

PETITIONER:
PURSHOTAM H. JADYE AND OTHERS

Vs.

RESPONDENT:
V. B. POTDAR

DATE OF JUDGMENT:
26/10/1965

BENCH:
GAJENDRAGADKAR, P.B. (CJ)
BENCH:
GAJENDRAGADKAR, P.B. (CJ)
WANCHOO, K.N.
HIDAYATULLAH, M.
RAMASWAMI, V.

CITATION:
1966 AIR 856 1966 SCR (2) 353

ACT:

Business Profits Tax Act, 1947- Schedule 11, rules 2(1) and (3) "Premium" and "reserves" in computation of capital under r. 2(1) whether cover accounts described as "capital paid in surplus" and "Earned Surplus" according to American accounting practice.

HEADNOTE:

The assessee company was incorporated in the State of Delaware in the United States of America with the object of taking over the assets of two other American companies in return for stock in the assessee company. Upon the acquisition, although the book value of the assets taken over from each of the two transferor companies was different, the two companies were allotted an equal number of shares in the assessee company. Part of this difference was covered by issuing serial bonds, to one of the companies which were later redeemed. As the total book-value of the assets taken over by the assessee company was in excess of the par value of the stock issued to the two transferor companies, this excess, in accordance with established accounting practice in the United States of America, was entered in the books of the assessee company in an account styled "Capital paid in Surplus".

The net profits earned by the assessee company from year to year, after certain appropriations, were also in line with American accounting practice, shown in the balance sheet under the caption "Earned surplus" or "Earnings reinvested".

In proceedings for assessment under s. 4 of the Business Profits Tax Act, 1947, the Income Tax Officer disallowed the claim of the assessee company for the inclusion of the accounts "Capital paid in Surplus" and "Earned Surplus" in the computation of taxable capital under Schedule IT r. 2(1) of the Act and the Appellate Assistant Commissioner agreed with him. But the Tribunal, in appeal, held that the difference between the value of the assets taken over and the value of stock issued by the assessee company was premium realised from the issue of its shares and retained in the business within the meaning of rule 3 of Scb. 11 and

was in any event reserve not allowed in computing profits within the meaning of r. 2(1). The Tribunal also held that the "Earned Surplus" represented reserves liable to be taken into account in assessing business profits tax. Upon a reference, the High Court agreed with the views of the Tribunal.

It was contended on behalf of the Revenue, inter alia, (i) that shares may be said to be issued at a premium only when they were issued for cash in excess of par value and not otherwise; (ii) that the amount of "Capital paid in Surplus" could not be regarded as "reserves" as the reserves contemplated by r. 2(1) are only those which are built out of profits processed for the purpose of taxation under the Indian income-tax Act and that where a reserve is brought into existence by creating or increasing, by revaluation or otherwise a book asset, it cannot be included in the computation of capital by virtue of the Explanation to r. 2; (iii) that the "Earned Surplus" in the balance sheets of the assessee company

Sup. CI/66-10

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were not reserves, as accumulated profits could only be deemed reserves within the meaning of r. 2(1) if they were specifically allocated to reserves and not otherwise.

HELD: (i) The High Court was right in holding that the difference between the book value of the assets transferred and the par value of capital stock was premium. [376 E]

In the absence of any restriction in the law of Delaware against the issue of shares otherwise than for cash, when shares were issued for consideration other than cash, the value of assets transferred in excess of the par value of shares issued would be regarded as "premium" under the Indian system of law. [374 F]

When shares are issued at a premium, ordinarily premium at a uniform rate would be charged from all applicants for shares; but on principle there is no objection to the charging of varying rates of premium for shares issued under a single resolution, if all the parties concerned agree. In the present case although the book value of the assets transferred by the transferor companies was larger than that of the assets transferred by the other company, these two companies agreed with the assessee company to receive stocks of equal par value carrying equal rights. [374H; 375E]

Shares at or without premium may be issued subject to express statutory provision to the contrary for money or services or in consideration of transfer of property. There was no provision in the companies Act, 1913, nor was any shown in a statute in the State of Delaware which enacted a different rule. [376 A-B]

(ii) The amount of "capital paid in surplus" also represented "reserves" within the meaning of r. 2(1).

Reserves built up from sources other than profits would be admissible for inclusion in capital under r. 2(1)

Commissioner of Income-tax, Bombay v. Century Spinning & Manufacturing Co. Ltd., 24 I.T.R. 499, referred to.

Difference between the assets received by the company and the par value of the shares issued was not a book asset "brought into existence by creating or increasing (by valuation or otherwise)". These assets received by the assessee company were real and tangible and it was only for accountancy purposes that a part of the value of assets was allocated to the par value of the shares and the balance to the "Capital paid in Surplus" account. [378 A-D]

(iii) The High Court was right in holding that the "Earned Surplus" in the assessee company's accounts

represented "reserves" within the meaning of r. 2(1). In accordance with accountancy practice in the United States of America, the balance of net profits after allocation to specific reserves and payment of dividend is entered in the account under the caption "Earned Surplus" and it is intended thereby to designate a fund which is to be utilised for the purpose of the business. Such a fund may be regarded according to the Indian practice as "general reserves".

First National City Bank v. Commissioner of Income-tax, Bombay, 42 I.T.R. 17, referred to.

The accounts of the assessee company maintained according to the general accountancy practice prevailing in the United States of America

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disclosed that the balance of "Earned Surplus" at the end of the year did not merge into the account of the subsequent year. It represented a specific account into which were added the net profits of the year and appropriations were made out of it and the balance was regarded as "Earned Surplus" at the end of the year. This account was specifically allocated for utilisation for the purpose of the business year after year. Therefore the conditions regarded as essential in the Century Spinning & Manufacturing Company's for constituting the, "Earned Surplus" into reserves" were fulfilled. [379G-383E-G]

JUDGMENT:

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 268 of 1964.

Appeal by special leave from the judgment and order dated January 29, 1962 of the Calcutta High Court in Income-tax Reference No. 1.8 of 1955.

A. V. Viswanatha Sastri, N. D. Karkhanis, R. H. Dhebar and R. N. Sachthey, for the appellant.

N. A. Palkhiwala, Ramachandran, J. B. Dadachanji, O. C. Mathur and Ravinder Narain, for the respondent.

The Judgment of the Court was delivered by

Shah, J. At the instance of the Commissioner of Income-tax (Central) Calcutta, the Income-tax Appellate Tribunal referred the following questions for the opinion of the High Court of Calcutta under s. 19 of the Business Profits Act 21 of 1947 :

"(1) Whether on the facts found the Tribunal was right in holding that the sum of \$117,000,000 appearing in the Balance Sheet of the assessee Company under the head "Capital paid in Surplus" and constituting the excess of the book value of the assets over the face value of the shares represented premium realised from the issue of the s

hares as

contemplated by Rule 3 of Schedule II of the Business Profits Tax, Act, 1947.

(2) Whether on facts and in the circumstances of the case the Tribunal was right in holding that the fact that the amount in question had been built up out of capital and not out of taxed profits would not prevent it from being reserve as contemplated by Sub-Rule (1) of Rule 2 of the Schedule 11 of the Business Profits Tax Act.

(3) Whether on the facts and in the circumstances of the case, the Tribunal was

right in holding that the sum of \$29,000,000 odd, \$43,000,000 odd, \$56,000,000 odd and 73,000,000 & odd for the respective years appearing in the Balance Sheets of the assessee as,
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"Earned Surplus" would be treated as a reserve within the meaning of Sub-Rule (1) of Rule 2 of the Schedule 11 of the Business Profits Tax Act."

The High Court recorded answers in the affirmative on all the questions. The Commissioner of Income-tax has appealed to this Court with special leave.,

The assessee Company is a non-resident. It was incorporated in the State of Delaware in the United States of America with the object of taking over the assets of two companies- Socony Vacuum Oil Company and Standard Oil Company (New Jersey). The capital of the assessee company was \$10,000,000 divided into 100,000 shares of the value of \$100 each. On the date of acquisition the book values of the assets of the two companies as recorded in their books of account were:

Socony Vacuum Oil Company.... \$97,715,701

Standard Oil Company

(New Jersey).... \$46,767,397

In consideration of transfer of these assets, the assessee company allotted to each company 49,995 shares and to Socony Vacuum Oil Company serial bonds of the value of \$13,093,000. The remaining ten shares were divided equally between the two transferor companies for cash at par value. The assessee company entered in its books of account the book value of the assets taken over from the transferor companies. The excess of the net value of the assets so transferred over the par value of the stock issued and the serial bonds was entered in the books in an account styled "Capital paid in Surplus". The serial bonds issued to the Socony Vacuum Oil Company were later redeemed. By adjustment entries the "Capital paid in Surplus" account was reduced to \$117,561,317 and throughout the period of three years to which these appeals relate, in the balance sheets of the assessee company, the "Capital paid in Surplus" stood unchanged at that figure. The net profits earned by the Company year after year, subject to certain appropriations were shown in the balance sheet under the caption "Earned Surplus" or "Earnings reinvested". At the end of 1945, the balance of "Earned Surplus" was \$29,557,597 and by the end of 1948 the account stood at \$73,766,592.

The Income-tax Officer disallowed the claim of the assessee Company for inclusion of the accounts "Capital paid in Surplus" and "Earned Surplus" in the computation of taxable capital under Sch. II r. 2(1) of the Business Profits Tax Act and the Appellate

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Assistant Commissioner agreed with him. But the Income-tax Appellate Tribunal held that the difference between the value of the assets taken over and the value of stock and serial bonds issued by the assessee Company was premium realized from the issue of its shares and retained in the business within the meaning of r. 3 of Sch. II and was in any event reserve not allowed in computing profits within the meaning of r. 2(1). The Tribunal also held that the amount entered in the account "Earned Surplus" was reserve liable to be taken into account in assessing business profits tax. In a reference under S. 19 of the Business Profits Tax Act, the High Court agreed with the view of the

Tribunal on the three questions referred for its opinion. The provisions of the Business Profits Tax Act, 1947, which have a bearing on the questions raised in the reference to the High Court may first be summarised By s. 4 of the Act in respect of any business to which the Act applies, business profits tax is charged, levied and paid on the taxable profits during any accounting period at the rates specified in the Act. The expression "Taxable profits" is defined in s. 2(17) as the amount by which the profits during a chargeable accounting period exceed the abatement in respect of that period. "Abatement" is defined in s. 2(1) (insofar as it is material) as meaning, in respect of any chargeable accounting period ending on or before the 31st day of March, 1947 a sum which bears to a sum equal to (a) in the case of a company, not being a company deemed for the purposes of s. 9 to be a firm, six per cent of the capital of the company on the first day of the said period computed in accordance with Sch. II, or one lakh of rupees, whichever is greater, and (b) in respect of any chargeable accounting period beginning after the 31st day of March, 1947, such sum as may be fixed by the annual Finance Act. Schedule II prescribes rules for the computation "of the capital of a company for purposes of business profits tax". The material clauses are 2(1) and 3 :

"2. (1) Where the company is one to which rule 3 of Schedule I applies, its capital shall be the sum of the amounts of its paid-up share capital and of its reserves in so far as they have not been allowed in computing the profits of the company for the purposes of the Indian Income-tax Act, 1922 (XI of 1922), diminished by the, cost to it of its investments or other property the income from which is not includable in the profits, so far as that cost exceeds any debt for money borrowed by it.

(2).....
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Explanation.-A reserve or paid-up share capital brought into existence by creating or increasing (by revaluation or otherwise) any book asset is not capital for the purposes of ascertaining the abatement under this Act in respect of any chargeable accounting period.

3. So much of the premium realised by a company from the issue of any of its shares as it retained in the business shall be regarded as forming part of its paidup capital for the purposes of rule 2."

The first two questions referred by the Tribunal relate to the true nature of the amount entered in the books of account of the assessee company under the caption "Capital paid in Surplus". It is a common practice in the United States of America in transactions in which business assets are transferred to a new company, to issue shares of total par value less than the true value of the assets transferred. Singer, who was Treasurer of Standard Vacuum Oil Company and officiated as Treasurer and later as Vice-President of the assessee Company has stated in paragraph-5 of his affidavit that. "The reason for limiting the stated or par value of the capital stock of Standard Vacuum Oil Company to \$10,000,000 rather than including the entire capital of \$131,391,098.71 in the par value of issued stock was simply to reduce issuance taxes and fees payable on the basis of the par value of stock issued, in view of the fact that the stock was held by only two corporate shareholders

and there was no need for a larger number of shares to be issued and outstanding." In "Cases and Materials on Corporations" by Dodd and Baker, 2nd Edn., at p. 1118 under the head "Sources of Capital Surplus" the authors have stated

"Credits to an account that is still generally called Paid-in Surplus arise in a number of circumstances which include: (a) where shares having a par value including the very low par value that has recently come into use, are issued and sold for cash or non-cash consideration in an amount in excess of part..... The occasion for the issue may be an initial or subsequent acquisition of property. Such a property acquisition may be the purchase of all or substantially all assets of another corporation as a going concern, or a merger by which such another corporation is absorbed by the surviving corporation, or a consolidation by which two or more corporations are absorbed by a new corporation created in the consolidation proceedings. Upon such a purchase

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of assets or in a merger or consolidation, the defensible value of the assets of the vendor or of the absorbed corporation or corporations may not be "capitalized" in its entirety, so that a paid-in surplus emerges from the transaction."

In Fletcher's Cyclopaedia Corporations Vol. 19 Paragraph 9237, the author has set out the prevailing method of carrying into the balance sheet the amount of consideration received in excess of par value under the head "Surplus" :

".....as dividends can be declared only out of surplus earnings, and there must be an exact method of determining whether surplus earnings for that purpose actually exist, it is the view of sound attorneys and sound accountants that the only proper method of handling, in the accounts, the item of no par value stock is to set up on the books, as a charge against capital, the amount of the consideration received for each issue of such stock and that any other increases or any decreases in net assets should be carried on the balance sheet under the headings of Surplus and Deficit, just as if the capital charge had been made in connection with the issuance of stocks having a par value. They will therefore keep the capital stock entry a constant figure, representing the amount of consideration received for the same, and, if the corporation earns money, they will set up, on the liabilities side of the 'balance sheet an item which they call "Surplus" or "Undivided Profits." If

additional no par value stock is issued, although, under the theory of no par value stock, it need not be issued at the same price as the original issue but at such price as the directors determine to be for the best interests of the corporation, the number of shares issued will be added to the number of shares outstanding and the consideration

received for the same will be added to the figures opposite the entry "Capital Stock," and thereafter the entry of capital stock will continue to be a constant item, the adjustments for earnings or losses being made in the accounts of "Surplus" or "Deficit"

It is also stated :

"In some of the States the legislature has introduced a complication by writing into the statutes which

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provide for the issuance of no par value shares a provision "that, in setting up the no par value stock on the books, a portion of the consideration received therefor may be charged to "Stated Capital" and a portion to "Paid-In Surplus".

Under the statutes of Michigan, the item of "Paid-In-Surplus" must be carried on the balance sheet as a separate item from "Earned Surplus" or "Undivided Profits," and such is the policy of many accountants in the absence of any statutory provision."

Therefore stock is issued in consideration of transfer of assets, the par value of stock is not necessarily equal to the value of assets transferred. Where the value of assets transferred exceeds the par value, the difference may appropriately be regarded as "premium" according to the nomenclature used in India.

Under the Companies Act, 1913, shares could be issued for cash or against transfer of property, and it is not claimed that under the statute law in the State of Delaware a different rule prevailed at the time when the assessee company took over the assets of the transferor companies. The Indian Companies Act also places no restriction upon a company issuing shares for a consideration which exceeds the par value of the shares, and there is no evidence on the record that in the State of Delaware there is such a restriction. A share is not a sum of money : it represents an interest measured by a sum of money and made up of diverse rights contained in the contract evidenced by the articles of association of the Company. In the absence of any restriction in the law of Delaware against the issue of shares otherwise than for cash, when shares are issued for consideration other than cash the value of the assets transferred in excess of the par value of shares issued would be regarded as premium for purposes of our system of law. No serious argument has been advanced before us on behalf of the Commissioner controverting this part of the case.

When shares are issued to the public at a premium, ordinarily premium at a uniform rate would be charged from all applicants for shares. But that is not because the law contains any prohibition against charging differential premiums. The right of a company to charge varying premiums in respect of blocks of shares having the same rights issued under different resolutions is not denied, and on principle there is no objection to the

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charging of varying rates of premium for shares issued under a single resolution, if all the parties concerned agree. The amount or value which a person intending to be a shareholder may pay in excess of the par value for acquiring the shares of a company depends upon the contract between the company and such a person.

In the case under review, the two transferor companies were willing to combine into a larger corporation, presumably to avoid competition. The book value of the assets transferred by Socony Vacuum Oil Company was undoubtedly larger than the book value of assets transferred by the Standard Oil Company. But for effectuating a combine, the two transferor companies in a contract with the assessee company agreed to receive stocks of equal par value carrying equal rights in consideration of transfer of assets of different values. If the excess paid by the transferor companies over the par value of the shares received may be regarded as premium, and we hold that it does, it is not necessary to enter into the correctness of the submission of the assessee company that the difference in the value of the assets transferred by the two companies was nominal, because the Standard Oil Company had transferred valuable "intangible assets" which had not entered into the book valuation of its assets, and which bridged the difference between the value of the assets transferred by that company and the assets transferred by the Socony Vacuum Oil Company.

Under the Companies Act, 1913, shares of a class already issued could be issued by a company at a discount, subject only to the conditions prescribed by s. 105A. But the Act made no provision relating to the issue of shares at a premium. The matter was one governed by contract between the company and the intending acquirer of shares. In the Companies Act 1 of 1956, certain restrictions are imposed upon the application of premiums received on issue of shares by s. 78. Shares could therefore be issued at a premium under the Act of 1913 and that appears to be recognised by the terms of s. 78(3) of the Companies Act of 1956.

It was found by the Tribunal that the amount entered in the balance sheet as "Capital paid in Surplus" was retained in the business of the assessee company, and the correctness of that view was not challenged before the High Court. The only argument advanced before the High Court on this part of the case was that shares could be said to be issued at a premium only when

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they were issued for cash in excess of the par value and not otherwise. But shares may be issued subject to express statutory provision to the contrary for money or services or in consideration of transfer of property, and there is no reason to think that a different rule applies when shares are issued at a premium. There is no provision in the Companies Act of 1913, which enacts a different rule, and it is not said that there is a statute in the State of Delaware which enacts a different rule.

Counsel for the Revenue maintained that the use of the expression "premium realised from the issue of any shares" in r. 3 of Sch. 11 implies that there must, prior to the allotment of shares under which premium is charged, be some arrangement for payment of consideration in excess of the par value of shares, and in the absence of evidence to prove such an arrangement, the capital surplus is not premium realised from the issue of shares. No such contention was raised at any stage in these proceedings, and a finding that there was before the shares were issued an arrangement between the two transferor companies and the assessee company that the shares were to be issued in consideration of the transfer of assets of unequal book value held by the two transferor companies is clearly implicit in the view expressed by the Tribunal. The High Court was therefore right in holding that the difference between the book value of the assets transferred and the par value of capital stock

issued was premium.

The assessee company said that even if this amount of "capital paid in Surplus" be not regarded as premium within the meaning of r. 3, it is still "reserves" within the meaning of r. 2(1). This plea found favour with the High Court. Counsel for the Revenue raised two contentions against acceptance of that view of the High Court : (1) that reserves contemplated by r. 2(1) are only those which are built out of profits processed for the purpose of taxation under the Indian Income-tax Act; and (2) that where a reserve is brought into existence by creating or increasing, by revaluation or otherwise a book asset, it cannot be included in the computation of capital by virtue of Explanation to r. 2. In support of his first contention Mr. Vishwanath Sastri relied upon the observations of Chagla, C.J. in Commissioner of Income-tax v. Century Spg. & Mfg. Company Ltd.(1) In that case the Bombay High Court held that profits of a company not allocated to any specific head in the balance sheet at the end of the year of account of a company may be treated as "reserves" for the purpose of r. 2 of Sch. II of the Business Profits Tax Act, but

(1) 20 I.T.R. 260.

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the judgment of the Bombay High Court was reversed by this Court: video, Commissioner of Income-tax,, Bombay City v. Century Spg. & Mfg. Co. Ltd.(-'). The profits of the company had been subjected to tax, and the, question whether an account which is built up otherwise than out of profits of the business could be regarded as reserves for the purpose of r. 2 did not fall to be decided in that case. Under r. 2(1) reserves which insofar as they have not been allowed in computing the profits of the Company enter into the computation of capital for the purpose of r. 2(1). This Court observed In Century Spinning & Manufacturing Company's case(1) :-

"Two essential characteristics must be present before the assessee can avail himself of the benefit of the rule, namely, that the amount should not have been allowed in computing the profits of the company for the purposes of Income-tax Act and that it should be a reserve as contemplated by the rule."

Rule 2 does not expressly say that the reserve admissible in the computation of capital should be one built out of profits,, and this Court did not suggest that the rule contained such an implication. Observations made by Chagla, C.J. in Century Spinning & Manufacturing Company's cave 2) at p. 264 :

"Therefore in order to determine the capital of the company for the purposes of this Act you have got to take the paid-up share capital of the company, then you have to add to it the reserves and you have to add only those reserves which have been subjected to taxation"

and at p. 265

"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 dividends to the shareholders but kept back by the Directors for any purpose to which it may be put in future",

were only made in reference to the facts of the case and were not intended to lay down that reserves built up from sources other than profits will not be admissible for

inclusion in capital under r. 2(1) of the Business Profits Tax Act. This contention is also negated by the terms of the Explanation. Reserves which may be brought into existence by creating or increasing (by reevaluation

(1) 11 54] S.C.R. 203.

(2) 2) I.T.R. 260.

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or otherwise) any book asset are expressly declared to be not capital for the purpose of ascertaining the abatement. If reserves which were built not out of profits were excluded from the operation of r. 2(1), it was hardly necessary to enact the Explanation.

The Explanation to r. 2 has no relevance in the present case. The difference between the assets received by the company and the par value of the shares issued cannot be called a book asset "brought into existence by creating or increasing (by reevaluation or otherwise)". The assets received by the assessee company are real and tangible assets. It is only for accountancy purposes that a part of the value of the assets is allocated to the par value of the shares and the balance to the "Capital Surplus brought in" account. The High Court was therefore right in holding that the account "Capital Surplus brought in the balance sheet represents premium realised from the issue of its shares within the meaning of r. 3, or in the alternative represents reserves not allowed in computing the profits of the company for the purpose of the Indian Income-tax Act, 1922.

The next question is whether "Earned Surplus" may be treated as "reserves" within the meaning of sub-r. (1) of r. 2 of Sch. 11. It is found by the Tribunal that the profits earned year after year by the assessee company were retained and reinvested in its business. "Earned Surplus" has, it is true, not been called "reserve", but if it is truly a reserve, it must be taken into account in the computation of capital. In considering this question, it is necessary to note certain special features of the system of accounting obtaining in the United States of America. In the balance sheet% of companies the assets are balanced against liabilities, capital stock and surplus. In the company accounts it is usual to provide for specific or special reserves, but there is no allocation to a head called "General reserve" in the accounts. It is also well settled that the accounts of companies maintained under the American system are self-contained for each year. Under the system of accounting in vogue in India, after allocations are made to various purposes such as outgoing, expenses and reserves, specific and general the balance is generally carried forward to the next year. The amount so carried forward gets merged into the account of the next year. If the capital and liabilities side exceeds the property and assets side, the difference is carried forward as loss in the next year. Under the American system of accounting, whatever remains on hand at the end of the year is entered on the liabilities, capital stock and surplus side as "Earned

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Surplus". This was pointed out in First National. City Bank v. Commissioner of Income-tax, Bombay(1), where Kapur, speaking for the Court observed :

"There is a difference between the system of accounting of banking companies in India and the United States : In India at the end of a 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 U.S.A. each year's account is self-contained and nothing is carried forward. If after allocating the profits to diverse heads mentioned above any balance remains, it is carried to the "Undivided Profits" which 'become part of the capital fund. If in any year as a result of the allocation there is a 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 every nature the Undivided Profits are accumulation of amounts of residue on hand at the end of 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."

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 accounts of a banking company : they are applicable with appropriate variations to accounts of all companies, and 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 a 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 reserves".

The Appellate Tribunal held that the "Earned Surplus" in the balance sheets of the assessee company represented "reserves" within the meaning of r. 2 Sch. 11 of the Business Profits Tax Act. The High Court agreed with that view. But counsel for the Revenue contended that accumulated profits could only be

(1) [1961] 3 S.C.R. 371.

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deemed reserves for the purpose of the Business Profits Tax Act, if they are specifically allocated to reserves and not otherwise and in support of that contention, he relied upon the decision of this Court in the Century Spinning & Manufacturing Company Ltd.(1) Counsel pointed out that in that case this Court reversed the decision of the High Court of Bombay in which accumulated profits were regarded as reserves for the purpose of the Business Profits Tax Act. It is necessary carefully to scrutinise the facts in the Century Spg. & Mfg. Company's case(1). For the account year ending December 31, 1945, the profit of the assessee company, amounted to Rs. 90,44,677/-. After providing for depreciation and taxation there remained an unallocated balance of Rs. 5,08,637/- which was not allowed in computing the profits of the assessee for purpose of income-tax. In February 1946, the directors recommended that out of that amount a sum of Rs. 4,92,426/- be distributed as dividend and the balance of Rs. 16,21 1 /- be carried forward to the next year's account. The recommendation was accepted by the shareholders and dividend was shortly thereafter distributed. In computing the capital of the assessee company on April 1, 1946 under the Business Profits Tax Act, 1947, the assessee claimed that Rs. 5,08,637/- carried forward into the account of 1946 should be treated as

"reserve" for the purpose of r. 2 (1) of Sch. 11. This Court negatived the contention. Ghulam Hasan, J., speaking for the Court observed

"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 January, 1946, cannot automatically make it a reserve. On the 1st April, 1946, which is the commencement of the chargeable accounting period, there was merely a recommendation by the directors that the amount in question should be distributed as dividend. Far from showing that the directors had made the amount in question, a reserve, it shows that they had decided to ear-mark it for distribution as dividend."

After referring to the judgment of the High Court, the learned Judge observed :

(1) [1954] S.C.R. 203.

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"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 unutilized and not specially set apart for any purpose on the crucial date did not constitute reserves within the meaning of Schedule 11, rule 2(1)."

It was pointed out that under the Indian Companies Act, 1913, the directors are enjoined to attach to every balance sheet a report with respect to the state of the 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. It was also pointed out that S. 132 of the Indian Companies Act refers to the contents of the balance sheet to be drawn up in the Form marked 'F' in Sch. HI, and to Regulation 99 of the 1st Sch. Table A, and observed that any sum out of the profits which is to be carried into a reserve must be set aside before the directors recommend any dividend. The Court observed:

"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."

The Court was dealing in that 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 1st Sch. 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 & loss account was not preserved.

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It 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.

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 : some may be specific 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 reserve 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. The accumulated profits of the assessee company according to the system of accounting at the end of the year were not carried forward into the account of the next year as they could not be, according to the system of accounting prevalent in the United States. They had to be allocated to some account, and they were allocated to "Earned Surplus", which was intended for and was used in subsequent years for the purposes of the business of the assessee company. The account in which this amount was carried retained its identity year after year. In the First National City Bank's case(1), this Court held that the undivided profits brought into account of the assessee Bank under the head "Assets, capital, capital stock and reserves" were reserves within the meaning of r. 2(1) of Sch. II of the Business Profits Tax Act. In that case the Court was dealing with a case of a banking institution, and a letter from the Deputy Controller of Currency, Washington, was tendered in evidence which explained that in the United States the "Undivided Profits" as reflected in the accounting of a bank actually represent a part of its capital funds, and that the term "Undivided Profits" simply followed a bank accounting nomenclature used to designate profits set aside after provisions for expenses and taxes, dividends and reserves, for continuous future use in the business of the Bank.

(1) [1961] 3 S.C.R. 371.

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In the case before us we have no such evidence on the record about the nature of the "Earned Surplus" account, but the manner in which the balance sheets year after year are maintained, and the general accountancy practice prevailing

in the United States, suggest that there is specific allocation of the balance of profits ,at the end of each accounting year.

The following table prepared from the balance sheets and filed on behalf of the assessee company, (correctness of which has been accepted), clearly supports that view.

Earnings Year Reinvested Earned surplus) Opening Balance	Net Profit	Appro- priations (made within year)	Earnings Reinvested (Earned Surplus) Closing Balance	Fixed Assets (at cost)
\$	\$	\$	\$	
945 16299765	13257841	--29557597	7654167	
1946 29557597	24355370	100000000	43912958	82534231
1947 43912968	22861837	100000000	56774805	110767579
1948 56774805	36991787	200000000	73766592	19672)177
1849 73766592	38882589	200000000	92649181	2)7045227

The Table disclosed that the balance of "Earned Surplus" at the end of the year did not merge into the account of the subsequent year. It represented a specific account into which were added the net profits of the year and appropriations were made out of it and the balance was regarded as "Earned Surplus" at the end of the year. This account was specifically allocated for utilisation for the purpose of business year after year. It was an account in which the net profits less the appropriations were added, and the account was intended for application in extending the business of the assessee company. The amounts entered in the account 'Earned Surplus" cannot therefore be regarded as mere unallocated profits at the end of the accounting year.

The High Court was therefore right in holding that the "Earned Surplus" represented reserves. The method in which the accounts are maintained in the light of the accountancy practice clearly indicates that at the end of each year, there have been specific appropriations in the account, and the conditions which this Court regarded as essential in the Century Spinning & Manufacturing Company's case(1) for constituting the fund into reserve are fulfilled.

The appeals fail and must be dismissed with costs. There will be one hearing fee.

Appeals dismissed.

(1) [1954] S.C.R. 203.

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