

CASE NO.:  
Appeal (civil) 3818 of 1999

PETITIONER:  
SAKTHI TRADING CO.

Vs.

RESPONDENT:  
COMMISSIONER OF INCOME-TAX, COIMBATORE

DATE OF JUDGMENT: 02/08/2001

BENCH:  
Y.K. Sabharwal & Brijesh Kumar

JUDGMENT:

Y.K. SABHARWAL, J.

At the instance of the Revenue the question, in respect of the assessment year 1984-85, that was referred for the opinion of the High Court was :

"Whether on the facts and in the circumstances of the case where on the dissolution of the firm the business is taken over by a partner without discontinuance and the value of the closing stock determined under the regular method of accounting is accepted by the partners in the settlement of accounts for dissolution purposes, the Income-tax Officer can substitute the market value in respect of the closing stock alone for the purpose of determining the income of the firm upto the date of dissolution?"

Briefly, the facts are as follows :

The assessee is a registered firm. As a result of the death of one out of its six partners, on February 6, 1984, the firm was dissolved. It was, however, reconstituted with effect from the next day, that is, 7th February, 1984 with the remaining five partners. Two orders of assessments were made : one for the period upto February 6, 1984 and the other for the period from 7th February, 1984 to 31st March, 1984. The Commissioner of Income Tax made an order under Section 263 of the Income Tax Act, 1961 as according to him the assessment order made by the Income Tax Officer was erroneous and prejudicial to the interest of the Revenue in valuing the stock in trade as on 6th February, 1984 on the basis of cost or market rate, whichever is lower as that was the usual method the assessee used to adopt in valuing its stock. The Commissioner of Income Tax relying upon the decision of the Madras High Court in A.L.A Firm v. Commissioner of Income-tax [(1991) 189 ITR 285] came to the conclusion that the Income Tax Officer ought to have valued the closing stock at its market rate as on 6th February, 1984. Thus, setting aside the assessment order dated 30th May, 1984, the Income Tax Officer was directed to pass a fresh order.

The order of the Commissioner of Income Tax was challenged by the assessee in appeal before the Income Tax Appellate Tribunal. The contention of the assessee before the Tribunal was that the question of valuing the closing stock at the market value can arise only on

discontinuance of the business and as the business of the firm was never discontinued but was taken over on succession by another firm, the closing stock was not required to be revalued at the market value. The Tribunal found that the firm was reconstituted with the remaining five partners under the partnership deed dated 6th March, 1984 w.e.f. 7th February, 1984. The new deed recited that :

"Whereas the above said parties were carrying on business in Erode in the name "Sakthi Trading Company" along with one Shri P. Chenniappan S/o late Sri Palanippa Gounder, Erode and whereas the above said P. Chenniappan died on 6.2.1984, the parties hereto having decided to continue the business with all assets and liabilities in partnership from 7.2.1984 as orally agreed, this deed is drawn up reducing the oral agreement between the parties hereto taking effect from 7.2.1984, to carry on business in partnership upon the following terms and conditions."

The Tribunal came to the conclusion that if the business itself is discontinued and the stocks are realised then the value realised would have to be substituted for the value given in the accounts but where the business was not discontinued though the firm was dissolved, the question of realising the value of the goods does not arise and there was no necessity for revaluing the closing stock. According to the Tribunal, there was no warrant for revaluation of stock in a continuing business and the order of the Income Tax Officer accepting the profit shown by the assessee, on the method of accounting regularly followed, was not in any way erroneous and did not require to be revised under Section 263. In respect of the decision of the Madras High Court in A.L.A. Firm's case (supra), the Tribunal noticed that the firm in the said case had closed its accounts on 13th March, 1961, the date of dissolution and profit was arrived at by crediting to the profit and loss account the difference on revaluation of stock as on that date, but for income-tax purposes, the firm claimed that difference should be written back and the profit adjusted. The High Court did not countenance such a claim and following its earlier decision in G.R. Ramachari & Co. v. Commissioner of Income-tax, Madras [(1961) 41 ITR 142 (Mad)] held that when there is a dissolution, the stock in trade should be valued at market value. In these cases, the Tribunal noticed that the question posed was that where the value of the stock had been accepted by the partners upon dissolution, it could not be varied by the Income-tax Officer. The Tribunal was of the view that if on the dissolution of a firm, the business is also discontinued and the value of the stock realised, it may be possible for the Income-tax Officer to insist that the value realised shall be taken as the value of the closing stock instead of any notional value on the regular principle of cost or market value, whichever is less. But where the business is not discontinued, the question of revaluing the stock cannot arise at all. The Tribunal held that the valuation of the closing stock of a continued business on the principle of cost or market value whichever is less cannot be substituted with the market value only because the firm carrying on that business is dissolved and the business is taken over by another firm consisting of the remaining partners. In respect of A.L.A. Firm's case (supra), it was noticed that that was a case where partners had agreed to substitute the market value and wanted to retract from it. Both in the case of Ramachari and A.L.A. Firm, there was discontinuance of the business which was not so in assessee's case and, therefore, there was no warrant for revaluation as directed by the Commissioner of Income-tax whose order under Section 263 was set aside and appeal of the assessee was allowed. The High Court by judgment under challenge has answered the question in favour of the Revenue and, therefore, the assessee is in appeal before us.

In this appeal the question is not whether two assessment orders were required to be passed or not but is as to whether the value of the closing

stock was required to be determined on the market value for dissolution purposes upto the date of dissolution when the business has been taken over by remaining parties without discontinuance. The question itself suggests that the business was not discontinued. As noticed above, on the dissolution of the firm on 6th February, 1984 as a result of the death of one of the partner, the remaining partners continued the business w.e.f. 7th February, 1984. The question of valuing the closing stock on market value is required to be answered where business is not discontinued on the dissolution of the firm.

The Tribunal has recorded a finding that the business was not discontinued and this was the ground on which the decisions of Madras High Court in the case of G.R. Ramachari & Co. and A.L.A. Firm were distinguished stating that "moreover in both of those cases there was a discontinuance of the business itself which is not the case in the present case". In A.L.A. Firm's case, the appeal filed by the assessee has been dismissed by this Court.

According to the contention urged on behalf of the Revenue, the question in the present case is squarely covered by the decision in the case of A.L.A. Firm. Refuting this contention, learned counsel for the appellant contends that the facts of said case are clearly distinguishable and, in fact, the principles laid therein support the assessee. The decision in A.L.A. Firm's case deserves to be examined in some detail.

In that case three questions of law were referred for the opinion of the High Court but we are concerned with the second question which was as under :

"Whether, on the facts and circumstances of the case, the assessment of the sum of \$ 101,248 as revenue profit of the assessee-firm chargeable to tax for the assessment year 1961-62 is justified in law?"

The facts under which this question arose were that the assessee, a partnership firm, was carrying money lending business in Malaya and as part of and incidental to the said business, it was also carrying on the business of the purchase and sale of house properties, gardens and estates. The assessee firm was reconstituted under a deed dated 26th March, 1960. The firm's accounts for the year 1960-61, which commenced on 13th April, 1960 would normally have come to close on or about 13th April, 1961. However, the firm closed its accounts as on 13th March, 1961, with effect from which date it was dissolved. Along with its income-tax return for the assessment year 1961-62 filed on 10th April, 1962, the assessee filed a profit and loss account and certain other statements. In the profit and loss account, a sum of \$ 101,248 was shown as "difference on revaluation of estates, gardens and house properties" on the dissolution of the firm on 13th March, 1961, such difference being \$ 70,500 in respect of "house properties" and \$ 30,748 in respect of estates and gardens. In the memo of adjustment for income-tax purposes, however, the above sum was deducted on the ground that it was not assessable either as revenue or capital. A statement was also made before the officer that partner Ramanathan Chettiar forming one group and the other partners forming another group were carrying on business separately with the assets and liabilities that fell to their shares on the dissolution of the firm. For the subsequent assessment year 1962-63, the assessee filed a return showing nil income along with a letter pointing out that the firm had been dissolved on 13th March, 1961. Thereafter, on 3rd September, 1963, the Income-tax Officer wrote a letter to the assessee to the effect that the revaluation difference of \$ 101,248 should have been brought to tax in the assessment year 1961-62 in view of the decision of Madras High Court in G.R. Ramachari & Co. v. CIT. He called for the basis for the valuation and also for the assessee's objections. The assessee sent a reply stating that no profit or loss could be assessed on revaluation of assets. Relying on a circular of the Central Board of Revenue dated 21st June, 1956, it was urged that the assessee was gradually winding up its business in

Malaya and that, therefore, the surplus would only be capital gains. It was urged that the revaluation had been at the market price prevalent since 1st January, 1954 and that, therefore, no capital gains were chargeable to tax. The Income-tax Officer completed the reassessment on the firm after adding back a sum of Rs.1,58,057/- (equivalent to \$ 101,248) to the previously assessed income. The assessee having failed upto the High Court in reference was in appeal before this Court. This Court held that the question is squarely covered by the decision of Madras High Court in Ramachari's case wherein it had been held that principle of valuing the closing stock of a business at cost or market price at the option of the assessee is a principle that would hold good only so long as there is a continuing business and that where a business is discontinued, whether on account of dissolution or closure or otherwise by the assessee, then the profits cannot be ascertained except by taking a closing stock at market value. The contention of the assessee was that while it is true that the closing stock has to be valued, the well settled principle is that it should be valued at cost or market price, whichever is lower, and there is no justification for laying down a different principle for valuation of the closing stock at the point of discontinuance of business unless the goods are actually sold by the assessee at the time of discontinuance. Reliance was also placed on a series of decisions holding that when a firm is dissolved and assets are distributed among the partners, there is no sale or transfer of the assets of the firm to the various partners. The submission was that revaluation of the assets of a firm which is only for the division of assets among the partners on a real and not a notional basis is part of the division of the assets and, therefore, logically, in point of time, subsequent to the dissolution of the firm and since the revaluation takes place after the dissolution, no profits can be said to have accrued to the firm by the process of revaluation. It was urged that there is no principle by which the stock-in-trade can be valued at market price so as to bring to tax the notional profits which might in future be realised as a result of the sale of the stock-in-trade. This Court rejected the contention that Ramachari's case does not lay down the correct law and held that the High Court was right in pointing out that the several decisions relied upon for the assessee as to the nature of the transaction by which a firm, on dissolution, distributes its assets amongst its partners, have no relevance in the case since those cases relate to what happens after or in consequence of the dissolution of a firm whereas in that case the Court was concerned with a question that arose before or at the time of dissolution.

Dealing with the principle that permits the assessee to value the stock at cost, in *Kikabhai Premchand v. CIT* [(1953) 24 ITR 506 (SC)] Bose, J. said that :

"The appellant's method of book-keeping reflects the true position. As he makes his purchases he enters his stock at the cost price on one side of the accounts. At the close of the year he enters the value of any unsold stock at cost on the other side of the accounts thus cancelling out the entries relating to the same unsold stock earlier in the accounts; and then that is carried forward as the opening balance in the next year's account. This cancelling out of the unsold stock from both sides of the accounts leaves only the transactions on which there have been actual sales and gives a true and actual profit or loss on his year's dealings".

In *A.L.A. Firm's case*, the observations of Bose, J. were noticed and it was pointed out that the valuation of the closing stock at market value would invariably create a problem. For, if the market value is higher than cost, the accounts will reflect notional profits not actually realised. On the other hand, if the market value is less, the assessee will get the benefit of a notional loss he has not incurred. Nevertheless, the ordinary principle of commercial accounting permits valuation "at cost or market, whichever is the lower". The rationale behind it was explained by Patanjali Sastri, C.J. in *Chainrup Sampatram v. CIT* [(1953) 24 ITR 481 (SC)] wherein it was

observed that :

"It is wrong to assume that the valuation of the closing stock at market rate has, for its object, the bringing into charge any appreciation in the value of such stock. The true purpose of crediting the value of unsold stock is to balance the cost of those goods entered on the other side of the account at the time of their purchase, so that the cancelling out of the entries relating to the same stock from both sides of the account would leave only the transactions on which there have been actual sales in the course of the year showing the profit or loss actually realised on the year's trading. As pointed out in paragraph 8 of the Report of the Committee on Financial Risks attaching to the holding of Trading Stocks, 1919, 'As the entry for stock which appears in a trading account is merely intended to cancel the charge for the goods purchased which have not been sold, it should necessarily represent the cost of the goods. If it is more or less than the cost, then the effect is to state the profit on the goods which actually have been sold at the incorrect figure . . . . From this rigid doctrine one exception is very generally recognised on prudential grounds and is now fully sanctioned by custom, viz., the adoption of market value at the date of making up accounts, if that value is less, than cost. It is of course an anticipation of the loss that may be made on those goods in the following year, and may even have the effect, if prices rise again, of attributing to the following year's results a greater amount of profit than the difference between the actual sale price and the actual cost price of the goods in question' (extracted in paragraph 281 of the Report of the Committee on the Taxation of Trading Profits presented to British Parliament in April 1951). While anticipated loss is thus taken into account, anticipated profit in the shape of appreciated value of the closing stock is not brought into account, as no prudent trader would care to show increased profit before its actual realization. This is the theory underlying the rule that the closing stock is to be valued at cost or market price whichever is the lower, and it is now generally accepted as an established rule of commercial practice and accountancy."

This Court thus held that the proper practice is to value the closing stock at cost. That will eliminate entries relating to the same stock from both sides of the account. To this rule, custom recognises only one exception and that is to value the stock at market value if that is lower. But on no principle can one justify the valuation of the closing stock at a market value higher than cost as that will result in the taxation of notional profits the assessee has not realised.

The consideration which prevailed with the High Court in A.L.A. Firm's case is reflected in the following passage of the High Court's judgment :

"It seems to us that none of these cases has any application to the facts of the present case. There is no authority directly in point dealing with this question, where a partnership concern dissolves its business in the course of the accounting year, what is the basis on which the stock-in-trade has to be valued as on the date of dissolution. We have accordingly to deal with the matter on first principles."

This Court while dismissing the appeal of the assessee found

substance in this consideration that prevailed with the High Court. From the above, it is evident that in A.L.A. Firm's case this Court was considering the question of valuation of closing stock at market value in a case where there was dissolution and also discontinuance of the business of the firm. In that case after dissolution, two groups were carrying on separate business with the assets and liabilities which fell to their shares from the dissolution of the firm. In the present case, however, though there was dissolution on account of the death of one of the partner, but there was no discontinuance of the business. The unchallenged finding recorded by the Tribunal is that there was no discontinuance of business. Even as per principles laid down in A.L.A. Firm's case in such a case the closing stock is to be valued at the cost or market price, whichever is lower. That is an established rule of commercial practice and accountancy. The High Court was clearly in error in relying upon the decision of the Madras High Court in the cases of Ramachari and A.L.A. Firm for coming to the conclusion that assets had to be valued at market value. As already noticed, in the present case, there has no cessation of business and, therefore, the closing stock could not be directed to be valued at the market rate. For the aforesaid reasons, we answer the question in negative, i.e., in favour of the assessee and against the Revenue.

The appeal is accordingly allowed. The appellant will also be entitled to costs.

.....J.  
[Y.K.Sabharwal]

.....J.  
[Brijesh Kumar]

August 2, 2001