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**PANDHYAN INSURANCE CO. LTD.**

v.

**COMMISSIONER OF INCOME-TAX, MADRAS**

September 29, 1964

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(K. SUBBA RAO, J. C. SHAH AND S. M. SIKRI JJ.)

*Income Tax Act (11 of 1922) Schedule, rr. 3(b) and 6—Scope of*

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The appellant (assessee) was a company carrying on the business of general insurance. It erected a substantial modern building at a cost of about Rs. 12,00,000 towards the end of 1952. For the accounting year 1953 it wrote off a sum of about Rs. 1,00,000 as representing the depreciation with respect to various items. The Income-tax Officer disallowed 4/5 of the depreciation on the ground that only a fifth part of the building was utilised for the purpose of the appellant's business and the remaining 4/5 part was let out, and that the rent thereon was exempted under s. 4(3) (xii) of the Income-tax Act, 1922. On appeal by the assessee, the Appellate Assistant Commissioner dismissed the appeal and enhanced the assessment by disallowing even the 1/5

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of the depreciation allowed by the Income Tax Officer, on the ground that under r. 3(b) of the Schedule to the Act, the allowable depreciation was an actual depreciation of the value of the assets. On further appeal, the Appellate Tribunal restored the order of the Income-tax Officer with respect to 1/5 part but as to the 4/5 part agreed with the Appellate Assistant Commissioner. The High Court, on a reference as to whether the 4/5 part of the depreciation was also allowable as a deduction in the assessment completed under s. 10(7) and the rules contained in the Schedule, of the Act, held against the appellant. On appeal to the Supreme Court,

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HELD: The appeal must be allowed. [374C].

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Rules 3(b) and 6 of the Schedule to the Income-tax Act, which are the applicable rules, should be read against the background of the various provisions of the Insurance Act (4 of 1938) making detailed provision to ensure the true valuation of assets and the determination of the true balance of profits of an insurance business. So read, the Income Tax Officer can exclude from the balance of profits, only any expenditure which is not allowable under s. 10 of the Income-tax Act. The word "expenditure" in r. 6 means disbursement and does not comprehend depreciation. As regards "depreciation", it covers both actual and notional, and the Income Tax Officer has no option but to allow it under r. 3(b). He cannot ask the assessee to prove that there has been any actual depreciation. [370E; 372A, C; 373E, F; 374C].

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*Life Insurance Corporation of India v. Commissioner of Income-tax (1964) 51 I.T.R. 773, followed.*

**CIVIL APPELLATE JURISDICTION: Civil Appeal No. 816 of 1963.**

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Appeal by special leave from the judgment dated the July 4, 1961, of the Madras High Court in case referred No. 4 of 1957.

*A. V. Viswanatha Sastri, R. Venkataraman and R. Gopala-krishnan, for the appellant.*

*R. Ganapathy Iyer, R. H. Dhebar and R. N. Sachthey, for the respondent.* A

The Judgment of the Court was delivered by

**Sikri J.** This is an appeal by special leave against the judgment of the Madras High Court in a case referred to it under the Indian Income Tax Act, 1922, hereinafter referred to as the Act, answering the question of law against the assessee. The question referred is : B

“Whether four-fifth of the sum of Rs. 1,21,245 written off in the books of the assessee as depreciation for the calendar year 1953 is allowable as a deduction in the assessment completed under section 10(7) and the rules contained in the schedule of the Income-tax Act.” C

The facts relevant for answering the question are as follows. The assessee is a public limited company carrying on the business of general insurance. It erected a modern substantial building with lifts and air-conditioning at a cost of Rs. 12,08,252 and got it ready for occupation from December 1, 1952. In its books for the calendar year 1953, the previous year for assessment year 1954-55, it wrote off Rs. 1,21,245 as depreciation as follows : D

	Rate (Per cent)	Amount (in rupees)	E
Buildings	10	1,06,940	
Air conditioning plant	15	2,973	
Lifts	15	6,214	
Transformers	15	1,442	
Internal Telephone	15	3,676	F
		1,21,245	
	TOTAL	1,21,245	

It was common ground before the Income-tax Appellate Tribunal that one-fifth of the building could be considered as occupied for its own purposes and the remaining four-fifth as let out to tenants for rent. The Income-tax Officer disallowed four-fifth of the depreciation claimed on the ground that “the rentals received from this 4/5th portion are being shown separately under the head ‘Property’ which income in turn has been claimed as ‘exempt’ under s. 4(3)(xi). Had there been no exemption in the property income there would have been a statutory allowance which would compensate for depreciation. The fact that the whole income is exempt further strengthens that no allowance regarding these portions could be made.” H

**A** On appeal, the Appellate Assistant Commissioner disallowed the whole claim (including that allowed by the Income-tax Officer) on another ground. He held that the property fell within the words 'other assets' used in Rule 3(b) of the Schedule, but what Rule 3 (b) contemplated was an actual depreciation of the value of such assets. As the counsel of the assessee admitted before him that **B** the property being new, there could be no question of actual depreciation.

On further appeal, the Appellate Tribunal came to the conclusion that the immovable property to the extent of four-fifths thereof was an investment held 'solely for the purpose of earning **C** rent therefrom capable of appreciation either notionally or by sale and realisation', but under r. 6 of the Schedule, the Income-tax Officer has jurisdiction to fix a figure which is fair and just. It accordingly allowed the appeal in part.

On a reference being made to it, the High Court held that in computing profits and gains, the Income-tax Officer had the power **D** to examine the quantum of depreciation either written off or reserved and to satisfy himself that it did not exceed the amount allowable to meet the depreciation.

It is common ground between the parties that by virtue of s. 10(7) of the Act the profits and gains of any business of **E** insurance have to be computed in accordance with the rules contained in the Schedule to the Act, and ss. 8, 9, 10, 12 or 18 have no application. Rule 3(b) and r. 6, on the interpretation of which the answer to the question referred to depends, read thus :

"3. In computing the surplus for the purposes of rule 2—

**F** (b) any amount either written off or reserved in the accounts or through the actuarial valuation balance sheet to meet depreciation of or loss on the realisation of securities or other assets, shall be allowed as a deduction, and any sums taken credit for **G** in the accounts or actuarial valuation balance sheet on account of appreciation of or gains on the realisation of the securities or other assets shall be included in the surplus :

Provided that if upon investigation it appears to the **H** Income-tax Officer after consultation with the Controller of Insurance that having due regard to the necessity for making reasonable provision for bonuses to participating policy-holders and for contingencies, the rate of

interest or other factor employed in determining the liability in respect of outstanding policies is materially inconsistent with the valuation of the securities and other assets so as artificially to reduce the surplus, such adjustment shall be made to the allowance for depreciation of, or to the amount to be included in the surplus in respect of appreciation of, such securities and other assets, as shall increase the surplus for the purposes of these rules to a figure which is fair and just;

6. The profits and gains of any business of insurance other than life insurance shall be taken to be the balance of the profits disclosed by the annual accounts, copies of which are required under the Insurance Act, 1938 [4 of 1938], to be furnished to the Controller of Insurance, after adjusting such balance so as to exclude from it any expenditure, other than expenditure which may under the provisions of section 10 of this Act be allowed for in computing the profits and gains of a business. Profits and losses on the realisation of investments and depreciation and appreciation of the value of investments shall be dealt with as provided in rule 3 for the business of life insurance."

Mr. Viswanatha Sastri contends that the Insurance Act, 1938 (4 of 1938) makes detailed provisions to ensure the true valuation of assets and the determination of the true balance of profits of an insurance business. An examination of various sections of the Insurance Act discloses that he is right in this respect. Section 11 requires an insurer to prepare at the expiration of the calendar year a balance sheet, a profit and loss account, and a revenue account in accordance with the schedules. Part I of the First Schedule prescribes regulations and Part II gives forms for the preparation of a balance sheet. Regulation 6 enjoins the appending to the Balance Sheet a statement in Form AA, as set out in Part II of the First Schedule, showing the market value and the book value of the assets, including house property. This Form AA has three columns; (1) book value as per (a) below, (2) market value as per (b) below, and (3) remarks as per (c) below—(a) refers to the value for which credit is taken; (b) refers to the market value of assets which has been ascertained from public quotations, and (c) refers to how the value of the assets as has not been ascertained from public quotations has been arrived at. But it is not necessary to show the market values where they are not less than the book values, and a certificate to that effect is

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- A appended to the statement. In other words, if the market value is more than the book value, it need not be shown. The result of the above-mentioned provisions is that the statement of assets will show book value of house property and its market value unless the market value is more.
- B The Second Schedule prescribes the regulations and forms for the preparation of profits and loss account of some insurers. There are two columns in Form 'B' which need be mentioned: (1) Depreciation of Investments (not charged to Reserves or any particular Fund or Account); (2) Appreciation of Investments (not credited to Reserves or any particular Fund or Account).
- C The Third Schedule sets forth the regulations and forms for the preparation of a revenue account (one of the items to be shown in Form D is 'Rents for offices belonging to and occupied by the Insurer'). Form F is form for Revenue Account applicable to Fire Insurance Business, Marine Insurance Business, and Miscellaneous Insurance Business. One of the items to be shown is
- D "expenses of management" and note (c) says that if any sum has been deducted from this item and entered on the assets side of the Balance Sheet, the amount to be deducted must be shown separately.

E After the balance sheet, profit and loss account and revenue account have been prepared, they have to be audited unless they are subject to an audit under the Indian Companies Act. Under s. 15 the audited accounts and statements above referred to have to be furnished to the Controller as returns.

F Section 18 requires every insurer to furnish to the Controller a certified copy of every report on the affairs of the concern which is submitted to the members or policy holders of the insurer.

G Section 21 enables the Controller to get such further information from the insurer as he may consider necessary to correct or supplement a return, to examine books of accounts, registers and documents or to examine any officer. The Controller may decline to accept any return unless the inaccuracy has been corrected or the deficiency has been supplied. If he declines to accept any return, the insurer shall be deemed to have failed to comply with the provisions of s. 15, s. 16 or s. 28 or s. 28A relating to the furnishing of returns. Sub-section (2) of s. 21 enables an insurer

H to apply to court for cancellation of any order made under cls. (a), (b) or (c) of sub-section (1) or for directing the acceptance of any return which the Controller has declined to accept.

Mr. Sastri next contends that r. 6 and r. 3(b), quoted above, should be read in the light of this background. He says that r. 6 authorises an Income-tax Officer to make adjustments of two kinds. First, he can exclude from the balance of profits any expenditure which is not allowable under s. 10 of the Act. He says that the depreciation which has been claimed is not an expenditure within r. 6, for the expenditure must be a disbursement. He refers in this connection to s. 10(2) (xii), (xiv) and (xv) where the word 'expenditure' is expressly used. Coming to the second part of r. 6, he argues that the word 'depreciation' includes both actual and notional depreciation, and in r. 3(b) similarly the word 'depreciation' includes actual and notional depreciation. If he is right in this, he says that as r. 3(b) directs the Income-tax Officer to allow the depreciation, which has been written off, the Income-tax Officer has no option but to allow it and he cannot ask the assessee to prove that there has been any actual depreciation. He relies strongly on the decision of this Court in *Life Insurance Corporation of India v. Commissioner of Income-tax*.<sup>(1)</sup> Let us first see what is the exact scope of this decision. Sarkar J., interpreted r. 3(b) in the following terms :

"When we come to rule 3(b) we find that the first part of it lays down that it shall be obligatory on the Income-tax Officer to allow certain amounts written off or reserved by the assessee as a deduction and to include in the surplus any sums for which credit has been taken on account of appreciation or gains on the realisation of the securities or other assets. This part of the rule only compels the Income-tax Officer to allow certain amounts as deductions and to include certain amounts for which credit had been taken in the accounts of the assessee. *It, therefore, does not warrant what the Income-tax Officer did, namely, to adjust the accounts on the basis of a revaluation made by him.*" (emphasis supplied)

Hidayatullah J., said this about Rule 3(b);

"Under the main part of rule 3(b) certain special deductions and additions must be made to the annual average of the surplus determined under the second rule. Since the life fund is held in securities and the price of stocks and shares fluctuates, provision has been made in rule 3(b) to make adjustments. Rule 3(b) in its main part speaks of adjustments on the basis of the accounts and amounts as entered in the accounts determine what

(1) (1964) 51 I.T.R. 773.

A must be added to or deducted from the surplus. The  
 Income-tax Officer must deduct from the annual average  
 of the surplus for purposes of rule 2 any amount entered  
 in the account to cover depreciation of the securities and  
 assets and add any amount taken credit for on account of  
 appreciation. The Income-tax Officer here follows the  
 B accounts and gives effect to the entries such as they are.  
 The provision is mandatory and the Income-tax Officer  
 has no discretion."

He then adds :

C "The entire subject of such disparity between fact and  
 actual entries is comprehended in the proviso."

D It seems to us that this Court has held in categorical terms that  
 r. 3(b) does not empower the Income-tax Officer to adjust the  
 accounts on the basis of a revaluation made by him or to correct  
 the discrepancy between what is entered in the accounts and what  
 is fact.

E Mr. Ganapathy Iyer tried to distinguish the case on the ground  
 that r. 6 was not applicable to a life insurance business and was not  
 considered by the Court. He at first suggested that in the second  
 part of r. 6 the word 'depreciation' did not include notional  
 depreciation. When it was pointed out to him that if this is correct,  
 F r. 3(b) would not be attracted at all, he modified his stand and  
 argued that in r. 3(b) notional depreciation of property is not  
 included in the word 'depreciation'. We are unable to agree with  
 him that the word 'depreciation' in r. 3(b) should be construed  
 in this limited sense. The words "any amount written off . . . in the  
 accounts . . . to meet depreciation of . . . other assets" have to be  
 understood in the ordinary connotation. If the draftsman wanted  
 to include depreciation on buildings, what Mr. Ganapathy Iyer  
 calls notional depreciation, he could hardly have used any other  
 wording.

G Mr. Ganapathy Iyer says that this Court in *Life Insurance*  
*Corporation of India v. Commissioner of Income Tax*<sup>(1)</sup> did not  
 examine one aspect, and this aspect is derived from the words  
 "to meet" occurring in r. 3(b). He says that the effect of these  
 words is that the Income-tax Officer is obliged to allow any  
 amount written off only if it is really to meet actual depreciation  
 and not any other fanciful conception of depreciation. This  
 H question does not arise on the facts of this case, for once we hold  
 that the word "depreciation" covers notional depreciation, it is

(1) [1964] 51 I.T.R. 773.

nobody's case that it is not notional depreciation that is intended to be written off. There is no sanctity about the rate of depreciation prescribed under the Act. If the rate of depreciation applied by the assessee and accepted by the Controller differs from that allowed under the Act, it cannot be said that the assessee did not write off the amount to meet depreciation. A

Mr. Ganapathy Iyer has referred us to some cases but they were discussed in the above-mentioned decision of this Court and there is no point in discussing them again. We may mention that the learned Counsel for the Revenue has not rightly urged that the word "expenditure" in the first part of r. 6 comprehends depreciation. We agree with Mr. Sastri that the word "expenditure" in r. 6 means disbursement. B C

Accordingly, we accept the appeal and answer the question in the affirmative. The respondent will pay costs incurred in this Court and the High Court.

*Appeal allowed.*