

SUPREME COURT OF INDIA

Commissioner of Income Tax, Chennai

Vs.

Bilahari Investment (P) Ltd

C.A.No.1625 of 2008

(S. H. Kapadia and B. Sudershan Reddy JJ.)

27.02.2008

JUDGMENT

S.H.Kapadia,J.

1. Leave granted.

2. This batch of civil appeals filed by the Department is directed against judgment of the Division Bench of the Madras High Court dated 19.6.2006 in which it has been held that in the matter of chit transaction, the Completed Contract Method of accounting adopted by the respondents-assesses was erroneously rejected by the Department and that the Tribunal had erred in directing the discount to be spread over the balance period of the chit on a proportionate basis. In other words, the controversy arising in the present appeals is whether the Completed Contract Method followed by the assesses and accepted by the Revenue in the past needed to be substituted by percentage of Completion Method as contended by the AO.

3. We are concerned with assessment years 1991-1992 to 1997-1998.

4. Assesses is private limited companies subscribing to chits as their business activities. They were maintaining their accounts on mercantile basis and they were computing profit/loss, as the case may be, at the end of the chit period following completed contract method, which was earlier accepted by the Department over several years.

5. Chit funds are basically saving schemes in which certain number of subscribers joins together and each contributes a certain fixed sum each month, the total number of months being equal to the total number of subscribers. The subscriptions are paid to the Manager of the fund by a certain prescribed date each month and the total subscriptions to the fund are auctioned each month amongst the subscribers. At each auction, the lowest bidder is paid the amount of his bid and the balance received from out of the total subscriptions received is distributed equally amongst other subscribers, as premium. The Manager is paid a certain

percentage of the collections each month on account of expenses and charges for conducting the auction. In the auction, a maximum amount, which the highest bidder agrees to forego, is the amount, which is distributed to the other members, subject to deduction of the Manager's commission.

6. In this case, we are concerned with the tax treatment of the difference between the amount contributed and the amount received. In other words, in this case, we are concerned with allow ability of the claim for discount under the Income-tax Act, 1961 ("1961 Act") in order to arrive at "income" under that Act.

7. As stated hereinabove, assesses herein have been following completed contract method over the years, which was accepted by the Department. However, for the assessment years under consideration, the AO came to the conclusion that the completed contract method was not accurate in recognizing/identifying "income" under the 1961 Act, and according to him, therefore, in the context of the "chit discount", the correct method was deferred revenue expenditure calculated on proportionate basis. In other words, the AO has preferred percentage of completion method as the basis for recognizing/identifying "income" under the 1961 Act in substitution of completed contract method.

8. According to the Department, chit dividend had to be subjected to tax on accrual basis as the assesses were following the mercantile system of accounting. According to the Department, income accrued to the assesses in the form of chit dividend during the year whereas liability arose in the form of chit discount over the relevant period depending upon the remaining number of installments to be paid.

9. As far as the chit dividend is concerned, the Department rejected the completed contract method as suggested by the assesses, which has been accepted by the Tribunal and the High Court. However, in the matter of chit discount, the High Court, overruling the Tribunal, has held that the completed contract method of accounting adopted by the assesses was valid and that the Department had erred in spreading the discount over the remaining period of the chit on proportionate basis.

10. In the matter of chit dividend, assesses have accepted the view of the Tribunal and the High Court that the completed contract method was not correct. Therefore, to that extent, the controversy is settled.

11. The limited controversy is whether the completed contract method of accounting adopted by the assesses as method of accounting for chit discount is required to be substituted by percentage of completion method.

12. In this connection, it is the case of the assesses that, profits (loss) accrued to the assesses only when the dividends exceeded the discount paid and that difference could be known only on the termination of the chit when the total figure of dividend received and discount paid would be available. That, it would be possible for the assesses to make profits only when the

sum total of the dividend received exceeded the sum total of discounts suffered which is debited to P & L account. According to the assesses, the Department has all along been accepting the completed contract method and, therefore, there was no justification in law or in facts for deviating from the accepted practice. According to the assesses, a chit transaction has been treated by the various courts as one single scheme running for the full period and, therefore, according to the assesses, the completed contract method adopted by it over the years was not required to be substituted by any other method of accounting.

13. Before us, Shri Parag P. Tripathi, learned Additional Solicitor General, relied on the judgment of the Bombay High Court in the case of *Taparia Tools Ltd. v. Joint Commissioner of Income-tax*¹ reported in which the matching principle has been discussed threadbare. We quote herein below the said concept from the judgment, which reads as follows:

"The mercantile system of accounting is based on accrual. Basically, it is a Double Entry System of accounting. Under the mercantile system of accounting, profits arising or accruing at the date of the transaction are liable to be taxed notwithstanding the fact that they are not actually received or deemed to be received under the Act. Under the mercantile system of accounting, therefore, book profits are liable to be taxed. The profits earned and credited in the books of account constitute the basis of computation of income. The system postulates the existence of tax insofar as monies due and payable by the parties to whom they are debited (*see Keshav Mills Ltd. v. CIT*²). Therefore, under the Mercantile System of Accounting, in order to determine the net income of an accounting year, the revenue and other incomes are matched with the cost of resources consumed [expenses]. Under the mercantile system of accounting, this matching is required to be done on accrual basis. Under this matching concept, revenue and income earned during an accounting period, irrespective of actual cash in-flow, is required to be compared with expenses incurred during the same period, irrespective of actual out-flow of cash. In this case, the assesses is following mercantile system of accounting. This matching concept is very relevant to compute taxable income particularly in cases involving DRE. It has been recognized by numerous judgments. In the case of *Calcutta Co. Ltd. v. CIT*³ the facts were as follows: The assesses bought lands and sold them in plots. When the plots were sold the purchasers paid only a portion of the purchase price and undertook to pay the balance in installments. The assesses, in turn, agreed to develop the plots within six months. In the relevant Accounting Year, the assesses actually received only Rs. 29,392 towards sale price of the lands, but, in accordance with the mercantile system of accounting followed by the assesses, it credited in its accounts Rs. 43,692 representing the full sale price of the lands. At the same time, it also debited Rs. 24,809 as expenditure for the development it had undertaken even though, no part of that amount was actually spent. The Department, therefore, disallowed the expenditure of Rs. 24,809 on the ground that the amount was not actually spent. The assesses ultimately succeeded in the Supreme Court. It was held by the Supreme Court that the expression "Profits or Gains" in Section 10(1) of the Income-tax Act,

1922 should be understood in its commercial sense and there can be no computation of such profits and gains until the expenditure, which is necessary for the purposes of earning the receipts is deducted there from. Accordingly, the Supreme Court took the view, that since the assesses was following Mercantile System of Accounting and since the assesses had credited the full sale price of lands in its accounts amounting to Rs. 43,692, the assesses was entitled to estimate the expenditure because, without such estimation of expenditure, it was not possible to compute profits and gains. This concept is also applied by the Supreme Court in the case of *Madras Industrial Investment Corporation Ltd*⁴ under following observations (head note):”

"Ordinarily, revenue expenditure which is incurred wholly and exclusively for the purpose of business must be allowed in its entirety in the year in which it is incurred. It cannot be spread over a number of years even if the assesses has written it off in his books, over a period of years. However, the facts may justify an assesses who has incurred expenditure in a particular year to spread and claim it over a period of ensuing years. In fact, allowing the entire expenditure in one year might give a very distorted picture of the profits of a particular year. Issuing debentures is an instance where, although the assesses has incurred the liability to pay the discount in the year of issue of debentures, the payment is to secure a benefit over a number of years. There is a continuing benefit to the business of the company over the entire period. The liability should, therefore, be spread over the period of the debentures. Therefore, the matching concept, which we have referred to, is well recognized by various judgments of the Supreme Court. In this case, the issue is whether the entire expenditure distorts the profits of a particular year."

14. Further, learned ASG has also placed reliance on the judgment of this Court in the case of *J.K. Industries Ltd. & Anr. v. Union of India & Ors. Reported in*⁵ Paragraphs 82 and 83 of the said judgment are reproduced herein below:

"82. Matching Concept is based on the accounting period concept. The paramount object of running a business is to earn profit. In order to ascertain the profit made by the business during a period, it is necessary that "revenues" of the period should be matched with the costs (expenses) of that period. In other words, income made by the business during a period can be measured only with the revenue earned during a period is compared with the expenditure incurred for earning that revenue. However, in cases of mergers and acquisitions, companies sometimes undertake to defer revenue expenditure over future years which bring in the concept of Deferred Tax Accounting. Therefore, today it cannot be said that the concept of accrual is limited to one year.

83. It is a principle of recognizing costs (expenses) against revenues or against the relevant time period in order to determine the periodic income. This principle is an important component of accrual basis of accounting. As stated above, the object of AS 22 is to reconcile the matching principle with the Fair Valuation Principles. It may be noted that recognition, measurement and disclosure of various items of income,

expenses, assets and liabilities is done only by Accounting Standards and not by provisions of the Companies Act."

15. Recognition/identification of income under the 1961 Act is attainable by several methods of accounting. It may be noted that the same result could be attained by any one of the accounting methods. Completed contract method is one such method. Similarly, percentage of completion method is another such method.

16. Under completed contract method, the revenue is not recognized until the contract is complete. Under the said method, costs are accumulated during the course of the contract. The profit and loss is established in the last accounting period and transferred to P & L account. The said method determines results only when contract is completed. This method leads to objective assessment of the results of the contract.

17. On the other hand, percentage of completion method tries to attain periodic recognition of income in order to reflect current performance. The amount of revenue recognized under this method is determined by reference to the stage of completion of the contract. The stage of completion can be looked at under this method by taking into consideration the proportion that costs incurred to date bears to the estimated total costs of contract.

18. The above indicates the difference between completed contract method and percentage of completion method.

19. In the judgment of the Bombay High Court in *Taparia Tools Ltd.* (supra) it has been held that in every case of substitution of one method by another method, the burden is on the Department to prove that the method in vogue is not correct and it distorts the profits of a particular year. Under the mercantile system of accounting based on the concept of accrual, the method of accounting followed by the assesses is relevant. In the present case, there is no finding recorded by the AO that the completed contract method distorts the profits of a particular year. Moreover, as held in various judgments, the Chit Scheme is one integrated scheme spread over a period of time, sometimes exceeding 12 months. We have examined computation of tax effect in these cases and we find that the entire exercise is revenue neutral, particularly when the scheme is read as one integrated scheme spread over a period of time.

20. As stated above, we are concerned with assessment years 1991-1992 to 1997-1998. In the past, the Department had accepted the completed contract method and because of such acceptance, the assesses, in these cases, have followed the same method of accounting, particularly in the context of chit discount. Every assesses is entitled to arrange its affairs and follow the method of accounting, which the Department has earlier accepted. It is only in those cases where the Department records a finding that the method adopted by the assesses results in distortion of profits, the Department can insist on substitution of the existing method. Further, in the present cases, we find from the various statements produced before us, that the entire exercise, arising out of change of method from completed contract method

to deferred revenue expenditure, is revenue neutral. Therefore, we do not wish to interfere with the impugned judgment of the High Court.

21. Before concluding, we may point out that under section 211(2) of the Companies Act, Accounting Standards ("AS") enacted by the Institute of Chartered Accountants have now been adopted [see: judgment of this Court in J.K. Industries case (supra)]. Shri Tripathi, learned counsel for the Department, has placed reliance on AS 22 as the basis of his argument that the completed contract method should be substituted by deferred revenue expenditure (spreading the said expenditure on proportionate basis over a period of time). He also relied upon the concept of timing difference introduced by AS 22. It may be stated that all these developments are of recent origin. It is open to the Department to consider these new accounting standards and concepts in future cases of chit transactions. We express no opinion in that regard. Suffice it to state that, these new concepts and accounting standards have not been invoked by the Department in the present batch of civil appeals.

22. Subject to above, we see no reason to interfere with the impugned judgment of the High Court and accordingly the civil appeals are dismissed with no order as to costs.

¹2003 260 ITR 0102

²1953 23 ITR 230, 0239 SC

³1959 37 ITR 1 SC

⁴1997 225 ITR 0802

⁵2007 13 SCALE 0204