

Brij Bhushan Lal Parduman Kumar, Etc.

Vs

Commissioner of Income-Tax, Haryana, Himachal Pradesh and New Delhi-III. (and other appeals)

Civil Appeals Nos. 1701 to 1703 of 1974

(P. N. Bhagwati, V. D. Tu;zapurkar JJ)

06.10.1978

JUDGMENT

TULZAPURKAR J. -

1. The short question raised in these appeals by special leave is whether the cost of materials supplied by the Government (M.E.S. Department) for being used in the execution of works is liable to be taken into consideration while estimating the profits of a contractor and the question has assumed general importance as it affects the entire class of contractors who undertake works on behalf of the Government and in view of a conflict of decisions on the point among different High Courts.

The facts in all the three appeals are substantially the same though the assessee are different. In Civil Appeal No. 1701 of 1974, the material facts are these : The assessee (Brij Bhushan Lal Parduman Kumar of Ambala Cantonment), a registered firm, is a Military Engineering Services (M. E. S.) contractor, and as such carries on the business of executing contracts and works on behalf of the Government. For the execution of the works undertaken by the assessee certain materials such as cement, coal, items of steel, etc., is supplied at the fixed rates specified in Schedule B to the contract by the Government for being used in the works. Such material though in custody of the contractor always remains the property of the Government and if any surplus is left at the completion of the contract, the contractor (assessee) has to account for it at the same rates at which the supply was made to him (wear and tear excepted) and return the same to the Government. The assessment year involved was 1966-67 for which the accounting year commenced on October 1, 1964, and ended on September 30, 1965. The assessee-firm had taken two contracts, one at Delhi and the other at Ambala. For the said assessment year, it filed its return of income declaring income of Rs. 44,462 being 10% of the total cash payments of Rs. 4,44,622 received from the military authorities. The assessee, however, did not furnish any figures about the stores (material) received by it from the M. E. S. The ITO called upon the assessee to produce the relevant certificate in respect of such stores but the assessee failed to do so on the ground that the departments were not co-operating with it. The ITO, therefore, estimated cost of such material at 50% of the cash payments, namely, at Rs. 2,22,311 and by adding this figure to the net cash receipts of Rs. 4,44,622 he arrived at total receipts (including the cost of materials) of Rs. 6,66,933 and after rejecting the book results applied a flat rate of 10% and worked out the net income or profits at Rs. 66,693, which was rounded up to Rs. 66,690 and on that basis the tax was levied after allocating the said profits among the three partners of the firm. The assessee preferred an appeal to the AAC, contending that the addition of the cost of materials supplied by the Government to the figure of cash receipts received by it during the year for applying the flat rate of 10% was erroneous and in any case the estimate of the value of such stores at 50% of the cash payments was excessive. The AAC rejected the first contention but reduced the

estimate of the value of the stores supplied by the Government to 25% and confined the addition to Rs. 1,11,155. Aggrieved by that order, the assessee preferred further appeal to the ITA Tribunal and the Tribunal accepted the contention of the assessee that the cost of the stores or materials supplied by the Government to the assessee could not be added to the figure of cash payments received by the assessee on the ground that the stores (material) supplied by the Government were "never sold" to the contractor, that the same always remained the property of Government and that no profit could be said to have arisen to the assessee when such stores (material) was merely handled and manipulated by the assessee in the execution of the works under the contract. The Tribunal followed the decision of the Kerala High Court in *M. P. Alexander & Co. v. CIT* [1973] 92 ITR 92, where that court has taken the view that the cost of such materials supplied by the Government was not to be included while estimating the profits of a contractor. The revenue sought a reference to the Punjab and Haryana High Court on the question whether, on the facts and circumstances of the case, the Tribunal was justified in holding that the cost of the materials supplied by the Government was not to be included while estimating the profits of the contractor and the High Court in reference No. 38 of 1972, answered the question against the assessee and in favour of the department and restored the view of the taxing authorities by its order dated September 26, 1973, and in doing so the High Court followed its own earlier judgment in the case of *Brij Bhushan Lal v. CIT* [1971] 81 ITR 497, where it had held that the cost of the materials supplied by the military authorities was liable to be included before applying the flat rate to the assessee's receipts.

Civil Appeals Nos. 1702 & 1703 of 1974 relate to the assessments of Brij Bhushan Lal Ramesh Kumar for the assessment years 1965-66 and 1966-67, the relevant accounting years being the ones which ended on March 31, 1965, and March 31, 1966, respectively. The assessee-firm, a M. E. S. contractor, carried on the business of executing works wherein stores/materials were supplied by the military authorities to the firm on identical terms. For the assessment year 1965-66, the assessee filed its returns declaring an income of Rs. 18,684 and disclosing the net cash receipts from the Government at Rs. 2,63,853. Though this income was based on books of accounts maintained by the firm, the assessee during the course of assessment proceedings offered that a flat rate of 9% on the cash receipts of Rs. 2,66,853 may be applied. The ITO did not accept the offer but applied a flat rate of 10% on Rs. 3,07,605 which included the value of the stores supplied by the department to the assessee with the result that the profits were assessed at Rs. 30,760 and after allowing depreciation of Rs. 5,107 the net taxable income was determined at Rs. 25,653 which was rounded up to Rs. 25,650. For the assessment year 1966-67, the firm declared an income of Rs. 62,414, calculated by adopting the flat rate of 10% on the cash receipts of Rs. 6,24,144. The firm had received stores/materials of the value of Rs. 1,36,520 from the military authorities and the ITO after adding the value of the stores to the cash receipts arrived at a total receipt of Rs. 7,60,664 and by applying the flat rate of 10% determined the taxable income at Rs. 76,070. The assessee's appeals for both the years to the AAC were unsuccessful but in further appeals the Appellate Tribunal by its order dated October 31, 1970, accepted the assessee's contention and held that the cost or the value of the stores/material supplied by Government to the contractor was not liable to be included while estimating the profits or income of the contractor. In coming to this conclusion, as in the other case, the Tribunal followed the Kerala High Court's decision in *M. P. Alexander's case* [1973] 92 ITR 92. At the instance of the revenue two references (being Income Tax References Nos. 2 and 3 of 1973) were made to the Punjab and Haryana High Court and the High Court, following its earlier decision in *Brij Bhushan Lal's case* [1971] 81 ITR 497, answered the questions referred to it in the negative, i.e., in favour of the department and against the assessee. Both the assessee have come up to this court by special leave challenging the view taken by the High Court.

In support of these appeals counsel for the appellants has contended that it was well settled that even

while making a best judgment assessment the ITO must make an honest and fair estimate of the income of the assessee and that having regard to the terms and conditions of the contract (a specimen whereof was produced during the hearing before us) and particularly the terms on which the stores/materials were supplied by the military authorities to the assessee for being used in the works undertaken by the firm, it was clear that no element of profit was embedded in such stores/materials that were made available to the contractor for being used in the works entrusted to the contractor and as such the cost or value of such stores/materials could not be added to the total cash payments received by the contractor from the department under the contract for the purpose of estimating the income or profits derived by the contractor from such contract. He pointed out that under the terms and conditions of the contract such stores/material was never "sold" by the department to the contractor but the same always remained the property of the department and the contractor had merely handled, manipulated or used the same in the works completed by him and the surplus of such stores/material, if any, that remained was required to be and was actually returned by the contractor to the department and this being the true nature of the supply of such stores/material, the cost or the value thereof could not be included or added to the total cash payment received by the contractor under the contract for computing his income or profits from the said contract. In support of his contention reliance was placed upon M. P. Alexander's case [1973] 92 ITR 92 (Ker), the Madras High Court's decision in CIT v. K. S. Guruswami Gounder & K. S. Krishnaraju [1972] 92 ITR 90, the Gujarat High Court's decision in Trilokchand Chunilal v. CIT [1976] 104 ITR 732 and the Full Bench decision of the Andhra Pradesh High Court in Addl. CIT v. Trikramji Punia & Sons [1977] 106 ITR 597.

On the other hand, counsel for the revenue contended that not only the cash payments received by the assessee under the contract but also the cost of stores/material supplied by the department to the contractor, both together, represented the real value of the contract to the contractor and, as such, since the book results were rejected, the taxing authorities and the High Court were right coming to the conclusion that the income or profits derived by the contractor from such contracts was liable to be determined by applying the flat rate to the entire value of the contract. In other words, it was contended by him that the cost of the stores/material supplied by the Government to the contractor was liable to be taken into account while estimating the income or profits of the contractor under such contract and in that behalf he pressed for our acceptance the view of the Punjab and Haryana High Court in Brij Bhushan Lal's case [1971] 81 ITR 497.

At the outset, it may be stated that in the case of both the assessee's returns and book results were rejected on the ground that proper and reliable books of account had not been maintained and the ITO was required to make the assessments on "best judgment" basis. However, the principles to be followed by the ITO while making a best judgment assessment have been clearly laid down by the Privy Council as also by this court in a number of decisions. In CIT v. Laxminarain Badridas [1937] 5 ITR 170 (PC) their Lordships of the Privy Council observed as follows :

"The officer is to make an assessment to the best of his judgment against a person who is in default as regards supplying information. He must not act dishonestly or vindictively or capriciously because he must exercise judgment in the matter. He must make what he honestly believes to be a fair estimate of the proper figure of assessment, and for this purpose he must, their Lordships think, be able to take into consideration local knowledge and repute in regard to the assessee's circumstances, and his own knowledge or previous returns by and assessments of the assessed and all other matters which he thinks will assist him in arriving at a fair and proper estimate; and though there must necessarily be guesswork in the matter, it must be

honest guesswork. In that sense, too, the assessment must be, to some extent, arbitrary."

Since the law relating to "best judgement assessment" is the same both in the case of income-tax assessment and sales tax assessment, the following observations of this court in *Raghubar Mandal Harihar Mandal v. State of Bihar* [1957] 8 STC 770, 778(SC), a case under the Bihar Sales Tax Act, would be material :

"No doubt it is true that when the returns and the books of account are rejected, the assessing officer must make an estimate, and to the extent he must be related to some evidence or material and it must be something more than mere suspicion."

Again in *State of Kerala v. C. Velukutty* [1966] 60 ITR 239 (SC), which was a case under the Travancore-Cochin General Sales Tax Act, *Subba Rao J.* (as he then was), speaking for this court, observed at page 244 of the report thus :

"The limits of the power are implicit in the expression 'best of his judgement'. Judgement is a faculty to decide matters with wisdom truly and legally. Judgement does not depend upon the arbitrary caprice of a judge, but on settled and invariable principles of justice. Though there is an element of guesswork in a 'best judgement assessment', it shall not be a wild one, but shall have a reasonable nexus to the available material and the circumstances of each case."

It will appear clear from what has been said above that the authority making a best judgement assessment must make an honest and fair estimate of the income of the assessee and though arbitrariness cannot be avoided in such estimate the same must not be capricious but should have a reasonable nexus to the available material and the circumstances of the case. It is with reference to these principles that the question raised before us will have to be considered and looking at it from that point of view the real question is whether the turnover represented by the cost of the stores/material supplied by the M.E.S. department involves any element of profit having regard to the terms and conditions on which such supply is made? If it does, then the cost of such stores/material will have to be taken into account, but if it does not, such cost will have to be excluded.

In order to decide the aforesaid question, it will be necessary to advert to the terms and conditions of the works contracts undertaken by the two assessee-firms, which as stated earlier, are common. The assessee-firms in both the cases are M.E.S. works contractors tendering and obtaining from the M.E.S. department what are known as "lump sum contracts" which are governed by the General Conditions of Contracts I.A.F.W. 2249 (1963 print). In addition to the general conditions, the particular work undertaken by the contractor is also governed by special terms contained in the Acceptance of Tender, and the specifications and schedules annexed thereto. In "lump sum contracts" of M.E.S. department two salient features are always present, namely, (i) there is a Schedule "B" which specifies the items of stores/material to be supplied by the department to the contractor solely for being used, fixed or incorporated in the works together with the fixed rates at which the same will be supplied and such supply is governed by General Conditions Nos. 10 and 33; apart from the stores/material specified in Schedule "B", the contractor also brings his own stores/material to site for the purposes of the works which is also governed by some paragraphs of General Conditions Nos. 10 and 33; and (2) the final financial liability of the Government is fixed on completion of the contract on the basis of the actual measurements and on the basis of the rates which are already

standardised; a detailed measurement is undertaken at the end of the work at which the Garrison Engineer and the assessee's representative remain present and the measurements are entered in Measurement Books and after the measurements, final bills are prepared as per the M. E. S. Schedule and payments are made after making adjustments for the advances already made. With regard to stores/material, Conditions Nos. 10 and 33 of the General Conditions are material. Condition No. 10, so far as is material, runs thus :

"Condition 10-Stores and Materials :

The contractor shall, at his own expense, supply all stores and materials required for the contract, other than those listed in Schedule 'B' which are to be provided by the Government at the rates detailed therein.....

all stores and materials to be supplied by the contractors shall be the best of the respective kinds described in the specifications and the contractor shall upon the request of the engineer-in-charge furnish him with proof to his satisfaction that the stores and materials so comply.....

In the case of stores provided under schedule 'B', the contractor shall bear the cost of loading, transporting to site, unloading, storing under cover as required, assembling and joining the several parts together as necessary and incorporating and fixing these stores and materials in the works, including all preparatory work of whatever description as may be required, and of closing, preparing, loading and returning empty cases or containers to the place of issue without any extra charge."

Condition No. 33, so far as is material, runs thus :

"Condition 33-Stores and Materials on site :

Stores and materials required for the works are to be deposited by the contractor only in places to be indicated by the Engineer-in- charge.....

All stores and materials brought to the site shall become and remain the property of Government and shall not be removed off the site without the prior written approval of the G. E. But whenever the works are finally completed, the contractor shall at his own expense forthwith remove off the site without the prior written approval of the G. E. But whenever the works are finally completed, the contractor shall at his own expense forthwith remove from the site all surplus stores and materials originally supplied by him and, upon such removal, the same shall reinvest in and become the property of the contractor. All Government stores and materials issued to the contractor for incorporation or fixing in the works and which, making due allowance for reasonable wear and tear and/or waste, have not on completion of the works been so incorporated or fixed shall be returned by the contractor at his own expense to the place of issue.

Surplus stores and/or materials returned by the contractor will be credited to him at a price not exceeding that at which the said stores and materials were originally issued to him but due consideration shall be given to and allowance claimed by Government in respect of any depreciation or damage suffered by the stores and/or materials whilst in the custody of the contractor."

From the tender documents that are made available to the contractor and the aforesaid terms and conditions of the "Lump Sum Contracts", two or three aspects emerge very clearly. In the first place, the contractor becomes aware that certain specified stores/materials will be supplied to him by the department at fixed rates for being used in the works to be undertaken by him for which he has not to pay from his pocket and it is on that footing that he submits his tender quoting a particular figure for the entire work; secondly, such stores/material so supplied by the M. E. S. department has to be used, fixed or incorporated by the contractor in the works undertaken by him and the surplus, if any, that would remain after the completion of the work is to be returned to the department; thirdly, since for accounting purposes the initial supply is debited to the contractor at the specified fixed rates, credit for the balance of the stores/materials so returned is also given at the same rates, some adjustment being made in respect of the wear and tear of such stores/material but in regard to the stores/material out of such supply as is actually used, fixed or incorporated into the works, no accounting is done vis-a-vis the contract payment that is made to the contractor. In other words, in substance and in reality, such store/material always remains the property of the department and the contractor has merely the custody of it and he fixes or incorporates the same into the works. It seems to us clear that in such circumstances and having regard to the terms and conditions on which such supply of store/materials is made there is not even a theoretical possibility of any element of profit being involved in the turnover represented by the cost of such stores/material. It is conceivable that when the contractor himself purchases materials in the open market and supplies the same to the department by using, fixing or incorporating the same in the works, as in the case of materials other than those specified in Schedule "B", some profit element would be embedded in the turnover represented by the cost of such material but when stores/material is supplied by the Government department at fixed rates for being used, fixed or incorporated in the work on terms indicated above, there would be no element of profit involved in the turnover represented by the cost of such material. It is true that, ordinarily, when a works contract is put through or completed by a contractor the income or profits derived by the contractor from such contract is determined on the value of the contract as a whole and cannot be determined by considering several items that go to form such value of the contract but in our view where certain store/material is supplied at fixed or incorporated in the works undertaken on terms and conditions mentioned above, the real total value of the entire contract would be the value minus the cost of such store/material so supplied. Therefore, since no element of profit was involved in the turnover represented by the cost of stores/material supplied by the M. E. S. to the assessee-firms, the income or profits derived by the assessee firms from such contracts represented by the cash payments received by the assessee-firms from the M. E. S. department exclusive of the cost of the material/stores received for being used, fixed or incorporated in the works undertaken by them.

Having regard to our aforesaid conclusion the view taken by the Punjab and Haryana High Court in Brij Bushan Lal's case [1971] 81 ITR 497 must be regarded as erroneous and we approve the view taken by the Kerala High Court (M. P. Alexander & Co's. case [1973] 92 ITR 92), the Madras High Court (K. S. Guruswami Gounder's case [1973] 92 ITR 90), the Gujarat High Court (Trilokchand Chunilal's case [1976] 104 ITR 732) and the Andhra Pradesh High Court (Trikanji Punia's case [1977] 106 ITR 597 [FB]).

In the result, appeals are allowed, the impugned orders of the High Court are set aside and those of the Appellate Tribunal are restored. The revenue will pay the costs of the appeals to the assessee-firms.

Appeals allowed.

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