
(1989) 01 MAD CK 0039

In the Madras High Court

Case No : Tax Case No's. 431, 432 and 433 of 1978

Chandmama Publications

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 19-01-1989

Acts Referred:

Income Tax Act, 1961 — Section 256(1), 37, 40A(7)

Citation : (1989) 76 CTR 97 : (1989) 176 ITR 321

Hon'ble Judges : V. Ratnam, J; Bhakthavatsalam, J

Bench : Division Bench

Advocate : M. Uttam Reddi, for the Appellant; N.V. Balasubramaniam, for the Respondent

Judgement

Ratnam, J.—The assessee is a registered firm. In relation to the assessment years 1973-74 to 1975-76, the assessee claimed deduction in

respect of the provision made for retrenchment compensation in sums of Rs. 18,561, Rs. 9,318 and Rs. 19,142, respectively. The Income Tax

Officer disallowed the claim so made by the assessee and on further appeal to the Appellate Assistant Commissioner, it was held that there was no

certainty of Payment with regard to retrenchment compensation as in the case of gratuity payment and that there was also no method of working

out the basis of quantification of the prospective retrenchment compensation if and when it was required to be paid and, therefore, the claim for

deducting the provision for retrenchment compensation from the profits and gains cannot be countenanced. In the appeals preferred by the

assessee before the Tribunal, the disallowance was upheld on the ground that there was no ascertained liability and the possibility of such a liability

arising may or may not happen and that there was no method of evaluating or

quantifying such liability, if any, in the accounting years in question

and further that the unilateral action on the part of the firm in making a provision would enable it to use funds for any of its purposes.

2. At the instance of the assessee, u/s 256(1) of the Income Tax Act, 1961 (hereinafter referred to as "the Act"), the following common question of

law has been referred to this court its opinion :

In the facts and circumstances of the case, was the Income Tax Appellate Tribunal right in holding that the assessee is not entitled to any

deduction by way of provision for retrenchment compensation ?

3. Learned counsel for the assessee contended that the adoption of modern methodology in business activities and business expediency have

established that retrenchment is a common feature in any commercial establishment and it is necessary to make provision therefore as a prudent

business expedient with a view to provide for commitments that may arise in future in that regard. The analogy of payment of insurance premium to

cover to a risk factor was pressed into service by learned counsel in support of the allowance of deduction. Reliance was also placed in this

connection upon the decision in Metal Box Company of India Ltd. Vs. Their Workmen, . On the other hand, learned counsel for the Revenue

submitted that, having regard to the well-understood concept of retrenchment in industrial law, the liability for payment of compensation arose only

on retrenchment, which was in the nature of an uncertain future event as it may or may not happen at all, and it cannot, therefore, be claimed that

there was any definite obligation cast on the firm in that regard when the business was run without retrenchment in the relevant accounting years. It

was also further pointed out that it is out that it is not possible to evaluate or quantify in praesenti the value of such an indefinite and uncertain

obligation which may or may not arise at all in the future and that cannot also be claimed as a permissible outgoing or deduction. In support of the

aforesaid submission, learned counsel for the Revenue invited our attention to Commissioner of Income Tax, Madras Vs. Indian Metal and

Metallurgical Corporation, , Commissioner of Income Tax, Kerala Vs. Gemini Cashew Sales Corporation, Quilon, , Commissioner of Income

Tax, Bombay Central Vs. Rajkumar Mills Ltd., Indore, , Commissioner of Income Tax, Bombay City II Vs. Otis Elevator Co. (India) Ltd., and

Shree Sajjan Mills Ltd. Vs. Commissioner of Income Tax, M.P., Bhopal and Another, .

4. We may first consider the nature of retrenchment as well as the liability to pay compensation therefor. Retrenchment is the termination of the services of a workman by the employer for any reason whatsoever, otherwise than as a punishment inflicted by way of disciplinary action and does not include voluntary retirement of a workman or his attaining the stipulated age of superannuation or the termination of his services on the ground of continued ill-health. u/s 25F of the Industrial Disputes Act, provision is made regarding the conditions precedent to retrenchment of a workman.

It is not necessary to go into the details of the provisions so made. But, it would suffice to point out that payments in accordance with the provisions thereunder have to be made at the time of effecting the retrenchment.

5. Retrenchment, essentially and principally, depends upon the volition of the employer dictated by reasons of economy, convenience as well as

bonafides and cannot ordinarily be assumed to take place or be given effect to in any business establishment in any given year. Thus, retrenchment

in a business establishment may or may not take place and in that sense, it would be a doubtful and uncertain future event of such retrenchment

taking place is only in the nature of a wholly contingent when the business is run. Any provision, therefore, made to cover such a doubtful

contingent liability, which may or may not arise at all, cannot be treated as a definite obligation and as a permissible outgoing or deduction. The

analogy of gratuity is also inapplicable while considering the provision made for retrenchment compensation. Payment of gratuity is made by the for

any reason and even though such payment is made at a particular point of time, it is generally not for the service rendered during the year when the

payment is made, but is made in consideration of the totality of the service and its computation depends upon several factors. The right to receive

gratuity accrues on retirement or termination and the liability to pay gratuity becomes the liability of the employer on the employee's retirement or

when his services are terminated and till then, the right to receive gratuity could be regarded only as a contingent right and the liability to pay, a

contingent liability for the employer. Even considering the payment of gratuity as a contingent liability, if the amount eventually payable could be

properly ascertained and its present value commercially determined by an actuarial valuation and discounted, that could be considered as deductible from the gross profits. Thus, the liability to pay gratuity arises out of a consideration of the entire period of service, though payable on the retirement or termination of the service of the employee and a provision made in that regard every year to meet the contingent liability for gratuity properly ascertained and discounted on actuarial basis, as fastened on the assessee in any year of accounting, could be deducted. But, however, unlike gratuity which is based essentially upon the number of years of service of the employee, payment of retrenchment compensation arises only in the event of retrenchment taking place and is not in any manner related to the number of years of service put in by the employee in an establishment, though the retrenchment compensation, as such, may be fixed with reference to such service. It is in this connection that the decision in *The Indian Hume Pipe Co. Ltd. Vs. The Workmen and Another*, , and *Dalmia Cement (Bharat) Ltd. Vs. Their Workers* represented by the *Dalmia Cement Workers' Union, Dalmia*, , may be usefully referred to. In these cases, the Supreme Court had occasion to consider the difference between gratuity and retrenchment compensation and whether the payment of one would exclude the claim or the grant of the other. The Supreme Court pointed out that gratuity is a kind of retirement benefit like the provident fund or pension and such payment is intended to help the workmen after retirement and the general principle underlying such a scheme of gratuity is that by their length of service, the workmen are entitled to claim certain amounts as retiral benefits and that the object of retrenchment compensation is to give partial protection to the retrenchment employee and the members of his family thrown out in the streets being obliged to face the grim problem of unemployment by tiding over the hard period such retrenchment compensation and payment of gratuity is borne in mind, it is at once apparent that the purposes of payment of gratuity and retrenchment compensation are totally different and one cannot have any connection whatever with the other. We have pointed out the distinction only for considering the scope of the decision of the Supreme Court reported in *Metal Box Company of India Ltd. Vs. Their Workmen*, , considerable reliance upon which was placed by learned counsel for the assessee. That case dealt with a provision made on an actuarial valuation

in respect of estimated liability for payment of gratuity under two schemes framed under the Act. In considering the question whether the liability for payment of gratuity under such schemes can be estimated on an actuarial valuation and that amount be deducted in the profit and loss account, the Supreme Court pointed out that if such a liability is properly ascertainable and it is possible to arrive at a properly ascertainable and it is possible to arrive at a properly discounted present value, it can be taken into account and even such contingent liabilities so discounted whose present value is ascertained can be taken into account as trading expenses, if they are sufficient capable of evaluation. In view of the basic difference with regard to the payment of gratuity and retrenchment compensation noticed earlier, the principles applicable to payment of gratuity cannot be applied in respect of payment of retrenchment compensation. We may also point out that amounts in respect of which an allowance was claimed by the assessee towards payment of retrenchment compensation arising out of a future doubtful retrenchment cannot be considered as a provision made for any known or existing liability. There is also no satisfactory method of evaluating or quantifying that liability and attributing the same to the accounting years in question. Factually, during the accounting years, there has been no retrenchment. Assuming that in future there is likely to be retrenchment, it cannot now be postulated as to whether the entire staff will be retrenched or only a few of them and there cannot, therefore, be any satisfactory method of quantifying the liability, even assuming that such a liability could be considered as a quantifiable contingent liability. We are, therefore, of the view that the assessee cannot claim the benefit of allowance on the strength of the decision in Metal Box Company of India Ltd. Vs. Their Workmen, .

6. We may now proceed to consider the analogy of payment of insurance premium, urged by learned counsel for the assessee. It may be that the object of effecting insurance is generally to cover an insurable interest subject to risk, which may or may not take place. To that extent, the risk may be contingent. Even so, the payment of insurance premium to cover such a contingent risk or an insurable interest is a definite outgoing. In other words, to cover a possible risk, there is a present expenditure, which is not present when a mere provision is made for such a contingency

which may or may not arise in future. We are, therefore, of the view that the analogy of payment of insurance premium for coverage of the risk factor is wholly inappropriate.

7. We now proceed to make a brief reference to the decision cited by learned counsel for the Revenue Commissioner of Income Tax, Madras Vs.

Indian Metal and Metallurgical Corporation, dealt with the question of a claim by the assessee as business expenditure u/s 10(2)(xv) of the Indian

Income Tax Act, 1922, of the amounts credited to a fund to meet an eventual liability u/s 25F of the Industrial Disputes Act. Such a liability, it was

pointed out, may arise de futuro on the happening of a particular contingency and need not be allowed as a deduction either u/s 10(2)(xv) or on

commercial principles as to computation of profits. Further, it was also pointed out that the liability of the assessee in respect of retrenchment

compensation u/s 25F of the Industrial Disputes Act was not a liability in praesenti, but was only a contingent liability, which cannot be taken into

account as an accrued liability, even though the assessee has been maintaining accounts on the mercantile system and that the assessee had still

control or dominion over the reserve, which it was at liberty to recall for use for its own business purposes and the claim for deduction as an

expenditure" cannot be countenanced. In Commissioner of Income Tax, Kerala Vs. Gemini Cashew Sales Corporation, Quilon, , a firm stood

dissolved by the death of one of the partners and its business was taken over the continued by the surviving partner and while settling the accounts

of the firm, an amount was taken into account as retrenchment compensation payable to the employees u/s 25FF of the Industrial Disputes Act,

which would arise on a transfer of ownership. The question arose whether the sum constituted an allowable expenditure in computing the income of

the firm for the assessment year 1958-59. The Supreme Court pointed out that the present value, on commercial evaluation of money to become

due in future, under a definite obligation, will be trader, even if, in certain conditions, the obligation may cease to exist because of forfeiture of the

right. Where, however, the obligation of the trader is purely contingent, no question of estimating the present value may arise, for, to be a

permissible outgoing or allowance, there must, in the year of account, be a present obligation capable of commercial valuation. Considering the

question whether the amounts taken into account as retrenchment compensation can be regarded as wholly for the business, the court ruled that where the liability is, during the whole of the period that the business is carried on, wholly contingent does not rise any definite obligation during the time the business is carried on, it cannot fall within the expression ""expenditure laid out or expended wholly and exclusively"" for the purpose of the business. The admissibility as permissible expenditure of a sum set apart by an employer for meeting a contingency of his workers going on leave in the next year came to be considered in Commissioner of Income Tax, Bombay Central Vs. Rajkumar Mills Ltd., Indore, . The claim for deduction was negatived holding that the question of payment of wages for leave to a worker would arise only if he went on leave or was discharged or refused leave or he quit his employment and till those circumstances arose, the liability that rested on the employer remained a contingent liability which the employer may or may not be called upon to discharge and any sum set apart by an employer for meeting the contingency of his workers going on leave in the next year cannot be regarded as a permissible expenditure u/s 10(2)(xv) of the Indian-tax Act, 1922. In Commissioner of Income Tax, Bombay City II Vs. Otis Elevator Co. (India) Ltd., , a question arose whether a reserve for paying retrenchment compensation to employees could be included in the computation of the capital for purposes of surtax. The assessee-company had appropriated various sums to an account called ""Reserve for Employees" Indemnities"" with a view to meet any claim of retrenchment compensation arising out of retrenchment of any member of the staff. All the authorities took the view that the appropriation was not designed to meet any known liability and that the amount of reserve would be includible for purposes of the capital computation for surtax. It was held that the setting apart of the amount by way of provision for employees' indemnities intended to be spent for payment of retrenchment compensation arising out of a future retrenchment of any member of the staff could not be regarded as one for any known or existing liability and, therefore, the setting apart of this item would have to be regarded as a reserve which would be properly includible in the capital computation for surtax purposes. Though the decision was rendered with reference to the includibility of the amount set apart in the capital for surtax purposes, we are of the view that that would not make any difference

to the applicability of the principle. In *Shree Sajjan Mills Ltd. Vs. Commissioner of Income Tax, M.P., Bhopal and Another*, the Supreme Court had occasion to consider the question whether a provision made for gratuity would qualify as an item of expenditure prior to and after the introduction of section 40A(7) of the Act. At page 598, the Supreme Court pointed out that the payment of gratuity made on retirement or termination of service was not for the service rendered during the year in which the payment is made, but is in consideration of the entire length of service and the right to receive the payment by the employee on retirement or on termination of service is a contingent right and the liability to pay gratuity continues to be a contingent liability for the employer. It has also been further laid down that an employer may pay gratuity when the employee retires or his service is terminated and claim the expenditure as made for the purpose of business or he may provide for the payment of gratuity which became payable during the previous year and claim the expenditure on accrued basis, if he followed the mercantile system and that contingent liabilities do not constitute expenditure and that expenditure deductible for Income Tax purposes should be towards the liability actually existing at the time of setting apart, and that which might become expenditure on the happening of an event is not expenditure. Referring to the distribution between an actual liability in praesenti and a liability in futuro, the Supreme Court pointed out that a distinction is often made between an actual liability in praesenti and a liability de futuro, which for the time being is only contingent and the former is deductible, but not the latter. Though this decision has been rendered with reference to the provisions of section 40A(7) of the Act, the principles enunciated therein prior to the introduction of section 40A(7) of the Act would be equally applicable to the present case as well. We are, therefore, of the view that as per the principles laid down in the decisions relied on by learned counsel for the Revenue, the liability to pay retrenchment compensation is only in the nature of a contingent liability and there is also no satisfactory method of evaluating or quantifying the value of that liability in any particular year of account and cannot, therefore, appropriately form the subject-matter of a claim for deduction.

8. We, therefore, answer the question in the affirmative and against the assessee. The Revenue is entitled to recover the costs of this reference.

Counsel"s fees Rs. 500. One set.