

BOMBAY HIGH COURT

Commissioner of Income Tax

Vs

Raipur Manufacturing Co., Ltd

(Stone, C.J.)

06.03.1946

JUDGMENT

Stone, C.J.

1. This is a reference under the conjoint effect of Section 21 of the Excess Profits Tax Act and Section 66(1) of the Indian Income-tax Act and relates to the computation for the purposes of excess profits tax to be made in the case of the assessee company. The first Schedule to the Excess Profits Tax Act contains the rules for the computation of profits for the purpose of excess profits tax and the second Schedule contains rule for computing the average amount of the capital employed in the business concerned. In order to make calculations for excess profits tax in any case four elements have to be considered. First, the profits for what the Act describes as the standard period; secondly, the capital on which such standard period profit was made; thirdly, the profits for the chargeable accounting period; and fourthly, the capital employed in the chargeable accounting period to make those profits; and, it is by comparing the first and the second with the third and the fourth of these calculations that the necessary basis of computation is arrived at. In this reference it is the capital during the standard period, which was the accounting year for income-tax purposes of 1936-37, with which we are concerned, and as formulated by the Appellate Tribunal the question referred to us is :

"Whether upon the fact found by the Tribunal, the Tribunal was correct in holding, upon the true construction of the provisions of Rule 1 of Schedule II to the Excess Profits Tax Act, that the Excess Profits Tax Officer could not value the trading stocks of the assessee company at cost price which was higher than the fixed rate at which the stocks were valued for the purpose of computing the profits of the standard period for income-tax purposes ?"

Now this question turns upon the true construction which is to be put upon Rule 1, sub-rule (2), of Schedule II, to the Excess Profits Tax Act. The rule deals with the amount of capital employed in a business and sub-rule (2) is as follows :-

"The price or value of any assets other than a debt shall be subject to such deductions for depreciation as are necessary to reduce the asset to its written down value and to such other deductions in respect of reduced values of assets as are allowable in computing profits for the purposes of income-tax and, in the case of a debt, the nominal amount of the debt shall be subject to any deduction which has been allowed in respect thereof for income-tax purposes."

If the Commissioner is right in this case, the result will be that in order to ascertain the capital employed during the standard period, he will be able to re-open the accounts on which the assessee was in fact assessed for income-tax purposes in 1936-37, and disturb what was in fact done nearly ten years ago, in spite of the fact that when such assessment was made the power to revise it under the Income-tax Act was one year-now four years under the amendments to the Act made in 1939. Mr. Setalvad for the Commissioner submits that he is not bound by what the Income-tax Officer in fact did in assessing the profits for the years 1936-37 and that the whole calculation can be re-opened in order to ascertain what ought to have been allowed in 1936-37. This argument is largely based on a comparison of the expressions "as are allowable" with "as has been allowed" contained in the sub-rule is at first sight significant. But, when the sub-rule is analysed, it will be found that there is a reason for it, since deductions from the assets which can be made under it fall into three categories. First, a deduction for depreciation of assets, other than a debt, as is necessary to reduce the assets to their written down value; secondly, other deductions in respect of reduced values of assets, other than a debt, as are allowable in computing profits for purposes of income-tax; and, thirdly, deductions in respect of a debt being the nominal amount of the debt subject to any deduction which has been allowed in respect thereof for income-tax purposes. Such an analysis invokes the question as to the right to make the deductions in respect of these three categories. The first category is dependent upon Section 10(2)(vi) of the Indian Income-tax Act and rule 8 of the Income-tax Rules made thereunder, and when that sub-section and that rule are examined, it will be found that what is to be allowed is such percentage on the original cost as is prescribed with respect to the particular commodity and it is Rules made thereunder, and when that sub-section and that rule are examined, it will be found that what is to be allowed is such percentage on the original cost as is prescribed with respect to the particular commodity and it is Rule 8 which sets out in columns the commodity and fixed percentage. There is nothing discretionary about this, it is all prescribed by a table of percentage. With regard to the second category there is in respect of it no reference in the Income-tax Act, and the right to make the deductions depends on commercial usage in making up accounts. It is in fact the cost price or the market price, taxation purposes. That such a commercial usage should be accepted for taxation purposes. That such a commercial usage should be accepted has been held by authority. In the case of *Whimster & Co. v. Commissioners of Inland Revenue*, the Lord President says this :-

"In computing the balance of profits and gains for the purposes of income-tax, or for the purposes of excess profits duty, two general and fundamental commonplaces have always to be kept in mind."

The Lord President then goes on to describe how the profits in a particular year are made up, and finally he gives this example :-

"For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchants or manufacturers business the values 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 price, whichever is the lower; although there is nothing about this in the taxing statutes."

Here again in respect of these deductions it is something fixed and certain and permits of no discretion being exercised by the Income-tax Officer with regard to them. But the third category which is dependent upon Section 10(2)(xi) of the Indian Income-tax Act stands on a wholly different basis. That sub-section deals with the allowance to be made in respect of bad and doubtful debts due to the assessee, and provides that the Income-tax Officer may estimate within a stated limit what is irrecoverable. So that far from it being something fixed or certain this third category depends on the Income-tax Officers estimate. This is the difference between the first and second categories on the one hand and the third category on the other, and explains the difference in language between the first and second category being "as are allowable" and the third category being "as has been allowed." It does not point to any revaluation being necessary or permissible in the former two categories any more than it is in the latter. I am satisfied that this result can be arrived at not only upon the true construction of the sub-rule of the schedule we are considering, but also as being in accordance with the dictates of commonsense. In my opinion therefore the question should be answered in the affirmative, and the Commissioner pay the costs of this reference.

KANIA, J.

In the statement of case the Tribunal has observed as follows :-

"While making the excess profits tax assessments for the chargeable accounting periods commencing from 1st September, 1939 to 31st December, 1939 and the year 1940 and 1941 the Excess Profits Tax Officer had to compute the capital employed for the business of the assessee during the standard periods and in the course of that computation the question of valuing the business assets was taken up.... He considered that at the time of making the income-tax assessments, covering the standard periods, the Income-tax Officer had accepted the stock valuations made by the assessee on the basis of a fixed rate

which was lower than either the market or cost. Upon this consideration, the Excess Profits Tax Officer felt that the deductions in respect of the reduced values allowable to the assessee was nil, since the cost price was below the market price and in his opinion no further deduction was called for in terms of sub-rule (1)(a) of the rules of the second Schedule to the Excess Profits Tax Act. In this view he rejected the valuations made at a fixed rate in income tax assessments for the standard periods and revalued the stocks on the basis of his own and included his own valuation for the purpose of making the capital computations."

The question thereupon arose whether the Excess Profits Tax Officer had authority to ignore the valuation of the assets and the allowance made by the Income-tax Officer for ascertaining the profits of the assessee company for income-tax purposes for the standard period. The rival contentions are these. On behalf of the Commissioner it is contended that under Section 4 of the Excess profits Tax Act the excess profits tax has to be charged on the amount by which the profits during any chargeable accounting year exceed the standard profits. It is therefore necessary to consider what are the standard profits. The answer is in Section 6(1) of the Excess Profits Tax Act. It is there provided that the standard profits of a business in relation to any chargeable accounting period shall, subject to the provisions of sub-section (3) and (4), be an amount bearing to the profits of the business during the standard period, if in respect of that business a standard period is available, the same proportion as the chargeable accounting period bears to the standard period. The natural question on this statement of law would be, "But what if the capital differs?" The answer to that is found in the proviso to that sub-section. It is there provided that if the average amount of capital employed in the business during such chargeable accounting period is greater or less than the average amount of capital employed during the standard period, such amount shall be increased or decreased, as mentioned in the said proviso. In order therefore to determine what tax on excess profits has to be paid by the assessee, the officer has first to ascertain the standard period, the profits of the standard period and the capital employed during that period. He has next to ascertain the profits of the chargeable accounting period and the capital employed during that period. Having got these data the amount of tax has to be worked out as provided in the Act. It is thus necessary to find out the profits and capital as discussed above. For this, provision is made in two separate schedules of the Excess Profits Tax Act. The first Schedule contains rules for the computation of profits for the purposes of excess profits tax, and Rule 1 provides that the profits of a business during the standard period or during any chargeable accounting period shall be separately computed and shall, subject to the provisions of that Schedule, be computed on the principles on which the profits of a business are computed for the purposes of income-tax under Section 10 of the Indian Income-tax Act. There is a proviso to this rule which runs as follows :-

"Provided further that where the profits during any standard period have already been determined for the purpose of an assessment under the Indian Income-tax Act, 1922, such profits as so determined shall, subject to the adjustments required by this Schedule, be taken as the profits during that period for the purpose of excess profits tax :"

The remaining provisions of the Schedule are not material on the facts of this case. The expression "average amount of capital" is defined in Section 2(3) of the Act as the average amount of capital employed in any business as computed in accordance with the second Schedule. The material portion of Rule 1 runs as follows :-

"(1) subject to the provisions of this Schedule, the average amount of the capital employed in a business (so far as it does not consist of money) shall be taken to be :-

(a) so far as it consists of assets acquired by purchase on or after the commencement of the business, the price at which those assets were acquired, subject to the deductions hereafter specified;

(b) so far as it consists of assets being debts due to the person carrying on the business, the nominal amount of those debts, subject to the said deductions;

(c) so far as it consists of any other assets which have been acquired otherwise than by purchase as aforesaid, the value of the assets when they became assets of the business, subject to the said deductions.

(2) The price or value of any assets other than a debt shall be subject to such deductions for depreciation as are necessary to reduce the asset to its written down value and to such other deductions in respect of reduced values of assets as are allowable in computing profits for the purposes of income-tax, and in the case of a debt, the nominal amount of the debt shall be subject to any deduction which has been allowed in respect thereof for income-tax purposes."The rest of that rule is not material. On behalf of the Commissioner it is argued that the computation of profits made by the Income-tax Officer may be binding on the Excess Profits Tax Officer to the extent mentioned in the first Schedule, but that has nothing to do with the computation of the average amount of capital for which separate provision is made in the second Schedule. It is contended that when the Excess Profits Tax Officer is making that computation it is his sole absolute right to fix the value of the assets and he is not bound by any valuations or deductions in the values made by the Income-tax Officer in calculating profits for the standard period. To this, it is conceded that there is an exception in respect of a debt, which is allowed for income-tax purposes because of the last words used in the second sub-rule of the first rule of the second Schedule. It is pointed out that in the last part of that sub-rule (relating to deductions in the amount of debt) the expression used is "which has been allowed," while the expression used in

respect of the reduced values of other assets is "as are allowable." It is contended that this distinction is deliberately made by the Legislature. On the other hand, it is contended on behalf of the assessee that the distinction sought to be made by the use of these two expressions is imaginary. The Court must look at the substance of the legislation and the whole scheme of the Act. It is pointed out that if the Commissioners' argument is accepted, the result will be that while for income-tax purposes the standard profits will be one figure, for the same period it will be a different figure for the excess profits tax. It is contended that this cannot be the scheme of the Act. In this connection strong reliance is placed on the proviso to Rule 1 of the first Schedule where it is provided that the Excess Profits Tax Officer is bound to accept the computation of profits for the standard period as made by the Income-tax Officer. It is argued that the present contention is a device to get round this position, which the taxing authorities cannot legitimately do under the provisions of the Income-tax Act. They find that they are unable to revise or set aside a computation of profits made by the Income-tax Officer for the standard period, and to get round that difficulty this argument is advanced. The question for determination therefore is, what is the effect of Schedule I, Rule 1, and the proviso quoted above, when read with Schedule II, Rule 1, sub-rule (2) ? In my opinion the contention of the Commissioner is wrong. The Excess Profits Tax Act as shown by the preamble itself is a legislation to impose tax on excess profits arising out of certain businesses. The Income-tax Act is the principal legislation which imposes a tax on the income of a person. Section 6 divides the income under five heads which are chargeable to tax. The fourth head is profits and gains of business, profession or vocation. Out of that a certain portion is carved out by the Legislature for the purpose of imposing the excess profits tax. I am unable to accept the contention of the Commissioner that the Excess Profits Tax Act is an entirely independent legislation, which is connected with the Income-tax Act only to the extent it is expressly so stated in the Excess Profits Tax Act. The scheme of the two Acts clearly shows that the Excess Profits Tax Act is a legislation intended to tax the profits of certain businesses in excess of a certain limit as provided in that Act. It is therefore complementary to the Income-tax Act by its very nature. The argument that for considering the average amount of capital employed in the business, the Excess Profits Tax Officer is entitled to completely ignore the provisions of the Income-tax Act, in my opinion, is quite unsound. The scheme appears to me to be simple and clear. The taxing authorities have to ascertain first the standard profits for the standard period. The computation of profits is a recognised method. As observed in *Whimster & Co. v. Commissioners of Inland Revenue*, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or a manufacturer'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 price, whichever is the lower. This pronouncement recognises that the profits ascertained are a result of the following calculations. The stock in hand at the beginning of the year, plus the circulating assets consisting of goods and materials bought during the year

are to be entered on one side of the account. The expenses relating to production and sale of goods have to be entered on that side. In addition to these there may be certain allowances due to wear and tear. On the other side of the account are the sales. Moreover the stock in hand at the end of the year has to be entered. The balance is the profits of the year. This recognised method of computing profits has been accepted as the correct method. The Income-tax Officer, working on this method, arrives at a particular figure as the profits for the standard period. The conclusion, i.e., the amount so determined, is binding on the Excess Profits Tax Officer under Schedule I, Rule 1, proviso. Moreover in accordance with the first rule of the first Schedule it is equally his duty to calculate the profits of the business during the standard period and also during the chargeable accounting period on the principles on which the profits of a business are computed for the purposes of income-tax under Section 10 of the Indian Income-tax Act. This leaves no doubt in my mind that it is not open to the Excess Profits Tax Officer to tinker with any of the figures which have been used for arriving at the profits. The provisions of the second Schedule are to be taken into consideration when he is faced with the question, what increase or decrease in the profits is due to a change in the average capital used in the year ? The wording of Rule 1 of Schedule II is very significant. It is to determine the average amount of capital employed in a business. It is stated to consist of three descriptions : (1) Assets acquired by purchase. (2) Assets being debts due to the person carrying on business. This clearly means capital brought by the owner himself, and not any outside debts or funds borrowed by the owner. (3) Assets which have been acquired otherwise than by purchase. If the rule stopped there, the assessee would be in a difficult situation because the law then calculates the amount of capital used by the assessee at cost of assets and his own capital. Clause 2 of that rule therefore makes provision for devaluing those assets. The wording of that clause clearly shows that the method adopted in valuing the assets in the Income-tax Act is recognised as binding and has to be used for the Excess Profits Tax Act also. The first part of that clause deals with the value of assets, other than a debt. It is provided that the same shall be subject to such deductions for depreciation as are necessary to reduce the asset to its "written down value." The term "written down value" is defined in Section 2(2) of the Excess Profits Tax Act as having the same meaning assigned to that term in sub-section (5) of Section 10 of the Indian Income-tax Act. That sub-section defines "written down value" as follows :-

"Written down value means - (a) in the case of assets acquired in the previous year, the actual cost to the assessee; (b) in the case of assets acquired before the previous year the actual cost to the assessee less all depreciation actually allowed to him under this Act, or any Act repealed thereby, or under executive orders issued when the Indian Income-tax Act, 1886, was in force."

The use of the word "allowed" in this case is very significant. It shows that the expressions

"allowable" and "allowed" have the same meaning. It is therefore clear that under the first sentence of Schedule II, Rule 1(2), the deductions for depreciation are those which are allowable under the Indian Income-tax Act, so as to bring it to its written down value. The second sentence is added by Act XLII of 1940. When this sentence did not exist in the clause it could have been contended that in computing the average amount of capital the only deductions permitted by the rule in that Schedule were the deductions which would come under the expression "written down value" of the Income-tax Act, and the debts which had been allowed to be reduced. No other deductions were permissible. To defeat that argument the Legislature inserted the second sentence in the clause. According to that, such other deductions in respect of reduced values of the assets, as are allowable for the purpose of computing profits for the purposes of income-tax, are to be allowed. The standard for all allowances and deductions therefore remains the standard which is allowed under the Income-tax Act. The last sentence deals with debts and it is clearly connected with Section 10(2) (xi) of the Income-tax Act. The words "which has been allowed" are clearly proper in that case, because a debt is a fixed sum. The question to what extent a deduction is permissible is a matter of inquiry. It has to be ascertained to what extent and within what period it has become a bad debt. The Income-tax Officer has to make these inquiries and allow the necessary deductions under Section 10 of the Income-tax Act. It is therefore clear that all the three provisions contained in Schedule II, Rule 1(2), relate to and are directly connected with the deductions permissible under the Income-tax Act. It was argued that it is the duty of the Excess Profits Tax Officer and not of the Income-tax Officer under Schedule II to fix these allowances. This argument is advanced in respect of the deductions or values of the circulating assets which have been valued by the Income-tax Officer for the standard period. My observations are limited to that particular asset which is under discussion in this case. As to the nature of these calculations the observations of Viscount Finlay in *John Smith & Son v. Moore* (H. M. Inspector of Taxes) may be noticed with advantage. The learned Law Lord in discussing the nature of capital clearly differentiated between fixed assets and circulating assets. That was a case dealing with excess profits duty sought to be levied on the assessee. At page 290 it is stated as follows :-

"Lord Johnston stated very clearly the difference between fixed assets and floating assets. The fixed capital assets comprised, he says, land, leases, works and plant. He goes on :- But there were other assets of a different kind, namely, the floating assets consisting of the stocks of material to be worked up and of the manufactured articles to be sold. With these the appellant company had to commence business, and it was on the turnover of these and their replacement by further material and further manufactured articles that the company was to make its profits or loss. The whole of the argument which has been addressed to your Lordships on behalf of the Crown on the score of the Pounds 30,000 being in the nature of capital expenditure appears to me to ignore the broad distinction between these two classes of assets, the one class consisting of fixed assets, the other consisting of

circulating assets which are bought for the very purpose of being re-sold. I desire in this connection to refer to what was said by Lord Atkinson in delivering the judgment which was adopted by the other members of the House in *Farmer v. Scottish North American Trust, Limited*, and to quote what Lord Herschell said in *Russell v. Town and County Bank*. He was dealing with the income-tax, but his language is just as applicable to the excess profits duty :- The duty is to be charged upon "a sum not less than the full amount of the balance of the profits or gains of the trade, manufacture, adventure, or concern"; and it appears to me that that language implies that for the purpose of arriving at the balance of profits all that expenditure which is necessary for the purpose of earning the receipts must be deducted, otherwise you do not arrive at the balance of profits; indeed, you do not ascertain, and cannot ascertain, whether there is such a thing as a profit or not. The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts. That seems to me to be the meaning of the word "profits" in relation to any trade or business. Unless and until you have ascertained that there is such a balance, nothing exists to which the name "profits" can be properly applied."

Bearing in mind these observations, it is clear that when the word "profits" is used it means the balance of an account in which on one side are entered the opening stock, the cost of goods purchased, the sales expenses, and the expenses of manufacture during the year, and on the other side the price realised by sales and the balance of stock and materials on hand. Each of these figures remains fixed if the profits are to remain what are ascertained as a result of these calculations. If, therefore, in the present case, the amount of profits of the standard period is binding on the Excess Profits Tax Officer under the proviso to Schedule I, Rule 1, it is equally clear that the factors which form part of the calculations in arriving at those profits are equally binding on him. In my opinion, an attempt to disturb either the figure of the opening stock or the closing stock would result in the profits being entirely different. If the Excess Profits Tax Officer is precluded from disturbing the profits of the standard period, in my opinion, the wording of Schedule II, Rule 1(2), does not permit him, in calculating the average amount of capital of the standard period, to disturb the figure of opening or closing stock of that period. By virtue of Schedule I, Rule 1, his authority to fix the deductions in respect of reduced values to that extent is curtailed. This construction reconciles the provisions of Schedule I, Rule 1, and Schedule II, Rule 1. The Proviso to Schedule I, Rule 1, becomes operative when the profits of the standard period have been determined by the Income-tax Officer. In the present case it is common ground that the profits have been so determined. We are not concerned therefore with a case where the Excess Profits Tax Officer has to ascertain for himself the profits of the standard period and the profits of the chargeable accounting period. This aspect is material to be borne in mind because it was argued that Schedule II, Rule 1(2), contains the provision in respect of debts where an

allowance has been made under the Income-tax Act. Apart from this clause there is no provision enabling the Excess Profits Tax Officer to make an allowance in respect of a debt due to the business. The assets of a business would include a debt due to it. If under none of the clauses of Schedule II, Rule 1, the Excess Profits Tax Officer is authorised to decide, to what extent a debt had become bad and should therefore be deducted in arriving at the profits, how should be determine that ? As we are not faced with these facts, I do not consider it necessary to discuss the question. On the admitted facts it is clear that for the standard period the Income-tax Officer had made the assessment of profits under the Income-tax Act in force at the time and the same is binding on the Excess Profits Tax Officer under the proviso to Schedule I, Rule 1 of the Excess Profits Tax Act. I therefore agree that the answer to the question submitted for our opinion by the Tribunal should be as stated in the judgment of the Chief Justice.

Reference answered accordingly.

