1953

Oct. 9.

CHAINRUP SAMPATRAM

v.

COMMISSIONER OF INCOME-TAX, WEST BENGAL.

[PATANJALI SASTRI C. J., S. R. DAS, VIVIAN BOSE, GHULAM HASAN and BHAGWATI JJ.]

Indian Income-tax Act (XI of 1922), ss. 4(1)(b) and 14(2)(c)—Ascertainment of profit by valuation of stock—Stock-in-trade removed to Native State—Place where profit accrues—Exemption under s. 14 (2) (c)—Principles underlying valuation of stock.

The assessee firm which carried on business at Calcutta in bullion despatched during the accounting year to Bikaner, where its partners resided, a certain quantity of silver bars and showed them as having been sold to the partners. The Income-tax authorities disbelieved the story of the sale and, treating the bars as stock-in-trade and valuing them at their market value at the close of the year which was much higher than the cost, assessed the firm's profits at Rs. 2,20,887. The assessee contended that, even admitting that the bars were the stock-in-trade of the business, the increased value at the close of the year accrued at Bikaner and was exempt from tax in British India under s. 14(2)(c) of the Income-tax Act. The High Court held that the notional profit representing the appreciation in value of the stock-in-trade emerged out of the valuation and the profit accordingly arose at the time when, and at the place where, the valuation was made, and as the valuation was made at Calcutta s. 14(2)(c) did not apply and the profit was taxable. On appeal,

Held, that the view of the High Court that the profit arose out of the valuation of the closing stock and the situs of its accrual or arising was therefore where the valuation was made, was erroneous. The conclusion of the High Court that the profit did not accrue in Bikaner but at Calcutta could, however, be supported on another ground, *viz.*, that the source of the profit was the business and as the profit could be correctly ascertained according to the method adopted by the assessee only after bringing into the trading account his closing stock wherever it may exist, the whole of the profits must be taken to accrue or arise at the place of carrying on the business, *viz.*, Calcutta.

The principles underlying the method of ascertaining profits by valuation of stock at the beginning and close of the year and of the rule that the closing stock is to be valued at cost or market value, whichever is the *lower*, explained.

Whimster and Co. v. *Commissioners of Inland Revenue* (12 Tax Cas. 813) and *Commissioner of Income-tax, Madras* v. *Chengalvaraya Chetty* (I.L.R. 48 Mad. 836) *referred to.*

CIVIL APPELLATE JURISDICTION Civil Appeal No. 142 of 1952.

Appeal by special leave granted by the Supreme Court by its order dated the 14th March, 1952, from the Judgment and Order dated the 4th day of June, 1951, of the High Court of Judicature at Calcutta (Chakravartti and Das Gupta JJ.) Special Jurisdiction (Income-tax) in I.T.R. Nos. 7 and 6 of 1947 arising out of the Order dated the 26th day of March, 1946, of the Income-tax Appellate Tribunal, Calcutta Bench, in 66 R.A. No. 3 Bengal 1946-47 and 66 R.A. No. 4 Bengal 1946-47.

N. C. Chatterjee (*S. N. Mukherji*, with him) for the appellant.

C. K. Daphtary, Solicitor-General for India (*G. N. Joshi*, with him) for the respondent.

1953. October 9. The Judgment of the Court was delivered by

PATANJALI SASTRI C. J.—This is an appeal by special leave from a judgment of the High Court of Judicature at Calcutta answering a reference by the Income-tax Appellate Tribunal under section 66 (2) of the Indian Income-tax Act, 1922, hereinafter referred to as "the Act".

The appellant is a registered firm consisting of two brothers as partners with equal shares. The firm was carrying on business at Calcutta as bullion merchants dealing mainly in silver and kept its books of account on the mercantile basis. In the course of the year of account 1997 (Ramnavami) corresponding to 1941-42, 582 bars of silver (some from the old stock in hand at Calcutta and some purchased elsewhere during the year) were sent to Bikaner where the partners resided, and their value at cost was credited in the books of the firm. In the assessment of the firm for the year 1942-43, it was alleged that the said silver bars had been sold to the partners for their domestic use but the Income-tax authorities held that the alleged sale was not genuine and that the said silver bars still formed part of the stock-in-trade of the firm at the close of the previous year 1997, and they accordingly included in the taxable profits a sum of Rs. 2,20,887 as the excess arising from the valuation of the said 582 bars at market price on the closing day. They were valued at market rate at which the rest of the closing stock at Calcutta was valued in the books of the firm.

On appeal the Appellate Tribunal, on a consideration of all the facts and circumstances of the case, recorded its finding as follows :

"All these circumstances make it clear to us that the action of the Income-tax authorities in treating the stock of silver bars in Bikaner as part of the stock-in-trade of the Calcutta business was amply justified. The appellant on account of the panic in Calcutta had to remove the valuable stock-in-trade to a safe place in Bikaner just as many other Calcutta businessmen did at that time. The partners of the firm then noticed the upward trend of the silver market, and decided to take advantage of the camouflage afforded by the entries in the books of account and the story of sale to partners, so that the profit of the year of account could be substantially reduced artificially."

The appeal was accordingly dismissed. The application by the firm under section 66(1) of the Act asking

for a reference to the High Court of six questions as questions of law arising out of the order of the Tribunal was also rejected.

Thereupon the firm moved the High Court under section 66(2), and the court directed the Tribunal to refer the following question of law for its decision :

Whether in the circumstances of the case and on a true construction of section 4 (1) (b) and section 14 (2) (c) of the Indian Income-tax Act, the sum of Rs. 2,20,887 was in law assessable to tax ?

The reference was heard by Chakravartti and Das Gupta JJ., who answered the question in the affirmative.

The firm being admittedly resident and ordinarily resident within the meaning of sections 4-A and 4-B in what was then known as British India, its total income would include also income accruing or arising to it without British India under section 4 (1) (b) (ii). The firm, however, claimed exemption in respect of the said sum under section 14(2)(c) which provided that the tax shall not be payable by an assessee in respect of any income, profits or gains accruing or arising to him within an Indian State. It was contended that even on the finding of the Income-tax authorities that the silver bars in question formed part of the stock-in-trade of the business at Calcutta and their removal to Bikaner had been effected only for reasons of security, the said bars having remained there during the rest of the accounting year, their value at the market rate at the close of the year being an increment to the goods at Bikaner, the profit accrued at Bikaner (then an Indian State), with the result that it was exempted under section 14 (2) (c).

The High Court rejected this contention on the ground that the "notional profit" represented by the appreciation in value of the stock-in-trade "emerges out of the valuation and only when it so emerges it arises or accrues. The source of the profit is thus the valuation, and its *situs* is where the valuation is made. What is valued is the firm's business at the site of the

firm and all the stock-in-trade of the firm is necessarily drawn into the valuation wherever they may be physically situated. The profit which is the result of the stock valuation of a business is thus *sui generis*, a type by itself, to which the ordinary notions of a physical accrual will not apply. It comes into existence when the valuation is made and since it arises out of the valuation, it arises, in respect of the whole stock-in-trade, at the site of the firm whose stock-in-trade is being valued irrespective of where parts of the stock-in-trade may be."

While we agree with the conclusion that no part of the profits of the firm in the accounting year can be said to have accrued or arisen at Bikaner, the reasoning by which the learned Judges arrived at that conclusion seems to us, with all respect, to proceed on a misconception. 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 the account, as no prudent trader would care to show increased profit before its actual realisation. 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. As profits for income-tax purposes are to be computed in conformity with the ordinary principles of commercial accounting, unless, of course, such principles have been superseded or modified by legislative enactments, unrealised profits in the shape of appreciated value of goods remaining unsold at the end of an accounting year and carried over to the following year's account in a business that is continuing are not brought into the charge as a matter of practice, though, as already stated, loss due to a fall in price below cost is allowed even if such loss has not been actually realised. As truly observed by one of the learned Judges in *Whimster & Co.* v. *Commissioners of Inland Revenue*(1), " Under this law (Revenue law) the profits are the profits realised in the course of the year. What seems an exception is recognised where a trader purchased and still holds goods or stocks which have fallen in value. No loss has been realised. Loss may not occur. Nevertheless, at the close of the year he is permitted to treat these goods or stocks as of their market value."

An illustration of the rule in its practical working is to be found in the case of the *Commissioner of Income-tax, Madras* v. *Chengalvaraya Chetti*(2). In 1921 the

assessee purchased a large stock of piece-goods at Rs. 13-8 a piece. At the end of the year the market value fell to Rs. 6 a piece, and he made out a loss by valuing the *whole* stock at the market rate, including the unsold pieces in hand at the end of the year. The loss was allowed in his assessment to income-tax. In the following year (1922), however, he entered the same unsold goods as opening stock at the cost price of Rs. 13-8. Some of those pieces remained unsold at the end of 1922 also and he credited their value at Rs. 8-8 a piece, the market rate then prevailing, and showed a loss on the year's trading. The Income-tax authorities refused to allow the loss thus calculated, and assessed him as having made a profit on the footing that the opening stock of 1922 should have been valued at Rs. 6 a piece and the unsold pieces at Rs. 8-8 a piece. The assessment was upheld as properly made, though, it will be seen, the transactions of 1922, or even of the two years taken together, ended actually in a loss. Thus, while the valuation of the unsold stock at the end of each year at market rate which was less than cost was accepted, the valuation of the unsold goods carried over as opening stock of 1922 at Rs. 6 a piece consistently with their valuation as the closing stock of 1921 was insisted upon in order to rectify the distorted picture of the trading results of 1921 which were not correctly reflected in the accounts by reason of the assessee having adopted the lower market rate instead of cost as the value of the closing stock in 1921. If the market had risen to, say, Rs. 15 instead of to Rs. 8-8 a piece at the end of 1922, then, on the principles indicated above, it would have been open to the assessee to value the closing stock at cost (Rs. 13-8), and the Income-tax authorities could not have claimed to bring into the assessment the appreciated value of the unsold goods. It will thus be seen that no question of charging the appreciated value of closing stock as "notional profits" can really arise. In the present case, although it would appear that the cost price of part of the silver despatched to Bikaner was less than the market price at the end of the year, the reference did not raise any question regarding the

basis on which the amount in dispute, *viz.*, Rs. 2,20,887, was arrived at. On the other hand, the question referred assumed that the said sum was correctly computed and put in issue only its assessability in law of on a true construction of section 4(1) (b) and section 14(2) (c) of the Act.

Again, it is a misconception to think that any profit "arises out of the *valuation* of the closing stock" and the *situs* of its arising or accrual is where the valuation is made. As already stated, valuation of unsold stock at the close of an accounting period is a necessary part of the process of determining the trading results of that period, and can in no sense be regarded as the "source" of such profits. Nor can the place where such valuation is made be regarded as the "*situs* of their accrual". The source of the profits and gains of a business is indubitably the business, and the place of their accrual is where the business is carried on. As such profits can be correctly ascertained according to the method adopted by an assessee only after bringing into the trading account his closing stock wherever it may exist, the whole of the profits must be taken to accrue or arise at the place of carrying on the business. On the finding of the Income-tax authorities that the 582 bars of silver lying at Bikaner had not been really sold but remained part of the unsold stock of the firm's business at the end of the accounting year, the whole of the profits of that year must be taken to have accrued or arisen at Calcutta where the business was carried on, no part of that business having admittedly been transacted at Bikaner.

We agree with the High Court that the question referred should be answered in the affirmative though on different grounds. The appeal is accordingly dismissed with costs.

Appeal dismissed.

Agent for the appellant: *P. K. Mukherji.*
Agent for the respondent: *G. H. Rajadhyaksha.*