made contra entries in the unpublished balance sheets only and no such entries were passed in

books and that the published balance-sheets did not contain any contra entries. The amounts were in fact treated as reserves. These are entitled to be considered as reserves under Rule 1(xi)(b) of the First Schedule to the Act. We, therefore, direct that these be so treated. Both the issues are decided in all the assessment years, in favour of the assessee."

(emphasis supplied)

10. The High Court, in answering the questions referred to it, by judgment dated 27.7.1992, adverted to the landmark decisions of this Court in *Metal Box Co. of India Ltd. Vs. Their workmen* (73 ITR 53), *Vazir Sultan Tobacco Co. Ltd. Vs. Commissioner of Income-Tax, A.P.* (132 ITR 559), *Commissioner of Income-Tax, Kanpur vs. Elgin Mills Ltd.* (161 ITR 733) and *C.I.T. Vs. Saran Engineering Co. Ltd.* (161 ITR 741), and stated thus:-

"Thus, where a fund has been created to meet a liability which has actually arisen and is known on the date of the preparation of the balance-sheet, it would obviously be provision. Again fund created or a sum of money set apart to meet any liability which the assessee can reasonably and legitimately anticipate on the date of preparation of the balance sheet though the quantum of that liability is not yet determined, has also been equated with the present known liability and the fund to meet such liability cannot be treated as a reserve. If, on the other hand, a fund is created to meet some future unknown liability which has not yet arisen and which could not legitimately and reasonably be anticipated by the assessee at the time of the preparation of the accounts, the fund would be treated as a 'reserve'. Whether in respect of bad and doubtful debts, an account could be treated as reserve or a provision would depend upon the facts and circumstances of each case. Again, whether a particular liability could reasonably and legitimately be anticipated by an assessee on the date of the balance sheet would be a question of fact to be determined in the circumstances of each case and the nature of the business carried on by the assessee would be one relevant factor.

Applying these tests to the case in hand, one cannot lose sight of the fact that the assessee before us is a banking company whose primary business, is to lend

money. In the very nature of things, it would be reasonable and legitimate for such an assessee to assume that in the course of its business, it is bound to have bad and doubtful debts for which it may in anticipation make a provision in the balance sheet by having a separate fund or an account to meet such anticipated liability although its quantum would be determined at some later date. Since such anticipated liability has been equated with known and existing liability, the fund is to be considered a 'provision' and not a 'reserve'."

(emphasis supplied)

The High Court concluded, thus:-

"For the reasons recorded above, we are of the view that on the facts and circumstances of the present case, the sums of money set apart by the assessee herein for meeting its anticipated liability was a 'provision' and the Tribunal erred in law in holding it to be a 'reserve'. In the result, both the questions referred to us are answered in the negative i.e. against the assessee and in favour of the Revenue."

(emphasis supplied)

11. We are of the view that the learned judges of the High Court misunderstood and misapplied the ratio laid down in the decisions of this Court, referred by it. In *Metal Box Co. of India Ltd. vs. Their workmen* (73 ITR 53) at pp. 67-68 this Court laid down the law thus:-

"The next question is whether the amount so provided is a provision or a reserve. The 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 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 42). An amount set aside out of

profits and other surpluses, not designed to meet a liability, contingency, commitment or diminution in the value of assets 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 edition, p.192; Part III, clause 7, Schedule VI to the Companies Act, 1956, which defines provision and reserve)."

(emphasis supplied)

In Vazir Sultan Tobacco Co. Ltd. vs. Commissioner of Income-Tax, A.P. (supra), after referring to the above observations in Metal Box Company's case (supra), the Court held at p. 569, thus:-

"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. & 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."

(emphasis supplied)

After referring to the relevant provisions of Companies Act, 1956 regarding the form of balance-sheet wherein the words "reserve and surplus" and "current liabilities and provisions" etc. are dealt with, the Court observed, thus:-

"On a plain reading of cl. 7(1)(a) and (b) and cl. 7(2) above it will appear clear that though the term "provision" is defined positively by specifying what it means the definition of "reserve" is negative in form and not exhaustive in the sense that it only specifies certain amounts which are not to be included in the term "reserve". In other words the effect of reading the two definitions together is that if any retention or appropriation of a sum falls within the definition of "provision" it can never be a reserve but it does not follow that if the retention or appropriation is not a provision it is automatically a reserve and the question 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 intent on which and the purpose for which such retention or appropriation has been made because the substance of the matter is to

be regarded and in this context the Primary dictionary meaning of the term "reserve" may have to be availed of. But it is clear beyond doubt that if any retention or appropriation of a sum is not a provision, that is to say, if it is not designated to meet depreciation, renewals or diminution in value of assets or any known liability the same is not necessarily a reserve. We are emphasising this aspect of the matter because during the hearing almost all counsel for the assessee strenuously contended before us that once it was shown or became clear that the retention or appropriation of a sum out of profits and surpluses was for an unknown liability or for a liability which did not exist on the relevant date it must be regarded as a reserve. The fallacy underlying the contention becomes apparent if the negative and non-exhaustive aspects of the definition of reserve are borne in mind. Having regard to the type of definitions of the two concepts which are to be found in cl. 7 of Pt. III the proper approach in our view would be first to ascertain whether the particular retention or appropriation of a sum falls within the expression "provision" and if it does then clearly the concerned sum will have to be excluded from the computation of capital, but in case the retention or appropriation of the sum is not a provision as defined the question will have to be decided by reference to the true nature and character of the sum so retained or appropriated having regard to several factors as mentioned above and if the concerned sum is in fact a reserve then it will be taken into account for the computation of capital."

(emphasis supplied)

In Commissioner of Income-Tax, Kanpur vs. Elgin Mills Ltd. (supra) the Court stated the guidelines to be borne in mind to distinguish between 'provision' and 'reserves' in the following words:-

"The distinction between "provision" and "reserve" must be found out bearing in mind the main features of the reserve. These are: (1) it must be an appropriation of profits, current or accumulated, and a charge against the profits for the year. (2) The conduct of the parties must bear out that

intention. (3) It must not be to set apart to meet any known liability - a liability known to exist on the date of the balance-sheet. Reference in this connection may be made to the observations of this Court in Vazir Sultan's case [1981] 132 ITR 559 at pages 569-570."

Again in Commissioner of Income-Tax vs. Saran Engineering Co. Ltd. (supra), dealing with the question as to whether bad and doubtful debts will constitute a 'provision' or 'reserve', the Court stated, thus:-

"Bad and Doubtful Debts Reserve was created in 1956 through the Profit and Loss Appropriation account. The amount involved was Rs. 50,00,000. It was submitted on behalf of the assessee by Shri Salve that this was created by transfer from the appropriation account and not as a charge against profit. Furthermore, a separate provision was made for bad and doubtful debts which provision was reduced from the value of the assets. It was not the Revenue's case that the provision for bad and doubtful debts provided was less than the amount reasonably necessary to be provided in respect of bad and doubtful debts, then it constituted a "reserve". It is not correct to state that by the very nomenclature, this was not a reserve. The true nature of the transaction has to be examined."

(emphasis supplied)

And again at p. 748 the Court concluded, thus:-

"It may be mentioned that where the liability has actually or is anticipated legitimately by the assessee though the quantum of the liability has not been determined, a fund to meet such present liability cannot be treated as "reserves". A fund, however, created for payment of a liability which had not already arisen or fallen due but is only a provision with regard to the sum that might become liable to be paid is "other reserves" within the meaning of rule 1 of the Second Schedule and should be taken into account in computing the capital of the company for the purpose of the Companies (Profits) Surtax Act, 1964."

(emphasis supplied)

12. A fair reading of the above decisions would go to show that if the transfer of amount is made ad hoc, when there is no known or anticipated liability, such fund will only be treated as 'reserve'. In this case, substantial amounts were set apart as reserves. No amount of bad debt was actually

written off or adjusted against the amount claimed as reserves. No claim for any deduction by way of bad debts were made during the relevant assessment years. The assessee never appropriated any amount against any bad and doubtful debts. The amounts throughout remained in the account of the assessee by way of capital and the assessee treated the said amounts as "reserves" and not as "provisions" designed to meet liability, contingency, commitment or diminution in the value of assets known to exist at the relevant dates of balance sheets. These facts have been found by the Tribunal. On the facts, the amount set apart as reserves cannot be said to be so earmarked, when any liability has actually arisen or was anticipated by the assessee. It cannot be said either, that the amounts set apart out of the profits were designed to meet any known liability, that existed at the date of the balance-sheet. Tested in the light of the decisions of this Court, referred to hereinabove, it appears to us, that the amounts set apart towards bad and doubtful debts in these cases are "reserves" qualifying for appropriate relief under rule 1(xi)(b) of the First Schedule and rule 1(iii) of the Second Schedule of the Act.

13. We are afraid that the High Court has grossly misunderstood the following observations of this Court contained in Commissioner of Income-Tax vs. Saran Engineering Co. Ltd. (161 ITR 741) at p. 748.

"It may be mentioned that where the liability has actually arisen or is anticipated legitimately by the assessee though the quantum of the liability has not been determined, a fund to meet such present liability cannot be treated as "reserves"."

(emphasis supplied)

14. The High Court has taken the view that the "fund created or a sum of money set apart to meet any liability which the assessee "can reasonably and legitimately anticipate " on the date of preparation of the balance sheet, is the same, as in a case "where the liability has actually arisen", (a present known liability) and the fund to meet such liability cannot be treated as reserve". In the view of the High Court, since the assessee is a banking company, it would be "reasonable and legitimate to assume" that in the course of its business, "it is bound to have" bad and doubtful debts for which "it may", in anticipation, make a provision in the balance sheet by having a separate fund or an account to meet such anticipated liability. We are afraid that the aforesaid assumption is totally unjustified and proceeds on mere surmises and conjectures. This is not a case, when at the time fund is earmarked, there is a known liability one which has either arisen or anticipated legitimately, by the assessee - and the fund to meet such eventuality cannot be treated as "reserves". The observations of this Court that the liability should be one "which has actually arisen or is anticipated legitimately by the assessee", cannot be extended to hold, that in the case of an assessee carrying on banking business, it is "bound" or "can reasonably anticipate" on the date of the preparation of balance sheet "bad and doubtful debts", for which "it ought", in anticipation, make a provision and such provision for anticipated liability should be equated with known and existing liability and should be construed as a provision. The question in such cases, is whether the liability was "known" or "anticipated" on the date when the balance sheet was prepared. The question is not whether the assessee "can

anticipate" or "reasonably anticipate" on the date when the balance sheet was prepared about "the bad and doubtful debts". The High Court was in error in surmising that the assessee being a banking company is bound to have bad and doubtful debts. It need not necessarily be so. It is not bound to anticipate on the date of preparation of balance sheet that all or any of its debts "are bound to be bad and doubtful". It all depends upon facts and circumstances. We are of the view that the High Court misunderstood the scope of the observations in Saran Engineering Co.'s case (supra) and surmised that the observations quoted at page 748 will even cover cases, where the liability was not factually anticipated on the date of the preparation of the balance sheet, but also will apply to cases, where the company "ought and can" anticipate on the date of preparation of the balance sheet.

14. We set aside the judgment of the High Court, rendered in ITR No. 235-238 of 1990 dated 27.7.1992 and restore the order passed by the Appellate Tribunal dated 23.1.1980. We answer the questions, referred to the High Court, in the affirmative, in favour of the assessee and against the Revenue.

15. It was agreed that the decision taken in special leave petitions Nos. 2392-95/93 for the assessment years 1971-72, 1972-73, 1973-74 and 1975-76 will cover the other cases as well. Therefore, we hold that the assessee is entitled to the appropriate relief for the years 1979-80 to 1987-88 as well, which are covered by the other two sets of appeals.

16. The appeals are allowed. There shall be no order as to costs.