CIVIL MISCELLANEOUS

Before G. D. Khosla, C.J., and A. N. Grover, J.

THE COMMISSIONER OF INCOME-TAX,—*Petitioner.*

versus

M/S BHARAT INSURANCE CO., LTD., NEW DELHI,— *Respondent.*

Incom-tax Civil Reference No. 6 D of 1957

1960

March. 2nd

Indian Income-tax Act (XI of 1922)—Proviso to Rule 3(b) of the Schedule—Meaning and scope of—Power of Income-tax Officer to correct the valuation of the securities—Extent of—Consultation of the Controller of Insurance—When necessary.

Held, that the proviso to Rule 3(b) of the Schedule to the Indian Income-tax Act, 1922 means that if there is a depreciation in the securities, such depreciation becomes a permissible deduction and if there is any appreciation, the resulting increase must be added to the surplus from which the taxable amount is to be calculated. It may, however, happen that owing to a set of circumstances the amount in the reserve fund and the liability, which it is intended to meet, show an appreciable disparity. The reserve fund may be greatly in excess of the liability in respect of the outstanding policies or it may fall considerably below it. In both these cases the Income-tax Officer is allowed to make the necessary adjustment after consulting the Controller of Insurance.

Held, that the proviso to Rule 3(b) does not apply to a case where the Income-tax officer has to see whether the securities have been correctly valued or not. He must satisfy himself without any reference to the Controller of Insurance that the securities which are being transferred to the reserve fund are no more than necessary to meet depreciation or loss that has actually occurred or has actually been suffered, and to determine this he must have the correct valuation of the securities. The intention of the proviso is that where a difficult and complicated matter relating to the correctness of the calculations is concerned, the Income-tax Officer should have the advice of the

Controller of Insurance before he makes any changes on the basis of his own knowledge. The Income-tax Officer, however, has not been deprived of the authority of correcting erroneous or fradulent valuation and the proviso is not intended to cover those cases where an assessee, in order to evade income-tax, overvalues his securities while transferring them to the reserve fund or undervalues the securities which are already in the reserve fund in order to show a depreciation in the quantum of the reserve fund. The Controller of Insurance is to be consulted only in those cases where accepting the valuation of the securities as correct the Income-tax Officer finds an inconsistency between the amount of the reserve fund and the amount of the liability in respect of the outstanding policies. The Income-tax Officer is not obliged to consult the Controller of Insurance before he corrects the valuation of the securities which he has full jurisdiction to do.

Reference under Section 66(1) of the Indian Income Tax Act, 1922(XI of 1952) by the Income Tax Appellate Tribunal to state the case and refer it on the following question of law :—

> *"Whether upon the facts found by the Tribunal, the Income-tax Officer had in this case jurisdiction to proceed to make adjustments in terms of rule 3(b) of the Schedule to the Indian Income-tax Act ?"*

SHRI HARDYAL HARDEY AND MR. D. K. KAPUR, ADVOCATES for the Petitioner.

SHRI T. P. S. CHAWLA, ADVOCATE, for the Respondent.

JUDGMENT.

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G. D. KHOSLA, C. J.,—In Civil Reference No. 6-D/ of 1957 the following question of law has been referred to us by the Income-tax Appellate Tribunal for our opinion under section 66(1) of the Indian Income-tax Act:—

> "Whether upon the facts found by the Tribunal, the Income-tax Officer had in

this case jurisdiction to proceed to make adjustments in terms of rule 3(b) of the Schedule to the Indian Income-tax Act?"

The question as originally framed by the Commissioner of Income-tax was in the following terms:—

"Whether the proviso to rule 3(b), Schedule to Indian-tax Act, 1922, was applicable and whether the Income-tax Officer was bound to consult the Controller of Insurance in this case where no question arose about the rate of interest or other factors employed in determining the liability in respect of outstanding policies?"

The Tribunal took the view that the question as redrafted and actually referred for our opinion was comprehensive enough to cover the points arising in the case and, therefore, it was unnecessary to adopt the phraseology proposed by the Commissioner of Income-tax. The Commissioner of Income-tax has made a fresh application to us (Income-tax case No. 8-D/1957) in which the prayer is that the Income-tax Appellate Tribunal be directed to refer the question as originally drafted by him instead of the question actually referred. It will be presently seen that there is no difference in substance in the two questions and that the points raised before us can be disposed of by a consideration of the question actually referred.

The circumstances in which the matter arose are as follows: The assessee is the Bharat Insurance Company, Limited, doing insurance business. The years of assessment are 1952-53, 1953-54 and

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1954-55. The Income-tax Officer had to assess the gains of this Company in accordance with the provisions of the Schedule as directed by section 10(7) of the Indian Income-tax Act. Section 10(7) is in the following terms :—

> "Notwithstanding anything to the contrary contained in sections 8, 9, 10, 12 or 18, the profits and gains of any business of insurance and the tax payable thereon shall be computed in accordance with the rules contained in the Schedule to this Act".

The Schedule lays down a detailed procedure for computing the taxable profits and gains of life insurance business. The Income-tax Officer, in calculating the profits disallowed a sum of Rs. 1,75,000 out of a total sum of Rs. 18,75,000 which had been transferred by the Company to the transfer reserve fund. This amount (Rs. 1,75,000) represented the amount by which certain securities held by the Insurance Company had been undervalued and a sum of Rs. 30,420 representing the actual balance to the credit of the investment reserve fund on 31st December, 1951, which is the relevant date for making the computation. The Insurance Company had valued these securities at Rs. 18,75,000 and in the opinion of the Income-tax Officer the securities had been undervalued.

In order to understand the nature of the dispute in this case it is necessary to state briefly the manner in which the profits and gains of an insurance company are calculated. The income of the insurance company consists of the premiums received and the interest on its investment. The liabilities consist of the management expenses and the amount paid out to the policy-holders on

account of the policies which mature. In the Schedule two methods for computing profits are set out. Under rule 2(a) of the Schedule the management expenses are deducted from the gross external incomings and the resulting figure represents the profits and gains. The other method is a little more complicated and is based on the annual average of the surplus which is arrived at in the manner set out under rule 2(b). The figure which is the larger of the two figures obtained by the two methods is to be considered the taxable profit. In the present case both methods were adopted by the Income-tax Officer, and since the first method gave a deficit, he adopted the figure given by the second method. In view of the peculiar nature of insurance business the Legislature has provided certain safeguards of the policyholders' interests. One of these is the obligation to maintain a reserve fund. Assets in the form of securities and cash are transferred from time to time to this fund. The quantum of this fund must be sufficient to meet the liability of the company in respect of outstanding policies. As the value of securities varies with the variation in market prices, the quantum of this reserve fund may increase or decrease. If the value falls below the amount required to meet the liabilities in respect of the outstanding policies, it must be made good by further transfers. If, on the other hand, the securities appreciate or for some other reason the amount exceeds the actual liabilities, a corresponding adjustment has to be made. The amounts which are transferred *bona fide* and legitimately to the reserve fund in order to maintain it at the requisite figure, are permissible deductions from the total gains for the purposes of income-tax. If larger amounts are transferred, no deduction would be permissible. According to the Income-tax Officer, what happened in this case was that a

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sum of Rs. 18,75,000 was required to be transferred to the reserve fund. The assessee transferred securities of which he showed the value at the figure of Rs. 18,75,000. In fact, the value of these securities was considerably more and, therefore, the excess could not be treated as a permissible deduction. Also a sum of Rs. 30,420 was part of a larger sum of Rs. 22,64,733 which represented the depreciation as worked out by the assessee-Company. In point of fact, the actual depreciation was less by Rs. 30,420. Therefore this amount could not be treated as a permissible deduction.

The Income-tax Officer accordingly disallowed a sum of Rs. 1,75,000 from the deductions claimed by the assessee. The assessee appealed to the Appellate Assistant Commissioner of Income-tax and this authority reduced the amount to Rs. 1,45,000. The assessee took a further appeal to the Appellate Tribunal and at the same time the Income-tax Officer appealed against the deduction of Rs. 30,000 by the Appellate Assistant Commissioner. The Tribunal took the view that since the Income-tax Officer had not consulted the Controller of Insurance before disallowing this item, he had acted without jurisdiction. The appeal of the assessee was accordingly allowed *in toto* and the appeal of the Income-tax Officer was dismissed. On this the Commissioner of Income-tax made an application under section 66 of the Income-tax Act for referring the above-mentioned question of law to this Court.

Before dealing with the question it is necessary to state briefly the reasons given by the Income-tax Officer for holding that the securities had been under-valued. The first item which the Income-tax Officer dealt with was Government securities. There was firstly 3 per cent loan of

1946-86. The market rate according to the official quotation of the Calcutta Exchange was Rs. 100, whereas the assessee had taken the Bombay rate of Rs. 99-15-0. Similarly, in the case of the 2½ per cent loan of 1955 the official Calcutta Exchange quotation was Rs. 98-5-0 and the rate mentioned by the assessee was Rs. 98. Lastly, the 1957 loan was shown at Rs. 97-13-0, whereas the Calcutta official quotation was Rs. 98. The Income-tax Officer's view was that the official figures given by the Calcutta Exchange should be adopted, and on this basis he found that there had been undervaluation of Government securities to the extent of Rs. 27,416. The Appellate Assistant Commissioner thought that the differences were much too small and that the assessee's figures should have been accepted. The Income-tax Officer apparently acted on the assumption that these securities had not been sold and there was no reason why the official quotation of the Calcutta Exchange should not form the basis of calculating the value of these securities. The second item was Preference Shares. The Bharat Fire and General shares were valued by the assessee at Rs. 60, but th Income-tax Officer valued them at Rs. 65. This figure was adopted by the Income-tax Officer on the basis of a letter which had been produced by the assessee himself and according to this letter actual transfers of the shares of the Bharat Fire and General Insurance Company had been effected at Rs. 65. The other preference shares were of Dalmia Dadri Cement. These were valued by the assessee at Rs. 60, whereas the Income-tax Officer, on the basis of some transactions during the relevant period, adopted the figure Rs. 70. He observed in his order that the Dalmia Dadri Cement shares gave a dividend of 6 per cent free of income-tax and another Dalmia concern giving a dividend of 6 per cent less tax had

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been assessed at cost price by the assessee, and since the Dalmia Dadri Cement gave a much better return, the price of their shares must be higher than the price of Dalmia Jain Aviation shares. The last item was Ordinary Shares. The Bank of Bihar fully paid-up shares were valued by the assessee at Rs. 150 and this figure was accepted by the Income-tax Officer. The partly paid Bank of Bihar shares were valued by the assessee at Rs 60 and the Income-tax Officer thought that this was a gross understatement, because on each share of Rs. 100, Rs. 50 premium had been paid and so, although the shares were paid up only to the extent of Rs. 50 per cent, a sum of Rs. 100 had actually been spent on acquiring these shares (Rs. 50 part price of the shares and Rs. 50 premium). In view of this circumstance the Income-tax Officer valued the shares at Rs. 100. To these items he added the sum of Rs. 30,420 already mentioned above. The total thus came to Rs. 1,89,185 which represented the excess in the permissible deduction. He, however, disallowed only a sum of Rs. 1,75,000.

Therefore, it will be seen that in arriving at his conclusions all that the Income-tax Officer did was to value the securities at what he considered their proper price. In his opinion the securities had been undervalued with the object of transfering a larger amount to the reserve fund than was actually necessary and than was actually shown in the books. He was, therefore, justified in reducing the amount and including the reduction in the taxable income.

The case of the assessee, however, is that this reassessment and the consequent reduction could not have been made without consulting the Controller as provided in the proviso to rule 3(b). It

is necessary to examine carefully the wording of rule 3(b) and the proviso to it, which read—

"3(b) any amount either written off or reserved in the accounts or through the actuarial valuation balance sheet to meet depreciation of or loss on the realisation of securities or other assets shall be allowed as a deduction, and any sums taken credit for in the accounts or actuarial valuation balance sheet on account of appreciation of or gains on the realization of the securities or other assets shall be included in the surplus:

Provided that if upon investigation it appears to the Income-tax Officer after consultation with the Controller of Insurance that having due regard to the necessity for making reasonable provision for bonuses to participating policyholders and for contingencies, the rate of interest or other factor employed in determining the liability in respect of outstanding policies is materially inconsistent with the valuation of the securities and other assets so as artificially to reduce the surplus, such adjustment shall be made to the allowance for depreciation of, or to the amount to be included in the surplus in respect of appreciation of, such securities and other assets, as shall increase the surplus for the purpose of these rules to a figure which is fair and just;"

We are here dealing with a case both of depreciation and appreciation. The depreciation is of the sum of Rs. 30,420 and the appreciation is alleged to be in respect of the securities of which details

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have been given above. What the above provision means is this. If there is a depreciation in the securities, such depreciation becomes a permissible deduction. If there is any appreciation, the resulting increase must be added to the surplus from which the taxable amount is to be calculated. It may, however, happen that owing to a set of circumstances the amount in the reserve fund and the liability, which it is intended to meet, show an appreciable disparity. The reserve fund may be greatly in excess of the liability in respect of the outstanding policies or it may fall considerably below it. In both these cases the Income-tax Officer is allowed to make the necessary adjustment after consulting the Controller of Insurance. The adjustment must be made after paying "due regard to the necessity for making reasonable provision for bonuses to participating policy-holders and for contingencies." The existence of the disparity can be determined by seeing whether "the rate of interest or other factor employed in determining the liability in respect of outstanding policies is materially inconsistent with the valuation of the securities and other assets." It may be that by employing a wrong rate of interest or other factors on the basis of which the liability in respect of outstanding policies is calculated, this liability is shown to be considerably less or considerably more than the correct amount. The computation of the insurance company's liability, in respect of outstanding policies is a technical matter and depends, as I have mentioned above, on the rate of interest and other factors. This is a matter for a specialist and these calculations are usually made by actuaries in the employ of insurance companies. The Controller of Insurance is able to check the correctness of these calculations and the intention of the proviso is that where a difficult and complicated matter of this

kind is concerned, the Income-tax Officer should have the advice of the Controller of Insurance before he makes any changes on the basis of his own knowledge. The valuation of securities is not a difficult matter and the valuation mentioned in rule 3(b) and its proviso is obviously the correct valuation, because the statute really does not assume that an erroneous or a fraudulent valuation cannot be set right without the advice of the Controller of Insurance. The valuation of securities can be done even by a layman on the basis of market quotations. The Income-tax Officer has not been deprived of the authority of correcting errors of this kind and the proviso is not, in my view, intended to cover those cases where an assessee, in order to evade income-tax, overvalues his securities while transferring them to the reserve fund or undervalues the securities which are already in the reserve fund in order to show a depreciation in the quantum of the reserve fund. The adjustment made by the Income-tax Officer in the case before us was not the sort of adjustment contemplated by the proviso. All that the Income-tax Officer did was to fix of the amount of permissible deduction at the figure permitted by rule 3(b). In calculating the quantum of the deduction he took as his basis the correct valuation of the securities. The Income-tax Officer was perfectly justified in holding that a certain asset had ben undervalued. In fixing the correct value of this asset he was not making the sort of adjustment which is contemplated by the proviso to rule 3(b) because it is quite clear that rule 3(b) assumes that the securities and assets have been correctly valued. It is only the disparity between the correctly valued assets and the liability in respect of outstanding policies that requires previous consultation with the Controller of Insurance. That clearly is not the case in the matter before us.

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Mr. Hardy, who appeared on behalf of the Income-tax Department, relied upon certain observations made by Beaumont, C. J., in *Western India Life Insurance Co. Ltd., In re.*, (1). In this case there was a reduction in the valuation of securities in the reserve fund in the years 1930 and 1931. To cover this depreciation, the company transferred sums of money to the reserve fund and claimed that the sums so transferred were permissible deductions. It so happened that in the year 1932 there was considerable appreciation in the securities and this appreciation wiped out the losses of the two previous years, the net result being a small appreciation in the three years taken as a whole. The Income-tax Officer objected to the deductions being made in respect of the years 1930 and 1931 on the ground that these deductions were not necessary in view of the subsequent appreciation in the year 1932. The Bombay High Court held that the appreciation of 1932 could not disentitle the assessee from claiming deductions in respect of the years during which a loss had been sustained by the depreciation of securities in the reserve fund. Beaumont, C. J., remarked—

> "These sums having been properly placed to the special reserve fund in the first two years of the triennial period. I can find nothing in the rules which require that they be brought back into the revenue account as soon as the depreciation which they were designed to meet has been made good".

The learned Judge went on to say—

> "But it is to be noticed that sums placed to the special reserve fund must be in

(1) (1938) 6 I.T.R. 44.

respect of depreciation or loss, which, in my view, means depreciation or loss which has actually occurred, and that reserve fund can be used for no other purpose."

In that case the Controller of Insurance does not appear to have been consulted, clearly because it was not a case which can fall within the purview of the proviso to rule 3(b). The rule then in force was rule 30. The point that emerges from this case, however, is that the transfer to the reserve fund must be in respect of actual depreciation or loss and the assessee cannot take an imaginary or notional figure by overestimating the securities which he is transferring or by underestimating the securities already in the reserve fund. Another case relied upon by Mr. Hardy is *Commissioner of Income-tax* v. *Indian Life Insurance Co., Ltd* (1). This was also a case in which the securities were alleged to have depreciated. The principle affirmed by Beaumont, C. J. was reiterated in this case, and Davis, C. J. of the Sind Chief Court observed—

> * * what is properly to be carried to the reserve fund for the purpose of rule 30 is not any amount that the directors in their discretion think necessary to safeguard the future position of the company, or to meet future contingencies, but only such amounts as are necessary to meet depreciation or loss that has actually occurred or has actually been suffered.
>
> * * It is not, therefore, open to the assessee company to write off amounts

(1) (1946) 14 I.T.R. 347.

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larger than those actually lost by depreciation of securities. It is true that under new rule 2, sub-rule (3), the Income-tax Officer after consultation with the Superintendent of Insurance has been given discretion to control to some extent amounts which can be regarded as fair provision for meeting contingencies and should be free from income-tax, but this does not, in my opinion, affect the answer to the question now before us."

It is, therefore, clear that the proviso does not apply to a case where the Income-tax Officer has to see whether the securities have been correctly valued or not. He must satisfy himself without any reference to the Controller of Insurance that the securities which are being transferred to the reserve fund are no more than necessary to meet depreciation or loss that has actually occurred or has actually been suffered, and to determine this he must have the correct valuation of the securities. *The Bombay Mutual Life Asurance Society Ltd.* v. *Commissioner of Income-tax*, (1) was another case in which the question of appreciation in the value of securities was considered. In that case the appreciation was not shown in the revenue account nor in the surplus; it was, however, shown in the balance-sheet of the company. The Court held that the appreciation should be added to the surplus, because it was shown in the accounts as contemplated by rule 3(b). Mr. Chawla, who appeared on behalf of the assessee, submitted that this case was an authority for the proposition that the figures as given in the assessee's accounts must be accepted without demur. The ruling, however, does not lay down

(1) (1951) 20 I.T.R. 189.

any such proposition. The question of the valuation of securities was not before the Court. The amount of appreciation was correctly computed and all that the Court held was that such appreciation must be added to the surplus. If the Income-tax Officer is entitled to add the appreciation to the surplus account without consulting the Controller, he can also determine the quantum of this appreciation. In this case the Insurance Controller was clearly not consulted, because the judgment does not contain any reference to the proviso to rule 3(b). No ruling in which the question of consultation of the Controller was considered was cited before us and it appears to me that the Controller is to be consulted only in those cases where accepting the valuation of the securities as correct the Income-tax Officer finds an inconsistency between the amount of the reserve fund and the amount of the liability in respect of the outstanding policies. This disparity may be due to the fact that the rate of interest and the other factors employed in calculating the liability were erroneous; it will not arise because of incorrect or fraudulent valuation of the securities, because in the latter case the valuation can be corrected without any reference to the Controller. In the present case what happened was that the assessee withdrew a sum of money from the available surplus and transferred it to the reserve fund. He undervalued the amount so transferred in order to show that the quantum of the reserve fund was entirely consistent with the liability in respect of outstanding policies. There is no allegation that the liability is incorrectly computed and the Income-tax Officer has not sought to alter this item nor is it the case of the assessee that the liability should be at a higher figure. The matter in dispute relates only to the quantum of the reserve fund and the dispute is confined to its

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valuation. It is not denied that if the securities are to be valued at the figure stated by the Income-tax Officer, then a sum of Rs. 1,89,185 must be reduced from the permissible deductions.

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I would, therefore, find that the Income-tax Officer was not obliged to consult the Controller of Insurance before he corrected the valuation of the the securities and that he had full jurisdiction to deal with the matter in the manner employed by him. The question referred to us, therefore, must be answered in the affirmative.

In the result, the petition (Income-tax Case No. 8-D of 1957) is dismissed and the question referred to us by the Tribunal is answered in the affirmative. The assessee will pay costs of these proceedings which we assess at Rs. 200.

A. N. GROVER, J.— I agree.

K.S.K.

APPELLATE CIVIL

Before Daya Krishan Mahajan, J.

GURBAKSH SINGH,—*Appellant.*
versus

DR. DAYAL CHAND,—*Respondent.*

Regular Second Appeal No. 1403 of 1959.

1960

March 14th

Displaced Persons (Debts Adjustment) Act (LXX of 1951)—Sections 5, 16, 28 and 32—Debt secured by mortgage of property in Pakistan—Displaced creditor electing to retain the security in proceedings under section 5 before the Tribunal—Tribunal after scaling down the debt declaring the amount due to the creditor and making it a first charge on property allotted to the displaced debtor in India in lieu of mortgaged property left in Pakistan—Suit to enforce the charge—Whether competent.

Held, that under section 16 of the Displaced Persons (Debts Adjustment) Act, 1951 the option is given to the