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**(1985) 12 KL CK 0018**

**In the High Court Of Kerala**

**Case No : Income-tax Reference No. 141 of 1980**

Popular Workshops

APPELLANT

Vs

Commissioner of Income Tax

RESPONDENT

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**Date of Decision :** 19-12-1985

**Acts Referred:**

Income Tax Act, 1961 — Section 189

**Citation :** (1987) 166 ITR 348

**Hon'ble Judges :** T. Kochu Thommen, J; K.P. Radhakrishna Menon, J

**Bench :** Division Bench

**Advocate :** T.L. Viswanatha Iyer, for the Appellant; P.K. Ravindranatha Menon and N.R.K. Nair, for the Respondent

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## **Judgement**

T. Kochu Thommen, J.—The following question has been, at the instance of the assessee, referred to us by the Income Tax Appellate Tribunal, Cochin Bench :

"Whether, on the facts and in the circumstances of the case, the closing stock should be valued at the market value as claimed by the Department or at cost as claimed by the assessee for the purpose of determining its income for the assessment year under consideration?"

2. The assessee was a firm which was dissolved on June 30, 1971, when two of the five partners retired. The retiring partners were allowed to withdraw the closing stock valued at Rs. 94,390.75. Their accounts were duly debited. On the next day, the remaining partners entered into a fresh partnership deed to carry on the same business as that of the dissolved firm. For the assessment year 1972-73, which is the year in question, assessment was completed on the basis that the total income of the assessee-firm was Rs. 1,04,770. This was on the basis that the closing stock was correctly valued at Rs. 94,390.75. Subsequently, the assessment was reopened. The Income Tax Officer held that on dissolution of the firm on June 30, 1971, the closing stock should have been taken not at the cost price as shown in the books, but at the market price. Accordingly, he determined the value of the closing stock as on June 30, 1971, at Rs. 1,17,987,

and the taxable income was determined on that basis. On appeal, the Appellate Assistant Commissioner affirmed the principle followed by the Income Tax Officer, but gave some reduction by determining the market value of the stock on the closing day by adding 20 per cent. to the cost. On further appeal by the assessee, the Tribunal, following the decisions of the Madras High Court in *G. R. Ramachari and Co. Vs. Commissioner of Income Tax, Madras*, and *A.L.A. Firm Vs. Commissioner of Income Tax*, , upheld the principle followed by the authorities below and held that the closing stock of the dissolved firm should be valued only at the market rate and not at the cost price as claimed by the assessee.

3. In *G. R. Ramachari and Co. Vs. Commissioner of Income Tax, Madras*, , the Madras High Court held (headnote):

"The privilege of valuing the opening and closing stocks in a consistent manner is available only to a continuing business and it cannot be adopted where a business has come to an end and the stock on hand has to be disposed of in order to determine the exact position of the business on the date of the closure.

Where a partnership, which has been valuing its opening and closing stocks at cost price when its business was continuing, dissolves and one of the partners takes over the stock on hand, 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 on hand should be made on the basis of the prevailing market price. Therefore, that the partner who takes over the stock on hand values them at cost price is of no effect."

4. In *A.L.A. Firm Vs. Commissioner of Income Tax*, , the Madras High Court, following its earlier decision in *G. R. Ramachari and Co. Vs. Commissioner of Income Tax, Madras*, , held (headnote):

"Stock-in-trade of a firm does not cease to be stock-in-trade on the dissolution of the firm. Though an assessee has an option to value the stock-in-trade at cost or market value, whichever was lower, during the subsistence of a business, that option is not available to it at the point of termination of business, when the stock-in-trade has to be valued at market value."

5. The assets of a partnership for the purpose of winding up after the dissolution should be taken, not at the book value, but at their fair value to the firm. The annual accounts are not the basis for determining the rights of a deceased or retiring partner. The annual settlement of account is for the purpose of determining profits at the end of the year. So long as the firm continues, it makes no difference to the partners that notional value is taken as the value of the assets. The assets at the book value continue to belong to the firm and the benefit or the loss arising from fluctuations in their value would accrue to the firm. But the position is entirely different upon dissolution of the firm or upon retirement of a partner. The accounts in such an event must be settled not on a notional basis, that is, the book value, but on the real basis, that is, by conversion of every asset into money and the account of each partner settled on

that basis. For this purpose, the assets have to be valued on the basis of the market value as on the date of the dissolution (see *Muhammed Ussain Sahib v. Abdul Gaffor Sahib*, AIR 1950 Mad 758 ; *Lindley on the Law of Partnership*, 14th edn., page 878). Upon dissolution of a firm, the share of each partner is his proportion of the assets of the firm after they are realised and converted into money and after the debts and liabilities of the firm have been paid and discharged (see *Addanki Narayanappa and Another Vs. Bhaskara Krishtappa and Others*, ).

6. It is, therefore, clear that for the purpose of assessment of a dissolved firm u/s 189 of the Income Tax Act, 1961, the income of the firm has to be computed with reference to the market value of the closing stock and not the book value of such stock. On the other hand, in the case of a continuing business, it is open to the assessee-firm to value its stock-in-trade either at cost or market value, whichever is lower. This privilege does not extend to a dissolved firm.

7. In this connection, reference may be made to the recent decision of the Supreme Court in *Sunil Siddharthbhai Vs. Commissioner of Income Tax, Ahmedabad, Gujarat*, , where the court, referring to a partner's interest in the asset brought in by him as his contribution to the capital of the firm, says (at p. 518):

"..... an asset which originally was subject to the entire ownership of the partner becomes now subject to the rights of other partners in it. It is not an interest which can be evaluated immediately, it is an interest which is subject to the operation of future transactions of the partnership, and it may diminish in value depending on accumulating liabilities and losses with a fall in the prosperity of the partnership firm. The evaluation of a partner's interest takes place only when there is a dissolution of the firm or upon his retirement from it."

8. This observation supports the contention of the Revenue that the value of the stock at the time of the dissolution of the firm has to be determined according to its true worth and not according to the book value.

9. Counsel for the assessee, however, refers to *Chainrup Sampatram Vs. Commissioner of Income Tax, West Bengal*, , *Commissioner of Income Tax Vs. Kikabhai Premchand*, , *Sri Ramalinga Choodambikai Mills Ltd. Vs. Commissioner of Income Tax, Madras*, and *Commissioner of Income Tax, West Bengal Vs. Calcutta Discont Co. Ltd.*, , which were all cases of continuing business entities entering into transactions at concessional rates. In those cases, the courts upheld the validity of those transactions in the absence of any finding that they were sham and held that it was not open to the Revenue to ignore the real price fetched in ascertaining the profits of the business. In *Commissioner of Income Tax, Gujarat Vs. Keshavlal Chandulal*, , although the main business of the assessee-firm had been terminated, the firm apparently continued as a business entity and, in the absence of any evidence to show that the transaction was sham, the court accepted the concessional price at which twenty-eight shops

were distributed among the partners. This price, although less than the market value, was more than the cost as shown in the books of account. These decisions, in our view, do not support the assessee's contention that upon dissolution of the firm, its profits have to be computed taking into account not the market value of the stock, but only their book value.

10. We are in respectful agreement with the reasoning of the Madras High Court in G. R. Ramachari and Co. Vs. Commissioner of Income Tax, Madras, and A.L.A. Firm Vs. Commissioner of Income Tax, . We are of the view that the closing stock of the assessee as on the date of the dissolution should be valued at the market rate and not on the basis of the cost shown in the assessee's books of account. Accordingly, we answer the question referred to us in favour of the Revenue and against the assessee.

11. We direct the parties to bear their respective costs in this tax referred case.

12. A copy of this judgment under the seal of the High Court and the signature of the Registrar shall be forwarded to the Income Tax Appellate Tribunal, Cochin Bench.