
(1995) 03 MAD CK 0069

In the Madras High Court

Case No : Tax Case No. 430 of 1983 (Reference No. 212 of 1983)

Income Tax Officer

APPELLANT

Vs

Palani Andavar Mills Ltd.

RESPONDENT

Date of Decision : 13-03-1995

Acts Referred:

Income Tax Act, 1961 — Section 28, 36, 36(1), 37, 40A

Citation : (1996) 133 CTR 315

Hon'ble Judges : T. Jayarama Chouta, J; K.A. Thanikkachalam, J

Bench : Division Bench

Advocate : Deokinandan and C.V. Rajan, for the Appellant; K.M.L. Majele and S.A. Balasubramaniam, for the Respondent

Judgement

1. At the instance of the Department, the Tribunal referred the following questions for the opinion of this court u/s 256(1) of the Income Tax Act,

1961 :

1. Whether, on the facts and in the circumstances of the case, the Appellate Tribunal's finding that a sum of Rs. 2,10,769 claimed in the

adjustment statement as a liability towards contribution to the approved gratuity fund is an allowable deduction within the meaning of section

40A(7)(b)(i) is correct in law ?

2. Whether, on the facts and in the circumstances of the case, the Appellate Tribunal should not have confirmed the Income Tax Officer's

disallowance of the sum of Rs. 2,10,769 as not an allowable deduction either u/s 40A(7)(b)(i) or u/s 36(1)(v) or u/s 37 ?

3. The assessee is public utility company, engaged in the manufacture of cotton yarn. By a deed executed on September 7, 1973, and registered

on October 12, 1973, it created an irrevocable trust to provide a fund for future

payments of gratuity to its employees and the said fund was approved by the Commissioner of Income Tax with effect from the first of the aforesaid dates. Its liability to gratuity as on December 31, 1975, as per actuarial valuation amounted to Rs. 36,54,088 and when compared to its liability as on December 31, 1974, which amounted to Rs. 34,43,319, its incremental liability for the year ended December 31, 1975, amounted to Rs. 2,10,769. Since the assessee had already made payments to the gratuity fund to the tune of Rs. 36,66,134 which exceeded its liability as on December 31, 1975, it did not make any provision in its accounts towards its incremental liability for that year. The assessee, however, made a claim for deduction in its adjustment statement for the year 1976-77 of the sum of Rs. 2,10,769. The Income Tax Officer negated the assessee's claim for two reasons : (i) that the assessee had already made over payments to the gratuity fund by reason of which it was no more under obligation to provide for anything towards its incremental liability for that year; and (ii) that the assessee itself had not made provision in its accounts in respect of its incremental liability. On appeal, the Commissioner of Income Tax (Appeals) held that the quantum of balance in the fund as on December 31, 1975, was irrelevant to decide the allowability or otherwise of the assessee's claim. He also held that the incremental liability was an expenditure of the year and the same was, therefore, allowable u/s 36(1)(v) read with section 43(2) of the Income Tax Act. On appeal by the Department to the Tribunal, the Tribunal while agreeing with the view of the Commissioner of Income Tax (Appeals) that the quantum of balance in the fund as on December 31, 1975, was irrelevant to decide the issue, disapproved the second line of reasoning adopted by the Commissioner of Income Tax (Appeals). According to the Tribunal, the incremental liability was towards contribution to an approved gratuity fund it cannot be deemed to be a statutory liability. The Tribunal, however, held that the assessee was still entitled to succeed. According to the Tribunal, a provision made u/s 40A(7)(b)(i) of the Income Tax Act, 1961, for the purpose of payment of a sum by way of contribution towards any approved gratuity fund is deductible. The Tribunal is also of the view that a mere claim made in the adjustment statement would amount to a "provision" within the meaning of section 40A(7) of the Income

Tax Act. It has accordingly held that the assessee's claim for deduction of the sum of Rs. 2,10,769 should be allowed.

4. Before this court, learned standing counsel for the Department submitted that in the revised adjustment statement, the assessee has claimed a

sum of Rs. 2,10,769 being the actuarial liability to be allowed as deduction in computing the total income. The amount available in the gratuity fund,

viz., Rs. 36,66,134, is more than the actuarial liability of Rs. 36,54,088 as on December 31, 1975. Therefore, the assessee's claim for deduction

of Rs. 2,10,769 cannot be allowed. Further, the assessee has not made any provision for this amount of Rs. 2,10,769 in the accounts, but has

merely claimed this amount in the adjustment statements. Therefore, even on this ground also, deduction of Rs. 2,10,769 is not possible.

5. On the other hand, learned counsel appearing for the assessee submitted that it is for the assessee to decide as to how much it should pay into

the fund. If the claim is allowable as deduction under any provision of the Income Tax Act, it has to be allowed. u/s 40A(7), a provision made by

the assessee for the purpose of payment of a sum by way of contribution towards and approved gratuity fund is deductible. According to the

Department, what is claimed in the adjustment statement is not a provision. According to learned counsel, a deduction claimed in the adjustment

statement is actually a provision and, therefore, u/s 40A(7) the provision made for incremental liability is an allowable one.

6. In Vazir Sultan Tobacco Co. Ltd., Hyderabad and Others Vs. Commissioner of Income Tax, Andhra Pradesh, Hyderabad, , the distinction

between ""provision"" and ""reserve"" is brought out in the following manner (headnote :

"Provision" is a charge against the profits to be taken into account against gross receipts in the profit and loss account, a "reserve" is an

appropriation of profits, the asset or assets by which it is represented being retained to form part of the capital employed in the business. Though

the term "provision" is defined in clause 7 of Part III of Schedule VI to the Companies Act, 1956, positively by specifying what it means, the

definition of "reserve" is negative in form and not exhaustive in the sense that it only specifies certain amounts which are not to be included in the

term "reserve". The effect of reading the two definitions together is that if any retention or appropriation of a sum falls within the definition of

"provision" it can never be a reserve, but it does not follow that if the retention or appropriation is not a provision it is automatically a reserve and

the question will have to be decided having regard to the true nature and character of the sum so retained or appropriated depending on several

factors including the intention with which and the purpose for which such retention or appropriation has been made, because the substance of the

matter is to be regarded and in this context, the primary dictionary meaning of the term "reserve" may have to be availed of. If any retention or

appropriation of a sum is not a provision, i.e., it is not designed to meet depreciation, renewals or diminution in the value of assets or any known

liability, the same is not necessarily a reserve. The question whether the concerned amounts constitute "reserves" or not will have to be decided by

having regard to the true nature and character of the sums so appropriated depending on the surrounding circumstances particularly the intention

with which and the purpose for which such appropriations had been made.

7. In Commissioner of Income Tax Vs. Remington Rand India Ltd. and Others, , the Calcutta High Court held that (headnote : ""When the liability

for payment of gratuity is ascertained by actuarial valuation in which all contingencies are taken into consideration, such liability is in praesenti and

the amount so set apart is a permissible business expenditure in the year concerned for an assessee following the mercantile system of accounting"".

8. In Coimbatore Cotton Mills Ltd. v. CIT [1985] 154 ITR 240, this court held that (headnote : ""in view of section 40A(7), no provision for

payment of any gratuity could be allowed as a deduction except a provision for contribution to an approved gratuity fund. As the amount claimed

in the instant case as a deduction was not a provision in the accounts of the assessee, the Tribunal was justified in holding that the assessee was not

entitled to the deduction and accordingly no question of law could be said to arise out of the order of the Tribunal"".

9. While considering the provisions of section 40A(7) of the Income Tax Act, 1961, the Supreme Court in the case of Shree Sajjan Mills Ltd. Vs.

Commissioner of Income Tax, M.P., Bhopal and Another, held as under (headnote :

On a plain construction of clause (a) of section 40A(7) of the Income Tax Act, 1961, 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 a deduction in the computation of profits and gains of the year of account, unless the respective conditions specified in clause (b) were fulfilled. The expression provision made by the assessee" is not used in any artificial sense, e.g., of setting apart specifically by the assessee for meeting the liability for gratuity in his account books, but in its ordinary sense. The embargo under clause (a) is on deduction 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 amount 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 spreadover 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. In CIT v. New Swadeshi Mills of Ahmedabad Ltd. [1984] 147 ITR 163, the Calcutta High Court held that (headnote : ""the assessee was not entitled to claim any deduction on account of its liability to pay gratuity estimated on an actuarial basis without making any provision for that liability. In order to claim the deduction the assessee must follow the procedure and fulfil the conditions laid down in the Act"").

11. Similarly, in Commissioner of Income Tax Vs. D.B.R. Mills Ltd., , the Andhra Pradesh High Court held that (headnote : ""Sub-section (7) of section 40A of the Income Tax Act, 1961, 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 any gratuity that has become payable during the previous year. 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 the 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. 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) used 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. A provision is an appropriation of money for a known and existing

liability.... 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 which in this case is for the purpose of payment into an approved gratuity fund.

12. In the present case also, the assessee has not made any provision in the sum of Rs. 2,10,769 in the accounts, but has merely claimed this

amount in the adjustment statement. Further, the amount available in the gratuity fund, viz., Rs. 36,66,134 is more than the actuarial liability of Rs.

36,54,088 as on December 31, 1975. The assessee is not entitled to the deduction of the sum of Rs. 2,10,769 u/s 40A(7) of the Act. The claim

made in the adjustment statement was accepted by the Department as provision made as contemplated u/s 40A(7) of the Act. Therefore,

according to the assessee, in the present case also, the Department should accept the claim made in the adjustment statement as provision made

u/s 40A(7). But this line of argument cannot be accepted. Therefore, the conclusion arrived at by the Tribunal that this amount of Rs. 2,10,769 is

deductible u/s 40A(7) of the Act is not acceptable. Accordingly, we answer question No. 1 in the negative and in favour of the Department and

question No. 2 in the affirmative and in favour of the Department. No costs.