
(1980) 06 CAL CK 0032

In the Calcutta High Court

Case No : Income-tax Reference No. 30 of 1977

Commissioner of Income Tax (Central-I)

APPELLANT

Vs

Eastern Spinning Mills Ltd.

RESPONDENT

Date of Decision : 07-06-1980

Acts Referred:

Income Tax Act, 1961 — Section 36(1), 37(1)

Citation : (1980) 126 ITR 686 : (1981) 5 TAXMAN 164

Hon'ble Judges : Sudhindra Mohan Guha, J; Sabyasachi Mukharji, J

Bench : Division Bench

Advocate : S. Sen and A. Sengupta, for the Appellant; R.N. Bajoria, S.K. Bagaria and A.K. De, for the Respondent

Judgement

Sabyasachi Mukharji, J.—In this reference u/s 256(1) of the I.T. Act, 1961, the following question has been referred to this court:

"Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the provision for gratuity amounting to Rs. 8,87,863 was allowable in its entirety as a revenue deduction for the assessment year 1972-73 ?"

2. As is apparent from the question, the assessment year involved is the assessment year 1972-73. The ITO had noticed that the assessee had created a provision for gratuity to the extent of Rs. 8,57,863. The ITO was of the opinion that the allowable amount pertaining to the year of account was only Rs. 1,79,595. In that view of the matter he disallowed the sum of Rs. 6,78,267. He held that the amount represented excess provision. The assessee preferred an appeal before the AAC.

3. It was argued before the AAC that the entire provision of Rs. 8,57,8.63 was made on actuarial basis and was in consonance with the statutory provisions of the West Bengal Employees' Payment of Compulsory Gratuity Act, 1971 (hereinafter referred to as "the said Act"). It was submitted that in view of the

decision of the Allahabad High Court, which we shall presently note, the disputed amount has been wrongly disallowed. The AAC accepted the assessee's contention. He, therefore, deleted the addition made by the ITO on this score.

4. Being aggrieved by the decision of the AAC, there was a further appeal to the Tribunal and reliance was placed on several decisions to which we shall presently refer and after discussing the contentions of the parties the Tribunal was of the opinion that the AAC was right in allowing this appeal of the assessee. Accordingly, the appeal by the revenue was dismissed by the Income Tax Appellate Tribunal. In these circumstances, the question as indicated before has been referred to this court.

5. The fundamental question involved in this reference is how to compute the profit for the purpose of Income Tax for the relevant accounting year. In the facts and circumstances of the case, it is important in this connection to bear in mind the provisions of the West Bengal Employees' Payment of Compulsory Gratuity Act, 1971. This Act came into effect during the year in question with which we are concerned. The relevant provision of this Act which is material for our present purpose is Section 4 which makes payment of certain gratuity compulsory for certain companies and the petitioner is one of those companies. The said section reads as follows :

"Payment of gratuity.--(1) Gratuity shall be payable to an employee :--

(a) on his superannuation,

(b) on his retirement or resignation,

(c) on his death or total disablement due to accident or disease, after completion of not less than five years of continuous service :

Provided that the completion of continuous service of five years shall not be necessary where the termination of the employment of any employee is due to death or disablement.

Explanation.--For the purposes of this section, total disablement means such disablement as permanently incapacitates an employee for all work which he was capable of performing before the accident or disease resulting in such disablement.

(2) Notwithstanding anything contained in Sub-section (1), no gratuity shall be payable to an employee whose employment has been terminated for his gross misconduct.

Explanation.--For the purpose of Sub-section (2), "gross misconduct" means:

(a) any act or wilful omission on the part of the employee resulting in loss or damage to, or destruction of, property belonging to or owned by the employer; or

(b) any serious act of violence on the part of the employee; or

(c) any act on the part of the employee which constitutes an offence involving moral turpitude punishable under the Indian Penal Code (45 of 1860).

(3) In the case of death of an employee, the gratuity shall be payable to the nominee of the employee or in the absence of a nominee to his heirs.

(4) The employer shall pay gratuity to an employee at the rate of fifteen days' wages based on the rate of wages last drawn by the employee concerned, for every completed year of service or part thereof in excess of six months :

Provided that the amount of gratuity payable to an employee shall not exceed fifteen months' wages :

Provided further that nothing in this section shall affect the right to any better terms of gratuity or retirement benefits under any award or agreement or contract with the employer."

6. The assessee claims that as it maintains its accounts on the mercantile basis, in order to arrive at its proper income assessable to tax, the liability accrued should be deducted in computing its profits for the purpose of tax. The question, therefore, is whether this sum of Rs. 8,57,863 could be said to be a liability which had accrued to the assessee on account of payment of gratuity to the employees which the assessee was entitled to deduct for arriving at its net profits ? Section 36 of the I.T. Act, 1961, provides for deduction in computing the income referred to u/s 28 of the said Act and Sub-clause (v) of Sub-section (1) of Section 36 covers "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". Section 37 of the Act under which this deduction is claimed provides that any expenditure (not being expenditure of the nature described in Sections 30 to 36 and Section 80VV 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 as a deduction in computing the income chargeable under the head "Profits and gains of business or profession". The question, therefore, is whether this provision which the assessee claims to have accrued for the year in question was an expenditure which should be allowed in computing the income chargeable as profit.

7. Several decisions, both in England and in India, have examined this question from various angles. In this connection, we may first refer to the decision of the House of Lords in the case of *Southern Railway of Peru Ltd. v. Owen* (Inspector of Taxes) [1957] 32 ITR 737; [1957] AC 334. There, under the relevant legislation of Peru, an English company, operating a railway there, was bound to pay its employees compensation on the termination of their services, the legislative provisions being deemed to be incorporated into all contracts of service. The right arose on dismissal or on termination of the employment by the employee by proper notice, or on such termination by the death of the employee or on the expiry of the term of the employment. Exceptions were : (a) in the case of fixed

term contracts, where the contract was determined by the employee before the expiry of the term otherwise than on account of infringement by the company, and (b) in the cases of all contracts of service where there had been wrongful conduct of certain kinds by the employee (e.g., dishonesty or insubordination). The compensation was an amount equivalent to one month's salary at the rate in force at the date of determination for every year of service. The company claimed to be entitled to charge against each year's receipt the cost of making provision for the retirement payments which would ultimately be thrown on it, calculating what sum would be required to be paid to each employee if he retired without forfeiture at the close of the year and setting aside the aggregate of what was required in so far as the year had contributed to the aggregate. In the facts of that case, it was, however, held that the company was not entitled to make the deductions sought to be made. It was held by the majority of the law Lords that the company was entitled to charge against each year's receipt the cost of making provision for the retirement payments which would ultimately be payable as it had had the benefit of the employees' services during that year, provided the present value of the future payments could be fairly estimated.

8. Earl Jowitt, Lord MacDermott, Lord Radcliffe and Lord Tucker held that since in calculating the amount which it claimed to deduct in each year the company had ignored the factor of discount, the claim should be rejected. In the circumstances it was not proper, their Lordships found, to remit the case to the Special Commissioners whether a satisfactory method of provision could be extracted from the evidence. Lord MacDermott further dissented and held despite this defect, it was not to be assumed that a set of acceptable deductions could not be produced, and the case, according to his Lordship, should be remitted to the Special Commissioners. Lord MacDermott observed at page 747 of the Income Tax Reports [1957] 32 ITR that there is a fundamental distinction between a contingent liability and a payment dependent upon a contingency. This distinction is significant in discussing the contingent liability or accrued liability. The liability might arise. But the liability might make discharge of that liability dependent upon a contingency. His- Lordship further observed that in computing the taxable profit of a particular year a trader, if there was a definite obligation to pay his employees for their services in that year an immediate payment and also future payments in some subsequent years, might properly deduct not only the immediate payment but the present value of the future payments, provided such value could be satisfactorily determined or fairly estimated. In discussing the liability created in that case, his Lordship further observed at page 748 of the reports ([1957] 32 ITR) that the assessee's liability to pay a lump sum could be avoided only by some breach of contract or grave misconduct on the part of the employee concerned. The question was would it be correct to say that such liability would be contingent ? But his Lordship emphasized that the contingency seemed to justify a prudent trader or, for that matter, a competent accountant, not to ignore the liability until the day for payment had arrived. The nature of this contingency, according to his Lordship, was relevant. It will be more correct,

in our opinion, to say that the contingency in such cases where a statutory obligation of the nature is imposed is not only relevant but is very real in the proper sense of the term. It should be taken into account in proper accounting. It was also observed in that decision that what the assessee claimed was to charge against each year's receipt the cost of making provision for the retirement payments that would be ultimately thrown upon it by virtue of the fact that it had had the benefit of its employees' services during that year. As a corollary it would not make any charge to cover the actual payments made in the year in respect of retirement benefits. Only by such a method, it was said, the assessee would be able to bring against the receipts of the year the true cost of the services that it had used to earn those receipts. This proposition would be apparent from the observations of Lord Radcliffe at page 754 of the reports ([1957] 32 ITR). His Lordship further observed that whereas it was possible that any one of its many employees might forfeit his benefit and so never require a payment, the substantial facts of the situation were that when the company had paid every salary and wage that was due for current remuneration of the year it had not by any means wholly discharged itself of the pecuniary burden which had fallen upon it in respect of the year's employment.

9. In considering the aforesaid observations, we have to bear in mind that in this case for the first time in the year in question, by virtue of the statutory provision, which we referred to hereinbefore, the said liability was imposed upon the petitioner.

10. The principle behind this decision has been followed universally in all the subsequent decisions, though the application of this principle has created different results. It has to be emphasised that in a case of this nature where a statutory liability is being accrued for the first time and an assessee deducts or seeks to deduct its estimated value of that liability for computing the profit and the contingent part is so insignificant or so irrelevant that it could not be considered contingent in the real sense of the term. Therefore, in earning the income for that year that liability had been incurred by the assessee-company by virtue of the Act in question.

11. In the case of Calcutta Company Ltd. Vs. The Commissioner of Income Tax, West Bengal, , the assessee bought lands and sold them in plots fit for building purposes undertaking to develop them by laying out roads, providing a drainage system and installing lights, etc. When the plots were sold the purchaser paid only a portion of the purchase price and undertook to pay the balance in instalments. The assessee in its turn, undertook to carry out the developments within six months but time was not the essence of the contract. In the relevant accounting year the assessee actually received in cash only a sum of Rs. 29,392 towards the sale price of the lands, but in accordance with the mercantile system of accounting adopted by it, it credited in its accounts the sum of Rs. 43,692 representing the full sale price of lands. At the same time it also debited an estimated sum of Rs. 24,809 as expenditure for the developments it had

undertaken to carry out, even though no part of that amount was actually spent. The revenue had disallowed the expenditure. There it was held by the Supreme Court that the undertaking to carry out the developments within six months from the dates of the deeds of sale (which, in view of the fact that time was not of the essence of the contract, meant a reasonable time) was unconditional, the assessee binding itself absolutely to carry out the same. That undertaking imported a liability on the assessee which accrued on the dates of the deeds of sale, though that liability was to be discharged at a future date. It was thus an accrued liability and the estimated expenditure which would be incurred in discharging the same could be deducted from the profits and gains of the business, and the amount to be expended could be debited in accounts maintained in the mercantile system of accounting before it was actually disbursed. The difficulty in the estimation thereof did not, according to the Supreme Court, convert the accrued liability into a conditional one, because it was always open to the I.T. authorities concerned to arrive at a proper estimate thereof having regard to all the circumstances of the case. The Supreme Court further held that the sum of Rs. 24,809 represented the estimated amount which would have to be expended by the assessee in the course of carrying on its business and was incidental to the business and, having regard to the accepted commercial practice and trading principles, was a deduction which, if there was no specific provision for it u/s 10(2) of the Indian I.T. Act, 1922, was certainly an allowable deduction, in arriving at the profits and gains of the business of the assessee, u/s 10(1) of the Act, there being no prohibition against it, express or implied, in the Act. It was further held by the Supreme Court that the expression "profits or gains" in Section 10(1) of the Indian I.T. Act, 1922, had to be understood in its commercial sense and there could be no computation of such profits and gains until the expenditure which was necessary for the purpose of earning the receipt was deducted therefrom--whether the expenditure was actually incurred or the liability in respect thereof had accrued even though it might have to be discharged at some future date.

12. In the case of *Indian Molasses Co. (Private) Ltd. Vs. Commissioner of Income Tax, West Bengal*, the Supreme Court was concerned with Section 10(2)(xv) of the Indian I.T. Act, 1922, and held that the "spending" in the sense of "paying out or away" of money was the primary meaning of "expenditure". "Expenditure" was what was paid out or away and was something which was gone irretrievably. Expenditure, which was deductible for Income Tax purposes, was one which was towards a liability actually existing at the time, but the putting aside of money which might become expenditure on the happening of an event was not an expenditure. The Income Tax law, according to the Supreme Court, made a distinction between an actual liability in praesenti and a liability de futuro which, for the time being, was only contingent. The former was deductible but not the latter. In that case, H was the managing director of the assessee-company, who had by 1948 served the company for 13 years and was due to retire at the age of 55 years on September 20, 1955. In the implementation of

an agreement to provide a pension for him after his retirement the company had paid a sum of ₹8,208 to certain trustees and executed a trust deed on September 16, 1948, whereby it undertook to pay annually ₹326 for six consecutive years. The trustees undertook to hold the sums upon trust for taking out a deferred annuity policy in the name of the trustees with an insurant society on the life of H under which ₹720 per annum would be payable to H for life from September 20, 1955. The trust deed also provided that the trustees could, if they so desired, take out instead a deferred longest life policy in favour of H and Mrs. H for an annuity of ₹558 payable during their joint lives from that date, provided that if H died before he attained the age of 55 years the annuity payable to Mrs. H would be ₹611. Should H die before attaining the age of 55 years the trustees were to purchase with the capital value of the deferred annuity policy an annuity for Mrs. H. The trustees took out a policy providing for annuity of ₹563 if both H and Mrs. H be living on September 20, 1955, an annuity of ₹720 if Mrs. H should die before that date and an annuity of ₹645 if H should die before that date leaving Mrs. H surviving him. There was a special provision in the policy which entitled the trustees to surrender that annuity for the capital sum of ₹10,169 after giving notice. Clause III of the second schedule to the policy provided for the return of all premiums paid to the insurance society should both H and Mrs. H die before September 20, 1955, and under Clause IV the trustees were entitled to surrender the contract at any time before that date for a cash surrender value. In the assessment years 1949-50, 1950-51, 1951-52 and 1952-53, the assessee claimed deduction of the initial sum and the yearly premia, from its profits u/s 10(2)(xv) of the Indian I.T. Act, 1922. In that case, the Supreme Court held that as until September 20, 1955, the assessee-company had dominion, through the trustees over the sums paid at least in two circumstances, viz., under the special provision and Clause III of the second schedule to the policy, and there was a possibility of there being a resulting trust in favour of the company, the sums paid should be treated as set apart to meet a contingency, the payment of those sums was not a paying out or away of those sums irretrievably and did not amount to "expenditure", and a deduction could not be made in respect thereof u/s 10(2)(xv) of the Indian I.T. Act, 1922. It was further held by the Supreme Court that Section 10(2)(xv) of the Indian I.T. Act, 1922, which is similar to Section 37 of the present Act, enacted affirmatively what was stated in the negative form in the English statute and was substantially in pari materia with the English enactment and the courts might consider the English authorities as aids to the interpretation thereof. Reliance was placed on behalf of the revenue on this decision. It was emphasized by the learned advocate for revenue that like *Indian Molasses Co. (Private) Ltd. Vs. Commissioner of Income Tax, West Bengal*, in the instant case, until the contingency in which the payment had to be made to the employees, the assessee had dominion over the money. It is true that the assessee had the dominion over the money. But unlike the facts of the *Indian Molasses* case, the liability here was created by a statute and, unlike the facts of the *Indian Molasses* case, here the liability was in respect of the employees and there was

no similar clause like Clause III of the second schedule to the policy which provided for a return of the premiums paid to the company, though the liability in the case of particular employees might be defeated on their being guilty of misconduct or moral turpitude or in the contingencies mentioned in the sub-clauses of Section 4 which have been set out hereinbefore. Those contingencies were so very contingent that those contingencies, in the words of the House of Lords, could not be considered to be really contingent in any relevant or real sense of the term. In the case of *Indian Molasses Co. (Private) Ltd. Vs. Commissioner of Income Tax, West Bengal*, the Supreme Court was dealing with a particular employee and his wife. Though death was certain, the other contingencies were not too real to make the liability dependent on the happening of the contingency. The Supreme Court reiterated that the Income Tax law did not allow as expenses all the deductions a prudent trader would make in computing his profits. The money might be expended on grounds of commercial expediency but not of necessity. The test of necessity was whether the intention was to earn trading receipts or to avoid future recurring payments of a revenue character. Expenditure in this sense was equal to disbursement which, to use a homely phrase, meant something which went out of a trader's pocket. Thus, in finding out what profits there would be, the normal accountancy practice might be to allow as expense any sum in respect of liabilities which would be accrued over the accounting period and to deduct such sums from profits. But the Income Tax laws did not take every such allowance as legitimate for purposes of tax. A distinction was made between an actual liability in praesenti and a liability defuturo which, for the time being, was only contingent.

13. The Supreme Court referred to the English cases and specially to the case of *Southern Railway of Peru Ltd. v. Owen* [1957] 32 ITR 737, which has been discussed before, and reiterated that the proposition that the recurring liability of a pension which was compressed into a lump payment should itself be a legal obligation, and that, if contingent, the present value of the future payments should be fairly estimable. In this case, we have further to bear in mind that the liability was in respect of a large number of employees in a piece of social legislation created by statute. Therefore, a prudent businessman in the present context was bound to make a fair estimate of that liability from year to year, but as in the year in question with which we are concerned the liability had come for the first time the assessee was entitled to make a prudent estimate of this liability which would be accrued for the payment of gratuity in the form of a deferred payment of wages for the employees concerned, which was necessary for earning its profit. In a case where the liability itself was contingent, there was no accrued liability. But in a case of the present type, where a large number of employees are concerned and the circumstances under which it could be defeated are remotely contingent and so insignificant in reality in view of the number of employees concerned, it could not be said to be contingent in the real sense of the term.

14. In the case of *Standard Mills Co. Ltd. Vs. Commissioner of Wealth-tax*,

Bombay City, , the Supreme Court was concerned with the meaning of the expression "debt" in computing the net wealth of the assessee u/s 2(m) of the W.T. Act, 1957. In that case, in its assessment to wealth-tax, the assessee had claimed that in computing its net wealth a certain estimated amount should be deducted on account of liability for gratuity to its workmen and staff in accordance with certain awards of the industrial court and the Labour Appellate Tribunal made before the relevant valuation date. Under the awards gratuity was payable to an employee, at certain specified but varying rates, viz., (i) on his death while in service (ii) on his voluntary retirement or resignation after 15 years" continuous service and (iii) on termination of his service after certain specified periods. But gratuity was not to be paid to an employee who was dismissed for dishonesty or misconduct. In that case, the Supreme Court held that the liability of the assessee to pay gratuity to its employee on the determination of the employment was a mere contingent liability which arose only when the employment of the employee was determined by death, incapacity, retirement or resignation. According to the Supreme Court, the liability did not exist in praesenti. Therefore, that liability was not a debt in computing the net wealth of the assessee.

15. Learned advocate for the revenue strongly relied on the said decision and drew our attention to page 474 of the report ([1967] 63 ITR), where the relevant terms of the awards upon which payment had to be made have been set out and stressed that those terms were similar to the provisions of the Act with which we are concerned. The Supreme Court referred to the observations of the House of Lords in the case of Southern Railway of Peru Ltd. v. Owen [1957] 32 ITR 737 and accepted the proposition that the assessee-company was entitled to charge against each year's receipts, the cost of making provision for the retirement payments which would ultimately be payable as it had the benefit of the employees' services during that year, provided the present value of the future payments could be fairly estimated. But their Lordships of the Supreme Court found that that case was not relevant in considering the expression "debt" u/s 2(m) of the W.T. Act, 1957. Their Lordships of the Supreme Court quoted there the observations of Lord Mac Dermott which we have set out hereinbefore. But referring to the said observations, their Lordships of the Supreme Court observed at page 476 of the report ([1967] 63 ITR) and held thus:

"The same considerations cannot, however, apply to a case under the W.T. Act, where the liability to pay wealth-tax is charged upon the net wealth of an assessee ".

16. Therefore, the principle that the House of Lords had enunciated in the case of Southern Railway of Peru Ltd. v. Owen [1957] 32 ITR 737 was not, in any way, doubted or dissented from. It was, in this light, that the Supreme Court understood the said decision in the subsequent decisions which we shall presently notice.

17. In the case of Metal Box Company of India Ltd. Vs. Their Workmen, this

question was considered. There the Supreme Court held that where the liability under a scheme of gratuity in respect of the accounting year was stated in the profit and loss account, in the absence of any challenge by the workmen to the correctness of the method of valuation and in the absence of a challenge that such liability could not be estimated on any fair standard, the amount claimed according to the profit and loss account should be presumed to be genuine and allowed. The Supreme Court further held that the contingent liabilities discounted and valued as necessary, could be taken into account as trading expenses if they were sufficiently certain to be capable of being valued and if profits could not be properly estimated without taking them into consideration. An estimated liability under a scheme of gratuity, if properly ascertainable and its present value was discounted, was deductible from the gross receipts while preparing the profit and loss account. That was recognised in trade circles and there was nothing in the Bonus Act which prohibited such a practice. Such a provision provided for a known liability of which the amount could be determined with substantial accuracy. It could not, therefore, be termed a "reserve ". There, at page 63 of the report ([1969] 73 ITR), the Supreme Court noted the two contentions which were urged, viz., (i) that the amount which could be debited was that which was actually paid and the company was not entitled to debit in the P & L account any amount worked out by it as the estimated liability. The Tribunal, therefore, was not justified in allowing the company to debit any such amount and that the Tribunal arbitrarily fixed Rs. 10 lakhs and allowed wrongly that amount to be deducted ; and (ii) even if such estimated liability was debitible, the appropriation amounted to a reserve and under the Bonus Act such a reserve had to be added back while working out the gross profits under the 2nd Schedule to the Act.

18. There, the two questions which arose were I (i) whether it was legitimate in such a scheme of gratuity to estimate the liability of an actuarial valuation and deduct such estimated liability in the P & L account while working out its net profits ? and (ii) if it was, whether such appropriation amounted to a reserve or a provision ? The Supreme Court referred to the Calcutta Company Ltd. Vs. The Commissioner of Income Tax, West Bengal, , which we have noted hereinbefore, other relevant cases and also Standard Mills Co. Ltd. Vs. Commissioner of Wealth-tax, Bombay City, , which we have noted hereinbefore, and at page 64 of the report ([1969] 73 ITR) observed as follows:

"These observations show that the court was of the view that though such a liability is a contingent liability and, therefore, not a "debt" u/s 2(m) of the Wealth-tax Act, it would be deductible under the Income Tax Act while computing the taxable profits. In the instant case, the question is not whether such estimated liability arising under the gratuity schemes amounts to a debt or not. The question that concerns us is whether, while working out the net profits, a trader can provide from his gross receipts his liability to pay a certain sum for every additional year of service which he receives from his employees. This, in our view, he can do, if such liability is properly ascertainable and it is possible to

arrive at a proper discounted present value."

19. There, the Supreme Court further observed that contingent rights, if capable of valuation, could similarly be taken into account as trading receipts where it was necessary to do so in order to ascertain the true profits. of the report ([1969] 73 ITR 67), the Supreme Court observed as follows :

"That there is no rule against providing for any such contingent liability but on the contrary such a provision is permissible can be seen from the form of balance-sheet in Schedule VI to the Companies Act, 1956, where provisions for taxation, dividends, provident fund schemes, staff benefit schemes and other items for which a company is contingently liable are to be treated as current liabilities and, therefore, debitable against the gross receipts. Schedule VI, Part 2, lays down the requirements of profit and loss account and Clause 3(ix) of it provides that a profit and loss account shall set out amongst other things the aggregate of amounts set aside or provisions made for meeting specific liabilities, contingencies or commitments. But the contention was that though Schedule VI to the Companies Act may permit a provision for contingent liabilities, the Income Tax Act, 1961, does not, for, u/s 36(v), the only deduction from profits and gains permissible is of a sum paid by an assessee as an employer by way of his contribution towards an approved gratuity fund created by him for the exclusive benefit of his employees under an irrevocable trust. This argument is plainly incorrect because Section 36 deals with expenditure deductible from out of the taxable income already assessed and not with deductions which are to be made while making the P & L account. In our view, an estimated liability under gratuity schemes such as the ones before us, even if it amounts to a contingent liability and is not a debt under the Wealth-tax Act, if properly ascertainable and its present value is fairly discounted is deductible from the gross receipts while preparing the P & L account. It is recognised in trading circles and we find no rule or direction in the Bonus Act which prohibits such a practice."

20. In the case of Bombay Dyeing and Manufacturing Co. Ltd. Vs. Commissioner of Wealth Tax, Bombay, , the Supreme Court was asked to consider whether there was any conflict between the decisions in the case of Standard Mills Co. Ltd. Vs. Commissioner of Wealth-tax, Bombay City, and Metal Box Company of India Ltd. Vs. Their Workmen, as referred to hereinabove. The Supreme Court observed that there was no difference because the Standard Mills" case was confined to the question of whether a particular liability was a debt u/s 2(m) of the W.T. Act.

21. In this connection, it may be instructive to refer to a decision of the First Division of the Inner House of the Court of Session as the Court of Exchequer in Scotland, viz., the decision in the case of IRC v. Titaghur Jute Factory Co. Ltd. [1978] Simon's Tax Cases 166. The case is significant because the case dealt with the provisions of the West Bengal Employees' Payment of Compulsory Gratuity Act, 1971, the Act with which we are concerned. There, the taxpayer company, which was resident in the United Kingdom, carried on business in West

Bengal and was subject to the laws of that State. In August, 1971, the Act came into force with effect from 14th June, 1971. Under it, the taxpayer company became liable to pay gratuities to all its employees in West Bengal earning less than 7.50 rupees per month on their leaving its employment for any reason other than gross misconduct. The amount to which each such employee would be entitled had to be calculated by reference to, inter alia, his salary at the end of his employment and his length of service. Service prior to the coming into force of the Act had to be taken into account. The taxpayer company had not hitherto operated any scheme or agreement by which its employees in West Bengal were entitled to receive any retirement gratuity. It decided to make an annual provision to meet its accruing liability to pay the gratuities under the Act rather than charge the actual liability in its accounts for the respective years in which the payments were made. It took actuarial advice as to the amount to be provided as at 31st December, 1971. Pursuant to that advice, the provision made by the taxpayer company took account of the pre-1971 service of the individual employees to whom the Act applied as well as their service in 1971. The sum of ₹ 221,619 was debited, under the heading "Current Liabilities--Provision for Retirement Gratuities", in its accounts for the year ended 31st December, 1971. Of that sum ₹ 23,547 related to the service of the employees in 1971. The taxpayer company applied to the Special Commissioners against an assessment to corporation tax for the year ended 31st December, 1971, on the ground that the provision for the payment of the compulsory gratuities should have been allowed as a deduction in computing its profits for that year. The Special Commissioners found that ₹ 2,21,619 was reliable and accurate estimate of the measure of the taxpayer company's liability to its employees which had accrued by 31st December, 1971, and held that it was an allowable deduction. The Crown appealed. It conceded that the taxpayer company was entitled to make provision for a maturing obligation during the years preceding the payment and charge it against profits but disputed the amount which might properly be debited in the year in which the obligation arose. It contended that the portion of ₹ 2,21,619 which related to service in the years prior to 1971 was a capital provision and was not, in any event, a proper debit item to be charged against trading receipt when computing the taxpayer company's profits for the year 1971.

22. It was held by the First Division of the Inner House of the Court of Session as the Court of Exchequer in Scotland that the sum which related to the service prior to 1971, was not in the nature of a capital payment but was revenue and the taxpayer company could charge the whole of ₹ 2,21,619 against its profits for 1971. The taxpayer company, in the discharge of the obligation imposed on it by the Act, was making, on the basis of a reliable estimate, provision for the amount of the gratuities for which its employees had qualified as at the end of that year by reason of their having been in its employment on and after 14th June, i.e., when the retrospective statutory obligation was introduced.

23. In debiting that sum in its accounts it was showing the true amount by which its liabilities in respect of the employment of its work-force were increased in

1971. It could not have made any provision earlier for the payments required by the Act for the years preceding 1971, as it was under no liability to pay any gratuities until the Act came into force. The appeal was dismissed. The Lord President Lord Emslie, at page 174 of the report ([1978] Simon's Tax Cases), had observed that there was much common ground. It was accepted that as a result of the 1971 Act the taxpayer company came under the obligation to pay gratuities to its work-people at the end of their service, the amount of the gratuity payable to each employee being calculated in the manner prescribed by the Act itself. This obligation or liability arose for the first time in the course of the accounting year which ended on 31st December, 1971. With most of the observations of the Lord President we are in respectful agreement. The Lord President, thereafter, went on to observe that payment of gratuity to which an employee had acquired a vested right was, however, deferred until the end of his service to which learned advocate for the revenue before us took strong objection. We need not for the purpose of the present reference enter into the controversy whether this observation of the Lord President is correct or not. So, for our present purpose, the statute of 1971 which created a liability for the first time and where an estimate of the liability was possible, as it was found to be possible within such a fair estimate, such liability was properly deductible for computing the profit of the year in question of the assessee-company. His Lordship observed that so far as the primary question was concerned there is nothing improper in admitting, as deductions, provisions to meet contingent liabilities if by so doing a truer balance was arrived at between the receipts of the year and the cost of earning them, or between the expenses of the year and the fruits of incurring them. This was accepted by the majority in the House of Lords in *Southern Railway of Peru Ltd.* [1957] 32 ITR 737, a decision which we discussed before. Any sums claimed as such a provision must, however, be seen to be an essential charge against the receipts of the year in which it appears in the accounts in order to enable a true profit from that source to be stated. No provision was allowable as a deduction except to the extent to which its amount was related to service due to work in the particular year in question and, in this case, there was no tie of the appropriate kind between the disputed part of the provision and the employment of the work-force in 1971. It is a common case that the liability arose for the first time on 14th June, 1971. If that liability did not arise in that year for the first time different considerations might have arisen.

24. The question was also considered by several High Courts. In the case of *Madho Mahesh Sugar Mills (P.) Ltd. v. CIT* [1973] 92 ITR 503, the Division Bench, Allahabad High Court, had to consider this question. There in the case of an assessee maintaining its accounts on the mercantile system a liability already accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy. The estimated liability of an assessee for payment of gratuity to its workers based on actuarial valuation is a permissible deduction. Such a liability was an ascertainable liability

in praesenti though payable in future. There, in 1961, the U.P. Government issued a notification with regard to the sugar industry imposing a liability on persons running sugar mills to provide gratuity to their workmen in accordance with the scale provided in that notification. In pursuance of this notification the assessee set apart the sum of Rs. 1,37,811 representing the sum that the assessee would be required to pay to its workmen as gratuity and made an appropriate entry in its books of account, crediting the gratuity account and debiting the profit and loss account for the assessment year 1962-63. This sum was claimed by the assessee as business expenditure but the claim was disallowed by the ITO, the AAC and the Appellate Tribunal. On a reference to the High Court it was contended for the revenue that at best the assessee could claim only the gratuity relevant to the previous year. The discounted value of the assessee's liability to pay gratuity based on actuarial valuation was determined at the instance of the High Court at Rs. 1,05,200. It was held that the Government order provided that the gratuity would be payable to an employee not only in respect of his future services but also for his past services. Thus, in order to ascertain the quantum of liability as on the date the order came into effect, the past services of the employees had also to be taken into account. In the circumstances every businessman would make provision every year for his liability under the notification. Though no part of the gratuity might have been payable by the assessee in any of the earlier years, the past services of the employees had to be taken into account merely to arrive at the quantum of the liability which became payable after the notification. The liability for payment of gratuity ascertained on actuarial calculations, in which all contingencies were taken into consideration, was a liability in praesenti and : was capable of ascertainment and, therefore, the sum of Rs. 1,05,200 was a permissible business expenditure in the assessment year concerned.

25. Their Lordships discussed all the relevant cases. It was argued that in view of the decision in *Metal Box Company of India Ltd. v. Their Workmen* [1969] 13 ITR 53 the principle laid down in the *Metal Box Company's* case would not be applicable. Their Lordships quoted (at p. 509) the observation made in the *Metal Box Company of India Ltd. Vs. Their Workmen*, . The question was again considered by the Delhi High Court in the case of *Delhi Flour Mills Co. Ltd. Vs. Commissioner of Income Tax*, . Similar view was expressed. The case was also examined by the Bombay High Court in the case of *India United Mills Ltd. Vs. Commissioner of Income Tax, Bombay City-I*, , where, after discussing the relevant authorities, the Division Bench of the Bombay High Court delivered judgment. The Division Bench of the Bombay High Court also held that, under the award, the gratuity was payable to an employee not only in respect of his future services but also for his past services. In order to ascertain the quantum of liability as on the date the award came into effect, the past services of the employees had to be taken into account. Every businessman would also make provision every year for his liability under the award. Though no part of the gratuity might have been payable by the assessee in any of the earlier years, the

past service of the employees had to be taken into account to arrive at the quantum of the liability which became payable under the award. The liability for payment of such gratuity ascertained by actuarial calculations, in which all contingencies were taken into considerations, was a liability in praesenti and was capable of ascertainment and, therefore, the amount set apart was a permissible expenditure in the assessment year concerned. The gratuity was payable when a workman dies, retires, resigns or is removed from service. These events no doubt would take place in the future but they could be said to be uncertain. The services of every workman were bound to come to an end on account of one or the other of the causes stated above. Under the award, every employer was bound to pay gratuity to his workman for his past and future services. In the circumstances, every businessman would make provision every year for his liability under the award. Under the mercantile system of accounting, an expenditure was admissible not when it was actually paid but when the liability for the expenditure is incurred. It was legitimate in such a scheme of gratuity to estimate the liability by actuarial valuation. Their Lordships referred to the other decisions which we have discussed before they upheld the assessee's contention. It would be material to refer to the observation of the court at page 435 of the report ([1975] 98 ITR). These observations must be understood in the context of the facts and circumstances of the case. The question again was considered by the Bombay High Court in the case of *Tata Iron and Steel Co. Ltd. Vs. D.V. Bapat*, Income Tax Officer, Companies Circle I(2), Bombay and Another, , where discussing the provisions of Section 4(1) of the Payment of Gratuity Act, 1972, the court held that provision made was a permissible provision in computing the true profit. It was also observed that it was settled that the list of allowances and deductions contained in Sections 30 to 43A of the I.T. Act, 1961, was not exhaustive in the sense that an item of loss or expenditure incidental to business might be deducted in computing profits and gains even if it did not specifically find a place within those sections, provided it is an item which was allowable as a deduction on ordinary commercial principles. We are in respectful agreement with the said observation. Their Lordships also referred to the decision of the Supreme Court in the *Metal Box Company of India Ltd. Vs. Their Workmen*, , which we have referred to hereinbefore and accepted the assessee's contention. Similarly, in the instant case, we may incidentally mention that in a different context a similar view was expressed by Mr. Justice Chittatosh Mookerjee, sitting singly, in his judgment in Civil Rule No. 16384(w) of 1975. The judgment was delivered on 18th June, 1979 (unreported) [since reported *Birpara Tea Co. Vs. Income Tax Officer and Others*,].

26. In that view of the matter as the estimate made was not excessive and unreal and the Act in question came into operation for the first time, in arriving at the true profit of the company, in our opinion, u/s 37 of the Act, this was a permissible deduction. The fact that under Clause (v) of Sub-section (1) of Section 36 of the Act the sum paid by the assessee by way of contribution towards approved gratuity fund for the exclusive benefit of the employee is

deductible does not, in our opinion, affect the position. The assessee claimed its right to deduct this sum because this amount was a special liability which, we have noticed before, was created for the first time in 1971. If the assessee had dominion over the money, such money was not beyond the reach of the assessee, and there was a possibility of misuse, it was sought to be urged on behalf of the revenue. But upon the possible contingency of misuse by the assessee the rights of the parties under the Act cannot be decided. It seems that the legislature has taken note of that possibility by Sub-section (7) of Section 41A of the I.T. Act, 1961.

27. In that view of the matter, in the facts and circumstances of the case, we are in agreement with the conclusion arrived at by the Tribunal and the question referred to us is answered in the affirmative and in favour of the assessee.

28. Each party will pay and bear its own costs.

Sudhindra Mohan Guha J.

29. I agree.