
(1986) 01 KL CK 0050

In the High Court Of Kerala

Case No : IT Reference No's. 177 and 178 of 1980

P.K. Mohammed (P.) Ltd.

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

Date of Decision : 02-01-1986

Acts Referred:

Income Tax Act, 1922 — Section 10, 10(1), 10(2)(vi)(b), 34(1)(b)

Income Tax Act, 1961 — Section 10, 11, 147(6), 147(b), 2(4)

Payment of Bonus Act, 1965 — Section 15, 15(1), 36(1)(ii), 37

Citation : (1986) 29 TAXMAN 511

Hon'ble Judges : P.C. Balakrishna Menon, J;K. Sreedharan, J

Bench : Division Bench

Advocate : M. Pathrose Mathai, for the Appellant; P.K.R. Menon, for the Respondent

Judgement

P.C. Balakrishna Menon, J.—The Tribunal, Cochin Bench has referred the following questions as directed by this Court in O.P. Nos. 1833 and 1834 of 1977-B u/s 256(2) of the income tax Act, 1961 ("the Act").

O.P. No. 1833 of 1977-B

" (1) Whether in the facts and circumstances of the case, the Tribunal was right in holding that the ITO was entitled to reopen the assessment u/s 147(b) of the income tax Act, 1961?

(2) Whether the Tribunal was right in rejecting the contention of the assessee that the amount of Rs. 18,446 set apart in the profit and loss account pursuant to the provisions of the Bonus Act did not form part of the assessable income of the assessee?

(3) Whether the Tribunal was right in rejecting the contention of the assessee that in any view of the matter the said amount is an allowable deduction under the income tax Act, 1961?"

O.P. No. 1834 of 1977-B

"(1) Whether the Tribunal was right in rejecting the contention of the assessee that the amount of Rs. 16,167 set apart in the profit and loss account pursuant to the provision of the Bonus Act did not form part of the assessable income of the assessee?

(2) Whether the Tribunal was right in rejecting the contention of the assessee that in any view of the matter the said amount is an allowable deduction under the income tax Act, 1961?

The assessee is a private limited company carrying on the business of clearing and forwarding. During the year ending 30-9-1972 the company had paid to its employees by way of bonus Rs. 23,058. In the profit and loss account for that year the company had made a provision of Rs. 18,446 towards its future liability for bonus u/s 15 of the Payment of Bonus Act, 1965. In the year ending 30-9-1974 the assessee had paid Rs. 39,094 by way of bonus to its employees. In the profit and loss account for that year the company had debited Rs. 16,167 as reserve for payment of bonus u/s 15 of the Bonus Act. In completing the assessment for the assessment year 1973-74 the ITO allowed deduction not merely of the bonus actually paid but also the sum of Rs. 18,446 reserved for payment of bonus u/s 15. Subsequently on internal audit it was pointed out as per the audit note dated 22-3-1974 that it was not known whether the provision for bonus u/s 15 related to an ascertained liability. By reason of the information furnished by the audit note the ITO reopened the assessment for the assessment year 1973-74 u/s 147(b) of the Act and in the revised assessment disallowed the deduction of the bonus reserved under the Payment of Bonus Act. The revised assessment was upheld by the AAC and the Tribunal.

2. As per the return filed for the assessment year 1975-76 the assessee had claimed a deduction of Rs. 16,167 being provision made for bonus u/s 15. The ITO disallowed the deduction and the order of assessment was upheld by the AAC and the Tribunal. The above questions of law are referred by the Tribunal as directed by this Court in O.P. Nos. 1833 and 1834 of 1977 u/s 256(2).

3. Section 15(1) is extracted below:

15. Set on and set off of allocable surplus - (1) Where for any accounting year, the allocable surplus exceeds the amount of maximum bonus payable to the employees in the establishment u/s 11, then, the excess shall, subject to a limit of twenty per cent of the total salary or wage of the employees employed in the establishment in that accounting year, be carried forward for being set on in the succeeding accounting year and so on up to and inclusive of the fourth accounting year to be utilised for the purpose of payment of bonus in the manner illustrated in the Fourth Schedule.

It is clear from sub-section (1) of section 15 that the reserve created thereunder is a provision for bonus payable to the employees in future covering a period of four years in case the available surplus in those years falls short of the amount of minimum bonus payable under the Act. The reserve made is not an amount

expended during the accounting year. The assessee himself retains the reserve fund created under the compulsion of section 15(1) and it is only a provision to satisfy a contingent liability that may arise in future. Any sum paid to an employee as bonus is a permissible deduction u/s 36(1)(ii) of the Act, but a reserve fund statutorily created and retained by the assessee himself forms part of his income and cannot also be claimed as a permissible deduction under the residuary section 37 of the Act. The amount to be paid as bonus from out of the reserve fund cannot be ascertained until the liability accrues in future covering a period of four years. A provision to meet an unascertained future contingent liability is not a permissible deduction under the Act as the profits earned in the particular year should be assessed as assessable income during the year.

4. The counsel for the assessee places considerable reliance on the decision of the Supreme Court in *The Commissioner of Income Tax, Kerala, Ernakulam Vs. The Travancore Sugar and Chemicals Ltd.*, in support of his proposition that the statutory reserve created u/s 15(1) cannot be treated as part of the assessee's income during the relevant accounting period. In the case before the Supreme Court the assessee-company, namely, the Travancore Sugars & Chemicals Ltd. the major shares of which were owned by the Government and also two other concerns, a distillery and a tincture factory belonging to the Government. The Government agreed for the sale of the aforesaid assets to the assessee-company for cash consideration. The agreement between the company and the Government also provided that the Government shall be entitled to 20 per cent of the annual net profits of the company subject to a maximum of 40,000 after providing for depreciation and remuneration of the secretaries and treasurers. The share of profit due to the Government was later modified to 10 per cent by consent of parties. The Supreme Court in *Travancore Sugars & Chemicals Ltd.*'s case (*supra*) states:

... It is true that sub-section (1) of section 10 of the Indian income tax Act, 1922, imposes a charge on the profits and gains of a business which accrue to the assessee while sub-section (2) of the said section enumerates various items which are admissible as deduction. Where income which accrues to the assessee is not his income, the question of admissible deductions would not arise. Therefore, where income is diverted at source so that when it accrues it is really not his income but is somebody else's income the question as to whether that income falls under sub-section (2) of section 10 does not arise. Again, income can be said to be diverted only when it is diverted at source so that when it accrues it is really not the income of the assessee but is somebody else's income. It is thus clear that where by the obligation income is diverted before it reaches the assessee, it is deductible. But, where the income is required to be applied to discharge an obligation after such income reaches the assessee it is merely a case of application of income to satisfy an obligation of payment and is therefore not deductible." (p. 13)

5. Considering the terms of the contract and the obligations arising therefrom,

the Supreme Court in Travancore Sugars & Chemicals Ltd.'s case (supra) came to the conclusion that the obligation to pay the share of profits to the Government is interlinked with the transfer of assets by the Government to the company and viewed from any point of view "whether as a revenue expenditure or as an overriding charge of the profit making apparatus or as laid out and expanded wholly and exclusively for purposes of trade, the answer must be in the affirmative and against the revenue". Since the obligation of the assessee-company was found to be an overriding charge of the profit making apparatus and was diverted at source, it was held not to constitute part of the income of the assessee-company, and, even if considered as an item of revenue expenditure, it is a permissible deduction.

6. The allocable surplus referred to in section 15(1) of the Payment of Bonus Act is a part of the profits of the assessee-company is clear from section 2(4) read with section 5 of the 1961 Act. Part of the profits is set apart to constitute a separate fund to make provisions for certain contingencies that may arise in future, limited to a period of four years from the accounting year. There is no diversion of the income of the assessee at its source. Nor is it an expenditure incurred during the accounting period. The amount set apart u/s 15 is not expended. It is only to meet certain future contingencies that may or may not arise and the amount so set apart or so much of it as remains unspent can be withdrawn by the assessee after a period of four years.

7. In Poona Electric Supply Co. Ltd. Vs. Commissioner of Income Tax, Bombay, , the Supreme Court was concerned with the question as to whether the amounts credited by the assessee, an electric supply company to the "consumers" benefit reserve account" would form part of the taxable income of the assessee u/s 10(1) of the Indian income tax Act, 1922. The amount transferred to the consumers" benefit reserve fund was in accordance with the requirements of the Electricity Supply Act, 1948 and those amounts diverted out of the profits are to be distributed to the consumers in future in such manner as the State Government may direct. The Supreme Court held that such amounts diverted to the consumers" benefit reserve account do not form part of the profits of the assessee-company for the following reason stated:

Under section 10(1) of the income tax Act, tax shall be payable by an assessee under the head "Profits and gains of business" in respect of profits and gains of any business carried on by him. The said profits and gains are not profits regulated by any statute, but profits in a business computed on business principles. They are business profits and not statutory profits. They are real profits and not notional profits. The real profit of a businessman u/s 10(1) of the income tax Act cannot obviously include the amounts returned by him by way of rebate to the consumers under statutory compulsion. It is as if he received only from the consumers the original amount minus the amount he returned to them. In substance there cannot be any difference between a businessman collecting from his constituents a sum of Rs. Y in addition to Rs. X by mistake and

returning Rs. Y to them and another businessman collecting Rs. X alone. The amount returned is not a part of the profits at all." (p. 525)

A provision made u/s 15 is not akin to the consumers' benefit reserve account considered by the Supreme Court in Poona Electric Supply Co. Ltd.'s case (supra). The fund created u/s 15(1) remains with the assessee earmarked to meet any contingent liability for payment of bonus that may arise in future, limited to a period of four years. There is no diversion of funds from out of the hands of the assessee and the amount reserved is for the purpose of utilisation to meet the liability of the assessee himself if it may arise in future.

8. The decisions of the Kerala High Court in Cochin State Power and Light Corporation Ltd. Vs. Commissioner of Income Tax, and the Bombay High Court in Amalgamated Electricity Co. Ltd. Vs. Commissioner of Income Tax, Bombay City I, were concerned with the question whether the respective assessee, namely, the licensees under the Electricity Supply Act, are entitled to deduction of part of the revenue appropriated towards certain reserves statutorily required to be made under the said Act. It was found that the "development reserve", which would be available to the assessee for the purpose of investment in the business of the electricity supply undertaking, is not a diversion of the assessee's income and is not a permissible deduction under the Act. "Contingencies reserve", on the other hand, not being available to the assessee for any purpose of his own and is to be a permanent reserve to be utilised for specific purposes enumerated in the statute with the approval of the State Government, was held to be a diversion of part of the revenue by reason of the overriding obligation created by the statute and is, therefore, to be deducted in determining the commercial profits of the assessee. Both these decisions have followed the principle laid down by the Supreme Court in the Poona Electric Supply Co. Ltd.'s case (supra). In regard to a "special reserve" created as per the instructions issued by the Electricity Board, this Court in Cochin State Power & Light Corpn. Ltd.'s case (supra) stated:

We can dispose of the case of the assessee with regard to the last of these items, namely, the deduction of the amount under the "special reserve". It has not been shown that the amount so reserved was not available to the assessee for diversion for any purpose of his own. It has not been attempted to be proved that the terms of the instruction to the assessee in any way affects the right of the assessee to deal with such a reserve as in the case of any ordinary reserve which the assessee is not bound to apply to any particular purpose only. Therefore, merely because some instruction is said to have been given by the electricity board and a reserve is created which reserve, in the normal course, would be available for appropriation by the assessee without any restriction, it cannot be said that it should be deductible from the income...." (p. 589)

8A. In regard to the sums appropriated towards the "development reserve" required to be created under para V-A of the Sixth Schedule to the Electricity Supply Act this Court in the abovesaid decision held:

We will now take up the case of development reserve provided under Paragraph V-A of the Sixth Schedule. This, as we have already pointed out, is of the same character as the 75 per cent of the development rebate which the assessee was bound to plough back into the business of the undertaking under the proviso to section 10(2)(vi)(b) of the income tax Act, 1922. It cannot be said that the amount is expended by the assessee nor could it be said that it is lost to the assessee by an overriding obligation. The development reserve is still available to the assessee with the only limitation that it is so available only for investment in the business of the electricity supply undertaking. There is no restriction as to the scope of investment of the amount so reserved in any particular manner. Even the sum to be so appropriated towards the development reserve in respect of any accounting year could be appropriated in annual installments spread over for a period not exceeding five years. The benefit of the amount so set apart as reserve is available to the assessee directly. It could be applied by him as he pleases as investment in the business of the electricity supply undertaking. We do not think that this is in the nature of the consumers' benefit reserve with which the Supreme Court was dealing in the *Poona Electric Supply Co. Ltd. Vs. Commissioner of Income Tax, Bombay*, . As indicated earlier, the consumers' benefit reserve was intended for the benefit of the consumer alone and there is no direct or indirect return of the benefit to the licensee under any circumstances. That is not the case here and we do not think there is a diversion of the revenue which has to be deducted for the purpose of determining the real profits of the assessee or that there is an "expenditure" liable to be deducted under the income tax Act. In fact, it is not a diversion in the real sense of the term since a diversion should be one which goes out and is no longer that of the person who so diverts it. We, therefore, hold that the assessee's claim for deduction of the amount under the development reserve ought not to be allowed...." (p. 591)

9. In regard to the "contingencies reserve" required to be made under the statute, it was however found that the said reserve is not available to the assessee for any purpose of his own or for any purpose other than those indicated in para V of the Sixth Schedule to be utilised for certain specific purposes with the approval of the Government, and that the assessee does not even get compensation on account of his reserve when the electricity undertaking is to be transferred to the Electricity Board or the Government. "Contingencies reserve" was, therefore, found to be a diversion by reason of the obligation created by the statute falling within the principle laid down by the Supreme Court in *Poona Electric Supply Co. Ltd.'s case* (supra), and is, therefore, to be deducted in determining the commercial profits of the assessee. The decision of the Kerala High Court is followed by the Bombay High Court in *Amalgamated Electricity Co. Ltd.'s case* (supra). The Supreme Court in *Indian Molasses Co. (Private) Ltd. Vs. Commissioner of Income Tax, West Bengal*, observed:

... The income tax law does not allow as expenses all the deductions a prudent

trader would make in computing his profits. The money may be expended on grounds of commercial expediency but not of necessity. The test of necessity is whether the intention was to earn trading receipts or to avoid future recurring payments of a revenue character. Expenditure in this sense is equal to disbursement which, to use a homely phrase, means something which comes out of the trader's pocket. Thus, in finding out what profits there be, the normal accountancy practice may be to allow as expense any sum in respect of liabilities which have accrued over the accounting period and to deduct such sums from profits. But the income tax laws do not take every such allowance as legitimate for purposes of tax. A distinction is 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. The case which illustrates this distinction is *Peter Merchant Ltd. v. Stedeford* [1948] 30 Tax Cas. 496. No doubt, that case was decided under the system of income tax laws prevalent in England, but the distinction is real. What a prudent trader sets apart to meet a liability, not actually present but only contingent, cannot bear the character of expense till the liability becomes real." (p. 75)

This decision was followed in a recent decision of the Supreme Court in *Shree Sajjan Mills Ltd. Vs. Commissioner of Income Tax, M.P., Bhopal and Another*, where the question was whether a provision made for payment of gratuity to the employees of the assessee is a permissible deduction. It was held that contributions made to an approved gratuity fund created for the benefit of the employees under an irrevocable trust will be a permissible deduction u/s 36(1) (v). But in the absence of such a fund, it will not be a permissible deduction u/s 40A(7) of the Act. A provision made in the profit and loss account for the estimated present value of the contingent liability for payment of gratuity, properly ascertained and discounted on an accrued basis as falling on the assessee in the year of account was, however, held to be deductible either u/s 28 or u/s 37 of the Act. It is stated:

... 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 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)." (p. 598)

10. A Division Bench of the Madras High Court in *Additional Commissioner of Income Tax Vs. Anamallais Bus Transports (P.) Ltd.*, , in considering the question whether the amounts provided for payment of bonus was a permissible deduction, stated:

... In *Commissioner of Income Tax Vs. Anamallais Bus Transports (P.) Ltd.*, , this Court had to consider the question whether allowing deductions on the basis of the provision was permissible in relation to the years 1962-63 and 1963-64, the same years regarding which the Tribunal had held that such deductions were permissible. This Court held that deductions could not be permitted on a mere provision and that, in the absence of any agreement or actual payment, no deductions could be claimed. We only wish to add that, apart from agreement or payment, there may be cases where the liability might arise by virtue of some statutory provision. If a statutory provision is pleaded and the liability is established, amounts which had accrued due under the statutory provision could also be claimed as bonus...." (p. 740)

In the present case the deduction claimed is not with respect to an accrued liability for payment of bonus. As earlier stated section 15(1) is only a provision to meet a contingent liability that might arise in future. There is no diversion of income from the hands of the assessee, nor has he incurred a liability for payment of bonus during the accounting year. We are, therefore, clearly of the view that the sums set apart as a provision made u/s 15(1) would form part of the assessable income of the assessee and is not a permissible deduction under the Act.

11. We are, however, of the view that the audit note is not "information" within the meaning of section 147(b) and the ITO was not justified in reopening the assessment for the assessment year 1973-74. The Supreme Court in *Indian and Eastern Newspaper Society, New Delhi Vs. Commissioner of Income Tax, New Delhi*, :

... That part alone of the note of an audit party which mentions the law which escaped the notice of the income tax Officer constitutes "information" within the meaning of section 147(b); the part which embodies the opinion of the audit party in regard to the application or interpretation of the law cannot be taken into account by the income tax Officer. In every case, the income tax Officer must determine for himself what is the effect and consequence of the law mentioned in the audit note and whether in consequence of the law which has now come to his notice he can reasonably believe that income has escaped assessment. The basis of his belief must be the law of which he has now become aware. The opinion rendered by the audit party in regard to the law cannot, for the purpose of such belief, add to or colour the significance of such law. In short, the true evaluation of the law in its bearing on the assessment must be made directly and solely by the income tax Officer.

Now, in the case before us, the income tax Officer had, when he made the original assessment, considered the provisions of sections 9 and 10. Any different view taken by him afterwards on the application of those provisions would amount to a change of opinion on material already considered by him. The revenue contends that it is open to him to do so, and on that basis to reopen the assessment u/s 147(6). Reliance is placed on (1976) 102 ITR 287 (SC) , where a Bench of two learned Judges of this Court observed that a case where income had escaped assessment due to the "oversight, inadvertence or mistake" of the income tax Officer must fall within section 34(1)(b) of the Indian income tax Act, 1922. It appears to us, with respect, that the proposition is stated too widely and travels farther than the statute warrants insofar as it can be said to lay down that if, on reappraising the material considered by him during the original assessment, the income tax Officer discovers that he has committed an error in consequence of which income has escaped assessment, it is open to him to reopen the assessment. In our opinion, an error discovered on a reconsideration of the same material (and no more) does not give him that power. That was the view taken by this Court in *Kamal Singh v. CIT* (supra), *CIT v. Raman & Co.* (supra) and *Bankipur Club Ltd., Patna Vs. The Commissioner of Income Tax , Bihar and Orissa, Patna*, and we do not believe that the law has since taken a different course. Any observations in *Kalyanji Mavji & Co.*'s case (supra) suggesting the contrary do not, we say with respect, lay down the correct law." (p. 1304)

It is further held that the discovery of a mistake committed in the original assessment is not "information" within the meaning of section 147(6). In the present case the ITO had, as per his original order of assessment for the assessment year 1973-74, allowed deduction of the amount set apart in the profit and loss account in pursuance to section 15(1). The ITO is not entitled to take a different view on material already considered by him for the reason of an audit note which is not "information" within the meaning of section 147(6).

For the aforesaid reasons we answer question No. 1 in O.P. No. 1833 of 1977-B against the revenue and in favour of the assessee. In view of our answer to question No. 1 there is no need to answer question Nos. 2 and 3. We answer both the questions in O.P. No. 1834 of 1977-B against the assessee and in favour of the revenue. The parties are directed to suffer their respective costs.

Order accordingly.