

**A** BRIJ BHUSHAN LAL PARDUMAN KUMAR ETC.

v.

COMMISSIONER OF INCOME TAX, HARYANA, HIMACHAL  
PRADESH AND NEW DELHI-III

**B** October 6, 1978

[P. N. BHAGWATI AND V. D. TULZAPURKAR, JJ.]

*Liability to tax—Whether in a lump sum contract, where the stores and materials are supplied by the Government, the cost thereof was liable to be taken into account while estimating the income or profits of the assessee contractor—Best Judgment assessment, principle to be followed.*

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The appellant assesseees are Military Engineering Services' contractors and as such carry on business of executing contracts and work on behalf of the Government. Their contracts are "Lumpsum contracts" where the department supplies the materials at fixed rates. The revenue was of the opinion that the cost of the materials supplied by the military authorities was liable to be included before applying the flat rate to the assessee's receipts and estimating the profits for the purposes of tax liability. The High Court of Punjab and Haryana on a reference at the instance of the Revenue confirmed it following its own earlier Judgments in the case of *Brij Bhushan Lal v. C.I.T. Delhi*, (1971) 81 I.T.R. 497.

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Allowing the appeals by special leave, the Court,

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HELD : 1. The law relating to 'best judgment assessment' is same both in the case of income tax assessment and the sales tax assessment. The authority making a best judgment assessment must make an honest and fair estimate of the income of the assessee and though arbitrariness cannot be avoided in such estimate the same must not be capricious, but should have a reasonable nexus to the available material and the circumstances of the case. [22G-H, 23D-E]

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*Commissioner of Income Tax v. Laxminarain Badridas*, (1937) 5 I.T.R. 170 (PC), *Raghubar Mandal Harihar Mandal v. State of Bihar*, (1957) 7 S.T.C. 770 at p. 778 and *State of Kerala v. C. Velukutty*, (1966) 60 I.T.R. 239; referred to.

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2. Ordinarily when a works contract is put through or completed by a contractor the income or profits derived by the contractor from such contract is determined on the value of the contract as a whole and cannot be determined by considering several items that go to form such value of the contract but where certain stores/material is supplied at fixed rates by the Department to the Contractor solely for being used for fixed or incorporated in the works undertaken on terms and conditions mentioned in the contract, the real total value of the entire contract would be the value minus the cost of such stores/material so supplied. Therefore, since no element of profit was involved in the turnover represented by the cost of stores/material supplied

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by the M.E.S. to the assessee firms, the income or profits derived by the assessee firms from such contracts will have to be determined on the basis of the value of the contracts represented by the cash payments received by the assessee

firms from the M.E.S. Department exclusive of the cost of the material/stores received for being used, fixed or incorporated in the works undertaken by them. [26E-H]

In Lumpsum contracts of M.E.S. Department two salient features are always present namely, (1) there is a Schedule 'B' which specifies the items of stores/material to be supplied by the Department to the contractor solely for being used, fixed or incorporated in the works together with the fixed rates at which the same will be supplied and such supply is governed by General Conditions Nos. 10 and 33; apart from the stores/material specified in Schedule 'B' the contractor also brings his own stores/material on site for the purposes of the works which is also governed by some Paragraphs of General Conditions Nos. 10 and 33; and (2) the final financial liability of the Government is fixed on completion of the contract on the basis of the actual measurements and on the basis of the rates which are already standardised; a detailed measurement is undertaken at the end of the work at which the Garrison Engineer and the Assessee's representative remain present and the measurements, are entered in Measurement Books and after the measurements final bills are prepared as per the M.E.S. Schedule and payments are made after making adjustments for the advances already made. [24A-D]

From the tender documents that are made available to contractor and the aforesaid terms and conditions of the "Lump Sum Contracts" two or three aspects emerge very clearly. In the first place the contractor becomes aware that certain specified stores/materials will be supplied to him by the Department at fixed rates for being used in the works to be undertaken by him for which he has not to pay from his pocket and it is on that footing that he submits his tender quoting a particular figure for the entire work; Secondly, such stores/material so supplied by the M.E.S. Department has to be used, fixed or incorporated by the contractor in the works undertaken by him and the surplus, if any, that would remain after the completion of the work is to be returned to the Department; thirdly, since for accounting purposes the initial supply is debited to the contractor at the specified fixed rates, credit for the balance of the stores/materials so returned is also given at the same rates, some adjustment being made in respect of the wear and tear of such stores/material but in regard to the stores material out of such supply as is actually used, fixed or incorporated into the works, no accounting is done viz-a-viz the contract payment that is made to the contractor. In other words, in substance and in reality such stores/material always remains the property of the Department and the contractor has merely the custody of it and he fixes or incorporates the same into the works. In such circumstances having regard to the terms and conditions on which such supply of stores/materials is made there is not even a theoretical possibility of any element of profit being involved in the turnover represented by the cost of such stores/materials. It is conceivable that when the contractor himself purchases materials in the open market and supplies the same to the Department by using, fixing or incorporating the same in the works, as in the case of materials other than specified in Schedule 'B' some profit element would be embedded in the turnover represented by the cost of such material but when stores/material is supplied by the Government Department at fixed rates for being used, fixed or incorporated in the work on terms indicated above there would be no element of profit involved in the turnover represented by the cost of such material. [25G-H, 26A-E]

**A** *Brij Bhushan Lal v. Commissioner of Income Tax, Delhi*, (1971) 81 I.T.R. 497 (Pb and Haryana); overruled.

*M. P. Alexander and Co. v. Commissioner of Income Tax* (1973) 92 I.T.R., 92 (Kerala); *Commissioner of Income Tax, Madras v. K. S. Guruswami Gounder and K. S. Krishnaraju* (1973) 72 I.T.R. 90 (Madras); *Trilokchand Chunilal v. Commissioner of Income Tax Gujarat* (1976) 107 I.T.R. 732 (Gujarat), *Additional Commissioner of Income Tax v. Trikamji Punia and Sons*, (1977) 106 ITR 597 [AP (F.B.)]; approved.

**B** CIVIL APPELLATE JURISDICTION : Civil Appeal Nos. 1701-1703 of 1974.

**C** Appeal by Special Leave from the Judgment and Order dated 26-9-73 of the Punjab & Haryana High Court in Income Tax Reference Nos. 38/72, 2/73, 3/73.

*S. T. Desai* and *Ramesh Chand* for the Appellant.

*P. G. Gokhale* and *Miss A. Subhashini* for the Respondent.

**D** The Judgment of the Court was delivered by

**E** TULZAPURKAR, J.—The short question raised in these appeals by special leave is whether the cost of materials supplied by the Government (M.E.S. Department) for being used in the execution of works is liable to be taken into consideration while estimating the profits of a contractor and the question has assumed general importance as it affects the entire class of contractors who undertake works on behalf of the Government and in view of a conflict of decisions on the point among different High Courts.

**F** The facts in all the three appeals are substantially the same though the assesseees are different. In Civil Appeal No. 1701 of 1974 the material facts are these : The assessee (M/s. Brij Bhushan Lal Praduman Kumar of Ambala Cantonment), a registered firm, is a Military Engineering Services (M.E.S.) contractor and as such carries on the business of executing contracts and works on behalf of the Government. For the execution of the works undertaken by the assessee certain material such as cement, coal, items of steel etc. is supplied at the fixed rates specified in Schedule B to the contract by the Government for being used in the works. Such material though in custody of the contractor always remains the property of the Government and if any surpluses is left at the completion of the contract, the contractor (assessee) has to account for it at the same rates at which the supply was made to him (wear and tear excepted) and return the same to the Government. The assessment year involved was 1966-67 for which the accounting year commenced on 1-10-1964 and ended on September

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30, 1965. The assessee-firm had taken two contracts, one at Delhi and the other at Ambala. For the said assessment year it filed its return of income declaring income of Rs. 44,462 being 10% of the total cash payments of Rs. 4,44,622 received from the military authorities. The assessee, however, did not furnish any figures about the stores (material) received by it from the M.E.S. The Income-tax Officer called upon the assessee to produce the relevant certificates in respect of such stores but the assessee failed to do so on the ground that the Departments were not cooperating with it. The Income-tax Officer, therefore, estimated the cost of such material at 50% of the cash payments, namely, at Rs. 2,22,311 and by adding this figure to the net cash receipts of Rs. 4,44,622 he arrived at total receipts (including the cost of material) of Rs. 6,66,933 and after rejecting the book results applied a flat rate of 10% and worked out net income or profits at Rs. 66,693 which was rounded upto Rs. 66,690 and on that basis the tax was levied after allocating the said profits among the three partners of the firm. The assessee preferred an appeal to the Appellate Assistant Commissioner contending that the addition of the cost of material supplied by the Government to the figure of cash receipts received by it during the year for applying the flat rate of 10% was erroneous and in any case the estimate of the value of such stores at 50% of the cash payments was excessive. The Appellate Assistant Commissioner rejected the first contention but reduced the estimate of the value of the stores supplied by the Government to 25% and confined the addition to Rs. 1,11,155. Aggrieved by that order the assessee preferred further appeal to the Income Tax Appellate Tribunal and the Tribunal accepted the contention of the assessee that the cost of the stores or material supplied by the Government to the assessee could not be added to the figure of cash payments received by the assessee on the ground that the stores (material) supplied by the Government were 'never sold' to the contractor, that the same always remained the property of the Government and that no profit could be said to have arisen to the assessee when such stores (material) was merely handled and manipulated by the assessee in the execution of the works under the contract. The Tribunal followed the decision of the Kerala High Court in *M.P. Alexander & Co. v. Commissioner of Income-tax*<sup>(1)</sup> where that Court has taken the view that the cost of such material supplied by the Government was not to be included while estimating the profits of a contractor. The Revenue sought a reference to the Punjab & Haryana High Court on the question whether on the facts and circumstances of the case, the Tribunal was justified in holding that the cost of the material supplied by the Government was not to be

(1) (1973) 92 I.T.R. 92.

**A** included while estimating the profits of a contractor and the High Court in Reference No. 38 of 1972 answered the question against the assessee and in favour of the Department and restored the view of the taxing authorities by its order dated September 26, 1973 and in doing so the yearly income tax paid by them is Rs. 70 to Rs. 80 only. There is *Bhushan Lal v. Commissioner of Income-Tax, Delhi*<sup>(1)</sup> where it had held that the cost of the materials supplied by the military authorities was liable to be included before applying the flat rate to the assessee's receipts.

Civil Appeals Nos. 1702 & 1703 of 1974 relate to the assessments of M/s. Brij Bhushan Lal Ramesh Kumar for the assessment years **C** 1965-66 and 1966-67, the relevant accounting years being the ones which ended on March 31, 1965 and March 31, 1966 respectively. The assessee firm, a M.E.S. Contractor, carried on the business of executing works on behalf of the Government under similar M.E.S. contracts wherein stores/materials were supplied by the military authorities to the firm on identical terms. For the assessment year **D** 1965-66 the assessee filed its return declaring an income of Rs. 18,684 and disclosing net cash receipts from the Government at Rs. 2,63,853. Though this income was based on books of accounts maintained by the firm, the assessee during the course of assessment proceedings offered that a flat rate of 9% on the cash receipts of Rs. 2,66,853 may be applied. The Income Tax Officer did not accept the offer but applied **E** a flat rate of 10% on Rs. 3,07,605 which included the value of the stores supplied by the Department to the assessee with the result that the profits were assessed at Rs. 30,760 and after allowing depreciation of Rs. 5,107 the net taxable income was determined at Rs. 25,653 which was rounded up to Rs. 25,650. For the assessment year 1966-67 **F** the firm declared an income of Rs. 62,414 calculated by adopting the flat rate of 10% on the cash receipts of Rs. 6,24,144. The firm had received stores/material of the value of Rs. 1,36,520 from the military authorities and the Income Tax Officer after adding the value of the stores to the cash receipts arrived at a total receipt of Rs. 7,60,664 and by applying the flat rate of 10% determined the taxable income at Rs. **G** 76,070. The assessee's appeals for both the years to the Appellate Assistant Commissioner were unsuccessful but in further appeals the Appellate Tribunal by its order dated October 31, 1970 accepted the assessee's contention and held that the cost or the value of the stores/material supplied by Government to the contractor was not liable to be included while estimating the profits or income of the contractor. In **H** coming to this conclusion, as in the other case, the Tribunal followed the Kerala High Court's decision in *M. P. Alexander's case* (supra).

(1) (1971) 81 ITR 497.

At the instance of the Revenue two references (being Income Tax References Nos. 2 and 3 of 1973) were made to the Punjab & Haryana High Court and the High Court following its earlier decision in *Brij Bhushan Lal's* case (supra) answered the questions referred to it in the negative i.e. in favour of the Department and against the assessee. Both the assesses have come up to this Court by special leave challenging the view taken by the High Court.

In support of these appeals counsel for the appellants has contended that it was well settled that even while making a best judgment assessment the Income-Tax Officer must make an honest and fair estimate of the income of the assessee and that having regard to the terms and conditions of the contract (a specimen whereof was produced during the hearing before us) and particularly the terms on which the stores/materials were supplied by the military authorities to the assessee for being used in the works undertaken by the firm, it was clear that no element of profit was embedded in such stores/materials that were made available to the contractor for being used in the works entrusted to the contractor and as such the cost or value of such stores/material could not be added to the total cash payments received by the contractor from the Department under the contract for the purpose of estimating the income or profits derived by the contractor from such contract. He pointed out that under the terms and conditions of the contract such stores/material were never 'sold' by the Department to the contractor but the same always remained the property of the Department and the contractor had merely handled, manipulated or used the same in the works completed by him and the surplus of such stores/material, if any, that remained was required to be and was actually returned by the contractor to the Department and this being the true nature of the supply of such stores/material, the cost or the value thereof could not be included or added to the total cash payment received by the contractor under the contract for computing his income or profits from the said contract. In support of his contention reliance was placed upon *M.P. Alexander's* case (supra), Madras High Court's decision in *Commissioner of Income-tax Madras v. K. S. Guruswami Gounder & K. S. Krishnaraju*(<sup>1</sup>); Gujarat High Court's decision in *Trilokchand Chunilal v. Commissioner of Income-Tax, Gujarat*(<sup>2</sup>) and Full Bench decision of the Andhra Pradesh High Court in *Additional Commissioner of Income-tax v. Trikamji Punia & Sons*(<sup>3</sup>).

On the other hand, counsel for the Revenue contended that not only the cash payments received by the assessee under the contract but

(1) (1973) 92 ITR 90.

(2) (1976) 107 ITR 732.

(3) (1977) 106 ITR 597.

**A** also the cost of the stores/material supplied by the Department to the contractor—both together represented the real value of the contract to the contractor and as such, since the book results were rejected, the Taxing Authorities and the High Court were right in coming to the conclusion that the income or profits derived by the contractor from such contracts was liable to be determined by applying the flat rate to the entire value of the contract. In other words, it was contended by him that the cost of the stores/material supplied by the Government to the contractor was liable to be taken into account while estimating the income or profits of the contractor under such contract and in that behalf he pressed for our acceptance the view of the Punjab & Haryana High Court in *Brij Bhushan Lal's* case (supra).

**C** At the out set it may be stated that in the case of both the assesseees their returns and book-results were rejected on the ground that proper and reliable books of account had not been maintained and the Income-tax Officer was required to make the assessments on "best judgment" basis. However, the principles to be followed by the Income-tax Officer while making a best judgment assessment have been clearly laid down by the Privy Council as also by this Court in a number of decisions. In *Commissioner of Income-Tax v. Laxminarain Badridas*(<sup>1</sup>), their Lordships of the Privy Council observed as follows :

**E** "The officer is to make an assessment to the best of his judgment against a person who is in default as regards supplying information. He must not act dishonestly or vindictively or capriciously because he must exercise judgment in the matter. He must make what he honestly believes to be a fair estimate of the proper figure of assessment, and for this purpose he must, their Lordships think, be able to take into consideration local knowledge and repute in regard to the assessee's circumstances, and his own knowledge of previous returns by and assessments of the assessee, and all other matters which he thinks will assist him in arriving at a fair and proper estimate; and though there must necessarily be guesswork in the matter, it must be honest guesswork. In that sense, too, the assessment must be to some extent arbitrary".

**G** Since the law relating to "best judgment assessment" is the same both in the case of income-tax assessment and the sales-tax assessment, the following observations of this Court in *Raghubar Mandal Harihar Mandal v. State of Bihar*,(<sup>2</sup>) a case under the Bihar Sales Tax Act, would be material :

(1) (1937) 5 I.T.R. 170 (PC).

(2) (1957) 7 STC 770 at p. 778.

“No doubt it is true that when the returns and the books of account are rejected, the assessing officer must make an estimate, and to that extent he must make a guess : but the estimate must be related to some evidence or material and it must be something more than mere suspicion.”

Again in *State of Kerala v. C. Velukutty*,<sup>(1)</sup> which was a case under the Travancore-Cochin General Sales Tax Act, Subba Rao, J. (as he then was), speaking for this Court observed at page 244 of the report thus :

“The limits of the power are implicit in the expression ‘best of his judgment’. Judgment is a faculty to decide matters with wisdom truly and legally. Judgment does not depend upon the arbitrary caprice of a judge, but on settled and invariable principles of justice. Though there is an element of guesswork in a ‘best judgment assessment.’ it shall not be a wild one, but shall have a reasonable nexus to the available material and the circumstances of each case.”

It will appear clear from what has been said above that the authority making a best judgment assessment must make an honest and fair estimate of the income of the assessee and though arbitrariness cannot be avoided in such estimate the same must not be capricious but should have a reasonable nexus to the available material and the circumstances of the case. It is with reference to these principles that the question raised before us will have to be considered and looking at it from that point of view the real question is whether the turnover represented by the cost of the stores/material supplied by the M.E.S. Department involves any element of profit having regard to the terms and conditions on which such supply is made ? If it does then cost of such stores/material will have to be taken into account but if it does not such cost will have to be excluded.

In order to decide the aforesaid question it will be necessary to advert to the terms and conditions of the works contracts undertaken by the two assessee firms, which as stated earlier, are common. The assessee firms in both the cases are M.E.S. Works Contractors tendering and obtaining from the M.E.S. Department what are known as “Lump sum contracts” which are governed by the General Conditions of contracts I.A.F.W. 2249 (1963 print). In addition to the general conditions the particular work undertaken by the contractor is also governed by special terms contained in the Acceptance of Tender, and the specifications and Schedules annexed thereto. In “Lump

(1) (1966) 60 I.T.R. 239.

**A** Sum Contracts” of M.E.S. Department two salient features are always present, namely, (1) there is a Schedule ‘B’ which specifies the items of stores/material to be supplied by the Department to the contractor solely for being used, fixed or incorporated in the works together with the fixed rates at which the same will be supplied and such supply is governed by General Conditions Nos. 10 and 33 : apart from the stores/material specified in Schedule ‘B’ the contractor also brings his own stores/material on site for the purposes of the works which is also governed by some Paragraphs of General Conditions Nos. 10 and 33 : and (2) the final financial liability of the Government is fixed on completion of the contract on the basis of the actual measurements and on the basis of the rates which are already standardised; a detailed measurement is undertaken at the end of the work at which the Garrison Engineer and the assessee’s representative remain present and the measurements are entered in Measurement Books and after the measurements final bills are prepared as per the M.E.S. Schedule and payments are made after making adjustments for the advances already made. With regard to stores/material Conditions Nos. 10 and 33 of the General Conditions are material. Condition No. 10 so far as is material runs thus :

*“Condition 10—Stores and Materials—*

**E** The Contractor shall, at his own expense, supply all stores and materials required for the Contract, other than those listed in Schedule ‘B’ which are to be provided by the Government at the rates detailed therein.

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**F** All stores and materials to be supplied by the Contractor shall be the best of the respective kinds described in the Specifications and the Contractor shall upon the request of the Engineer-in-Charge furnish him with proof to his satisfaction that the stores and materials so comply.

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**H** In the case of stores provided under Schedule ‘B’, the Contractor shall bear the cost of loading, transporting to site, unloading, storing under cover as required, assembling and jointing the several parts together as necessary and incorporating and fixing these stores and materials in the Works, including all preparatory work of whatever description as may

be required, and of closing, preparing, loading and returning empty cases or containers to the place of issue without any extra charge."

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Condition No. 33 so far as is material runs thus :

"Condition 33—Stores and Materials on site—

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Stores and materials required for the Works are to be deposited by the Contractor only in places to be indicated by the Engineer-in-Charge.

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All stores and materials brought to the site shall become and remain the property of Government and shall not be removed off the site without the prior written approval of the G.E. But whenever the Works are finally completed, the Contractor shall at his own expense forthwith remove from the site all surplus stores and materials originally supplied by him and upon such removal, the same shall revert in and become the property of the Contractor. All Government stores and materials issued to the Contractor for incorporation or fixing in the Works and which, making due allowance for reasonable wear and tear and/or waste, have not on completion of the Works been so incorporated or fixed shall be returned by the Contractor at his own expenses to the place of issue.

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Surplus stores and/or materials returned by the Contractor will be credited to him at a price not exceeding that at which the said stores and materials were originally issued to him but due consideration shall be given to and allowance claimed by Government in respect of any depreciation or damage suffered by the Stores and/or materials whilst in the custody of the Contractor."

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From the tender documents that are made available to contractor and the aforesaid terms and conditions of the "Lump Sum Contracts" two or three aspects emerge very clearly. In the first place the contractor becomes aware that certain specified stores/materials will be supplied to him by the Department at fixed rates for being used in the works to be undertaken by him for which he has not to pay from his pocket and it is on that footing that he submits his tender quoting a particular figure for the entire work; secondly, such stores/material so supplied by the M.E.S. Department has to be used, fixed or incorporat-

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- A** ed by the contractor in the works undertaken by him and the surplus, if any, that would remain after the completion of the work is to be returned to the Department; thirdly, since for accounting purposes the initial supply is debited to the contractor at the specified fixed rates, credit for the balance of the stores/materials so returned is also given
- B** at the same rates, some adjustment being made in respect of the wear and tear of such stores/material but in regard to the stores/material out of such supply as is actually used, fixed or incorporated into the works, no accounting is done vis-a-vis the contract payment that is made to the contractor. In other words, in substance and in reality such stores/material always remains the property of the Department
- C** and the contractor has merely the custody of it and he fixes or incorporates the same into the works. It seems to us clear that in such circumstances and having regard to the terms and conditions on which such supply of stores/materials is made there is not even a theoretical possibility of any element of profit being involved in the turnover represented by the cost of such stores/material. It is conceivable
- D** that when the contractor himself purchases materials in the open market and supplies the same to the Department by using, fixing or incorporating the same in the works, as in the case of materials other than specified in Schedule 'B' some profit element would be embedded in the turnover represented by the cost of such material but when stores/material is supplied by the Government Department at fixed
- E** rates for being used, fixed or incorporated in the work on terms indicated above there would be no element of profit involved in the turnover represented by the cost of such material. It is true that ordinarily when a works contract is put through or completed by a contractor the income or profits derived by the contractor from such contract is determined on the value of the contract as a whole and cannot be
- F** determined by considering several items that go to form such value of the contract but in our view where certain stores/material is supplied at fixed rates by the Department to the Contractor solely for being used or fixed or incorporated in the works undertaken on terms and conditions mentioned above, the real total value of the entire contract
- G** would be the value minus the cost of such stores/material so supplied. Therefore, since no element of profit was involved in the turnover represented by the cost of stores/material supplied by the M.E.S. to the assessee firms, the income or profits derived by the assessee firms from such contracts will have to be determined on the basis of the value of the contracts represented by the cash payments received by
- H** the assessee firms from the M.E.S. Department exclusive of the cost of the material/stores received for being used, fixed or incorporated in the works undertaken by them.

Having regard to our aforesaid conclusion the view taken by the Punjab and Haryana High Court in *Brij Bhushan Lal's* case (supra) must be regarded as erroneous and we approve the view taken by the Kerala High Court (*M. P. Alexander & Co. case*), Madras High Court (*K. S. Guruswami Gounder's case*), Gujarat High Court (*Trilokchand Chunilal's case*) and Andhra Pradesh High Court (*Trikamji Punia's case*).

In the result the appeals are allowed, the impugned orders of the High Court are set aside and those of the Appellate Tribunal are restored. The Revenue will pay the costs of the appeals to the assessee firms.

S.R.

*Appeals allowed.*