

COMMISSIONER OF INCOME TAX, PATIALA

v.

M/s. GROZ BACKERT SABOO LTD.

November 22, 1978

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

Taxable Profits—Computation of taxable property, when an assessee converts his capital assets received as gift, into stock-in-trade and starts dealing in them, explained.

During the assessment year 1962-63, the corresponding accounting year being the financial year ending 31st March, 1962, in respect of goods partly of raw materials and partly of semi-finished needles gifted by their collaborators in West Germany, the respondent assessee made entries in their books of account for the first time on 30th September 1961, as follows: Rs. 44,448.20 debited to the account of 'wire and strip' and credited to the 'wire and strip Gift Account' and Rs. 30,000 debited to the account of 'Semi-processed needles' and credited to the 'Semi-processed Needles Gift Account'. The assessee utilised these goods in the manufacture of finished products and sold the same in the market and the sale proceeds received by the assessee were credited in the trading account maintained in the books account of the business, since they represented revenue receipts arising from the sale of the finished products. On 31st March 1962, the assessee closed the above two gift accounts by transferring the respective sums of Rs. 44,448.20 and Rs. 30,000/- to the credit of the 'Capital Reserve Account' and debited the aggregate sum of Rs. 74,448.20 to the trading account by making corresponding contra credit entries in the accounts of 'wire and strip' and 'Semi-processed Needles'. The net effect of these entries was that the profit of the assessee was reduced by Rs. 74,448.20. The income-tax officer, in the course of the assessment of the assessee to income tax for the assessment year 1962-63 took the view that the debit of Rs. 74,448.20 was wrongly made in the trading account as on 31st March, 1962 since no monies were expended by the assessee in acquiring the raw-materials and semi-finished needles, but they were received by way of gift from the West German Collaborators and hence no amount was deductible in respect of the value of these goods. The same view was taken by the Appellate Assistant Commissioner in appeal and on further appeal, the Tribunal also affirmed the same view. But the High Court on a reference at the instance of the assessee, held that the value of these goods could not be treated as revenue receipt because they had been received by way of gift and in any event, even if they constituted revenue receipt, they could "in no sense be income" since they were taken out of the ambit of taxability by sub-section (3) of section 10 of the Income Tax Act, 1961. The High Court accordingly answered the questions referred by the Tribunal in favour of the assessee and against the Revenue. The Revenue thereupon brought the present appeal with special leave.

Dismissing the appeal, the Court

HELD : 1. The cost of raw materials and semi-finished needles received by the assessee from their West German Collaborators and introduced in the books of account of the business could not be said to be 'nil', but it would

A be their market value as on 30th September 1961. They were received by the assessee as capital assets and subsequently transferred to the business as part of its stock. [375E-G]

Commissioner of Income Tax v. Shirinbai Kooka, 46 I.T.R. (S.C.) 61; and *Commissioner of Income Tax v. Hantepara Tea Co. Ltd.* 89, I.T.R. (SC) 258; applied.

B 2. Where an assessee converts his capital assets into stock-in-trade and starts dealing in them, the taxable profit on the sale must be determined by deducting from the sale proceeds the market value at the date of their conversion into stock-in-trade (since this would be the cost to the business) and not the original cost to the assessee. [375G-H, 376A]

C In the instant case, the original cost of these raw-materials and semi-finished needles to the assessee was undoubtedly nil because these goods were received by the assessee from the West German Collaborators free of cost, but they were introduced in the business and converted into its stock on 30th September, 1961 and, therefore, their market value as on 30th September, 1961 would represent the cost to the business and that would have to be taken into account in determining the profit arising from the sale of the manufactured products. The entries made by the assessee in the books of account of the business on 30th September, 1961 clearly reflected this position. The assessee debited the sums of Rs. 44,448.20 and Rs. 30,000/- representing respectively the market value of these raw-materials and semi-finished needles to the stock accounts of 'Wire and Strip' and 'Semi-processed Needles', which would clearly show that these goods were treated by the assessee as having been introduced in the business as part of its stock at their market value represented by the sums of Rs. 44,448.20 and Rs. 30,000/-.

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Commissioner of Income Tax v. Shirinbai Kooka, 46 I.T.R. (SC) 61; and *Commissioner of Income Tax v. Hantepara Tea Co. Ltd.* 89 I.T.R. (SC) 258; applied.

F 3. In principle, the position would have been the same if instead of giving raw-materials and semi-finished articles to the assessee free of cost the West German contractors had gifted sums of money to the assessee and the assessee had introduced these amounts in the business and an identical quantity of raw materials and semi-finished products had been purchased for the business with these amounts. The cost of raw materials and semi-finished articles thus purchased would have been clearly liable to be deducted from the sale proceeds of the finished products manufactured out of them in determining the profit of the business. [3376D-F]

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H In the instant case, the cost of the raw materials and semi-finished needles to the business represented by the sums of Rs. 44,448.20 and Rs. 30,000/- debited in the respective accounts of 'Wire and Strip' and 'Semi-processed Needles' was liable to be deducted from the sale proceeds of the finished products in arriving at the profit of the business. It is true that initially on 30th September, 1961 the credit entries for the sums of Rs. 44,448.20 and Rs. 30,000/- were made in 'Wire and Strip Gift Account' and 'Semi-processed Needles Gift Account' respectively and it was only on the last date of the account year, namely, 31st March, 1962 that these amounts were transferred

to the credit of the Capital Reserve Account. But that cannot make any difference to the correct legal inference to be drawn from the proved facts because the nomenclature of the account or accounts in which the credit entries were made is not material but what is really decisive is that these amounts were debited to the respective accounts of 'Wire and Strip' and Semi-processed Needles' as representing their real value on 30th September, 1961. These raw-materials and semi-finished needles were introduced in the business as part of its stock at their real value represented by the sums of Rs. 44,448.20 and 30,000/-. The aggregate amount of Rs. 74,448.20 made up of Rs. 44,448.20 and Rs. 30,000/- was, therefore, liable to be deducted in determining the profit of the business and it was rightly debited to the trading account. [376F-H, 377A-C]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1482 of 1972.

Appeal by Special Leave from the Judgment and Order dated 20th September 1971 of the Punjab and Haryana High Court in Income Tax Reference No. 12/71.

Hardayal Hardy, K. C. Dua and Miss A. Subhashini for the Appellant.

G. C. Sharma, P. A. Francis, Anoop Sharma and P. K. Mukherjee for the Respondent.

The Judgment of the Court was delivered by

BHAGWATI, J.—This appeal by special leave arises out of an assessment to income-tax made on M/s Groz Backert Saboo Ltd. (hereinafter referred to as the assessee) for the assessment year 1962-63 the corresponding accounting year being the financial year ending 31st March, 1962. The assessee set up in collaboration with M/s Theodor Groz & Soehne and Ernst Backert, West Germany (hereinafter referred to as the West German Collaborators) a factory for fabrication and manufacture of hosiery needles and it was not disputed on behalf of the assessee that this factory started business sometime prior to the commencement of the relevant year of account. It appears that in the early part of the relevant accounting year, the assessee received from the West German Collaborators consignment of machinery costing Rs. 9,45,545/- and along with this consignment, the West German Collaborators also sent to the assessee certain goods free of cost. These goods consisted partly of raw-materials and partly of semi-finished needles at various stages of manufacture. The invoice in respect of this consignment was dated 4th April, 1961 and it showed only the price of the machinery consigned to the assessee and did not make any mention of the raw materials and semi-finished needles supplied to the assessee along with this consignment, since these goods were supplied free of cost and no charge was made in respect of the same.

A The Customs Authorities raised objection in respect of these goods and a separate invoice had, therefore, to be sent by the West German Collaborators showing Rs. 44,448.20 as the value of the raw-materials, namely, wire and strip and Rs. 30,000/- as the value of the semi-finished needles supplied to the assessee. These goods were not entered in the books of account of the business immediately on receipt by the assessee but they were brought into the books for the first time on 30th September, 1961 by making the following entries: Rs. 44,448.20 debited to the account of "Wire and Strip" and credited to the "Wire and Strip Gift Account" and Rs. 30,000/- debited to the account of "Semi-processed Needles" and credited to the "Semi-processed Needles Gift Account".

B The assessee utilised these goods in the manufacture of finished products and sold the same in the market and the sale proceeds received by the assessee were credited in the trading account maintained in the books of account of the business, since they represented revenue receipts arising from the sale of the finished products. On 31st March, 1962, being the last date of the accounting year, the assessee closed the "Wire and Strip Gift Account" and the "Semi-Processed Needles Gift Account" by transferring the respective sums of Rs. 44,448.20 and Rs. 30,000/- to the credit of the "Capital Reserve Account" and debited an aggregate sum of Rs. 74,448.20 to the trading account by making corresponding credit entries in the accounts of "Wire and Strip" and "Semi-processed Needles".

C The net effect of these entries was that the profit of the assessee was reduced by Rs. 74,448.20. The Income Tax Officer, in course of the assessment of the assessee to income tax for the assessment year 1962-63, took the view that the debit of Rs. 74,448.20 was wrongly made in the trading account as on 31st March, 1962 since no monies were expended by the assessee in acquiring the raw-materials and semi-finished needles, but they were received by way of gift from the West German Collaborators and hence no amount was deductible in respect of the value of these goods. The same view was taken by the Appellate Assistant Commissioner in appeal and on further appeal, the Tribunal also affirmed the same view. This led to a Reference by the Tribunal at the instance of the assessee and the following two questions were referred for the opinion of the High Court:

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1. Whether on the facts and in the circumstances of the case, the sum of Rs. 74,448.20 being the actual value of raw material received from German Collaborators free of cost represented Revenue receipt?

2. Whether on the facts and in the circumstances of the case, the amount of Rs. 74,448/- being the actual value of raw material received free of cost from German collaborators was rightly debited at that value to the revenue account?

The High Court misapprehended the true nature and scope of the controversy between parties and seemed to proceed on the erroneous impression that what the Tribunal had held was that the raw-materials and semi-finished needles received by the assessee from the West German Collaborators constituted revenue receipt and its value was, therefore, liable to be taxed as income in the hands of the assessee. The High Court held that the value of these goods could not be treated as revenue receipt because they had been received by way of gift and in any even, even if they constituted revenue receipt, they could "in no sense be income" since they were taken out of the ambit of taxability by sub-section (3) of section 10 of the Income Tax Act, 1961. The High Court accordingly answered the questions referred by the Tribunal in favour of the assessee and against the Revenue. The Revenue thereupon brought the present appeal with special leave obtained from this Court.

It was found as a fact by the Tribunal, and indeed there was no dispute about it, that the raw-materials and semi-finished needles were received by the assessee from the West German Collaborators free of cost by way of gift. These raw-materials and semi-finished needles were received some time in April, 1961 and it was only on 30th September, 1961 that they were for the first time introduced in the books of account of the business. There can, therefore, be no doubt that these raw-materials and semi-finished needles were received by the assessee as capital assets and subsequently on 30th September, 1961 they were transferred to the business as part of its stock. If that be so, the cost of these raw-materials and semi-finished needles to the business could not be said to be nil, but, on the principle laid down by this Court in *Commissioner of Income Tax v. Shirinbai Kooka*⁽¹⁾ and subsequently followed in *Commissioner of Income Tax v. Hanterpara Tea Co. Ltd.*⁽²⁾, it would be the market value of these raw-materials and semi-finished needles as on 30th September, 1961. It is now well settled by these decisions that where an assessee converts his capital assets into stock-in-trade and starts dealing in them, the taxable profit on the sale must be determined by deducting from the sale

(1) 46 I.T.R. 86.

(2) 89 I.T.R. 258.

- A** proceeds the market value at the date of their conversion into stock-in-trade (since this would be the cost to the business) and not the original cost to the assessee. Here, the original cost of these raw-materials and semi-finished needles to the assessee was undoubtedly nil because these goods were received by the assessee from the West German Collaborators free of cost, but they were introduced in the
- B** business and converted into its stock on 30th September, 1961 and, therefore, their market value as on 30th September, 1961 would represent the cost to the business and that would have to be taken into account in determining the profit arising from the sale of the manufactured products. The entries made by the assessee in the
- C** books of account of the business on 30th September, 1961 clearly reflected this opinion. The assessee debited the sums of Rs. 44,448.20 and Rs. 30,000/- representing respectively the market value of these raw-materials and semi-finished needles to the stock accounts of "Wire and Strip" and "Semi-processed Needles" which would clearly show that these goods were treated by the assessee as having been introduced
- D** in the business as part of its stock at their market value represented by the sums of Rs. 44,448.20 and Rs. 30,000/-. The position was no different than what it would have been if, instead of giving these raw-materials and semi-finished needles to the assessee free of cost, the West German Collaborators had gifted the sums of Rs. 44,448.20 and Rs. 30,000/- to the assessee and the assessee had introduced these
- E** amounts in the business and an identical quantity of raw materials and semi-finished needles had been purchased for the business with these amounts. The cost of raw-materials and semi-finished needles thus purchased would have been clearly liable to be deducted from the sale proceeds of the finished products manufactured out of them in determining the profit of the business. Would the position then be
- F** different if instead, the West German Collaborators gave these raw-materials and semi-finished needles to the assessee free of cost and the assessee introduced them in the business as part of its stock. We do not see any distinction in principle between these two types of cases and we are clearly of the view that the cost of these raw-materials and semi-finished needles to the business represented by the sums of
- G** Rs. 44,448.20 and Rs. 30,000/- debited in the respective accounts of "Wire and Strip" and "Semi-Processed Needles" was liable to be deducted from the sale proceeds of the finished products in arriving at the profit of the business. It is true that initially on 30th September, 1961 the credit entries for the sums of Rs. 44,448.20 and Rs. 30,000/- were
- H** made in "Wire and Strip Gift Account" and "Semi-processed Needles Gift Account" respectively and it was only on the last date of the account year, namely, 31st March, 1962 that these amounts were trans-

ferred to the credit of the Capital Reserve Account. But that cannot make any difference to the correct legal inference to be drawn from the proved facts because the nomenclature of the account or accounts in which the credit entries were made is not material but what is really decisive is that these amounts were debited to the respective accounts of "Wire and Strip" and "Semi-processed Needles" as representing their real value on 30th September, 1961. These raw-materials and semi-finished needles were introduced in the business as part of its stock at their real value represented by the sums of Rs. 44,448.20 and Rs. 30,000/-. The aggregate amount of Rs. 74,448.20 made up of Rs. 44,448.20 and Rs. 30,000/- was, therefore, liable to be deducted in determining the profit of the business and it was rightly debited to the trading account.

We accordingly dismiss the appeal and answer the questions referred by the Tribunal in favour of the assessee and against the Revenue. The Revenue will pay the costs of the appeal to the assessee.

S.R.

Appeal dismissed.