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T.C.A.No.191 of 2011

IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 04.11.2024

CORAM :

THE HONOURABLE DR.JUSTICE ANITA SUMANTH
and
THE HONOURABLE MR.JUSTICE G. ARUL MURUGAN

T.C.A.No.191 of 2011

Shriram City Union Finance Limited,
No.123, Angappa Naicken Street,
Chennai – 600 004.

.. Appellant

VS

Assistant Commissioner of Income Tax,
Company Circle VI(2)
Chennai – 600 034.

.. Respondent

Prayer : Appeal filed under Section 260A of the Income Tax Act against the order of the Income Tax Appellate Tribunal, Madras, 'A' Bench dated 08.12.2010 in ITA No.502/Mds/2010.

For Appellant : Mr.R.Sivaraman

For Respondent : Mr.J.Narayanaswamy
Senior Standing Counsel

JUDGMENT

(Delivered by Dr. ANITA SUMANTH.,J)

This tax case appeal has been filed by the assessee relating to assessment year (AY) 2006 – 2007. The substantial question of law that have been admitted are as follows:-

"1.Whether on the facts and circumstances of the case, the Tribunal was right in holding that there has been no diversion of income by overriding charge in respect of amount transferred to Statutory Reserve Fund in compliance with the mandatory provisions of Sec.45IC read with



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Sec.45Q of RBI Act?

2. Whether on the facts and circumstances of the case, the Tribunal was right in noticing that the amount transferred to Reserve Fund in compliance with the provisions of Reserve Bank of India Act, 1934, by the appellant from its income, is not an allowable deduction in computing the assessable income under the provisions of Indian Income Tax Act, 1961.?

2. The above substantial questions have been answered in the case of this very assessee for other assessment years by this Court in T.C.A.No.755 of 2009 and batch dated 30.06.2022. Their discussion and conclusion are as follows:-

"Statutory Reserve Fund

5.1. The assessees are Non-Banking Financial Companies. They had transferred certain amount to a statutory reserve under section 45 IC of the Reserve Bank of India Act, 1934 (hereinafter shortly referred to as the "RBI Act") and claimed deduction in computing the income under the provisions of the Income Tax Act, 1961 (hereinafter shortly referred to as "the Act") under the regular computation and under section 115 JB, as the case may be. During the course of assessment proceedings, the assessing officer disallowed the said claim on the premise that the assessees received income which was kept in the reserve fund as mandated under the provisions of the RBI Act and hence, it is only an application of income. The said finding of the assessing officer was also affirmed by both the appellate authorities. Therefore, the assessees are before this court by raising the issue, as to whether the Tribunal was right in holding that there has been no diversion of income by overriding charge in respect of the amount transferred to statutory reserve fund in compliance with the provisions of the RBI Act; and raised a consequential issue, as to whether the Tribunal was right in holding that the amount transferred to reserve fund in compliance with the RBI Act by the assessees, is not an allowable deduction in computing the assessable income



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under the provisions of the Income Tax Act, 1961.

5.2. The learned senior counsel appearing for the appellants / assesseees would contend that the Tribunal has erred in confirming the disallowance with respect to transfer of reserve fund under Section 45-IC of the RBI Act. As per Section 45-IC of the RBI Act, 20% of the net profits of the company cannot form part of the real income of the company. The company loses control over this part of the income from the commencement of the business and that, a part of the corpus of the right of the company to have the entire income is sliced away at the threshold itself. The Tribunal also did not consider that there is no divergence of funds since the transfer is not through any other obligation created by the company out of its own volition or gratuitously. Thus, according to the learned senior counsel, it is an expenditure laid out wholly and exclusively for the purpose of commencement or carrying out the business and the business of the assesseees cannot survive without complying with the mandatory provisions of the RBI Act and hence, it is an admissible deduction under section 37 of the Income Tax Act.

5.3. Adding further, the learned senior counsel appearing for the appellants / assesseees submitted that the assesseees are Non-Banking Financial Companies (NBFC) which fall under Chapter III-B of the RBI Act. As per Section 45-IC of the RBI Act, the assessee companies are mandated to create a reserve fund and transfer certain amount to such reserve. Further, Section 45Q of the RBI Act gives an overriding effect to Chapter III-B in respect of all other laws and therefore, Section 45-IC of the RBI Act creates an overriding charge and it cannot be disallowed under the Income Tax Act. Alternatively, the learned Senior counsel submitted that the NBFCs have no control over the reserve fund created under section 45-IC of the RBI Act and they have to wait for the directives to be issued by the Reserve Bank of India from time to time. Therefore, the learned Senior counsel submitted that the amount so transferred to the statutory reserve is only an application of income and the deduction claimed by the assesseees for the same, cannot be disallowed by the authorities below. To strengthen his submissions, the learned senior counsel placed reliance on the



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following decisions:

(i) Commissioner of Income Tax v. Travancore Sugar & Chemicals Ltd [(1973) 3 SCC 274];

(ii) Commissioner of Income Tax v. M/s.Vasisth Chay Vyapar Ltd [(2019) 13 SCC 747];

(iii) Commissioner of Income Tax v. Salem Cooperative Sugar Mills Limited [(1998) 229 ITR 285 (Madras)]; and

(iv) Keshkal Co-operative Marketing v. Commissioner of Income Tax [(1987) 165 ITR 437 (MP)].

5.4. Per contra, the learned Senior Standing Counsel for the respondent / Revenue submitted that the assessees being Non-Banking Financial Companies had transferred certain amount to the statutory reserve fund as mandated by the Reserve Bank of India Regulations as well as Section 45-IC of the RBI Act, however, the said transfer to statutory reserve cannot be termed as an expenditure at all, as the same is under the control of the assessees and the amount continues to be in the reserve. Further, the assessees had merely transferred the monies to the statutory reserve fund from the gross income shown. Therefore, the income was not diverted at source by overriding title to qualify for deduction and the said reserve fund can be allowed to be used by the assessees as per the Government Orders/RBI Regulations. It is further stated by the learned senior standing counsel that the Assessing Officer, after scrutinizing the nature of transaction and by applying the decisions of the Apex Court in Dalmia Cements Limited [237 ITR 517] and in Sitaldas Tirathdas [41 ITR 367] on explaining the meaning of -Diversion of income by overriding title-, held that the assessees are not entitled for deduction. The Tribunal also, as a fact finding authority, found that the assessees had not transferred the income at source by overriding title and consequently, held that the deduction is not allowable.

5.5. Elaborating further, the learned Senior Standing Counsel appearing for the respondent / Revenue submitted that if the funds are diverted at source, they shall not be included in the taxable income. Whereas, if they are diverted later, it must be included as a taxable income. In any event, such a diversion of funds is a question of fact and not of



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law. The Commissioner of Income Tax (Appeals) as well as the Income Tax Appellate Tribunal have dealt with the factual dispute at length, while rejecting the claim of the assesseees and hence, the same need not be interfered with by this Court. The learned Senior Standing Counsel also placed reliance on Section 45Q of the RBI Act and submitted that money in reserve fund only goes to the depositors and hence, it will not be allowed to be deducted for the purpose of arriving at taxable income. Adding further, it is submitted that when the income is diverted at source, it does not accrue to the assesseees and in that case, it is not really the income of the assesseees and it shall be deductible. On the other hand, when the income is required to be applied to discharge an obligation after the income reaches the assesseees, it is merely an application of income and thus, liable to be taxed. To substantiate his contentions, the learned senior standing counsel referred to the decisions in (i) Associated Power Co Ltd. V. CIT, [218 ITR 195 (SC)]; (ii) SREI Infra Structure Finance Limited v. CIT [54 Tax Man 254 (Del)] and (iii) Seshasayee Paper Boards Limited v. CIT [237 ITR 488 (Mad)]. Thus, the learned senior standing counsel prayed for dismissal of the appeals filed by the assesseees.

5.6. This court considered the rival submissions and case laws relied upon by both sides. It could be seen that for the assessment years under consideration, the assesseees claimed deduction for the amount transferred to statutory reserve fund created under section 45 IC of the RBI Act, which reads as follows:

(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



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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.?

5.7. The Assessing Officer disallowed the deduction so claimed by the assessees, on the premise that it is only an application of income. It was further pointed out by the assessing officer that the said deduction is not an expenditure incurred by the assessee companies and is an income accrued to the assessees during the financial year under consideration and hence, it cannot be allowed as deduction under section 37 of the Act. It was also observed that the creation of reserve under the RBI Act is only a prudential effort to safeguard the interest of the shareholders of a NBFC company and it cannot be interpreted as an authorization to create a notional income and hence, the same cannot be claimed as a deduction from the total income computed for the purpose of computing the income tax. After having found that the assessee companies have created statutory reserve for 20% of the profits, by way of appropriation, the assessing officer held that the creation of statutory reserve is nothing but an application of income after the profit has been earned by the assessee companies and not a diversion of income as claimed and hence, such profit needs to be taxed. Referring to the decisions of this court in Tamil Nadu Power Finance and Infrastructure Development Corporation Ltd v. JCIT [280 ITR 491] and the Hon'ble Supreme Court in Southern Technologies Ltd v. JCIT [320 ITR 577], the assessing officer was of the view that the directive of the RBI cannot override the statutory provisions of the Act.



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Accordingly, the assessing officer held that the amount transferred to the statutory reserve is not an allowable deduction and the same has to be added back to the total income of the assessee in both the regular computation and the computation of book profits under section 115 JB of the Act, as the case may be.

5.8. When the aforesaid orders of the assessing officer were put to challenge by the assessee before the appellate authorities viz., CIT(A) and ITAT, the same ended in failure. For better appreciation, the findings of the Tribunal in ITA Nos.570, 571, 806 & 807 /Mds/2008 dated 6th February, 2009, relating to the AY 2003-04 in respect of two assessee viz., Shriram Transport Finance Co. Ltd and Shriram Investments Ltd, are quoted below:

"2.5 We have heard both the counsels and perused the relevant records. We find that the transfer to reserve in this case is only an appropriation of the profits. It is settled law that appropriations are not a change to the profits and cannot be deducted in computation of business income. Moreover, the amount transferred to a reserve is as per Reserve Bank of India Act but the purpose for which the reserve has to be utilized has not been specified. Hence, the purposes for which reserve has been made can only be considered contingent as of present. Moreover, the funds representing the reserve are very much under the control of the assessee. There is no directive that amount equivalent to this reserve should be earmarked to a specific mode of investment.

.....

2.11. Now, we examine the present case on the anvil of above. By no stretch of imagination, it can be said that the amount sought to be deducted has in fact reached the assessee. The amount involved is only an appropriation out of company's own profits before declaration of dividend. The amount has very much reached and is in the business of the assessee. RBI has not attached any obligation that the fund be kept in any earmarked security nor the purpose of utilization of the fund has been specified.



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Even if some obligation is subsequently attached for specific appropriation of the fund, it will only be an application of income, which will need to be dealt with as per relevant tax law. The transfer of reserve fund in this can certainly not be called a diversion of income by overriding charge.

2.12. From the above, it is clear that the decisions referred to by the assessee's counsel are in a different context and are not applicable. On the other hand, the ratio from the Hon'ble Apex Court in the case of CIT vs. Sitaldas Tirathdas and Hon'ble Jurisdictional High Court in the case of Seshasayee Paper & Boards Limited is clearly applicable in this case. The Companies Act, 1956 also mandates transfer to reserve fund a certain percentage of the profits before declaration of dividend. The Hon-ble High Court in the case of Seshasayee Paper & Boards Ltd. had held that in such a case, there is no diversion of income by overriding title nor can the amount set apart be claimed as expenditure and it cannot also be stated that it was loss. The ratio from this decision is very much applicable in this case, because as per the Reserve Bank of India Act, the Assessee has to create a Transfer Fund and to transfer therein certain percentage of its profits before any dividend is declared. This transfer to Reserve Fund was to be utilised for such purposes as specified by the Reserve Bank of India from time to time. No such specification of utilisation of that fund had been issued by the Reserve Bank of India. Hence, it cannot be said that there was any diversion of income by overriding title nor can the amount set apart be claimed as expenditure and it also cannot be stated that it was a loss.

.....

2.17....Upon careful consideration, we do not see any reason to hold that this decision is helpful to the case of the assessee. The ratio from the Hon'ble Madras High Court decision in the case of T.N.Power Finance and Infrastructure Development Corporation Ltd. vs. JCIT clearly applies to the facts of the



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case. Moreover, as discussed earlier, this is only an appropriation of profits for purposes which have not yet been specified. Moreover, amount involved is very much under the control of the assessee and is lying in its business. Hence, in the background of aforesaid discussion and precedents, we uphold the well reasoned order of the learned Commissioner of Income Tax (Appeals) in this regard and decide the issue against the assesseees."

The aforesaid order was followed by the Tribunal, while deciding the cases relating to the subsequent assessment years as well.

5.9. In Salem Co-operative Sugar Mills Ltd case, referred to on the side of the appellants, it was concluded by this court that the Tribunal was correct in holding that a portion of sale proceeds of molasses, which was accounted for and kept separately for the construction of storage tanks, cannot be included in the assessee's income for taxation, on the premise that there was diversion of income by overriding title at source. However, as rightly pointed out by the learned senior standing counsel appearing for the Revenue, such reserve was created as per the provisions of the Molasses Control (Amendment) Order and hence, the same would not be applicable to the facts of the present case.

5.10. Similarly, in Keshkal Co-operative Marketing case, relating to transfer of amount to reserve fund under section 43(2) of the Madhya Pradesh Co-operative Societies Act, the question raised was, whether it is allowable as deduction as business expenditure or as having been diverted by an overriding title. The Madhya Pradesh High Court held that the amount diverted for statutory reserve funds is deductible under section 37(1) of the Act. The said judgment will also not be applicable to the appellants- case, as the amount was transferred according to the provisions of the Madhya Pradesh Co-operative Societies Act.

5.11. The Delhi High Court in Vasisth Chay Vyapar Ltd case, while considering the issue relating to addition of unrealized interest income on Inter Corporate Deposits (ICD) by the assessing



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officer, when the same had to be declared by the assessee (NBFC) as an NPA as per the directions of the RBI, dealt with section 45Q of the RBI Act and held that the provisions of the RBI Act override the provisions of the Income Tax Act and decided the issue in favour of the assessee. The judgment of the Delhi High Court was affirmed by the Apex Court. However, the said decision is not applicable to the facts of the present case as the interest as held by the High Court and confirmed by the Apex Court was never received by the Assessee therein and held that interest income had not accrued. The present case concerns the amount sought to be deducted by the assessee while computing the taxable income, which is already a part of the total income and transferred to reserve fund and therefore, the said decision may not be helpful to the case of the appellants.

5.12. In Travancore Sugar and Chemicals Ltd case, the issue that arose for consideration was, whether payment of fixed percentage of profits apart from cash consideration, in lieu of takeover of three undertakings of the government is deductible under section 10(2)(xv) of the Act. It was ultimately concluded by the Hon'ble Supreme Court that the assessee did not have any choice since its inception and therefore, the amount paid according to the terms of agreement with the Government, had to be deducted. That decision will also render no support to the appellants' case, as the amount was paid by the assessee, as per the terms of the agreement with the Government and in the present case, it is only kept as reserve.

5.13. On the other hand, in the decisions relied on the side of the respondent / Revenue in Associated Power Co. Ltd case, the Hon'ble Supreme Court was of the categorical view that the amount kept under contingency reserve as per the provisions of Electricity (Supply) Act and Sixth Schedule under it, must not be allowed as deduction and must be taxed. In Seshasayee Paper Boards Ltd case, this court, while considering the issue, whether the amount transferred to general reserve as required under section 205(2A) of the Companies Act, can be claimed as deduction, at the time of computing the total income, ultimately held that the amount transferred was out of its own profits and there was no diversion at source by



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overriding title even if the statute mandates the same; section 205(2A) merely restricts the declaration of entire profits as dividends and there are no other restrictions; and therefore, the amount transferred out of the income of the assessee, is not entitled to deduction of the money transferred to the reserve. Applying the ratio laid down in those decisions to the present case, wherein, the amount transferred by the assessee herein, to the reserve fund as mandated under the provisions of the RBI Act, is out of profits earned by them and hence, the same has to be treated as appropriation of profits. Furthermore, the amount so transferred is not a diversion of income at source by overriding effect, nor can the amount set apart be claimed as expenditure and it cannot be stated that it was a loss. It is relevant to refer to para no.22 of the judgment in Travancore Case (Supra) relied upon by the Appellants/Assessees, wherein the Apex Court has clearly held that only when the income is diverted at source, it can be deducted and the same reads as follows:

?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.?

In view of the above, we are of the firm view that when the income by way of profit, as in the present case, is received and then reflected as part of the total income, deduction is not permissible. Therefore, the authorities below were justified in disallowing the deduction claimed by the assessee for the amount transferred to reserve fund in



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compliance with the mandatory provisions of the RBI Act, which do not call for any interference by this court. Accordingly, the main issue stands answered against the assessees.

5.14. As regards the consequential issue raised by the assessees, it is to be noted that the assessing officer added the fund transferred to the statutory reserve to the total income of the assessees, while computing the taxable income under section 115JB, which was also affirmed by the appellate authorities. For better appreciation, the finding recorded by the Tribunal in the case of Shriram Transport Finance Company Limited relating to the AY 2012-13, is reproduced below:

"For the purpose of section 115 JB of the Act, the book profit has to be computed as per the provisions of the companies Act and further addition or deduction has to be made as provided under Explanation to section 115JB of the Act. It is not the case of the assessee that the amount transferred to statutory reserve is an item to be reduced from the book profit computed as per the provisions of companies Act. In the absence of any provision in Explanation to section 115JB of the Act to reduce the amount transferred to statutory reserve as per the guidelines of Reserve Bank of India, this Tribunal is of the considered opinion that the CIT(Appeals) has rightly confirmed the order of the Assessing Officer by placing his reliance on the order of this Tribunal in the assessee's own case for the assessment year 2009-10. Therefore, this Tribunal do not find any reason to interfere with the order of the lower authority and accordingly the same is confirmed."

5.15. Section 115JB states that for computing the book profit, the amount meeting out the liabilities other than ascertained liabilities, has to be added. The statutory reserve fund based on the RBI guidelines, is not based on any ascertained liabilities and hence, it has to be added for arriving at the book profit under section 115 JB. At this juncture, it would be relevant to refer to the decision of the Delhi High Court in SREI Infrastructure Finance Ltd v. Additional Commissioner of Income Tax, wherein, an identical



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question of law as raised herein i.e., whether the reserve created under section 45 IC of the RBI Act will have to be included while computing book profits u/s 115 JB of the Act, was considered and it was observed as follows:

"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.?"

Further, the Delhi High Court did not agree with the applicability of cases concerning Molasses Storage



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Fund and observed that reserve under section 45 IC is created out of profits earned and it cannot be said to be the diversion of income at source. Ultimately, it was held as follows:

"?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 utilise 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.?"

5.16. In the light of the aforesaid decision of the Delhi High Court, wherein, it was clearly stated that the reserve is the amount of profit which is retained for use in business, when difficulty arises and on the basis of our earlier findings and from the very language of section 45 IC, this court comes to



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a conclusion that the amount transferred by the assessee herein, to the statutory reserve as mandated under the provisions of the RBI Act, is not an allowable deduction in computing the assessable income under the provisions of the Act under the regular computation and computation of book profits under section 115JB, as the case may be and therefore, the orders of the authorities below, do not call for any interference. Accordingly, the consequential issue is also decided against the assessee."

3. Hence the substantial question of law are answered against the appellant and in favour of the Revenue.

4. This Tax Case Appeal is dismissed. No costs.

[A.S.M., J] [G.A.M., J]
04.11.2024

Index:Yes/No
Neutral Citation:Yes
ssm

To

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