

(1990) 10 MAD CK 0034
In the Madras High Court

Commissioner of Income Tax		APPELLANT
	Vs	
Bharath Auto Stores		RESPONDENT

Date of Decision : 26-10-1990

Acts Referred:

Income Tax Act, 1961 — Section 256

Citation : (1990) 90 CTR 177 : (1991) 188 ITR 477

Hon'ble Judges : V. Ratnam, J;T. Somasundaram, J

Bench : Division Bench

Advocate : N.V. Balasubramanian, for the Appellant; R. Janakiraman, for the Respondent

Judgement

Ratnam, J.—The assessee was a partnership firm, which consisted of two partners and was constituted under a deed of partnership dated

April 1, 1972. Under a codicil dated April 1, 1973, clause 9 was introduced into the deed of partnership to the effect that from April 1, 1972 in

the event of dissolution of the firm, the partners agreed that the assets of the firm, including stock on hand, shall be valued at book value and

divided. The partnership business was carried on at two places under the name and styled of ""Bharat Auto Stores"" and ""Balaji Automobiles"", and

by a deed of dissolution, the partnership was dissolved on March 31, 1974. Subsequent to the dissolution, one of the partners continued the

business under the name and style of ""Bharat Auto Stores"", while the other partner took over the business under the name and style of ""Balaji

Automobiles"". For the assessment year 1974-75 (accounting period ending on March 31, 1974) in accordance with the prior practice and clause

19 of the deed of partnership, the assessee valued the closing stock at book value. While finalising the assessment, the Income Tax Officer,

following the decision in G. R. Ramachari and Co. Vs. Commissioner of Income Tax, Madras, , revalued the closing stock on the basis of the

market value, and, after taking into account a portion of the dead and unsaleable stock, inclusive of articles, which were not quick moving, made

an addition of Rs. 90,468 to the income returned by the assessee from the business carried on in tyres, tubes, spare parts, etc., relating to truck

spares. On appeal by the assessee before the Appellate Assistant Commissioner, he took the view that the decision in G. R. Ramachari and Co.

Vs. Commissioner of Income Tax, Madras, would not be applicable and that, if proofs had been ascertained on the basis of a method of

accounting regularly followed by the assessee, by adopting a particular method for valuing the stock and if, in every case of dissolution of

partnership, the closing stock should be valued and notional profits added, it would be against the canons of justice and natural law. In this view,

the Appellate Assistant Commissioner allowed the appeal and deleted the addition. On further appeal to the Tribunal by the Revenue, after

referring to the decisions reported in G. R. Ramachari and Co. Vs. Commissioner of Income Tax, Madras, and A.L.A. Firm Vs. Commissioner of

Income Tax, , the Tribunal took the view that the rights of the parties will be governed by the provision in clause 19 of the deed of partnership,

and, therefore, the assets, including the stock-in-trade, were properly valued on the basis of the book value. so holding, the Tribunal dismissed the

appeal. That is how the following question of law u/s 256(1) of the Income Tax Act. 1961 (hereinafter referred to as ""the Act""), at the instance of

the Revenue, has been referred to this court for its opinion :

Whether, on the dissolution of a firm and where the partnership deed provides that, in the event of dissolution of the firm, the assets of the firm,

including stock on hand shall be valued at book value and divided, the assessee who is consistently, in the earlier years, valuing the closing stock at

cost, can be directed to value it at market value ?

2. Learned counsel for the Revenue contended that though it may be open to the partners to value the stock either at books value or at market

value, whichever is more advantageous, during the continuance of the business of the partnership, yet, on dissolution of the partnership, the only

method which could be adopted in the valuation of assets was the market value,

as the settlement of accounts at the point of dissolution could not be on a notional basis, and every asset of the partnership should be converted in terms of money and the account of the partner settled on that footing. It was also further submitted that the provision under clause 19 of the deed of partnership would not, in any manner, enable the assessee to justify the valuation of the assets on the date of dissolution according to the book value, as such an arrangement might at best hold good between partners, but not be binding on the Revenue, and that would also result in the profits of the firm being omitted to be brought to tax. Strong reliance in support of these contentions was placed upon the decisions in *G. R. Ramachari and Co. v. CIT* [1961] 41 ITR , *A.L.A. Firm Vs.*

Commissioner of Income Tax, , Popular Workshops Vs. Commissioner of Income Tax, , V.C. Venkata Subbaiah Chetty and Sons Vs.

Commissioner of Income Tax, , Popular Automobiles Vs. Commissioner of Income Tax, and Spanish Prospecting Co. Ltd., In re [1911] 1 Ch 92

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3. On the other hand, learned counsel for the assessee submitted that even during the course of the dissolution of the partnership, the method

adopted by the firm earlier, had been followed, and that clause 19 of the deed of partnership sanctioned it. The further faint submission of learned

counsel for the assessee was that the Revenue cannot proceed to subject to tax notional profits. Reference was made by learned counsel for the

assessee to the decisions in *COMMISSIONER OF Income Tax AND EXCESS PROFITS TAX, MADRAS Vs. MESSRS. CHARI AND*

RAM, MADURA., and Commissioner of Income Tax, (Central) Madras Vs. K. Sankarapandia Asari and Sons, .

4. Under clause 6 of the deed of partnership, proper books of account shall be maintained for the partnership and the accounts of the partnership

shall be closed for profit and loss account at the end of March 31, every year. It is not in dispute in this case that the assessee had been adopting

the book value for the stocks in the prior years, while making up the accounts. However, during the course of the carrying on of the business of the

firm, either due to motives of prudence, or sound business views, the value of the stock might have been shown at the book value. The account so

made up is for the limited purpose of ascertaining the profits or the loss at the

end of the year and so long as the business of the partnership was continued, to the partners, it would not have made any difference, even if the book value was put upon the assets. The assets on which such book value had been put would continue to remain assets of the firm and the benefit or loss of such fluctuations in the value of the assets, would accrue to the firm and be available to it. However, on dissolution of the firm, there is a total disruption of the firm and its business activities and settlement of accounts on dissolution cannot be on a notional basis, but with reference to the conversion of every asset of the partnership into money and the settlement of the accounts of the partners on that basis. We may also, in this connection, refer to the following passage at p. 612 of Lindley on the Law of Partnership (13 edition).

... an express agreement with reference to the taking of accounts may be, and frequently is, only applicable to the case of a continuing partnership, and may not be intended to be observed on a final dissolution of the firm, or even on the retirement of the one of its members. A similar observation applies to the mode in which the partners themselves have been in the habit of keeping their accounts, that which has been done for the purpose of sharing annual profits or losses is by no means necessarily a precedent to be followed when a partnership account has to be finally closed.

5. From the passage referred to above, it is clearly established that though the partnership firm had followed one method or mode of valuation of the assets for purposes of ascertaining the profit or loss, for any particular period in respect of a running business, for purposes of dissolution and for settling accounts, the method earlier adopted could not be really called into aid as a precedent.

6. We may now consider whether a provision of the kind under clause 19 would make any difference. Though, under that clause, the partners had agreed that even in the event of the dissolution of the firm, the book value of the assets should be adopted, that would not enable the assessee to maintain that only the book value of the assets should be adopted. Earlier, the reason for and the effect of the adoption of the books or the market value of the assets of a firm on its business, which is continuing and on a firm, which is dissolved, as the case may be had been noticed. It may be

that even if the partners agree that the book value of the assets should be adopted in the case of dissolution of the firm, but such an agreement may, at best, be good only as between partners. In so far as the Revenue is concerned, it has a right to a certain percentage of the profits of the firm by way of Income Tax and the profit and loss account of the firm arrived at in accordance with the provisions of the deed of partnership would in no way bind the Revenue. In view of the aforesaid considerations, the method adopted by the assessee in the earlier years in the matter of valuation of stocks or the provision under clause 19 of the deed of partnership cannot be pressed into service by the assessee to justify the valuation of the stock at cost price been on the dissolution of the firm.

7. We may now refer to the decisions relied on by learned counsel for the Revenue. In *G. R. Ramachari and Co. Vs. Commissioner of Income Tax, Madras*, the question that arose for consideration was whether the valuation of the closing stock at average cost on September 11, 1944, with reference to the branches at Bombay and Nagpur was correct. There was a dissolution of a firm through a decree of the court with effect from September 11, 1944. The firm had places of business at Madurai, Bombay and Nagpur. The valuation of the closing stock in the Bombay and Nagpur shops was given as Rs. 22,286 being its book value. In respect of the assessment year 1945-46, the assessee-firm admitted an income of Rs. 6,281, to which the Income Tax Officer added Rs. 8,715, being the difference between the value as per the books and the market value of the assets. All the authorities concurred in holding that the addition so made was in order and when the matter came up to this court, this court held that the privilege of valuing the opening and closing stocks in a consistent method is available only to a continuing business and it cannot be adopted where the business comes to an end and the stock-in-trade has to be disposed of in order to determine the exact position of the business on the date of closure. Adverting to the argument that the assessee is entitled to adopt the same method as before, even when the business is closed and the assessable entity ceases to exist, this court pointed out that that proposition cannot be accepted and it is obvious that, when a business ceases, all its stock-in-trade has to be disposed of and brought into account in order to balance the books. At page 149, this

court observed as follows :

The case of a firm which goes into liquidation forms a close parallel to the present case. In such a case, all the stock-in-trade and other assets of

the business will have to be sold and their value realised. It cannot be controverted that it is only by doing so that the true state of the profits or

losses of the business can be arrived at. The position is not very different when the partnership ceases to exist in the course of the accounting year.

The fact that Ramachari, one of the ex-partners, took over the entire stock and continued to run the business on his own, is not relevant at all,

when we consider the profits or losses of the partnership which has come to an end. It should, therefore, follow that, in order to arrive at the

correct picture of the trading results of the partnership on the date when it ceases to function, the valuation of the stock in hand should be made on

the basis of the prevailing market price.

8. The aforesaid principle had been reiterated and applied in the decision in A. L. A. Firm v. CIT [1976] 622 (Mad). In that case, the question

arose whether the difference on a revaluation of the assets of the dissolved assessee-firm credited to the profit and loss account could be subjected

to tax. In dealing with this question, Muhammad Ussain Sahib v. Abdul Gaffoor Sahib [1950] 1 MLJ 81 and G. R. Ramachari and Co. v. CIT

[1961] ITR 142 were referred to and it was observed that the option to value the stock at cost or market value, whichever was lower, is available

to the assessee during the subsistence of the business and that there is no authority that such an option available even at the point of termination of

the business and the stock had to be valued whatever be the method of accounting, at the time of dissolution of firm, at the market price. The two

decisions referred to above clearly lay down that whatever might have been the provision in the deed of partnership or even the practice during the

continuance of the business of the partnership firm, on dissolution, the valuation cannot be otherwise than at the market value.

9. In Popular Workshops Vs. Commissioner of Income Tax, , the principle that, on the dissolution of a firm, the stock-in-trade should be valued

with reference to the market value and not the book value, was accepted by the Kerala High Court on the strength of the decisions in G. R.

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Court in V.C. Venkata Subbaiah Chetty and Sons Vs. Commissioner of Income Tax, , in a case where a firm was dissolved on the death of one of

the partners and there was a sale of the stock to another partner at the books value, and there was an addition by the Income Tax Officer to the

profit of the firm over and above the book value, held that, after the death of a partner which resulted in the dissolution of the firm, the assets had

to be valued on the basis of the market value on the date of dissolution. In Popular Automobiles Vs. Commissioner of Income Tax, , the Kerala

High Court had again an occasion to consider the same question and it was laid down, referring to G. R. Ramachari and Co. Vs. Commissioner of

Income Tax, Madras, and Popular Workshops Vs. Commissioner of Income Tax, , that, on the dissolution of a firm, the stock-in-trade has to be

valued with reference to the market value and not with reference to the book value in order to arrive at the true profit earned by the firm during the

relevant previous year. We are of the view that the aforesaid decisions clearly support the stand of the Revenue that the valuation of the stock, as

on the date of dissolution, should be on the basis of the market value and not the book value. We have earlier pointed out that even in the presence

of clause 9 of the deed of the partnership, the method that should be adopted is that based on the market rate. We have also pointed out that at

best there may be an agreement between the partners inter se which may not be binding on the Revenue. It is in this connection that a reference to

Spanish Prospecting Co. Ltd. In re [1911] 1 Ch 92 has to be made. Fletcher-Moulton L. J. while dealing with the concept of profits and the wide

variation in the estimation of profits in the document of a firm, pointed out at page 99 that the value assigned to assets is usually according to an

arbitrary rule, by which, they are originally taken at their actual cost, though any such calculation cannot be regarded as necessarily giving their true

value either in use or in exchange, and that it would only be a variation of practice resting on no settled principle. It has also been further pointed

out that to render the ascertainment of the profits of the business of practical use, it is evidence that the assets, whatever their nature may be, must

be represented by their money value and the figure inserted to represent stock-in-trade must be arrived at by a valuation of the actual articles and

though there is a wide field for variation of practice in the estimation of profit, this liberty ceases when the rights of third persons intervene, like, for

instance, the Revenue, which has a right to a certain percentage of profits of the assessee-company by way of Income Tax, in respect of which the

actual profit and loss accounts of the company do not bind the Crown in arriving at the tax to be paid.

10. At page 101, Fletcher Moulton L. J. has categorically stated that profits in cases where the rights of third parties come in, mean actual profits

and they must be calculated as closely as possible, in accordance with the fundamental conception or definition of profits, based on money value.

We are of the view that this decision negatives the support sought to be draw by learned counsel for the assessee from clause 19 of the deed of

partnership.

11. That leaves for consideration the two decisions relied on by learned counsel for the assessee. In CIT/CEPT v. Chari and Ram [1949] 17 ITR ,

a question arose as to whether the assessee was in order in having value the closing stock at the average cost or the market value, whichever was

lower item-wise, but not in the aggregate. That, however, was not a case of dissolution of the firm and the method to be adopted in the valuation of

the assets of the dissolved firm. That decision cannot, therefore, be of any assistance to the assessee. Commissioner of Income Tax, (Central)

Madras Vs. K. Sankarapandia Asari and Sons, , dealt with a case of the entitlement of the assessee to amortisation in full, on the basis of the

consistent method of accounting adopted by the assessee, by which the entire cost of the distribution rights in the year of acquisition had been

written off, which had also been accepted by the Department. There was, in that case, also no dissolution of the firm and the need for any

revaluation of the assets as such. Thus, the decisions relied on by learned counsel for the assessee do not at all in manner assist it.

12. Thus, on a due consideration of the facts and circumstances of the case, we answer the question referred to us in the affirmative and in favour

of the Revenue. The Revenue will be entitled to its costs in this reference. Counsel's fee Rs. 500.