

Commissioner of Income-Tax, Madras

Vs

A. Krishnaswami Mudaliar and Others

Civil Appeal No. 250 of 1963

(J. C. Shah, K. Subha Rao, S. M. Sikri JJ)

16.04.1964

JUDGMENT

SHAH J. -

The respondents are a firm constituted under a deed dated December 12, 1947. The firm originally consisted of three partners : K. N. Damodara Mudaliar, A. Krishnaswami Mudaliar and V. Thangaraja Mudaliar. K. N. Damodara Mudaliar acquired for the firm for Rs. 1,00,000 the exploitation rights which were to enure for four years in a cinematograph film Apoorva Chinthamani for the North Arcot, the South Arcot and the Chingleput Districts and for Pondicherry. For the period December 25, 1947, to August 2, 1948, which was "the previous year" corresponding to the assessment year 1949-50 the firm filed a voluntary return declaring that Rs. 28,643 were earned by the exploitation of the film. In the statement submitted by the firm the total receipt credited in the firm's books were Rs. 1,46,849 and against that amount were debited Rs. 18,206 as expenses and Rs. 1,00,000 as the amount disbursed for acquiring the exploitation rights. Thereby in the computation of the profits of the business, the firm debited th

In the assessment of the respondent firm for the year 1949-50 the Second Additional Income-tax Officer, Vellore, declined to accept the statement of account that the firm had earned till August 2, 1948, a net profit of only Rs. 28,643 as truly representing the profits of the firm. He observed that "no stock valuation of the picture has been taken but only the excess collection over purchase value has been returned", indicating thereby that in his view from the statement of account which omitted to include at the close of the year the value of the rights in the film for the unexpired period, the profits of the firm could not properly be deduced. The Income-tax Officer estimated the value of the rights for the unexpired period of exploitation to which the firm was entitled on August 2, 1948, at Rs. 65,000 and computed the net profits of the firm as an unregistered firm at Rs. 93,642 and assessed income-tax and super-tax payable by the firm on that footing.

In appeal by the firm to the Appellate Assistant Commissioner, the correctness of the estimated value of the exploitation rights of the film at Rs. 65,000 was alone challenged and it was submitted that the sum of Rs. 4,000 was the true value of the assets at the end of the previous year, Damodara Mudaliar the retiring partner having relinquished his rights representing half share of Rs. 2,000 only. The Appellate Assistant Commissioner rejected the contention, holding that the valuation of the exploitation rights for the unexpired period in the deed of dissolution dated August 15, 1948, was "dictated by extra- commercial consideration", and confirmed the valuation of Rs. 65,000 made by the Income-tax Officer. Even in appeal to the Income-tax Appellate Tribunal, Madras, the respondent firm merely contended that the valuation of the exploitation rights for the unexpired period was excessive. The Tribunal partially upheld the plea, and reduced the valuation to Rs.

40,000 as on August 2, 1948, and directed modify

Pursuant to an order issued by the High Court of Madras in a petition under section 66(2) the Tribunal stated the case and referred the following question :

"Whether on the facts and circumstances of this case and Tribunal was justified in applying the proviso to section 13 of the Income-tax Act and in confirming the assessment on a mercantile basis of accounting ?

The High Court held that it was open to the assessee to maintain accounts according to a recognised system of accounting and the assessee having adopted the cash system of accounting and the Tribunal having assigned no reasons for discarding that system in the computation of the profits, the Tribunal was in making the assessment on the basis of the mercantile system of accounting. The High Court observed :

"When we reach the position that it was the cash system that the assessee had adopted in this case, and that valuation of the closing stock was not an incident of that system for ascertaining the profits, it should be obvious that the Income-tax Officer had no power under the proviso to section 13 to force a different system on the assessee either the mercantile system or a hybrid system of cash plus valuation of closing stock."

The High Court accordingly answered the question referred in the negative. Against the order, with special leave, this appeal is preferred.

The question to be determined in this appeal is whether in the computation of the income of the firm under the head "Profits and gains of business" the Income-tax Officer was bound by the method of accounting in which the cost of acquisition of the firm of which the exploitation rights were held was debited at the commencement of the year, but the value of the firm at the end of the year was ignored. Section 10 of the Indian Income-tax Act, 1922, provides that tax shall be payable by an assessee under the head "Profits and gains of business, profession or vocation" in respect of the profits or gains of any business, profession or vocation carried on by him. Such profits or gains have to be computed after making the allowance set out in sub-section (2). Section 13 provides that the income, profits and gains shall be computed, for the purposes of sections 10 and 12, in accordance with the method of accounting regularly employed by the assessee, provided that, if no method of accounting has been regularly employed

It may be recalled that the Income-tax Officer had in the order of assessment observed that the firm had not made a stock valuation of the firm and had merely taken the excess collection over the purchase value and had submitted its return of income on that basis. No express order was recorded by the Income-tax Officer that in his opinion the income, profits or gains of the business could not properly be deduced from the method of accounting employed by the firm, but it is implicit in what is stated by him that without valuation of the unexpired exploitation rights the profits of the year of account could not be computed. With this view, it appears, the Appellate Assistant Commissioner agreed.

In appeal to the Appellate Tribunal the only plea raised was that the Income-tax Officer had erred in estimating the value of the unexpired exploitation rights at Rs. 65,000. That was partially accepted, and the value was reduced to Rs. 40,000. It is difficult to appreciate how any question about the

regularity of the proceedings of the Income-tax Officer by the adoption of the mercantile system of accounting and by the application of the adoption of the mercantile system of accounting and by the application of the proviso to section 13 of the Income-tax Act arose from the order of the Tribunal. The High Court has under the Income-tax Act power to call upon the Appellate Tribunal to state a case, only if the High Court is not satisfied about the correctness of the decision of the Tribunal that no question of law arises from the order of the Tribunal. The grounds of a appeal filed before the Tribunal and before the Appellate Assistant Commissioner make it abundantly clear that the question as to the applicabi

The question referred to the High Court asks for advice on the justification for applying the proviso to section 13 and computation of the income on the basis of the mercantile system of accounting. On neither of these two branches there was any argument raised by the firm before the Tribunal. But we do not propose to dispose of this appeal on the limited ground that the question as framed did not arise out of the order of the Tribunal and need not be answered. The grounds given by the High Court in support of their answer to the question referred raise a matter of principle of some importance in the computation of income of an assessee carrying on a trading venture with the aid of a wasting asset; and we have heard elaborate arguments advanced by counsel at the Bar and we deem it necessary to express our opinion on the question debated.

It is true that the revenue authorities and the Tribunal did take into consideration the stock valuation at the end of the year of account, but that was not because in their view the system of accounting adopted was or should be mercantile : the truth of the matter is that in their view, profits of the firm for the year could not, having regard to the nature of the business, properly be deduced from the accounts, "unless the opening and closing stocks were brought into the picture". This is made clear by the observations of the Tribunal in paragraph 15 of the statement of the case :

"In all trading cases the true profits cannot be deduced from any system of maintaining accounts, whether cash or mercantile, unless the opening and closing stocks are brought into the picture at cost or market price whichever is lower : it will not avail an assessee to say that in his cash system, he had not made any profit on his cash sales till all his stock is disposed of. Income-tax is an annual levy and the profits of each year require to be ascertained for that purpose as accurately as circumstances permit. If, therefore, in any system of accounting maintained by the assessee, otherwise acceptable, the stocks are left out of account, the aforesaid proviso, it is humbly submitted, necessarily has to be invoked even if it were for the sole purpose of adjusting the book figures for the stock figures."

Correctness of this view especially in the context of a trading venture by the exploitation of a wasting asset, but which is the assessee's stock-in-trade, falls to be considered.

Section 13 of the Indian Income-tax Act was incorporated for the first time in the income-tax legislation in India by the Income-tax Act, 1922 (11 of 1922), because in a case decided under the Income-tax Act, 1918, Wallis, C.J., delivering the principal judgment of the Full Bench in Secretary, Board of Revenue, Madras v. Arunachalam Chettiar, expressed the view that whatever may be the system of accounting adopted by an assessee income assessable to tax means the income actually or constructively received and that the words of the charging section placed limits upon the succeeding sections specifying the different classes of income liable to tax. To supersede this exposition of the law the legislature while enacting Act 11 of 1922 found it necessary to enact section 13. The section leaves it to the assessee to adopt any system of accounting and obliges the Income-tax Officer to

compute the income, profits and gains for the purposes of sections 10 and 12 in accordance with such method of accounting regularly

".... the section relates to a method of accounting regularly employed by the assessee for his own purposes. . . . and does not relate to a method of making up the statutory return for assessment to income-tax. Secondly, the section clearly makes such a method of accounting a compulsory basis of computation, unless, in the opinion of the Income- tax Officer, the income, profits and gains cannot properly be deduced therefrom. It may well be that, though the profit brought out in the accounts is not the true figure for income-tax purposes, the true figure can be accurately deduced therefrom."

The Board also observed :

"It is duty of the Income-tax Officer, where there is such a method of accounting, to consider whether the income, profits and gains can properly be deduced therefrom, and to proceed according to his judgment on his question."

Again as observed by this court in *Commissioner of Income-tax v. Mc- Millan and Co.*, the expression "in the opinion of the Income-tax Officer" in the proviso to section 13 of the Indian Income-tax Act, 1922, does not confer a mere discretionary power; in the context it imposes a statutory duty on the Income-tax Officer to examine in every case the method of accounting employed by the assessee and to see whether or not it has been regularly employed and to determine whether the income, profits and gains of the assessee could properly be deduced therefrom.

But the section only deals with the computation of income, profits and gains for the purposes of sections 10 and 12 and does not purport to enlarge or restrict the content of taxable income, profits and gains under the Act. Section 2(15) of the Act defines "total income" as meaning total amount of income, profits and gains referred to in sub- section (1) of section 4 computed in the manner laid down in the Act. Section 4(1) lays down what income shall be included in the total income, and section 10(2), 12(2), 12B(2), 14, 15A, 15B, 15C, and 16 prescribe the manner of computation of income, profits and gains in different circumstances, and also prescribe special exemptions. Section 13 does not directly impinge upon the application of these provisions : it merely prescribes that the computation of taxable profits shall be made according to the method of accounting regularly employed. Where in the opinion of the Income-tax Officer the income, profits and gains cannot properly be deduced from the method of account

The only departure made by section 13 of the Indian Income-tax Act from the tax legislation in England is that whereas under the English legislation the Commissioner is not obliged to determine the profits of a business venture, according to the method of accounting adopted by the assessee, under the Indian Income-tax Act, prima facie, the Income-tax Officer has for the purpose of sections 10 and 12 to compute the income, profits and gains in accordance with the method of accounting regularly employed by the assessee. If, therefore, there is a system of accounting regularly employed and by appropriate adjustments from the accounts maintained taxable profit may properly be deduced, the Income-tax Officer is bound to compute the profits in accordance with the method of accounting. But where in the opinion of the Income-tax Officer the profits cannot properly be deduced from the system of accounting adopted by the assessee it is open to him to adopt a more suitable basis for computation of the true profits.

Among Indian businessmen, as elsewhere, there are current two principal systems of book-keeping. There is, firstly, the cash system in which a record is maintaining of actual receipt and actual disbursements, entries being posted when money or money's worth is actually received, collected or disbursed. There is, secondly, the mercantile system, in which entries are posted in the books of account on the date of the transaction, i.e., on the date on which rights accrue or liabilities are incurred, irrespective of the date of payment. For example, when goods are sold on credit, a receipt entry is posted as of the date of sale, although no cash is received immediately in payment of such goods; and a debit entry is similarly posted when a liability is incurred although payment on account of such liability is not made at the time. There may have to be appropriate variations when this system is adopted by an assessee who carries on a profession. Whereas under the cash system no account of what are called the outsta

But whichever method of book-keeping is adopted in the case of a trading venture, for computing the true profits of the year the stock- in-trade must be taken into account. If the value of stock-in-trade is not taken into account, in the ultimate result the profit or loss resulting from trading is bound to get absorbed or reflected in the stock-in-trade unless the value of the stock-in-trade remains uncharged at the commencement of the year and the end of the year. It must be remembered that under the Income-tax Act, tax is levied on income, profits and gains, and not on receipts; taxable profits therefore cannot ordinarily be deduced from cash receipts alone; if in the computation of profits of a trading venture, only the cash receipts and outgoings are taken into account, in substance the profits would be deferred, till the firm's capital outlay is completely recouped, thereby transforming what in truth are profits of the business into capital, by book-keeping entries.

In this case it is necessary to consider whether the method of accounting adopting of ignoring the value of the stock-in-trade may be regarded as regularly employed by the respondent firm, when it is the first year of account. It is common ground that the method of accounting was not mercantile, but was wholly or primarily cash. The Income-tax Officer was of the view that in the absence of stock valuation of the firm, which was a wasting asset of the partnership and which was exploited for earning profits, the income of the firm could not properly be deduced and with that view the Appellate Assistant Commissioner and the Tribunal have agreed. The High Court, however, held that the maintenance of accounts on cash basis being a recognised method of accounting, the Income-tax Officer was bound by the choice of the assessee who had adopted that system of accounting, and to compute the income in accordance with that method, unless the Income-tax Officer was satisfied that the assessee had not regularly adopted th

In coming to that conclusion, in our judgment, the High Court erred. Note the facts : and amount Rs. 1,00,000 was paid by the firm for acquiring a wasting asset, which was to be exploited for the benefit of the benefit of the partnership. The price paid for acquiring the asset was debited as an outgoing. At the end of the year there was expenses for carrying of Rs. 1,46,849, by the exploitation of the asset. The result according to the respondent firm was a net profit of Rs. 18,206. The result according to the respondent firm was a net profit of Rs. 28,647. This was arrived at by posting the outgoing for acquiring its stock-in-trade as a proper debit, and ignoring the value of that asset at the end of the year altogether. Under the Income-tax Act for the purpose of the assessment each year is a self-contained unit, and if out of the receipts the cost of the firm was to be deducted in the absence of an entry crediting the value of the asset at the end of the year, for arriving at the income, the profit of the

In Commissioners of Inland Revenue v. Cock, Russell and Co. Ltd., Croom-Johnson J., in dealing

with valuation of stock-in-trade for purpose of taxation, observed :

"There is no word in the statutes or rules which deals with this question of valuing stock-in-trade. There is nothing in the relevant legislation which indicates that in computing the profits and gains of a commercial concern the stock-in-trade at the start of the accounting period should also be taken in. It would be fantastic not to do it : it would be utterly impossible accurately to assess profits and gains merely on a statement of receipts and payments or on the basis of turnover. It has long been recognised that the right method of assessing profits and gains is to take into account the value of the stock-in-trade at the beginning and the value of the stock-in-trade at the end as two of the items in the computation. I need not cite authority for the general proposition, which is admitted at the Bar, that for the purposes of ascertaining profits and gains the ordinary principles of commercial accounting should be applied, so long as they do not conflict with any express provision of the relevant statute

We have already said that in England there is no provision which compels the tax officer to adopt in the computation of income the system of accounting regularly employed by the assessee. But whatever may be the system, whether it is cash or mercantile, as observed by Croom-Johnson J. in a trading venture it would be impossible accurately to assess the true profits without taking into account the value of the stock-in-trade at the beginning and at the end of the year. Reference may also be made to *Whimster and Co. v. Commissioners of Inland Revenue* in which Lord President Clyde observed at page 823 :

"In computing the balance of profits and gains for the purposes of income-tax,.... two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income-tax-Act, or of that Act as modified by the provisions and schedules of the Act regulating excess profits duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacture's business the value of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market p

Similarly, in *Commissioner of Income-tax v. Chari and Ram Rajamannar* C.J. observed that stock-in-trade in hand is an essential item in the computation of the profits for a period.

"Profits" as observed by Fletcher Moulton L.J. in *In re Spanish Prospecting Co. Ltd.* :

"... . implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

We start, therefore, with this fundamental definition of profits, namely, if the total assets of the business at the two dates be compared, the increase which they shew at the later date as compared with the earlier date. . . represents in strictness the profits

of the business during the period in question."

It is true that in that case Fletcher-Moulton L.J. made the observations not in dealing with a profit and loss account in a case relating to taxation, but with a balance-sheet of a company intended to show the actual financial condition of a business at the end of a year. The observations however do show that in ascertaining profits what may be regarded as normal book-keeping practice has to be observed. Whether in the case of trading in special classes of assets appropriate adjustments may have to be made is beside the point.

The Income-tax Act makes no provision with regard to the valuation of stock. It charges for payment of tax the income, profits and gains which have to be computed in the manner provided by the Income-tax Act. In the case of a trading venture these profits have to be adjusted in the light of the provisions of the Income-tax Act permitting allowances prescribed thereby. For that purpose it is the duty of the Income-tax Officer to find out what profits the business has made according to true accountancy practice, in the light of the system adopted, and thereafter to make the requisite adjustments, and even appropriate modification of the rule suggested by Fletcher- Moulton L.J. to ascertain the taxable profits. It is true, as observed by Lord Buckmaster in *Naval Colliery Co. Ltd. v. Commissioners of Inland Revenue*, that the principle of determining the profits of the trade by valuing everything at the beginning and at the end of the accounting period and by finding the difference may not be universally applicabl

These observation do not affect the true character of the profits of a business. Adjustments may have to be made in the principle having regard to the special character of the assets, the nature of the business and the appropriate allowances permitted, in order to arrive at the taxable profits. They do not support the proposition that, in the case of a trading venture, you can arrive at the true profits of a year by ignoring altogether the valuation of the stock-in-trade at the end of the year, while debiting its value at the commencement of the year as an outgoing; for determination of the profits by ignoring the valuation of the stock at the end of the year and debiting the value of the assets at the commencement of the year would not give a true picture of the profit for the year of account.

There is no warrant in this case for assuming that the revenue authorities and the Tribunal had sought to displace the method of accountancy adopted by the assessee. By applying the proviso to section 13, they made the computation upon the basis and in the manner in which in their opinion profits would be properly deduced. That they were entitled to do. We are, therefore, of the view that the High Court was in error in holding that because the assessee had maintained his accounts in the cash system it was not open to the Income-tax Officer to add to the receipts from the business the value of the stock-in-trade at the end of the year for the purpose of properly deducing the profits of the business for the year in question.

The appeal, therefore, must be allowed and the answer to the question referred to the High Court will be in the affirmative. The Commissioner will be entitled to his costs in this court as well as in the High Court.

Appeal allowed.

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