

Commissioner of Income Tax, Patiala

Vs

M/S. Groz-Beckert Saboo Ltd.

Civil Appeal No. 1482 of 1972

(P. N. Bhagwati, V. D. Tulzapurkar JJ)

22.11.1978

JUDGMENT

BHAGWATI, J. –

This appeal by special leave arises out of an assessment to income-tax made on M/s. Groz-Beckert Saboo Ltd. (hereinafter referred to as the assessee) for the assessment year 1962-63, the corresponding accounting being the financial year ending 31st March, 1962. The assessee set up in collaboration with Theodor Groz & Soehne and Ernst Peckert, West Germany (hereinafter referred to as the "West German Collaborators") a factory for fabrication and manufacture of hosiery needles and it was not disputed on behalf of the assessee that this factory started business sometime prior to the commencement of the relevant year of account. It appears that in the early part of the relevant accounting year, the assessee received from the West German Collaborators consignment of machinery costing Rs. 9,45,545 and along with this consignment, the West German Collaborators also sent to the assessee certain goods free of cost. These goods consisted partly of raw materials and partly of semi-finished needles at various stages of manufacture. The invoice in respect of this consignment was dated 4th April, 1961, and it showed only the price of the machinery consigned to the assessee and did not make any mention of the raw materials and semi-finished needles supplied to the assessee along with this consignment. Since these goods were supplied free of cost and no charge was made in respect of the same, the Customs Authorities raised objection in respect of these goods and a separate invoice had, therefore, to be sent by the West German Collaborators showing Rs. 44,448.20 as the value of the raw materials, namely, wire and strip and Rs. 30,000 as the value of the semi-finished needles supplied to the assessee. These goods were not entered in the books of account of the business immediately on receipt by the assessee but they were brought into the books for the first time on 30th September, 1961, by making the following entries : Rs. 44,448.20 debited to the account of "Wire and Strip" and credited to the "Wire and Strip Gift Account" and Rs. 30,000 debited to the account of "Semi-Processed Needles" and credited to the "Semi-Processed Needles Gift Account". The assessee utilised these goods in the manufacture of finished products and sold the same in the market and the sale proceeds received by the assessee were credited in the trading account maintained in the books of account of the business, since they represented revenue receipts arising from the sale of the finished products. On 31st March, 1962, being the last date of the accounting year, the assessee closed the "Wire and Strip Gift Account" and the "Semi-Processed Needles Gift Account" by transferring the respective sums of Rs. 44,448.20 and Rs. 30,000 to the credit of the "Capital Reserve Account" and debited an aggregate sum of Rs. 74,448.20 to the trading account by making corresponding credit entries in the accounts of "Wire and Strip" and "Semi-Processed Needles". The net effect of these entries was that the profit of the assessee was reduced by Rs. 74,448.20. The ITO in the course of the assessment of the assessee to income-tax for the assessment year 1962-63, took the view that the debit of Rs. 74,448.20 was wrongly made in the

trading account as on 31st March, 1962, since no monies were expended by the assessee in acquiring the raw materials and semi-finished needles, but they were received by way of gift from the West German Collaborators and hence no amount was deductible in respect of the value of these goods. The same view was taken by the Appellate Assistant Commissioner in appeal and on further appeal, the Tribunal also affirmed the same view. This led to a Reference by the Tribunal at the instance of the assessee and the following two questions were referred for the opinion of the High Court :

1. Whether, on the facts and in the circumstances of the case, the sum of Rs. 74,448.20 being the actual value of raw material received from German Collaborators free of cost represented revenue receipt ?

2. Whether, on the facts and in the circumstances of the case, the amount of Rs. 74,448.20 being the actual value of raw material received free of cost from German Collaborators was rightly debited at that value to the revenue account ?

2. The High Court misapprehended the true nature and scope of the controversy between the parties and seemed to proceed on the erroneous impression that what the Tribunal had held was that the raw materials and semi-finished needles received by the assessee from the West German Collaborators constituted revenue receipt and its value was, therefore, liable to be taxed as income in the hands of the assessee. The High Court held that the value of these goods could not be treated as revenue receipt because they had been received by way of gift and in any event, even if they constituted revenue receipt they could, "in no sense be income" since they were taken out of the ambit of taxability by sub-section (3) of Section 10 of the Income Tax Act, 1961. The High Court accordingly answered the questions referred by the Tribunal in favour of the assessee and against the revenue. The Revenue thereupon brought the present appeal with special leave obtained from this Court.

3. It was found as a fact by the Tribunal, and indeed there was no dispute about it, that the raw materials and semi-finished needles were received by the assessee from the West German Collaborators free of cost by way of gift. These raw materials and semi-finished needles were received some time in April, 1961, and it was only on 30th September, 1961, that they were for the first time introduced in the books of account of the business. There can, therefore, be no doubt that these raw materials and semi-finished needles were received by the assessee as capital assets and subsequently on 30th September, 1961 they were transferred to the business as part of its stock. If that be so, the cost of these raw materials and semi-finished needles to the business could not be said to be nil, but, on the principle laid down by this Court in *C. I. T. v. Shirinbai Kooka* (46 ITR 86 : AIR 1963 SC 477 : 1962 Supp 3 SCR 391) and subsequently followed in *C. I. T. v. Hantapara Tea Co. Ltd.* (86 ITR 258 : (1974) 3 SCC 202 : 1973 SCC (Tax) 526), it would be the market value of these raw materials and semi-finished needles as on 30th September, 1961. It is now well settled by these decisions that where an assessee converts his capital assets into stock-in-trade and starts dealing in them, the taxable profit on the sale must be determined by deducting from the sale proceeds the market value at the date of their conversion into stock-in-trade (since this would be the cost to the business) and not the original cost to the assessee. Here, the original cost of these raw materials and semi-finished needles to the assessee was undoubtedly nil because these goods were received by the assessee from the West German Collaborators free of cost, but they were introduced in the business and converted into its stock on 30th September, 1961 and, therefore, their market value as on 30th September, 1961, would represent the cost to the business and that would have to be taken into account in determining the profit arising from the sale of the manufactured products.

The entries made by the assessee in the books of account of the business on 30th September, 1961, clearly reflected this position. The assessee debited the sums of Rs. 44,448.20 and Rs. 30,000 representing respectively the market value of these raw materials and semi-finished needles to the stock accounts of "Wire and Strip" and "Semi-Processed Needles" which would clearly show that these goods were treated by the assessee as having been introduced in the business as part of its stock at their market value represented by the sums of Rs. 44,448.20 and Rs. 30,000. The position was no different than what it would have been if, instead of giving these raw materials and semi-finished needles to the assessee free of cost, the West German Collaborators had gifted the sums of Rs. 44,448.20 and Rs. 30,000 to the assessee and the assessee had introduced these amounts in the business and an identical quantity of raw materials and semi-finished needles had been purchased for the business with these amounts. The cost of raw materials and semi-finished needles thus purchased would have been clearly liable to be deducted from the sale proceeds of the finished products manufactured out of them in determining the profit of the business. Would the position then be different if instead, the West German Collaborators gave these raw materials and semi-finished needles to the assessee free of cost and the assessee introduced them in the business as part of its stock. We do not see any distinction in principle between these two types of cases and we are clearly of the view that the cost of these raw materials and semi-finished needles to the business represented by the sums of Rs. 44,448.20 and Rs. 30,000 debited in the respective accounts of "Wire and Strip" and "Semi-Processed Needles" was liable to be deducted from the sale proceeds of the finished products in arriving at the profit of the business. It is true that initially on 30th September, 1961, the credit entries for the sums of Rs. 44,448.20 and Rs. 30,000 were made in "Wire and Strip Gift Account" and "Semi-Processed Needles Gift Account", respectively, and it was only on the last date of the account year, namely, 30th March, 1962, that these amounts were transferred to the credit of the Capital Reserve Account. But that cannot make any difference to the correct legal inference to be drawn from the proved facts because the nomenclature of the account or accounts in which the credit entries were made is not material but what is really decisive is that these amounts were debited to the respective accounts of "Wire and Strip" and "Semi-Processed Needles" as representing their real value on 30th September, 1961. These raw materials and semi-finished needles were introduced in the business as part of its stock at their real value represented by the sums of Rs. 44,448.20 and Rs. 30,000. The aggregate amount of Rs. 74,448.20 made up of Rs. 44,448.20 and Rs. 30,000 was, therefore, liable to be deducted in determining the profit of the business and it was rightly debited to the trading account.

4. We accordingly dismiss the appeal and answer the questions referred by the Tribunal in favour of the assessee and against the Revenue. The Revenue will pay the costs of the appeal to the assessee.

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