

Commissioner of Income-tax, Bombay City-iii Vs. Century Spg. and Mfg. Co. Ltd.

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Court : Mumbai

Decided On : Aug-10-1976

Reported in : [1977]108ITR431(Bom)

Judge : R.M. Kantawala and ;V.D. Tulzapurkar, JJ.

Acts : [Income Tax Act, 1961](#) - Sections 84; [Super Profits Tax Act, 1963](#) - Schedule - Rule 1; ;[Companies Act, 1956](#)

Appeal No. : Income-tax Reference No. 175 of 1976

Appellant : Commissioner of Income-tax, Bombay City-iii

Respondent : Century Spg. and Mfg. Co. Ltd.

Advocate for Def. : S.P. Mehta, Adv.

Advocate for Pet/Ap. : R.J. Joshi, Adv.

Judgement :

Tulzapurkar, J.

1. In this reference made to this court under section 256(1) of the Income-tax Act, 1961, the following two questions have been referred to us for our determination at the instance of the Commissioner of Income-tax, Bombay City-III, Bombay :

'(1) Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that (i) the proposed dividend of Rs. 56,59,612, (ii) excess provision for taxation, (iii) provision for contingencies of Rs. 40,00,000 and (iv) provision for gratuity should be treated as reserve for inclusion in the capital computation for the purpose of the super profits tax assessment for 1963-64 assessment year

(2) Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that rule 3 of the Second Schedule to the [Super Profits Tax Act, 1963](#), is applicable only to a case where a part of the income of a company is not includible in its total income by virtue of the provisions contained in Chapter III of the Income-tax Act, 1961, and not to a case where a part of the income of the company is not included in its total income by virtue of that part of the income being allowed as deduction under section 84 of the Income-tax Act, 1961 ?'

2. At the outset it may be stated that so far as question No. 2 is concerned, it was common ground that in point of fact no benefit by way of any deduction under section

84 of the Income-tax Act, 1961, had been claimed by or allowed to the assessee-company and if that be the position, the question raised would be clearly academic and as such the same need not be answered.

3. Turning to question No. 1 out of four items which are covered by this question, three items, whether they are includible or not includible in the capital computation for the purpose of super profits tax are covered by decided cases and by decisions which have been delivered by us in this session and as such the question in regard to these three items need not be discussed in detail. As regards the item of proposed dividend of Rs. 56,59,612, the same is covered by our decision in the case of Shree Ram Mills (S. P. T. Reference No. 1 of 1972, decided on 1st July, 1976 - [1977] 108 ITR 29) and in view of that decision this item will have to be regarded as not includible in the capital computation. The question in that regard is answered accordingly.

4. As regards the item of excess provision for taxation, the question in that regard is covered by the decision in Commissioner of Income-tax v. Indian Steel Rolling Mills Ltd. : [1973]92ITR78(Mad) and in view of that decision the question in regard to that item is answered in favour of the assessee.

5. As regards the item pertaining to provision for gratuity, the same is covered by our decision delivered in I. T. Reference No. 152 of 1975 Commissioner of Income-tax v. Forbes Forbes Campbell and Co. : [1977]107ITR38(Bom) , and in view of that decision the question in regard thereto is answered in favour of the assessee and the said item will have to be included in the capital computation.

6. The only item that, therefore, remains to be considered is the one in regard to provision for contingencies of Rs. 40 lakhs and the material facts pertaining to this item may be stated : The question relates to assessment year 1963-64, the corresponding previous year being calendar year 1962. For the purpose of computing the capital base the material date would be January 1, 1962, being the first day of the previous year for the purpose of super profits tax under rule 1 of the Second Schedule to the [Super Profits Tax Act, 1963](#). In the balance-sheet of the assessee-company as at December 31, 1961, under the column 'liabilities' and below the heading 'current liabilities and provisions' a sum of Rs. 40 lakhs had been shown as 'provision for contingencies' and in the profit and loss account for the year ended December 31, 1961, also the said sum of Rs. 40 lakhs had been debited as 'provision for contingencies'. Therefore, on the relevant date being the first day of the previous year, i.e., January 1, 1962, the said sum of Rs. 40 lakhs stood appropriated as provision for contingencies. In the directors' report which was submitted to the shareholders of the assessee-company for the year ended December 31, 1962, it was stated that out of gross profit of Rs. 3,77,93,273 a sum of Rs. 77,00,425 had been set apart towards payment of bonus to the employees of the textile section (for the years 1958 - supplementary - 1959, 1960 and 1961) and the directors' report further stated that for the purpose of making this payment the amount of Rs. 40,00,000 which had been set apart as provision for contingencies had been drawn upon. The Income-tax Officer excluded this sum of Rs. 40 lakhs while computing the capital base of the assessee-company for the assessment year 1963-64. In the appeal which was carried to the Appellate Assistant Commissioner, relying upon the decision in Commissioner of Income-tax v. Security printers of India P. Ltd. : [1972]86ITR210(All) the Appellate Assistant Commissioner held that the Income-tax Officer was not justified in excluding the said amount from the capital computation. The matter was carried in further appeal to the Tribunal, where the revenue tried to support the Income-tax

Officer's order. On behalf of the assessee it was stated that the said sum of Rs. 40 lakhs which was a provision for contingencies had been created in 1961, in view of the pending disputes between the textile mills and workers regarding the bonus payments for earlier years, that the dispute was settled in October, 1962, and that the above provision was adjusted in 1962, towards the payment of bonus of Rs. 77,00,425 for the year 1958 to 1961, which became due as a result of settlement. The Tribunal took the view that the provision for contingencies made by the assess was not for an existing liability, inasmuch as the settlement regarding bonus was only arrived at in October, 1962, that is, after the end of 1961, and since the said sum was not set apart to meet any known liability and could not be ascertained with certainty, it should be treated only as a reserve and not a provision. The Tribunal, therefore, directed that the said amount should be included while computing the capital base of the assessee. At the instance of the Commissioner of Income-tax the relevant question disputing this conclusion of the Tribunal has been referred to us for our determination.

7. Mr. Joshi, appearing for the revenue, has contended before us that having regard to the distinction between a provision and a reserve as has been pointed out by the Supreme Court in Metal Box Co.'s case : (1969)ILLJ785SC and having regard to the definition of these two expressions as given in clause 7(1) of Part III of the 6th Schedule to the [Companies Act, 1956](#), even contingent liability, albeit a known contingent liability, is also included within the definition of the expression 'provision' and he urged that since in this case admittedly the sum of Rs. 40 lakhs had been set apart for the purpose of meeting the liability in the matter of bonus in respect whereof a dispute between the textile workers on the one hand and the mill owners on the other had been pending before the adjudicating machinery under the statute, the said setting apart of the sum of Rs. 40 lakhs will have to be regarded as a provision intended to meet a known or existing contingent liability and, therefore, this being in the nature of a provision, the same was not includible in the capital computation.

8. On the other hand, Mr. Mehta for the assessee-company tried to support the view taken by the Tribunal by urging before us that as on the material date, i.e., January 1, 1962, the amount set apart for contingencies could not be said to be for any known or existing liability as the settlement regarding the bonus was only arrived at in October, 1962, and as such the setting apart of the amount of Rs. 40 lakhs was rightly regarded by the Tribunal as a reserve includible in the capital computation.

9. The position in law is quite well-settled having regard to the decision of the Supreme Court in Metal Box Co.'s case : (1969)ILLJ785SC that if an amount is set aside out of the profits and other surplus to provide for any known liability, it would be a provision but if an amount is set aside out of the profits or other surplus not designed to meet a liability, contingency, commitment or diminution in value of assets known to exist at the date of the balance-sheet it would be a reserve. The expression 'provision' is defined in sub clause (a) of clause 7(1) of Part III of Schedule VI to the [Companies Act, 1956](#), thus :

'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.'

Sub-clause (b) of clause 7(1) defines 'reserve' thus :

'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'

10. After defining the two expressions in the aforesaid manner, clause 7(1) proceeds to run thus :

'... in this sub-clause the expression 'liability' shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.'

11. It was not disputed by Mr. Joshi appearing for the revenue before us that through the definition of the expression 'liability' as given in the latter part of clause 7(1) is an inclusive definition and the same includes contingent liabilities, such contingent liabilities will have to be a known or existing contingent liability. His contention, however, was that, in view of the admitted position in the instant case, the amount of Rs. 40 lakhs had been set apart as provision for contingencies for the purpose of meeting the liability for payment of bonus that was to arise in view of the pending dispute between the textile mill and the workers for earlier years as also for some future years, that is to say, for years from 1958 to 1961, the setting apart of this amount will have to be regarded as a provision, for, the liability to pay the bonus was in all probability likely to arise because a dispute between the textile workers on the one hand and the mill owners on the other was pending adjudication before an adjudicating machinery under the relevant statute. He urged that it was having regard to the pendency of adjudicating proceedings that the assessee-company set apart Rs. 40 lakhs as and by way of provision for contingencies for the purpose of meeting the liability in the matter of payment of bonus as and when the same would be declared by the adjudicating machinery. He pointed out that instead of award being made by the adjudicating machinery the matter was settled through the intervention of some intermediary and it was as a result of settlement that was arrived at that ultimately the sum of Rs. 77,00.425 was required to be kept by way of bonus to the workers for the years 1958 to 1961 and the amount of Rs. 40 lakhs which had been set apart was adjusted towards the said liability. He, therefore, urged that this was a case where a provision had been made for a known contingent liability and, therefore, the setting apart of the amount of Rs. 40 lakhs should be regarded as a provision not includible in the capital computation. We find considerable force in this contention of Mr. Joshi. The aforesaid position which has been canvassed by Mr. Joshi becomes very clear from the following passage which occurs in Spicer & Pegler's Practical Auditing (Fourth Indian Ed.), Part I, Chapter V, which deals with the subject 'The Audit of the Impersonal ledger' under the sub-heading 'Contingent liabilities', at page 149, where the learned authors have stated thus :

'(12) Contingent liabilities. - The auditor should ascertain whether there are any transactions outstanding at the date of the balance-sheet which might involve the payment of money at some subsequent date. Such outstandings are termed 'contingent liabilities', and may be of two classes : the one involving a loss should the liability accrue, and the other involving the acquisition of an asset of corresponding value.

It is sufficient for the amount of the contingent liability to be stated on the face of the balance-sheet by way of a note, unless there is a definite probability that a loss will materialise, when specific provision should be made therefor. The most familiar instance is the contingent liability on bills receivable which have been discounted. If

at the date of the balance-sheet any of the bills that have been discounted are outstanding, there will be a contingent liability in respect thereof, since, if the acceptors do not meet the bills on maturity, the holders will have a right of recourse against the drawer or any prior indorser.....

Other instances of contingent liabilities which might involve a loss, should they accrue, would be damages and costs in the case of an action pending, forward contracts, guarantees for third parties, and speculative transactions on the Stock Exchange still undecided.'

12. Mr. Joshi also invited our attention to the manner in which the expression 'contingent liability' has been explained in the Dictionary for Accountants by Kohler, 3rd edition, which runs thus :

'Contingent liability. - An obligation, relating to a past transaction or other event or condition, that may arise in consequence of a future event now deemed possible but not probable. If probable, the obligation is not contingent but real (ordinarily, a current liability), and recognition in the accounts is required, notwithstanding that its amount must be estimated in whole or in part. The possibility of a future loss, as from a fire, not linked with a past event does not give rise to a contingent liability. Following are the common sources of contingent liabilities :

Possible additional compensation arising out of a labour dispute.' Relying on the aforesaid passage, which occurs in Spicer & Pegler's Practical Auditing (4th Indian Ed.) as well as the explanation of the expression 'contingent liability' as occurring in the Dictionary for Accountants it was sought to be urged by Mr. Joshi that in the instant case the setting apart of the sum of Rs. 40 lakhs in the balance-sheet as on December 31, 1962, for contingencies, which according to the assessee-company's own statement before the Tribunal, was for the purpose of meeting the liability which might arise as a result of award that would be made in an industrial adjudication which was pending under a statute will have to be regarded as provision made for a known contingent liability, the quantification whereof was to depend upon either the actual award that would be made by the adjudicating machinery or as a result of settlement that may be arrived at by the parties, which was the case herein. In our view, there is force in Mr. Joshi's contention, and we are inclined to agree with his submission. In view of the statement which was made on behalf of the assessee-company before the Tribunal that this amount has been set apart in view of the dispute which was pending before the adjudicating machinery in the matter of claim for bonus that has been made by the textile workers under a statute, it would be clear that it was a case of a known contingent liability for which a provision was made. In our view, therefore, the setting apart of this amount being in the nature of a provision would not be includible in the capital computation for the purpose of the [Super Profits Tax Act, 1963](#). The question in regard to this item is, therefore, answered against the assessee and in favour of the department.

13. Assessee-company will pay the costs of the reference to the revenue.