

COMMISSIONER OF INCOME-TAX,
BOMBAY CITY

v.

THE CENTURY SPINNING AND
MANUFACTURING CO. LTD.

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MANUFACTURING CO. LTD.

v.

COMMISSIONER OF INCOME-TAX,
BOMBAY CITY.

[PATANJALI SASTRI C. J., S. R. DAS, VIVIAN BOSE,
GHULAM HASAN and BHAGWATI JJ.]

Business Profits Tax Act (XXI of 1947), Sch. II, rr. 2 and 3—Determination of capital of company—Inclusion of 'reserves'—Accumulated profit carried over to next year without declaring it as reserve—Whether 'reserve'—Indian Companies Act (VII of 1913), ss. 131-A, 132, Sch. I, Table A, Reg. 99.

The balance sheet of a company for the calendar year 1945 showed a profit of Rs. 90,44,677, subject to the provision for depreciation and taxation, and, after giving credit to these items

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the balance of Rs. 5,08,637 was carried to the balance sheet of the next year on the 1st January, 1946, without making or declaring it a reserve. On the 28th February, 1946, the directors marked it for distribution as dividend, on the 3rd April, a resolution was passed for distributing it as dividend, and a few days later it was actually distributed as dividend :

Held, that as the said sum of Rs. 5,08,637 was never earmarked or declared as a reserve, but was, on the other hand, earmarked for distribution as dividend on the 28th February and 3rd April and was actually so distributed, it cannot be deemed to be a reserve and added to the paid-up capital in determining the company's capital under rr. 2 and 3 of Sch. II to the Business Profits Tax Act, 1947, for the chargeable accounting period commencing on the 1st April, 1946.

Held also, that the profits of the company from the 1st January to 1st April, 1946, cannot also be treated as reserves.

CIVIL APPELLATE JURISDICTION: Civil Appeals Nos. 157 and 158 of 1952.

Appeals from the Judgment and Order dated the 29th day of March, 1951, of the High Court of Judicature at Bombay (Chagla C.J. and Tendolkar J.) in its Original Civil Jurisdiction in Income-tax Reference No. 27 of 1950.

G. N. Joshi for the Commissioner of Income-tax.

R. J. Kolah for the Century Spinning and Manufacturing Co. Ltd.

1953. October 8. The Judgment of the Court was delivered by

GHULAM HASAN J.—These two connected appeals, one by the Commissioner of Income-tax, Bombay, and the other by the Century Spinning & Manufacturing Co. Ltd., arise out of the judgment and order of the Bombay High Court delivered on a reference made by the Income-tax Appellate Tribunal, Bombay.

The two questions of law referred by the Tribunal were as follows :—

(1) Whether the amount of Rs. 5,08,637 is a part of the 'reserves' of the assessee company as on 1st April, 1946, within the meaning of rule 2(1) of the rules in Schedule II to the Business Profits Tax Act, and

(2) Whether the profits of the assessee company from 1st January to 1st April, 1946, should be included in the said reserves as on 1st April, 1946.

The High Court answered the first question in the affirmative and the second in the negative.

The accounting year followed by the assessee is the calendar year and the chargeable accounting period is the 1st of April, 1946, to the 31st of December, 1946, in respect of the profits ending with 31st December, 1945. The profits according to the profit and loss account were Rs. 90,44,677 subject to the provisions for depreciation and taxation. After making provisions for these, the balance of Rs. 5,08,637 was carried to the balance-sheet.

Two contentions were raised on behalf of the assessee before the Income-tax Officer, the first being whether the aforesaid sum could be called a "reserve" within the meaning of rule 2(1) of the Rules in Schedule II to the Business Profits Tax Act and whether it should be included in its reserves while determining the capital on the 1st April, 1946; the second that the proportionate profits of the assessee for three months, between the 1st January, 1946, and the 1st April, 1946, should also be included in the said reserves. The Income-tax Officer rejected the contention holding that "A 'reserve' represents profits set apart for some specific or general purpose and therefore profits which have not been so set apart cannot be treated as forming part of reserves for the purpose of inclusion in the capital." This order was confirmed on appeal by the Appellate Assistant Commissioner but was set aside by the Income-tax Appellate Tribunal. Thereupon the Tribunal formulated the two questions aforementioned for reference to the High Court under section 66(1) of the Act, read with section 19 of the Business Profits Tax Act of 1947. As already stated the High Court decided the first question in favour of the assessee and the second in favour of the department. Hence the two appeals.

The Business Profits Tax Act (No. XXI of 1947) came into force on the 11th April, 1947, having taken

the place of the Excess Profits Tax Act which was repealed on the 30th March, 1946. This Act, as is well known, was designed to assess large profits made by companies carrying on business during the boom years of the war. It was revived, as it were, after a year in the shape of the present Act, though in a modified form. Section 4 which is the charging section, so far as it is material for our purposes, permits the levying on the amount of the "taxable profits" during any "chargeable accounting period", a tax called the "business profits tax" which shall be equal to sixteen and two-thirds per cent. of the taxable profits. "Taxable profits" means the amount by which the profits during a chargeable accounting period exceed the abatement in respect of that period [section 2(17)]. "Abatement", according to section 2 (1) means, 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 section 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 Schedule II, or one lakh of rupees, whichever is greater the same proportion as the said period bears to the period of one year....."

"Accounting period" according to section 2(2) in relation to any business means any period which is or has been determined as the previous year for that business for the purposes of the Indian Income-tax Act, 1922. Lastly "chargeable accounting period" is defined in section 2(4) as follows:—

"(a) any accounting period falling wholly within the terms beginning on the first day of April, 1946, and ending on the thirty-first day of March ;

(b) where any accounting period falls partly within and partly without the said term, such part of that accounting period as falls within the said term :"

It appears that the definition of abatement contemplates that the normal profit of a company is six per cent. on its capital and where the profit exceeds

that amount, it becomes liable to pay business profits tax. Schedule II lays down the rule for computing the capital of a company for purposes of business profits tax and rule 2(1) of the Schedule which admittedly applies to the present case lays down that "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....."

The point that arises for consideration on the first question is whether the assessee is entitled to treat the sum of Rs. 5,08,637 as a reserve and to add it to its paid-up share capital for the purposes of computing the abatement. 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. That it has not been so allowed is not denied and therefore the only question is whether it can be treated as a reserve within the meaning of the rule. The balance-sheet shows that the company made a profit of Rs. 90,44,677 for the calendar year 1945 subject to the provision of depreciation and taxation. After giving credit for these items the balance of Rs. 5,08,637 was carried to the balance-sheet on 1st January, 1946, in the profit and loss account. On the 28th February, 1946, the directors recommended that the aforesaid sum should be appropriated in the following manner :—

Payment of a final dividend at the rate of Rs. 18 per share (making Rs. 28 per share for the whole year) free of income-tax absorbing ... Rs. 4,92,426-0-0

Balance to be carried forward to
next year's account ... Rs. 16,211-6-8

This recommendation was accepted by the shareholders in their meeting on the 3rd April, 1946, by a resolution passed to that effect. The dividend was made payable on the 15th April, 1946, and it is not

denied that it was actually distributed. These being the facts, the question arises whether the amount in question can be called a "reserve".

The term "reserve" is not defined in the Act and we must resort to the ordinary natural meaning as understood in common parlance. The dictionary meaning of the word "Reserve" is:—

"1(a) To keep for future use or enjoyment; to store up for some time or occasion; to refrain from using or enjoying at once.

(b) To keep back or hold over to a later time or place or for further treatment.

6. To set apart for some purpose or with some end in view; to keep for some use.

11. To retain or preserve for certain purposes." (Oxford Dictionary, Vol. VIII, p. 513).

In Webster's New International Dictionary, Second Edition, page 2118, "Reserve" is defined as follows:—

"1. To keep in store for future or special use; to keep in reserve; to retain, to keep, as for oneself.

2. To keep back; to retain or hold over to a future time or place.

3. To preserve."

What is the true nature and character of the disputed sum, must be determined with reference to the substance of the matter and when this is borne in mind, it follows that on the 1st of April, 1946, which is the crucial date, the sum of Rs. 5,08,637 could not be called a "reserve", for nobody possessed of the requisite authority had indicated on that date the manner of its disposal or destination. On the other hand, on the 28th February, 1946, the directors clearly ear-marked it for distribution as dividend and did not choose to make it a reserve. Nor did the company in its meeting on the 3rd April, 1946, decide that it was a reserve. It remained on the 1st of April as a mass of undistributed profits which were available for distribution and not ear-marked as "reserve". 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. By the resolution of the shareholders on the 3rd April, 1946, the amount was shortly afterwards distributed as dividend. The High Court appear to have been under a misapprehension as to the real position, for they observed :—“It was open to the directors to distribute the sum of Rs. 5,08,537 as dividends. They did not choose to do so and have kept back this amount. Therefore, by keeping back this amount they constituted it a reserve. 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 dividend to the shareholders but kept back by the directors for any purpose to which it may be put in future. Therefore, giving to the ‘reserves’ its plain natural meaning, it is clear that the sum of Rs. 5,08,637 was kept in reserve by the company and not distributed as profits and subjected to taxation. Therefore, it satisfied all the requirements of rule 2.” The directors had no power to distribute the sum as dividend. They could only recommend, as indeed they did, and it was up to 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 II, rule 2 (1).

Reference was made to sections 131 (a) and 132 of the Indian Companies Act. Section 131 (a) enjoins upon the directors to attach to every balance-sheet a report with respect to the state of 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. The latter section refers to the contents of the balance-sheet which is to be drawn up in the Form marked F in Schedule III. This Form contains a separate head of reserves. Regulation 99 of the First Schedule, Table A, lays down "that the directors may, before recommending any dividend set aside out of the profits of the company such sums as they think proper as a reserve or reserves which shall, at the discretion of the directors, be applicable for meeting contingencies, or for equalising dividends, or for any other purpose to which the profits of the company may be properly applied.....". The Regulation suggests that any sum out of the profits of the company which is to be made as a reserve or reserves must be set aside *before* the directors recommend any dividend. 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.

We are of the opinion that the view taken by the Bombay High Court is erroneous and must be set aside. The appeal of the Commissioner of Income-tax is allowed with costs.

As regards the second question, Mr. Kolah, the learned counsel for the company, frankly conceded that the view taken by the High Court on this part of the case is not open to challenge and is correct. The

High Court held that the profits for three months from the 1st January, 1946, to the 1st April, 1946, were not reserves which would attract the application of rule 2 of Schedule II. With this conclusion we agree. The assessee's appeal is, therefore, dismissed with costs.

Appeal No. 157 allowed.

Appeal No. 158 dismissed.

Agent for the Commissioner of Income-tax: *G. H. Rajadhyaksha.*

Agent for the company: *I. N. Shroff.*