

## Annexure 'C'

**Issue 3:** *SEZ Reinvestment Reserve has to be utilised for the purchase of plant and machinery within 3 years following the previous year in which the reserve is created. Does it mean that a Reserve can be created and utilised within the same year?*

To explain this better, can a reserve be created on 1 April 2016 and utilised by 31 December 2016? Would such a utilisation satisfy the conditions?

### **Creation of reserve**

“Reserve” means a part of company’s undistributed capital (excluding share capital) resulting from retained profits<sup>1</sup>. Based on the said definition, it could be noted that a reserve is created by setting aside a portion of profit earned by an entity. Further, if the reserve is created for a specific purpose, as in the instant case being a “Special Economic Zone Reinvestment Reserve”, a portion of profit is set aside for a specific purpose. As may be seen, the pre-requirement for creating a reserve is the existence of profits. An entity meaning that it is a retained profit used for additional or repeated investment.

The Act provides for creation and utilisation of SEZ Reinvestment Reserve within a period of three years from the end of the previous year in which the reserve was created. The Act uses the phrase

“(1).....

(ii) *for the next five consecutive assessment years, so much of the amount not exceeding fifty per cent of the profit **as is debited to the profit and loss account of the previous year** in respect of which the deduction is to be allowed and **credited to a reserve account (to be called the "Special Economic Zone Re-investment Reserve Account") to be created and utilized for the purposes of the business of the assessee** in the manner laid down in sub-section (2).*

(2) *The deduction under clause (ii) of sub-section (1) shall be allowed only if the following conditions are fulfilled, namely :—*

(a) ***the amount credited to the Special Economic Zone Re-investment Reserve Account is to be utilised— .....***”

The Act is silent in respect of the time of creation of the SEZ Reinvestment Reserve. The aforementioned provision uses phrase “*as is debited to profit and loss account of the previous year*”. The Act prescribes that the reserve is required to be created by way of a debit to profit and loss account and credit to reserve account.

Thus, on a plain reading it appears that precondition to creation of reserve is as below:

- a. The company has earned *profits during* the year which are *excess of credits over debits* in the profit and loss account.
- b. The profits are transferred to a reserve account by way of debit to profit and loss account and credit to reserve account.

Further, the phrase used in sub-clause (ii) of Section 10AA(1) is “*profit and loss account of the previous year*” and **not** “*profit and loss account for the previous year*”. This would clarify that the intention of section is to consider all the debits to the profit and loss account made **during the previous year** and **not at the end of the previous year**.

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<sup>1</sup> Law Lexicon 4095

However, it may be noted that the company may initially earn profits and may suffer losses subsequently during the previous year. Thus, it cannot be said that the company would be in a profitable position during the previous year due to a combination of profit and losses position during the previous year.

Assuming a scenario where the company has earned profits during the first few months of the previous year which has been used for creation of reserve, if the company subsequently suffer losses, the profits are first required to be used for recovering such losses and cannot be used for creation of reserve. Where the reserve has already been created, the profits held as reserve should be discharged back to profit and loss account, first for recovery of losses incurred.

In such an instance, the net profit available at the disposal of the company for the purpose of creation of reserve can be ascertained only at the end of the previous year. Thereby, the reserve could be created only at the end of the previous year post ascertaining the net profitability position of the company and ensuring that the company has sufficient profits for creation of reserve. This has also been supported by Supreme Court in case of E.D. Sassoon (26 ITR 27) where it was held that it would be absurd to view profits of a company as accruing from day to day or even from month to month, after referring to Fletcher Moulton's classic definition of "profits" in re: Spanish Prospecting Co. Ltd's case (1911) 1 Ch. 92 that profits can be ascertained only on a comparison of the net assets of a company at two different dates usually separated by a year and can be ascertained only on a comparison of the assets at two different dates. These decisions were applied by the Supreme Court in CIT vs Ashokbhai Chimanbai (1965) (56 ITR 42) (SC) where it was specifically recognised that that the working of the company may show a profit in a month and a loss in another month and therefore it would be reasonable to ascertain the working results at two dates separated usually by one year or a period of 12 months. A reserve, as accounting parlance and practice goes, is an appropriation of profits and such profits have to be ascertained only at the end of the year and for the concern as a whole.

Thereby, it could also be concluded that the reserve cannot be created during the year unless the company does not estimate incurring of losses and will not incur losses during the year.

### **Utilisation of Reserve**

A 'reserve' on the liability side of the Balance Sheet is represented by funds of the company on the asset side of the Balance Sheet. The utilisation of a reserve implies use of funds in connection with the purpose for which the same was created.

An utilisation of 'SEZ Reinvestment Reserve Account' is accounted by way of a debit to the reserve account and credit to the general reserve account. SEZ Reinvestment Reserve may be utilised as below as provided under section 10AA(2):

*"(a) the amount credited to the Special Economic Zone Re-investment Reserve Account is to be utilised—*

- (i) for the purposes of acquiring machinery or plant which is first put to use before the expiry of a period of three years following the previous year in which the reserve was created; and*
- (ii) until the acquisition of the machinery or plant as aforesaid, for the purposes of the business of the undertaking other than for distribution by way of dividends or profits or for remittance outside India as profits or for the creation of any asset outside India;"*

Based on the above provisions, the following are the conditions in relation to utilisation of reserve account:

- a. It should be utilised for acquiring machinery and plant;
- b. Such machinery and plant is first put to use before the expiry of three years. The said period of

- three year is counted from the end of the previous year in which the reserve was created.
- c. During the interim period, the funds may be used for the purposes of the business of the undertaking subject to restrictions laid down under clause (ii) as mentioned above.

The funds represented by the reserve are required to be utilised for the purpose mandated under section 10AA(2). It is a well settled proposition of general accounting principles and law that a reserve cannot be utilised before its creation<sup>2</sup>. A converse to the same would be that a reserve can be utilised subsequent to its creation.

As can be seen from the above, a restriction is placed by Section 10AA only on the last date by which the reserve is required to be utilised which is three years from the end of previous year in which the reserve was created. However, no restriction is placed on time of usage of reserve for acquisition of plant and machinery.

### **Report on creation and utilisation of SEZ Reinvestment reserve**

Section 10AA(2)(b) read with Form 56FF further specifies that the assessee is required to furnish particulars in prescribed form in connection with utilisation of reinvestment reserve for purchase of Plant and Machinery.

As required by Form 56FF, the following information is required to be provided in connection with creation and utilisation of Reserve:

#### **“A. Details of utilisation of Special Economic Zone Reinvestment Allowance Reserve**

I	<p><i>Amounts of eligible profits debited to the profit and loss account and credited to the Special Economic Zone Reinvestment Allowance Reserve Account</i></p> <p><b>(i) During the current previous year ending on _____</b></p> <p><i>(ii) During the previous year, immediately preceding the previous year mentioned at (i) ending on _____</i></p> <p><i>(iii) During the previous year, immediately preceding the previous year mentioned at (ii) ending on _____</i></p> <p><i>(iv) During the previous year, immediately preceding the previous year mentioned at (iii) ending on _____</i></p> <p><b>(v) Total (i) + (ii) + (iii) + (iv)</b></p>			
II	<p><i>Amounts withdrawn from the Special Economic Zone Reinvestment Allowance Reserve Account</i></p> <p><b>(i) During the current previous year ending on _____</b></p> <p><i>(ii) During the previous year, immediately preceding the previous year mentioned at (i) ending on _____</i></p> <p><i>(iii) During the previous year, immediately preceding the previous year mentioned at (ii) ending on _____</i></p> <p><i>(iv) During the previous year, immediately preceding the previous year mentioned at (iii) ending on _____</i></p>	<table border="0"> <tr> <td data-bbox="1031 1563 1190 1960"><i>Used for for eligible purpose</i></td> <td data-bbox="1190 1563 1404 1960"><i>Not used eligible purpose</i></td> </tr> </table>	<i>Used for for eligible purpose</i>	<i>Not used eligible purpose</i>
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<sup>2</sup> Madras High Court in the Case of Poompuhar Shipping Corporation Ltd. V JCIT [2006] 287 ITR 83 (Mad.)

	(v) Total amounts withdrawn [(i) + (ii) + (iii) + (iv)]	
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As provided above, Form 56FF make provision for disclosing the quantum of creation of reserve during the previous and utilisation of such reserve during the previous year. Thus, the timing of creation and utilisation of reserve can be in the same previous year. However, it may be argued that the term “*during the current previous year ending on \_\_\_\_*” as used in clause II above is in connection with the reserve already created during any of the previous years and utilised during the immediate previous year.

While the Form is conclusive to interpreting the position of law, we could draw guidance since this is in line with the intention of the Act.