
(1988) 06 AP CK 0030
In the Andhra Pradesh High Court
Case No : R.C. No. 175 of 1983

Commissioner of Income Tax

APPELLANT

Vs

D.B.R. Mills Ltd.

RESPONDENT

Date of Decision : 27-06-1988

Acts Referred:

Income Tax Act, 1961 — Section 28, 29, 30, 31, 32

Citation : (1988) 72 CTR 148 : (1988) 174 ITR 442

Hon'ble Judges : Y. Bhaskar Rao, J;B.P. Jeevan Reddy, J

Bench : Division Bench

Advocate : M. Suryanarayana Murthy and A.V. Krishna Koundinya, for the Appellant; Y. Ratnakar, for the Respondent

Judgement

Jeevan Reddy, J.—The Income Tax Appellate Tribunal, Hyderabad, has stated the following question for our opinion u/s 256(1) of the Income Tax Act, 1961 :

"Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in allowing the deduction of Rs. 9,54,947 claimed as expenditure towards gratuity ?"

2. The assessee is a company engaged in the manufacture of textiles. The question arises with reference to the assessment year 1977-78, the relevant accounting year being the year ending on June 30, 1976.

3. The assessee created a trust for gratuity fund for the benefit of employees on November 26, 1975, and applied for recognition which was granted by the Commissioner of Income Tax, Andhra Pradesh, on March 25, 1976, with effect from December 1, 1975. The assessee also got its actuarial liability determined through an actuary, Sri. P. S. Sundaram. The actuary ascertained the assessee's liability for gratuity at Rs. 25,55,725 as on June 30, 1975 (which falls within the assessment year 1976-77). The assessee had previously made a provision for a total sum of Rs. 15,29,199 in two assessment years, i.e., 1974-75 and 1975-76. During the accounting year relevant to the assessment year concerned herein

(1977-78), the assessee made no provision in its books, nor was any such provision made by the authority/officer of the company competent to make such provision. Yet, the assessee claimed that the difference amount between Rs. 25,55,725 and Rs. 15,29,199, i.e., 10,26,526, should be allowed as a deduction. The Income Tax Officer rejected the said claim on the finding that the assessee, not having actually contributed the said amount to the fund during the relevant accounting year, is not entitled to claim the deduction. He, however, allowed deduction of a sum of Rs. 71,579 which was the amount actually paid by the assessee to its employees during the relevant accounting year on account of gratuity. The Income Tax Officer observed that the assessee has neither actually contributed the said sum nor can it be said that any statutory liability for the said amount has been incurred by the assessee during the relevant accounting year. The claim was, accordingly, rejected both u/s 40A(7) as well as section 36(1)(v). On appeal, the Appellate Assistant Commissioner agreed with the reasoning of the Income Tax Officer and dismissed the appeal. On further appeal, however, the Tribunal took a different view. It held that the liability towards gratuity has crystallized during the year by virtue of the approval granted by the Commissioner of Income Tax to the gratuity fund; it is true that the assessee has not made a provision in its books, but since the law does not provide any particular mode for making a provision, the identification and earmarking of the said sum in the statement annexed to the revised return submitted by the assessee amounts to making a provision within the meaning of section 40A(7)(b) (i), and hence the assessee is entitled to claim the deduction. In that view, the Tribunal declined to go into the question whether the assessee is entitled to claim the said deduction u/s 36(1)(v). Thereupon, the Revenue applied for and obtained this reference.

4. Section 37 of the Act provides that any expenditure, not being expenditure of the nature described in sections 30 - 36 and not being in the nature of capital expenditure or personal expenses of the assessee, laid out or expended wholly and exclusively for the purposes of the business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession". Section 37 is residuary in nature, while sections 30 - 36 specifically mention the various deductions which are admissible, and the circumstances in which, and the conditions subject to which, they are admissible. Section 36 provides for certain types of deductions. Clause (v) in sub-section (1) provides that "any sum paid by the assessee as an employer by way of contribution towards an approved gratuity fund created by him for the exclusive benefit of his employees under an irrevocable trust" shall be allowed as deduction while computing the business income. Sub-section (7) in section 40A was added by the Finance Act, 1975, with retrospective effect from April 1, 1973. Sub-section (7) reads as follows :

"(7)(a) Subject to the provisions of clause (b), no deduction shall be allowed in respect of any provision (whether called as such or by any other name) made by the assessee for the payment of gratuity to his employees on their retirement or

on termination of their employment for any reason.

(b) Nothing in clause (a) shall apply in relation to -

(i) any provision made by the assessee for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity, that has become payable during the previous year; ...

Explanation 1 - For the purpose of sub-clause (ii) of clause (b) of this sub-section, "admissible amount" means the amount of the provision made by the assessee for the payment of gratuity to his employees on their retirement or on termination of their employment for any reason, to the extent such amount does not exceed an amount calculated at the rate of eight and one-third per cent. of the salary (as defined in clause (h) of rule 2 of Part A of the Fourth Schedule) of each employee entitled to the payment of such gratuity for each year of his service in respect of which such provision is made.

Explanation 2 - For the removal of doubts, it is hereby declared that where any provision made by the assessee for the payment of gratuity to his employees on their retirement or on termination of their employment for any reason has been allowed as a deduction in computing the income of the assessee for any assessment year, any sum paid out of such provision by way of contribution towards an approved gratuity fund or by way of gratuity to any employee shall not be allowed as a deduction in computing the income of the assessee of the previous year in which the sum is so paid."

5. The expression "paid" is defined in clause (2) of section 43. This definition is relevant for the purpose of sections 28 - 41. It reads thus :

""paid" means actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under the head "profits and gains of business or profession".

6. Part C of the Fourth Schedule to the Act lays down certain rules relating to "approved gratuity funds". Rule 2 provides that the Commissioner may accord approval to any gratuity fund which, in his opinion, complies with the requirements of rule 3. He is also empowered to withdraw the said approval if, in his opinion, such a withdrawal is warranted. Rule 3 provides that for obtaining the approval for a gratuity fund, the applicant shall satisfy the conditions mentioned therein, and any other conditions which the Board may, by rules, prescribe. The rule itself prescribes four conditions, viz., (i) that the fund shall be established under an irrevocable trust; (ii) that its sole purpose shall be the provision of gratuity to its employees; (iii) that the employer shall be a contributor to the fund; and (iv) that all benefits thereunder shall be payable only in India. The other rules in this Part are procedural in nature and need not be referred to.

7. Rules 98 to 111 of the Income Tax Rules, 1962, also deal with approved gratuity funds. They too are procedural in nature.

8. The position obtaining prior to the introduction of sub-section (7) in section 40A has been set out by the Supreme Court in *Shree Sajjan Mills Ltd. Vs. Commissioner of Income Tax, M.P., Bhopal and Another*, in the shape of the following five principles (headnote) :

"(1) Payments of gratuity actually made to the employee on his retirement or termination of his services were expenditure incurred for the purpose of business in the year in which the payments were made and allowed u/s 37 of the Act.

(2) Provision made for payment of gratuity which would become due and payable in the relevant previous year was allowed as an expenditure of the previous year on accrued basis when mercantile system was followed by the assessee.

(3) Provision made by setting aside an advance sum every year to meet the contingent liability for gratuity as and when it accrued by way of provision for gratuity or by way of reserve or fund for gratuity was not allowed as an expenditure of the year in which such sum was set apart.

(4) Contribution made to an approved gratuity fund in the previous year was allowed as deduction u/s 36(1)(v).

(5) Provision made in the profit and loss account for the estimated present value of the contingent liability properly ascertained and discounted on an accrued basis as falling on the assessee in the year of account could be deducted either u/s 28 or section 37 of the Act."

9. The said decision also sets out the object and purport of sub-section (7) of section 40A in the following words (at page 601 of 156 ITR) :

"On a plain construction of clause (a) of sub-section (7) of section 40A of the Act, what it means is that whatever is provided for future use by the assessee out of the gross profits of the year of account for payment of gratuity to employees on their retirement or on the termination of their services would not be allowed as deduction in the computation of profits and gains of the year of account. The provision of clause (a) was made subject to clause (b). The embargo is on deductions of amounts provided for future use in the year of account for meeting the ultimate liability to payment of gratuity. Clause (b) (i) excludes from the operation of clause (a) contribution to an approved gratuity fund and amounts provided for or set apart for payment of gratuity which would be payable during the year of account. Clause (b) (ii) deals with a situation where the assessee might provide by the spread-over method and provides that such provision would be excluded from the operation of clause (a) provided the three conditions laid down by the sub-clauses are satisfied"

10. The Supreme Court pointed out that the marginal note to section 40A is equally relevant. It reads :

"Expenses or payments not deductible in certain circumstances",

11. which means that. payments and expenses which would otherwise be

deductible would not be deductible except in certain circumstances indicated in the section. It further pointed out that the provisions in section 40A have been given overriding effect by virtue of the non obstante expression used in sub-section (1) thereof. It also made the following observations which bring out the nature and character of the employer's liability for gratuity, de hors section 40A(7) 0 (p. 598) :

"Payment of gratuity as commonly understood is the payment made to the employee by the employer on his retirement or termination of his service for any reason. It is made voluntarily by the employer as a regular practice or pressure of trade or business either under an agreement with the employees or on the understanding of the trade and after the enactment of the Payment of Gratuity Act, 1972, which came into force on September 16, 1972, as a statutory liability under the said Act. Although payment of gratuity is made on retirement or termination of service, it was not for the service rendered during the year in which the payment is made but it is made in consideration of the entire length of service and its ascertainment and computation depend upon several factors.

The right to receive the payment accrued to the employees on their retirement or on termination of their services and the liability to pay gratuity became the accrued liability of the assessee, when the employees retired or their services were terminated. Until then, the right to receive gratuity is a contingent right and the liability to pay gratuity continues to be a contingent liability qua the employer. An employer might pay gratuity when the employee retires or his service is terminated and claim the payment made as an expenditure incurred for the purpose of business u/s 37. He might, if he followed the mercantile system, provide for the payment of gratuity which became payable during the previous year and claim it as an expenditure on accrued basis u/s 37 of the said Act. Since the amount of gratuity payable in any given year would be a variable amount depending upon the number of employees who would be entitled to receive the payment during the year, the amount being a large one in one year and a small one in another year, the employer often finds it desirable and/ or convenient to set apart for future use, a sum every year to meet the contingent liability as a provision for gratuity or a fund for gratuity. He might create an approved gratuity fund for the exclusive benefit of his employees under an irrevocable trust and make contributions to such fund every year. Contingent liabilities do not constitute expenditure and cannot be the subject-matter of deduction even under the mercantile system of accounting. Expenditure which was deductible for Income Tax purposes is towards a liability actually existing at the time but setting apart money which might become expenditure on the happening of an event is not expenditure. (See in this connection, the observations of this court in *Indian Molasses Co. (Private) Ltd. Vs. Commissioner of Income Tax, West Bengal*, . A distinction is often made between an actual liability in praesenti and a liability de futuro, which for the time being is only contingent. The former is deductible but not the latter.

Amounts set apart by way of provision or by way of a reserve or fund to meet the liability of gratuity as and when it becomes payable will not be deductible allowance or expenditure. Where, however, an approved gratuity fund is created for the exclusive benefit of the employees under an irrevocable trust, contribution made to the fund during the year of account will be allowed to be deducted u/s 36(1)(v)".

12. The aforesaid observations clearly bring out the nature of gratuity. It is explained that it is a known liability, but a contingent one; it accrues only when an employee retires, dies, or his services are terminated otherwise than by way of punishment. Until then, the right to receive gratuity is a contingent right and the liability to pay gratuity continues to be a contingent liability qua the employer. It is also explained that even if the employer maintains his books of account on the mercantile system and creates an approved gratuity fund, even then only such amounts as have been contributed by him to that fund in the relevant accounting year alone are deductible. It is observed that contingent liabilities do not constitute expenditure and cannot be the subject-matter of deduction even under the mercantile system of accounting. Indeed, we find that the facts of the case before the Supreme Court are practically similar to the facts of the case before us. The appellant therein had entered into an agreement with the workers union for payment of gratuity. Its practice was to account for gratuity on cash basis as and when paid. After the coming into force of the Payment of Gratuity Act, 1972, and pending determination by actuarial valuation of its liability under that Act, the appellant made a provision of Rs. 20 lakhs against the total accruing liability in its balance-sheet. When filing its return of income for the assessment year 1973-74, the actuarial valuation had been determined at Rs. 48,59,341. The company added back the provision for gratuity amounting to Rs. 20 lakhs and claimed a total liability of Rs. 48,59,341 determined actuarially, as a deduction. The Tribunal did not allow the deduction of Rs. 20 lakhs on the ground that the said provision was made without complying with the requirements of section 40A(7). It, however, allowed the deduction in respect of the balance of Rs. 28,59,341. For the next assessment year 1974-75, the liability towards gratuity was worked out at Rs. 69,31,286 and the company had made a provision for Rs. 45,93,559. Out of the balance for which no provision was made, the Tribunal allowed deduction of Rs. 15,71,855, but did not allow deduction of provision made for Rs. 45,93,559 on the ground that the requirements of section 40A(7) have not been complied with. On a reference, the High Court held that no deduction towards gratuity was allowable unless the provisions of section 40A(7) were complied with and that the Tribunal was wrong in allowing the deduction of Rs. 28,59,431 for the assessment year 1973-74 and Rs. 15,71,855 for the assessment year 1974-75. This decision was affirmed by the Supreme Court on the reasoning mentioned above.

13. Now, coming back to the facts of our case, three factual aspects are significant, viz :-

(a) no provision was made in the books of account for the purpose of payment into, nor any actual contribution made to, the approved gratuity fund during the relevant accounting year. Nor did the board of directors, or other authority competent to make such a provision, make such provision (only an amount of Rs. 71,579 was actually paid to the employees during the relevant accounting year);

(b) the liability determined on actuarial basis at Rs. 25,55,725 was as on June 30, 1975, and not as on June 30, 1976. The liability as on June 30, 1976, was neither determined, nor disclosed during these proceedings; and

(c) even in the return filed by the assessee, no such claim was made. Only in the revised return filed on December 19, 1978, did the assessee claim the said amount of Rs. 10,26,526 (representing the difference between Rs. 25,55,725 being the liability determined on actuarial basis as on June 30, 1975 minus Rs. 15,29,199 which was the amount actually contributed to the approved gratuity fund for the assessment years 1974-75 and 1975-76), on the ground that the liability in the said sum has accrued by virtue of, and in terms of, the approved gratuity fund and that, therefore, it should be allowed as a deduction.

14. While the Income Tax Officer and the first appellate authority held that, on the above facts, it cannot be said that any provision has been made within the meaning of sub-section (7) of section 40A, the Tribunal held that "the identification and earmarking of the sum in the statement annexed to the (revised) return amounts to a provision within the meaning of section 40A(7)(b) (i) and, therefore, is eligible for deduction as there is a pre-existing fund prior to the last day of accounting year ...". The question is, whether the Tribunal was right in holding so ?

15. Sub-section (7) of section 40A uses the expression "provision made" as many as seven times, a circumstance emphasised by the Supreme Court in the above decision. In our opinion, that is a basic feature of this sub-section. The sub-section declares that no deduction shall be allowed in respect of any provision made by the assessee for payment of gratuity to its employees, unless provision has been made by the assessee (i) for the purpose of payment of a sum by way of contribution towards an approved gratuity fund, or (ii) for the purpose of payment of any gratuity that has become payable during the previous year. (We are not concerned herein with the third exception contained in sub-clause (ii) of clause (b), since it is not relevant herein). The sweep of the sub-section is evident from the expression "any" preceding the word "provision" and also the words within brackets, viz., " (whether called as such or by any other name)", immediately following the expression "provision" in clause (a). The idea is that no provision made for payment of gratuity shall be allowed except in the circumstances mentioned in the said sub-section. Since an overriding effect is given to the provisions contained in section 40A by sub-section (1) thereof, the provisions of sub-section (7) prevail over other provisions in the Act relating to computation of income under the head "Profits and gains of business or

profession". In other words, it overrides section 37, as also clause (v) in sub-section (1) of section 36. Indeed, section 36(1)(v) and the first limb of sub-clause (i) of clause (b) in sub-section (7) of section 40A are identical, the only difference being that, while section 36(1)(v) uses the expression "any sum paid", section 40A(7)(b)(i) uses the expression "any provision made", thereby making the sweep of the latter provision far wider. In this case, inasmuch as no provision was made by the assessee for the purpose of payment of a sum to an approved gratuity fund, it must be held that section 40A(7)(b)(i) is not satisfied. It is difficult to agree with the Tribunal that the identification and earmarking of the sum in the statement annexed to the revised return amounts to making such a provision. This, in turn, raises the question : what is a provision ? But, before considering the meaning of the expression "provision", it is necessary to notice that the Supreme Court has understood sub-clause (i) of clause (b) of section 40A(7) as meaning actual contribution. We have emphasised the said aspect by underlining the relevant words in the first extract from the said judgment (at page 450 of this judgment).

16. Now, coming to the meaning of the expression "provision", it has been the subject-matter of several decisions, including Commissioner of Income Tax, Bombay City Vs. The Century Spinning and Manufacturing Co. Ltd., ; CIT v. Standard Vacuum Oil Co. [1966] 59 ITR 686; Commissioner of Income Tax, Mysore Vs. Mysore Electrical Industries Ltd., and finally Vazir Sultan

17. Vazir Sultan Tobacco Co. Ltd., Hyderabad and Others Vs. Commissioner of Income Tax, Andhra Pradesh, Hyderabad, . These decisions uniformly say that a provision is an appropriation of money for a known and existing liability. It is not necessary that such liability is quantified, but it must certainly be a known and existing liability. Applying the said meaning, can it be said in this case that the assessee has appropriated a certain amount for the purpose of payment into the approved gratuity fund ? We think not. All that was done was to claim it as a deduction in the revised return filed by the assessee. Such revised return cannot be a "contribution", as understood by the Supreme Court, nor can it be called an "appropriation" of a certain amount by the assessee.

18. Y. Ratnakar, learned counsel for the assessee argued, on the basis of the decision of the Supreme Court in The Kedarnath Jute Mfg. Co. Ltd. Vs. The Commissioner of Income Tax, (Central), Calcutta, , that once there is an obligation to pay, it does not matter that the assessee has failed to debit the liability in its books of account. Such failure to debit the liability in its books of account, it is contended, did not preclude the assessee from claiming the sum as a deduction under the relevant provision. On this basis, learned counsel submitted that even though no entry has been made in the books of account appropriating certain amount towards this liability, still the assessee is entitled to claim it as a deduction, inasmuch as the liability has accrued by virtue of, and in terms of, the approved gratuity fund. We cannot agree. In The Kedarnath Jute Mfg. Co. Ltd. Vs. The Commissioner of Income Tax, (Central), Calcutta, , the

liability concerned was liability to pay sales tax which had attached and accrued by operation of law. Under the Sales Tax Act, the liability to pay attaches the moment the sale takes place. This liability cannot be ignored or undone by not making entries in the books of account maintained by the assessee. But, where there is no such statutory liability, or a liability attaching or accruing by operation of law, an entry in the books is absolutely essential to bring about an appropriation. Unless such a debit entry or appropriation is made, it cannot be said that a provision has been made by the assessee. Now, in this case,. neither the approved gratuity fund, nor the rules relating thereto, referred to above, created or brought about a statutory liability to pay a particular amount every year. Learned counsel could not bring to our notice any such provision either in the rules or in the approved scheme. All that the scheme means is that, if an assessee makes any payment into the said approved fund, it will be an admissible deduction by virtue of the first limb in sub-clause (i) of clause (b) of section 40A(7). Contributing a certain amount every year, or making a provision for payment of a certain amount into the fund every year, was not, and did not become, a statutory obligation. If the assessee did not. pay the amount, no one could have enforced that obligation. All that could have happened was that, for non-compliance with the terms of approval, the Commissioner could have revoked the approval. We are, therefore, of the opinion that the present case cannot be brought within the principle of *The Kedarnath Jute Mfg. Co. Ltd. Vs. The Commissioner of Income Tax, (Central), Calcutta, .* To reiterate, where a liability attaches or accrues by operation of law, the making of, or the failure to make, an entry (debit entry) in the books of account is immaterial. But, where the liability does not attach or accrue by operation of law, an entry is necessary to show that a particular sum has been appropriated for a particular purpose. In other words, such an appropriation is necessary to show that a provision has been made by the assessee for a particular purpose - in this case, for the purpose of payment into an approved gratuity fund.

19. For the above reasons, we hold that the assessee cannot be said to have made any provision for the purpose of making payment into the approved gratuity fund during the accounting year relevant to the assessment year concerned herein and, therefore, it cannot take advantage of the first limb of sub-clause (i) of clause (b) in section 40A(7).

20. Mr. Ratnakar sought to rely upon certain observations in *Swadeshi Cotton Mills Co. Ltd. Vs. Income Tax Officer, "A" Ward, ,* a decision of the Allahabad High Court. We do not think it necessary to deal with the facts or the ratio of the said judgment in detail for more than one reason. The correctness of this decision was doubted by the Madras High Court in *Commissioner of Income Tax Vs. Andhra Prabha P. Ltd.,* and the decision of the Madras High Court has been approved and affirmed by the Supreme Court in *Commissioner of Income Tax, Madras Vs. Andhra Prabha P. Ltd., .* Secondly, in view of the decision of the Supreme Court in *Shree Sajjan Mills Ltd. Vs. Commissioner of Income Tax, M.P., Bhopal and Another, ,* any contrary proposition by a High Court cannot be given

effect to. We may, however, refer to the decision of the Calcutta High Court in Commissioner of Income Tax Vs. New Swadeshi Mills of Ahmedabad Ltd., , the relevant observations wherein are referred to, with approval, by the Supreme Court in Shree Sajjan Mills Ltd. Vs. Commissioner of Income Tax, M.P., Bhopal and Another, . It has been held by the Calcutta High Court that the assessee was not entitled to claim any deduction on account of its liability to pay gratuity estimated on an actuarial basis, merely because it was following the mercantile system of accounting. It was held that the assessee must fulfil the conditions in section 40A(7)(b) to claim the deduction, which means that it must necessarily make a provision for that liability; it must necessarily follow the procedure prescribed by the said provision and fulfil the conditions laid down by it.

21. For the above reasons, we answer the question referred to us in the negative, i.e., in favour of the Revenue and against the assessee. Answered accordingly. No costs.