* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

\+ **INCOME TAX APPEAL NO. 371/2012**

Reserved on : 11th December, 2014
Date of decision : 13th February, 2015

SREI INFRASTRUCTURE FINANCE LTD. ..... Appellant
Through Mr. S. Ganesh, Sr. Advocate with Mr. U.A. Rana, Ms. Mrinal Elker Mazumdar, Mr. Himanshu Mehta and Mr. Abirat Kumar, Advocates.

versus

ADDITIONAL COMMISSIONER OF INCOME TAX..Respondent
Through Mr. Rohit Madan, Sr. Standing Counsel with Mr. Akash Vajpai and Mr. Ruchir Bhatia Advocates.

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CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE V. KAMESWAR RAO

SANJIV KHANNA, J.:

These two appeals under Section 260A of the Income Tax Act, 1961 (Act, for short) by the assessee SREI Infrastructure Finance Ltd. pertaining to assessment years 2006-07 and 2007-08, are directed against the common order dated 23rd February, 2012 passed by the Income Tax Appellate Tribunal (Tribunal, for short). The aforesaid appeals require adjudication on two separate aspects. The first aspect, which is common to both the assessment years, relates to rate of depreciation in respect of motor vehicles given on lease. The substantial question of law framed on the said aspect vide order dated 10th April, 2013, reads as under:-

> "Whether Income Tax Appellate Tribunal has erred in law in reminding the issue of claim of depreciation at the higher rate of 30% to the Assessing Officer in respect of motor vehicles given on lease?"

2. The Tribunal in the impugned order has referred to the decision of the Delhi High Court in ***CIT Vs. MGF (India) Ltd.*** (2006) 285 ITR 142 (Delhi) and ***CIT Vs. Bansal Credits Ltd.*** (2003) 259 ITR 69 (Del). Tribunal in the impugned order reproduced paragraph 23 of the judgment in the case of ***Bansal Credit Ltd.*** (supra), which reads as follows:-

> "Before we close, we may point out that in some of the cases before us (ITAs No.64/99, 65/99, 73/99 & 74/99), the Tribunal has remanded the matters back to the AOs to examine whether the leased out vehicles had been actually used by the lessee in the business of hire. In the light of the view taken by us, we do not find any infirmity in such a direction. As a matter of fact, wherever there is a doubt it must be examined whether the leased out vehicles are actually being used in the business of hiring. Only in such a situation depreciation at the higher rate of 40 per cent or 50 per cent as the case may be, is to be allowed under the relevant entry in Appendix I to the Rules."

3. In terms of the aforesaid observations, the Tribunal restored the matter to the file of the Assessing Officer to decide the issue in accordance with law, i.e. end user on part of the persons, who had put the vehicles to use. It was observed that the assessee had canvassed the said factum; however, necessary verification at the end of the Assessing Officer should have been undertaken. The contention of the assessee is that the order of remand should not have been and is not required to be passed.

4. The Supreme Court in the case of ***ICDS Vs. Commissioner of Income Tax, Mysore and Anr*** (2013) 350 ITR 527 (SC), had examined and considered the issue of depreciation on vehicles given on hire, in depth and detail. It is noticeable that under Section 32 of the Act, an assessee is entitled to depreciation on buildings, machinery, plant, furniture, etc. being tangible assets owned wholly or partly by the assessee and used for the purpose of business or profession. The Supreme Court observed that depreciation is the monetary equivalent of the wear and tear suffered by a capital asset that is set aside to facilitate its replacement when the asset becomes dysfunctional. Referring to the expression "for the purpose of business", it was observed that it does not mandate use of the asset by the assessee itself, but requires that the asset should be utilised for the purpose of business of the assessee. Thus, income derived from leasing of trucks by a financing company would be "business income" as the asset was used in the course of business. Reference was made to the decision of the Supreme Court in ***Commissioner of Income Tax Vs. Shaan Finance (P) Ltd. Bangalore*** (1998) 231 ITR 308 (SC), which interpreted analogous provisions of Sections 32A(2)(a), (b) and Section 33 of the Act dealing with investment allowance and development rebate, respectively. The

second contention of the Revenue that the assessee was not the owner of the asset, i.e. trucks, was also rejected after relying upon the observations of the Tribunal that vehicles were given under a lease agreement on payment of lease rent as prescribed under the schedule. A lease agreement it was elucidated was different from hire-purchase agreement and was a contract of bailment with no element of sale therein. The Supreme Court observed that the Tribunal had rightly held that the lease agreements in fact were transactions of "hire". The Supreme Court also observed that the lease rentals received were treated as "business income" in the hands of the assessee and as deductible revenue expenditure in the hands of the payer/lessee. It was accordingly held as under:-

> "Finally, learned senior counsel appearing on behalf of the assessee also pointed out a large number of cases, accepted and unchallenged by the Revenue, wherein the lessor has been held as the owner of an asset in a lease agreement (CIT v. A. M. Constructions [1999] 238 ITR 775 (AP) ; CIT v. Bansal Credits Ltd. [2003] 259 ITR 69 (Delhi) ; CIT v. M. G. F. (India) Ltd. [2006] 285 ITR 142 (Delhi) ; CIT v. Annamalai Finance Ltd. [2005] 275 ITR 451 (Mad)). In each of these cases, the leasing company was held to be the owner of the asset, and accordingly held entitled to claim depreciation and also at the higher rate applicable on the asset hired out. We are in complete agreement with these decisions on the said point."

5. On the question of rate of depreciation, it was exemplified:-

> "With regard to the claim of the assessee for a higher rate of depreciation, the import of the same term "purposes of business", used in the second proviso to section 32(1) of the Act gains significance. We are of the view that the interpretation of these words would not be any different from that which we ascribed to them earlier, under section 32(1) of the Act. There- fore, the assessee fulfils even the requirements for a claim of a higher rate of depreciation, and, hence, is entitled to the same.
> "In this regard, we endorse the following observations of the Tribunal, which clinch the issue in favour of the assessee.

> "15. The Central Board of Direct Taxes, vide Circular No. 652, dated June 14, 1993, has clarified that the higher rate of 40 per cent. in case of lorries, etc., plying on hire shall not apply if the vehicle is used in a non-hiring business of the assessee. This circular cannot be read out of its context to deny higher appreciation in case of leased vehicles when the actual use is in hiring business.
>
> (emphasis supplied)
>
> Perhaps, the author meant that when the actual use of the vehicle is in hire business, it is entitled for depreciation at a higher rate."

6. Following the said reasoning, we do not think that the order of remand was required to be passed as it is an accepted and admitted position that motor vehicles in question were given on lease and, therefore, motor vehicles have to be treated as given on "hire". Accordingly, the appellant-assessee was entitled to higher rate of depreciation. The substantial question of law is accordingly answered in favour of the appellant-assessee and against the respondent-Revenue.

7. The second aspect/question raised before us relates to computation of book profits under Section 115JB of the Act. The substantial question of law framed in the two appeals on the said aspect read as under:-

> **(Assessment year 2006-07)**
>
> "(1) Whether on the facts and in the circumstances of the case the Tribunal in computing book profit under Section 115JB was justified in confirming the addition of Rs. 9,80,00,000/- transferred to the special reserve pursuant to the provisions of Section 45-IC of the Reserve Bank of India Act, 1934 under Clause (b) of the Explanation to Section 115JB?"

(Assessment year 2007-08)

"(1) Whether on the facts and in the circumstances of the case the Tribunal in computing book profit under Section 115JB was justified in confirming the additions of :-

(a) Rs. 16,00,00,000/- transferred to the special reserve pursuant to the provisions of Section 45-IC of the Reserve Bank of India Act, 1934; and

(b) Rs. 18,66,00,000/- transferred to the debt redemption reserve,

both under Clause (b) of the Explanation to Section 115JB?"

8. Facts in brief may be noted.

9. The appellant is a non-banking financial company engaged, *inter alia*, in the business of leasing of commercial vehicles, infrastructure construction machinery/equipment and financing of infrastructure projects equipment/machinery. For the assessment year 2006-07, the appellant had filed return on 27th November, 2006, declaring total income of Rs.2,03,13,738/- under normal provisions and had declared book profit of Rs.38,95,04,834/- under Section 115JB of the Act. This return was revised on three occasions and in the last revised return dated 31st March, 2008, the returned income under normal provisions was revised to Rs.1,25,92,360/-. The book profits remained unchanged at Rs.38,95,04,834/-. By assessment order dated 31st December, 2008, the total income of the appellant-assessee was assessed under the normal provisions at Rs.16,17,08,631/- and the book profits under Section 115JB of the Act were computed at Rs.67,92,04,834/-. The appellant approached the Commissioner of Income Tax (Appeals) and then filed an appeal before the Tribunal. By the

impugned order, addition of Rs.9,80,00,000/- to the special reserve as per the mandate of Section 45-IC of the Reserve Bank of India Act, 1934 stands confirmed relying upon Explanation 1 clause (b) to Section 115JB(2) of the Act.

10. In the assessment year 2007-08, the assessee had filed return declaring loss of Rs.37,94,15,570/- under normal provisions and book profit of Rs.47,54,42,043/-. Assessee had created a special reserve of Rs.16 crores under Section 45-IC of the Reserve Bank of India Act, 1934. The Assessing Officer by his assessment order applied clause (b) to Explanation 1 to Section 115JB (2) of the Act and added back the said amount to Book profit. For the same reason, the Assessing Officer also made adjustment of Rs.18,66,00,000/-, which were treated by the assessee as Debt Redemption Reserve. The Commissioner of Income Tax (Appeals) and the Tribunal have affirmed the said findings of the Assessing Officer.

11. The contention of the appellant-assessee is two-fold. Firstly, the reserve created as per the mandate of Section 45-IC of the Reserve Bank of India Act, 1934, is in fact a liability and not a reserve. Reliance is placed upon decision of the Supreme Court in ***National Rayon Corporation Vs. Commissioner of Income Tax*** (1997) 227 ITR 764 (SC), and ***Vazir Sultan Tobacco Company Ltd. Vs. CIT*** (1981) 132 ITR 559 (SC). Secondly, it is submitted that in terms of Section 45-IC of the Reserve Bank of India Act, 1934, the appellant-assessee does not have any title over the reserve and, therefore, it is a case of diversion of income at source. Reliance is placed upon several decisions relating to Molasses Storage Fund, namely, ***DCM Ltd. Vs. Commissioner of Income Tax*** [2004] 192 CTR 0408**,** ***Commissioner of Income-tax Vs. Salem Co-operative Sugar Mills Ltd***

(1998) 229 ITR 285***, Commissioner of Income-tax Vs. Pandavapura Sahakara Sakkare Kharkane Ltd.*** (1992) 198 ITR 690***, Somaiya Orgeno-Chemicals Ltd. Vs. Commissioner of Income-tax*** (1995) 216 ITR 291**.** On the issue of Debt Redemption Reserve, again reliance is placed upon decision in ***National Rayon Corporation*** (supra) to the effect that the amount was neither a reserve nor a provision for unascertained liability so as to attract clause (b) or (c) of Explanation 1 to Section 115JB(2) of the Act. Revenue has contested and argued to the contrary. Decision of the Supreme Court in ***Southern Technologies Ltd. Vs. Joint Commissioner of Income Tax***, [2010] 320 ITR 577 (SC), was referred.

12. In order to appreciate the controversy, we would like to reproduce the provisions of Section 115JB of the Act as applicable to the assessment year 2007-08 reads:-

> [Special provision for payment of tax by certain companies.
>
> 115JB. (1) Notwithstanding anything contained in any other provision of this Act, where in the case of an assessee, being a company, the income-tax, payable on the total income as computed under this Act in respect of any previous year relevant to the assessment year commencing on or after the 1st day of April, [2007]], is less than [ten per cent]] of its book profit, [such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income shall be the amount of income-tax at the rate of [ten per cent]]].
> (2) Every assessee, being a company, shall, for the purposes of this section, prepare its profit and loss account for the relevant previous year in accordance with the provisions of Parts II and III of Schedule VI to the Companies Act, 1956 (1 of 1956) :
> Provided that while preparing the annual accounts including profit and loss account,—
> (i) the accounting policies;
> (ii) the accounting standards adopted for preparing such accounts including profit and loss account;
> (iii) the method and rates adopted for calculating the depreciation,

shall be the same as have been adopted for the purpose of preparing such accounts including profit and loss account and laid before the company at its annual general meeting in accordance with the provisions of section 210 of the Companies Act, 1956 (1 of 1956) :

Provided further that where the company has adopted or adopts the financial year under the Companies Act, 1956 (1 of 1956), which is different from the previous year under this Act,—
(i) the accounting policies;
(ii) the accounting standards adopted for preparing such accounts including profit and loss account;
(iii) the method and rates adopted for calculating the depreciation,

shall correspond to the accounting policies, accounting standards and the method and rates for calculating the depreciation which have been adopted for preparing such accounts including profit and loss account for such financial year or part of such financial year falling within the relevant previous year.

Explanation[1].—For the purposes of this section, "book profit" means the net profit as shown in the profit and loss account for the relevant previous year prepared under sub-section (2), as increased by—
(a) the amount of income-tax paid or payable, and the provision therefor; or
(b) the amounts carried to any reserves, by whatever name called 24 [, other than a reserve specified under section 33AC]; or
(c) the amount or amounts set aside to provisions made for meeting liabilities, other than ascertained liabilities; or
(d) the amount by way of provision for losses of subsidiary companies; or
(e) the amount or amounts of dividends paid or proposed ; or
(f) the amount or amounts of expenditure relatable to any income to which 25[section 10 (other than the provisions contained in clause (38) thereof) or 26[***] section 11 or section 12 apply; or
[(g) the amount of depreciation,]
[(h) the amount of deferred tax and the provision therefor,
[(i) the amount or amounts set aside as provision for diminution in the value of any asset,
if any amount referred to in clauses (a) to (i) is debited to the profit and loss account, and as reduced by,—]]
[(i) the amount withdrawn from any reserve or provision (excluding a reserve created before the 1st day of April, 1997 otherwise than by way of a debit to the profit and loss account), if any such amount is credited to the profit and loss account:

Provided that where this section is applicable to an assessee in any previous year, the amount withdrawn from reserves created or provisions made in a previous year relevant to the assessment year commencing on or after the 1st day of April, 1997 shall not be reduced from the book profit unless the book profit of such year has been increased by those reserves or provisions (out of which the said amount was withdrawn) under this Explanation or Explanation below the second proviso to section 115JA, as the case may be; or]

(ii) the amount of income to which any of the provisions of [section 10 (other than the provisions contained in clause (38) thereof)] or 31[***] section 11 or section 12 apply, if any such amount is credited to the profit and loss account; or

[(iia) the amount of depreciation debited to the profit and loss account (excluding the depreciation on account of revaluation of assets); or

(iib) the amount withdrawn from revaluation reserve and credited to the profit and loss account, to the extent it does not exceed the amount of depreciation on account of revaluation of assets referred to in clause (iia); or]

[(iii) the amount of loss brought forward or unabsorbed depreciation, whichever is less as per books of account.

Explanation.—For the purposes of this clause,—

(a) the loss shall not include depreciation;

(b) the provisions of this clause shall not apply if the amount of loss brought forward or unabsorbed depreciation is nil; or]

(iv) the amount of profits eligible for deduction under section 80HHC , computed under clause (a) or clause (b) or clause (c) of sub-section (3) or sub-section (3A), as the case may be, of that section, and subject to the conditions specified in that section; or

(v) the amount of profits eligible for deduction under section 80HHE computed under sub-section (3) or sub-section (3A), as the case may be, of that section, and subject to the conditions specified in that section; or

(vi) the amount of profits eligible for deduction under section 80HHF computed under sub-section (3) of that section, and subject to the conditions specified in that section; or

(vii) the amount of profits of sick industrial company for the assessment year commencing on and from the assessment year relevant to the previous year in which the said company has become a sick industrial company under sub-section (1) of section 17 of the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) and

ending with the assessment year during which the entire net worth of such company becomes equal to or exceeds the accumulated losses.

Explanation.—For the purposes of this clause, "net worth" shall have the meaning assigned to it in clause (ga) of sub-section (1) of section 3 35 of the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986); or

(viii) the amount of deferred tax, if any such amount is credited to the profit and loss account.]

Explanation 2.— For the purposes of clause (a) of Explanation 1, the amount of income-tax shall include—
(i) any tax on distributed profits under section 115-O or on distributed income under section 115R;
(ii) any interest charged under this Act;
(iii) surcharge, if any, as levied by the Central Acts from time to time;
(iv) Education Cess on income-tax, if any, as levied by the Central Acts from time to time; and
(v) Secondary and Higher Education Cess on income-tax, if any, as levied by the Central Acts from time to time.]

(3) Nothing contained in sub-section (1) shall affect the determination of the amounts in relation to the relevant previous year to be carried forward to the subsequent year or years under the provisions of sub-section (2) of section 32 or sub-section (3) of section 32A or clause (ii) of sub-section (1) of section 72 or section 73 or section 74 or sub-section (3) of section 74A.

(4) Every company to which this section applies, shall furnish a report in the prescribed form 37 from an accountant as defined in the Explanation below sub-section (2) of section 288, certifying that the book profit has been computed in accordance with the provisions of this section along with the return of income filed under sub-section (1) of section 139 or along with the return of income furnished in response to a notice under clause (i) of sub-section (1) of section 142.

(5) Save as otherwise provided in this section, all other provisions of this Act shall apply to every assessee, being a company, mentioned in this section.]

(6) The provisions of this section shall not apply to the income accrued or arising on or after the 1st day of April, 2005 from any business carried on, or services rendered, by an entrepreneur or a Developer, in a Unit or Special Economic Zone, as the case may be."

13. As noticed by this Court in ***Commissioner of Income Tax (Central-II) Vs. Goetze (India) Limited*** [2014] 361 ITR 505 (Del), Sub-section (1) to Section 115JB of the Act begins with a non obstante expression, which gives an overriding effect to the said section. Sub-section (2) states that every assessee being a company shall prepare a Profit and Loss account for the previous year in accordance with the provisions of Part II and III of Schedule VI of the Companies Act, 1956. Explanation to the said section in the first part refers to increase in book profit by amounts specified in sub paragraphs (a) to (g). Explanation in the second part states that the book profit shall be reduced under clause (i) to (iii). Thus, the book profits of the previous years preferred in accordance with the provisions of Part II and III of Schedule VI of the Companies Act, have to be decreased or increased as per the express mandate of the Explanation 1 to Section 115JB (2) of the Act.

14. In the present case, we are concerned with clause (b) to Explanation 1 which states that book profit prepared in accordance with Part II and III of Schedule VI of the Companies Act, 1956 will be increased by the amount carried to any reserve by whatever name called, other than a reserve specified under Section 33AC of the Act. The legislature in express, lucid and categorical terms has stipulated that the book profit shall be increased by the amounts carried to any reserve. The word "any", it is obvious, refers to all kinds of reserves and encompasses all types and categories without exception. The legislature did not stop and has thereafter used the expression "reserve by whatever name called". There could not have been more clarity and articulateness in the language of clause (b) to Explanation (1). The intention is unambiguous, i.e. book

profit would include all amounts carried to any reserve by whatever name called, except the reserve specified under Section 33AC of the Act. The nature and type of reserve or its character would not affect operation of clause (b) to Explanation (1). Only reserves specified in Section 33AC of the Act have to be excluded. Guidance Note on revised Schedule VI to the Companies Act, 1956 by the Institute of Chartered Accountants of India would indicate that reserves and surplus are generally classified as; (a) capital reserve; (b) capital redemption reserve; (c) securities premium reserve; (d) debenture redemption reserve; and, (e) revaluation reserve or other reserves. In addition, there can be share options outstanding account and surplus, i.e. the balance in the statement of profit and loss disclosing allocations and appropriations such as dividend, bonus shares and transferred to/from reserves, etc.

15. In view of the aforesaid legal position and language of clause (b) to Explanation (1) to Section 115JB of the Act, the appellant-assessee had adopted a different line of argument relying upon the decision of the Supreme Court in the case of ***National Rayon Corporation*** (supra) *and* ***Vazir Sultan Tobacco Company Ltd.*** (supra) and argued that the amounts "appropriated" under Section 45-IC of the Reserve Bank of India Act, 1934 are not a reserve. We record and express our inability to agree with the said contention for the reasons set out below.

16. In ***Vazir Sultan Tobacco Company Ltd.*** (supra), the Supreme Court was concerned with the Companies (Profits) Surtax Act, 1964 and it was observed that the terms "provision" and "reserve" were not defined in the said Act, but are well-known terms in commercial accountancy and are used in the Companies Act with reference to preparation of balance sheets

and Profit and Loss account. It was held that if a sum of money had not been set apart for certain purpose, it would not be a "provision" but it did not follow that it would be a "reserve". Referring to Part I and II of the Schedule VI, it was observed that the expression "provision" has been defined positively and meant any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which, the amount cannot be determined with substantial accuracy. However, the expression "reserve" has been defined in a negative manner, and would exclude, i.e., not include, any amount written off retained by way of providing for depreciation, renewal or diminution in value of assets, or retained by way of providing for any known liability. Therefore, an amount retained in excess of the amount retained for any known liability was not necessarily a reserve. A provision, it was held, is a charge against profits and therefore to be taken into account against gross receipts in the Profit and Loss account. The "reserve", on the other hand, is appropriation of profits, the assets by which it is represented being retained to form a part of the capital employed in business. Whether an amount was a "reserve" or "provision", it was observed, must be determined with reference to the nature and character of sum retained and substance of the matter. The balance-sheet contains separate heads for "reserve and surplus" and "current liabilities and provisions".

17. The aforesaid position still holds good when we refer to the Guidance Note issued by the Institute of Chartered Accountants of India on revised Schedule VI to the Companies Act, 1956 (December, 2011 Edition) in which it has been observed:-

"**8.1.2.1. Reserve:**

> The Guidance Note on Terms Used in Financial Statements defines the term 'Reserve' as "the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability." 'Reserves' should be distinguished from 'provisions'. For this purpose, reference may be made to the definition of the expression `provision' in AS-29 Provisions, Contingent Liabilities and Contingent Assets.
>
> As per AS-29, a `provision' is "a liability which can be measured only by using a substantial degree of estimation". A 'liability' is "a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits." 'Present obligation' – "an obligation is a present obligation if, based on the evidence available, its existence at the Balance Sheet date is considered probable, i.e., more likely than not."

18. Thereafter, the Guidance Note under different headings describes capital reserve, capital redemption reserve, securities premium reserve, debenture redemption reserve, revaluation reserve, share options outstanding account and other reserves.

19. Similarly, in the Guidance Note on the Terms Used in Financial Statements GN(A) 5 issued in 1983, the terms "reserve" and "provision" were explained as under:-

> "**14.04 Reserve**
> The portion of earnings, receipts or other surplus of any enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. The reserves are primarily of two types: capital reserves and revenue reserves.
> **13.14 Provision**
> An amount written off or retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy."

20. In the case of ***National Rayon Corporation*** (supra), the assessee company had issued secured redeemable mortgage debentures against the security of land, building and machinery and a floating charge on the undertaking. The High Court held that this was merely a "provision" to enable it to redeem debentures when they became due for redemption. The aggregate amount of the debentures was higher than the amount of Debenture Redemption Reserve. The High Court on the aforesaid reasoning held that the amount set aside to meet the future liability, which was certain to come into existence was a "provision" and not a "reserve". The Supreme Court, therefore, disagreed with the said reasoning observing that the High Court itself had come to the conclusion that the Debenture Redemption Reserve was less than the company's liability on this account. Further, the liability had arisen the moment money was borrowed, which would be repayable. The obligation or liability to repay would not cease just because the fact that the date of repayment was deferred by an agreement, as the obligation was an ascertained liability. Therefore, the money set apart for redemption of debentures must be treated as money set apart to meet a known liability and the amount should be shown as a liability. In these circumstances, it was held that the amount set apart was not a "reserve". Reference was made to Batliboi's *Advanced Accountancy* with reference to nature of sinking funds and it was held that redemption of debenture would not be a "reserve", though it was shown as "reserve" in the balance-sheet. An amount shown as a reserve is in the nature of allocation of profits and not a charge against them. The Debenture Redemption Reserve, it was held, was in the nature of charge against profits and not appropriation of profits.

21. We do not see how this decision can help and assist the appellant-assessee.

22. In respect of Debt Redemption Reserve of Rs.18,66,00,000/-, no specific explanation was given; on what account and why the said reserve was created. Nothing has been shown or pointed out to us to show why the said reserve was created. The reply dated 9th March, 2009 quoted in the assessment order refers to definition of the term "provision or reserve" and various decisions and in the end it is stated that the amounts set apart for provision of the Debt Redemption Reserve to meet any known liability cannot be termed as "reserve" as the same was essentially a "provision" for meeting ascertained liability and, therefore, cannot be added to the book profit either under clause (b) or clause (c) to Explanation 1. Why and for what reasons the amount of Rs.18,66,00,000/- represented an ascertained and known liability, is not indicated or stated. The nature and character of debt is not mentioned and adverted to. The Assessing Officer also noticed that in the earlier years, the Debt Redemption Reserve was offered or added by the assessee himself for computation of book profit. The assessment order records that the assessee had created a "reserve" for meeting any kind of debt without specifying its details or particulars.

23. It is noticeable that under clause (c) of Explanation (1) to Section 115JB of the Act, amount set aside to provisions made for meeting liabilities, other than ascertained liabilities, have to be added back while computing book profit. Thus, provisions for ascertained liabilities would be excluded and are not to be added to the book profit under Explanation (1) to Section 115JB of the Act. Unascertained provisions have to be added and included. It was for the appellant-assessee to explain and show

that what was treated as a Debt Redemption Reserve was in fact a provision and that too for an ascertained liability. This explanation is missing and absent.

24. The term 'provision' differs from 'liability' because liability is certain and definite amount whereas a provision is an amount which is estimated (*See* Note 3 of Schedule III of the Companies Act, 2013, with reference to the term "current liabilities"). Reserves fall on the other end/side for they are associated with equity. Transfer of such reserves is appropriation of retained earnings rather than expenses. Contingent liability, however, is not a provision or liability. It is less certain than a provision as the possible obligation has not yet been confirmed and the assessed does not have control whether or when it will be confirmed or the amount cannot be measured with sufficient reliability. The potential obligation is so uncertain that it should not be recognized in the accounts. A provision, therefore, is somewhat between accrual and the contingent liability.

25. The argument in respect of Section 45-IC of the Reserve Bank of India Act, 1934 and diversion of income at source is misconceived. The decisions of different courts including the Supreme Court and the Delhi High Court in the case of Molasses Storage Fund are inapplicable. Diversion of income at source by way of overriding title as a principle is applicable when under a statutory or contractual obligation or under the provisions of Memorandum and Articles of Association, the earning is divested and the assessed has no title over a particular receipt. When such charge exists, the amount or income so charged must be excluded from income of the assessed as income never reaches his hands and in fact

belongs to a third person. Thus, the income stands diverted at source. Diversion of income at source implies that income or the amount mentioned therein belongs to a third party and was not income of the assessed. Similar question arose before the Supreme Court in ***Associated Power Co. Ltd Vs. CIT*** (1996) 218 ITR 195**.** In that case, the assessed was a company engaged in the business of generation of electricity and distribution thereof to consumers. The companies were governed by the Electricity (Supply) Act, 1948. By reason of the provisions of the said Act and the VI Schedule thereto, the assessed appropriated certain sums out of its revenue to the contingency reserve account and claimed deduction of the same in the computation of its total income for the purposes of the Act. The Income-tax Officer rejected the claim of the assessee. However, on appeal, the Appellate Assistant Commissioner allowed the assessee's claim. On appeal by the Revenue, the Tribunal set aside the order of the Appellate Assistant Commissioner and referred the question regarding deductibility of the amount transferred to the contingency reserve fund account in arriving at the taxable business income of the assessee-company directly to the Supreme Court under Section 257 of the Act. The Supreme Court on consideration of the facts and circumstances of the case and the scheme of the Electricity (Supply) Act, 1948, observed that the monies in the contingencies reserve belonged to the electricity company. The Supreme Court, therefore, repelled the claim of the assessed that there was a diversion of income by overriding title. While doing so, the Supreme Court observed:-

> "The application of the doctrine of diversion of income by reason of an overriding title is quite inapposite. The doctrine applies when, by

> reason of an overriding title or obligation, income is diverted and never reaches the person in whose hands it is sought to be assessed. ”
>
> Applying the above principle to the facts of the case before it, the Supreme Court observed (page 207) :
>
> “ In the present case, the statute requires the electricity company to create certain reserve if its clear profit exceeds a reasonable return
>
> (clause II, Sixth Schedule). Again, the contingencies reserve is to be created from existing reserves or from ‘the revenues of the undertaking’. This clearly indicates that the monies which have to be put into the contingencies reserve, reach the electricity company and are not diverted away from it. ”

The Supreme Court further observed :

> “ It is the electricity company which has to invest the sums appropriated to the contingencies reserve. The investment would be in its name and it would be the owner thereof. The restriction that the investment can be made only in securities mentioned in the Indian Trusts Act makes no difference to this position. ”

The Supreme Court, therefore, concluded that the amount credited to the contingencies reserve was not diverted by reason of overriding obligation or title and, it being a taxable receipt/earning, it must be taken into account.

26. Section 45-IC of the Reserve Bank of India Act, 1934 reads as under:-

> 45-IC. Reserve fund.--(1) Every non-banking financial company shall create a reserve fund and transfer therein a sum not less than twenty per cent of its net profit every year as disclosed in the profit and loss account and before any dividend is declared.
> (2) No appropriation of any sum from the reserve fund shall be made by the non-banking financial company except for the purpose as may be specified by the Bank from time to time and every such appropriation shall be reported to the Bank within twenty-one days from the date of such withdrawal:
> Provided that the Bank may, in any particular case and for sufficient cause being shown, extend the period of twenty-one days by such further period as it thinks fit or condone any delay in making such report.

> (3) Notwithstanding anything contained in sub-section (1), the Central Government may, on the recommendation of the Bank and having regard to the adequacy of the paid-up capital and reserves of a non-banking financial company in relation to its deposit liabilities, declare by order in writing that the provisions of sub-section (1) shall not be applicable to the non-banking financial company for such period as may be specified in the order:
> Provided that no such order shall be made unless the amount in the reserve fund under sub-section (1) together with the amount in the share premium account is not less than the paid-up capital of the non-banking financial company."

27. The reserve, which is required to be created under Section 45-IC, is out of the profits earned by a non-banking financial institution. It is not an amount diverted at source by overriding title. The Reserve Bank of India Act, 1934 can permit appropriation in respect of the said reserve. The assessee can also ask for specific directions from the Central Government subject to proviso to sub-section (3) of the said Section.

28. The special reserve under Section 40IC of the Reserve Bank of India Act, 1934 of Rs.9,80,00,000/- and Rs.16,00,000/- relating to Assessment Years 2006-07 and 2007-09, respectively was not on account of specific or known liability to repay. It is not the case of charge on profits. It was only appropriation of profits after they had been earned. It is not an expense.

29. During the course of argument it was ascertained and accepted on behalf of appellant assessee that the reserve under Section 45-IC of the Reserve Bank of India Act, 1934 and debt redemption reserve were below the line allocations, after computing the financial profit and were not treated and regarded as expenditure/liability for the for the purpose of the profit and loss account in the accounts. The amount treated as reserve created under Section 45-IC of the Reserve Bank of India Act, 1934 was not regarded as diversion of income at source by the statutory auditors.

Indeed, the reserve created under Section 45-IC of the Reserve Bank of India Act, 1934 can neither be diversion of income at source nor constitute an expenditure or liability. Reserve under Section 45-IC of the Reserve Bank of India Act, 1934 of not less than 20% of net profit every year can only be computed after net profit is calculated and computed. Reserve, so created is not a liability known or ascertained, even estimated. Section 45-IC ensures that a Non- Banking Finance Company does not appropriate entire net profit as disclosed in the Profit and Loss account but this percentage is either ploughed back into business or is represented by a portion of the asset. No separate bank account is required to be maintained. It is an added measure of protection created by the statute, to prevent defaults by the Non Banking Financial Companies. Section 45-IC of the Reserve Bank of India Act, 1934 also permits appropriation but in restricted or controlled manner by a Non Banking Financial Company.

30. Accounts in case of a company are prepared as a going concern assuming that the business will continue in the foreseeable future. To ascertain the 'net profit' of each year, not only the current liabilities and the contingencies but future contingencies should also be considered. Thus, Chapter VI of the Companies Act in Part II and III provides for 'Provision' and 'Reserves' which relate to future payments, future needs and contingencies for which a part of the current earning is set aside.

31. The underlying purposes of financial accounts may not necessarily be the same as those of taxing accounts which are maintained and computed in accordance with the provisions of the taxing statute, i.e. the Income Tax Act, 1961. Notwithstanding clear commonalities such as matching of income with expenses, in the case of financial accounts there is

greater emphasis on ensuring that the profits are not overstated, in contrast in the tax accounts the emphasis is on ensuring that the profits are not understated.

32. As noticed above, 'provision' and 'reserves' are different accounting terms. A provision created to meet a known liability is a charge against the profit. Hence, it is debited to the Profit and Loss account and reduces the profit. Provisions should be created, even if there is insufficient profit. Provision is not, therefore, invested. On the other hand, 'reserve' is only appropriation of profit and, therefore, it is not debited to the Profit and Loss account. The purpose of reserve is to strengthen the financial position and to meet unforeseen liabilities which may arise in future. The reserves are created out of adequate profits. However, once reserve is created, it reduces divisible profit. This is the amount of profit which is retained for use in business when difficulty arises. Reserves can be invested. The said investments can be even outside the business and in such cases the reserve is called the reserve fund. Reserves are shown on the liability side of the balance sheet and are generally treated as belonging to the proprietor just as capital. It is a sum owned by the business to the proprietor. Reserves themselves are not assets but represent a portion of the assets which the proprietor is free to utilize for business as one likes, i.e. the assets equalling the reserves that are not required to pay liabilities. Generally reserves are created at the discretion of the management as a matter of prudence, but in certain cases a statute can direct creation of special reserves. For the purpose of Section 115JB of the Act, statutory reserves are treated alike and in a similar manner as other reserves.

33. Reserves are normally treated as a part of equity which is defined as residual, i.e. assets less liabilities, but as recorded above sometimes reserves are required to be created by statute in order to give the entity and its creditors an added measure of protection from the effect of losses.

34. To reiterate, a reserve is below the line of allocation of profits. The amount mentioned in the reserve does not get reflected in the Profit and Loss account. Further, the amount mentioned in the reserve is not to be kept in a designated bank account, but would get reflected in the form of assets under the heading "assets", etc.

35. In view of the aforesaid reasoning, the two substantial questions of law mentioned in paragraph 7 above have to be answered against the appellant-assessee and in favour of the respondent-Revenue. To this extent, the appeal is dismissed. As the substantial question of law relating to rate of depreciation has been answered in favour of the appellant-assessee, we are not inclined to impose costs.

-sd-
(SANJIV KHANNA)
JUDGE

-sd-
(V. KAMESWAR RAO)
JUDGE

FEBRUARY 13, 2015
NA/VKR