K. M. S. Reddy, Commissioner of Income-Tax, Kerala (Coimbatore), Ernakulam

Vs

The West Coast Chemicals and Industries Ltd. (in Liquidation), Alleppy

Civil Appeal No. 286 of 1961

(S. K. Das, M. Hidayatullah, J. C. Shah JJ)

20.03.1962

JUDGMENT

HIDAYATULLAH, J. -

In this appeal by the Commissioner of Income-tax, Kerala, filed with certificate of the High Court of Kerala, an important question of law was raised before the High Court, which was answered against the Department. It arose in the following circumstances. The respondent, the West Coast Chemicals and Industries, Ltd. (referred to as the assessee Company) was incorporated in 1937 primarily with the object of acquiring and working the rights, title and interest in a match factory belonging to one A. V. Thomas at Mudical. The Memorandum of Association of the assessee Company, however, empowered the Company to manufacture and deal in acids, alkalis and other chemicals. The assessee Company carried on its business of manufacturing matches till the account year ending on April 30, 1941. Thereafter, the profits from the business became less and less due to War conditions, and the assessee Company began to manufacture plywood chests for tea, paints and lemongrass oil. These were contemplated by cl. (3) of the Memorandum of Association.

On May 9, 1943, the assessee Company entered into an agreement with one Rao Sahib Natesa Iyer for the sale of the lands, buildings, plant and machinery of its match factory for Rs. 5,75,000. It was agreed that the price would not include manufactured goods, chemicals and other raw materials or any other asset not shown in the agreement of sale. The purchaser was allowed sixty days for the payment of the balance of the price, Rs. 57,500 having been already paid at the time the agreement was entered into. The purchaser made a default in payment, and on August 9, 1943, a fresh agreement was entered into by the parties, this time for a consideration of Rs. 7,35,000, and the sale included chemicals and paper for manufacture which had not been sold in the first instance. In a confidential report made on August 1, 1944, to the shareholders, the Directors stated that the price obtained had shown a capital appreciation of about six times the cost price, and the sale of chemicals had also resulted in a substantial profit.

Meanwhile, the assessment of the Company for the account year ending April 30, 1944, had been completed by the Deputy Commission of Income-tax, and the assessee Company had been assessed on an income of Rs. 36,498-6-4. The Deputy Commissioner of Income-tax then issued a notice under s. 25 of the Travancore Income-tax Act to the Company's Liquidator on the ground that the profits from the sale of the chemicals and paper for manufacture had escaped assessment. The Official Liquidator took up the position that the match manufacturing had been stopped, and that business had been wound up, and there was thus only an appreciation of the capital assets and not a business profit, which was liable to assessment. The Deputy Commissioner, however, relying upon the Memorandum of Association, which allowed the assessee Company to manufacture and sell

chemicals, and on the Directors' report, held that the assessee Company was liable to income-tax on a profit of Rs. 2 lakhs arising from this sale. The Commissioner of Income-tax on appeal, however, reduced the assessable profits to Rs. 1,15,259. Before the Commissioner, the Liquidator admitted that the profit from the sale of the chemicals was Rs. 1,15,259.

An appeal was then filed before the Income-tax Appellate Tribunal at Trivandrum and the assessee Company contented that a stock-in-trade could only be that which was the subject of trade, and that the stock of raw materials was not sold in the course of ordinary trading but in a realisation sale after the Company had been wound up. The Tribunal found that the business had not completely ceased to exist, since the assessee Company was carrying on manufacturing on behalf of the purchaser, and the sale could not be regarded as a realisation sale after the Company was wound up, but had the characteristics of a trading sale. At the request of the assessee Company, however, the Tribunal referred two questions to the High Court for its decision, and they were :

> "(1) whether the transaction of sale of the raw materials along with the business, including machinery, plant and premises is a revenue sale, and whether in the facts and circumstances of the case, the sum of Rs. 1,15,259 has been rightly charged to income-tax; and
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> (2) whether the decision that the sale of match, machinery and premises, was distinct from the sale of chemicals is legally warranted and whether there was legally a single transaction of the entire match factory inclusive of raw materials ?"

It may be pointed out that prior to the sale of chemicals to the purchaser, the only evidence of sale of chemicals by the assessee Company was of two transactions. In the first transaction, there was a sale of chemicals on July 24, 1943, to an educational institution for Rs. 50 and another sale on October 30, 1943, to a stranger for Rs. 7-12-0. The High Court held that by the sale no business was done, and that the amount obtained was only by way of realisation sale, and was not, therefore, liable to tax.

The argument of the Department (also raised before the High Court) proceeds in this way. The Department refers to the Memorandum of Association under which the assessee Company was to carry on the business of manufacturing and selling chemicals, that in the past it had sold chemicals, that in the first sale of its assets in had excluded chemicals and some other raw materials necessary for the manufacture of matches and had sold the concern for a lesser price, that later it included chemicals and raw materials and obtained a larger price, and that admittedly there was an identifiable profit of Rs. 1,15,259 on the sale of the chemicals and raw materials. The Department, therefore, contends that the amount of Rs. 1,15,259 was property brought to tax as a trading profit. The question, therefore, is whether there can be said to be a sale in the carrying on of the business in respect of the chemicals and other raw materials. This question is not one easy to decide, specially with the assistance of rulings, in which the facts were different. There is a great danger of extracting a principle from the reported cases, divorced from the facts. In Halsbury's Laws of England, 3rd Edn., Vol. 20, pp. 115-117, there is a list in the footnotes of the cases which have been decided on one side or the other of the dividing line. In the text, the law, as summarised from the cases, is stated as follows :-

> "210. Mere realisation of assets is not trading; but the completion of outstanding contracts after the dissolution of a firm, the commencement of liquidation of a company, or the winding up of the affairs of a trader, has been held to be trading......

> 211... The cases illustrating the question arising in such circumstances can be divided into two categories, first, those where the sales formed part of trading activities, and, second, those where the realisation was not an act of trading".

This distinction, in our opinion, is a sound one. The only difficulty is in deciding whether a particular case belongs to one category or the other. In this, much support cannot be derived from observations made by learned Judges pertaining to the facts of a case, but they do guide one in a true appraisement of the case in hand.

In the well-known case of Californian Copper Syndicate v. Harris ((1904) 5 T.C. 159.), the difference between the purchase price and the value of the shares for which the property was exchanged was considered as profit assessable to income-tax. There, the company was formed for the purpose of acquiring and reselling mining properties, and though what it had acquired had all been sold or exchanged, the transaction was considered a business transaction falling within the avowed objects, of the Company. The case has been accepted as decided on these narrow facts, in Tebrau (Johore) Rubber Syndicate Ltd. v. Farmer ((1910) 5 T. C. 658.), in which a different conclusion was reached on slightly different facts. There also, the Company was formed with the object of aquiring rubber estates and for developing them. Under the Memorandum, the Company had the power to sell its properties. Two properties having been acquired and the funds having run out, they were sold but at a profit. This profit was considered as an appreciation of capital and not as assessable profit. The difference between these two cases is that whereas in the former, though the whole of the property was sold, it was sold as a part of trading, in the letter, the property was sold not as part of trading but on a winding up sale.

The Department relies upon Californian Copper Syndicate v. Harris ((1904) 5 T.C. 159.), while the assessee Company relies upon Tebrau (Johore) Rubber Syndicate Ltd. v. Farmer ((1910) 5 T.C. 658.). These cases were also considered and applied by the Privy Council in Doughty v. Commissioner of Taxes ((1927) A.C. 327.), which is relied upon by both sides, in view of certain observations of the Privy Council, to which we shall presently refer. In that case, there were two partners carrying on business in New Zealand as general merchants. They sold the partnership to a limited company, of which they were the only shareholders. The sale was of the entire assets including the goodwill, and the price was payable in the shape of fully paid shares in the new company. The nominal value of the shares was more than the capital account as shown in the last balance sheet, and the partners prepared a new balance sheet in which a larger value was placed upon the stock-in-trade. The Income-tax authorities in New Zealand treated the difference between the value placed on the stock-in-trade in the old balance sheet and that placed in the new balance sheet as a profit liable to tax. The Privy Council held that this was wrong, pointing out that for profit to arise, there must be a trading, and that a mere alteration of a book-keeping entry was not evidence that there was profit. It also held that the sale was of the entire assets, and that the price represented a payment for the entire business without a separate sale or valuation of this stock-in-trade for purposes of sale. It referred to two cases decided respectively by the Supreme Court of New Zealand and the High Court of Australia, in which sales by pastoralists of their flock of sheep had taken place. In the New Zealand case, the excess obtained over the book value was treated as assessable profit, but in the Australian case, it was not. Both the sales were of the entire stock. The Privy Council approved of the Australian case, and though it did not expressly dissent from the New Zealand case, it indicated that it found it difficult to appreciate the decision. These two cases from New Zealand and Australia were, of course, relied upon by the rival parties before us, and we shall consider them.

The Australian case is Commissioner of Taxation (W.A.) v. Newman ((1921) 29 C.L.R. 484.). A person who carried on business in Western Australia as a pastoralist sold his property including all live-stock and plant, as a going concern. The Commissioner of Taxation for the State apportioned the purchase money in respect of the live-stock, and assessed the amount which was received in excess, as income derived from carrying on a business. The High Court held that the transaction was not during the carrying on of the business or even for the purpose of carrying on the business, but was for the purpose of putting an end to the business, and that thus the excess represented a capital appreciation and not a trading profit.

The New Zealand case is Anson v. Commissioner of Taxes ((1922) N.Z.L.R. 330.). In that case also, a sheep farmer sold his entire stock of sheep. He had the practice of placing on his sheep at the beginning and end of each year an arbitrary value without reference to the actual market value. When he sold his entire stock, a nominal profit of pound 5,000 odd appeared, and he was assessed on it. The Supreme Court held that it was not an accretion to capital but a profit on the sale of the appellant's stock-in-trade. Sir John Salmond, who delivered the judgment of Court, observed that the holding of a sheep farmer was not a capital holding, but his sheep represented a stock-in-trade, and since every appreciation of a stock-in-trade represented a profit assessable to income-tax, it mattered not that the stock-in-trade was sold at once or from time to time. Of this case, the Privy Council in Doughty's case ((1927) A.C. 327.) did not say much, but enough to cast a doubt upon it. This is what the Privy Council said at p. 335.

> "It would be difficult to arrive at the profit in this way if it were the case of a farmer in England; but the trade of a pastoralist is one with which the New Zealand Courts would be familiar, and which it would be more easy for the New Zealand Judges than for their Lordships to appreciate."

The Privy Council made a distinction between a sale of the entire stock as a part of trading and a sale of the same stock as a winding up sale. It observed that if the business be one of purely buying and selling, "a profit made by the sale of the whole of the stock, if it stood by itself, might well be assessable to income-tax". It observed that in Doughty's case ((1927) A.C. 327.) the sale was a slump transaction, and was a winding up of the business rather than a trading. The Privy Council further pointed out that there is a difficulty in deciding cases of a business, which involve breeding of sheep for the purpose of selling wool. This is quite true, because the sheep may be regarded as the capital, with which the wool, which is sold, is produced, or the sheep with the wool on them may be regarded as the stock-in-trade. Such a question, fortunately, does not arise in the present case, which can be decided on the narrow ground whether the business was being wound up and the sale, a realisation sale, or whether trading was going on in spite of the winding up, so as to attract tax on profits made.

Before we answer this question in relation to the facts of this case, we wish to refer to a few more cases, which were cited before us. In J. & R. O'Kane & Co. v. The Commissioners of Inland Revenue ((1922) 12 T.C. 303.), the appellants carried on business as wine and spirit merchants. They then wished to retire from the business and sent a circular letter to their customers. During the year, they sold their whole stock to diverse customers, and the question was whether they were still carrying on their trade during that period, and whether the profits were thus made in the ordinary course of trade. It was held by the King's Bench Division of the High Court of Justice in Ireland that the sales were not in the ordinary course of trade but were part of the realisation of the trading stock and winding up of the business, and thus not liable to tax. The Court of Appeal in Ireland unanimously reversed the decision of the High Court. Ronan, L.J., pointed out that though the

taxpayer had retired from business and had decided not to purchase any more stock, he was still carrying on the business of trading in wines and spirits till his existing stocks were exhausted, and, therefore, the excess obtained by him represented profit. On appeal to the House of Lords, it was held that there was evidence on which the Commissioners could arrive at their finding that trading was, in fact, being carried on. Lord Buckmaster, speaking of the facts in that case, observed as follows :

> "For in truth it is quite plain that right up to the end of 1917 they were engaged in trading which, so far as the external world is concerned, was the ordinary method of carrying on trade modified only by arrangements which were merely part of the machinery of business dealing adopted to effect their intention to retire. It may well be accepted that they did so intend; yet the intention of a man cannot be considered as determining what it is that his acts amount to; and the real thing that has to be decided here is what were the acts that were done in connection with this business and whether they amount to a trading which would cause the profits that accrued to be profits arising from a trade or business ?"

The case was, therefore, decided on the finding of the special Commissioners, for which there was enough material in evidence. Similarly, the case of The Commissioner of Inland Revenue v. "Old Bushmills" Distillery Co., Ltd. (in Liquidation) ((1926) 12 T.C. 1148.) was one decided on a finding, in support of which there was evidence. The two cases relied upon by the Department and the assessee Company respectively do not shed any light upon the problem before us, because the central decision in both of them was whether the Commissioners' finding was justified or not.

In J. and M. Craig (Kilmarnock), Ltd. v. Cowperthwaite ((1914) A.C. 327.), the question was how the opening stock should have been valued, and whether any profit could be said to have resulted. The Privy Council in Doughty's case ((1927) A.C. 327.) remarked about this case as follows :

> "There, on a transference from one company to another, one-third of the value of each item, other than stock in trade, as it stood in the books of the selling company, was treated as its value for transfer purpose, and the balance of a slump price, which, with an undertaking to discharge liabilities, formed the consideration, was inferentially attributable to the stock. It was held, however, in that case that no sum could be pitched upon as the actual price of the stock, and no claim to assess a profit could be based upon such a foundation."

This case shows that where a slump price is paid and no portion is attributable to the stock-in-trade, it may not be possible to hold that there is a profit other than what results from the appreciation of capital. The essence of the matter, however, is not that an extra amount has been gained by the selling out or the exchange but whether it can fairly be said that there was a trading from which alone profits can arise in business. If this test is applied to the present case, then the true answer would be the one given by the High Court in the judgment under appeal.

There is no doubt, in this case, that the assessee Company was wound up at least in so far as its match manufacture was concerned. That the business of the Company was sold as a going concern, and was, in fact, worked by the assessee Company on behalf of the buyer till the entire consideration was paid, makes no difference, because the agreement clearly indicated that the assessee Company was keeping the factory going, not on its own behalf but entirely on behalf of the buyer. One cannot fairly say, therefore, that a sale of the chemicals and raw materials for match

manufacture was anything more than a winding up sale, not with a view to trading in chemicals and raw materials but to close down the business and to realise the assets. There was, in fact, no identifiable price for the chemicals and raw materials except by comparing the two prices offered to be paid by the buyer, that is to say, the price without the chemicals and raw materials and the price with them. From that alone, however it is impossible to infer that the chemicals and raw materials were sold in the ordinary way of business or that the assessee Company was carrying on a trading business. The fact that the clause in the Memorandum gave power to the Company to sell chemicals cannot be used in this connection, because the evidence clearly shows that that clause was never used and the two sales of chemicals through the years were too petty in themselves to afford evidence of a continued or sustained trading in chemicals. In our judgment, this was a winding up sale with a view to realising the capital assets of the assessee Company and not a sale in the course of business operations, which alone would had attracted tax, if profit resulted.

In the result, the appeal fails, and is dismissed with costs.

Appeal dismissed.

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