

IN THE SUPREME COURT OF INDIA

CIVIL APPELLATE JURISDICTION

CIVIL APPEAL NO. 815 OF 2007

COMMISSIONER OF INCOME TAX-GUJARAT-II

... Appellant

VERSUS

KWALITY STEEL SUPPLIERS COMPLEX

... Respondent

WITH

CIVIL APPEAL NO. 4923 OF 2007

J U D G M E N T

The respondent-assessee was a registered firm engaged in the business of sale of scrap of ship materials. The firm was constituted with two partners, i.e., mother and son. During the period under consideration, the firm was dissolved on 01.02.1993 on account of the death of one of the partners. At the time of dissolution, the firm had valued the closing stock at cost price. The respondent-assessee filed return of income showing total income of Rs.16,41,760/- for assessment year 1993-1994. The relevant previous year is financial year 1992-1993. On this return, the assessment order was passed by the Assessing Officer on 24.02.1995 under section 143(3) of the Income Tax Act, 1961 (hereinafter referred to as 'Act') accepting the method of valuation adopted by the

respondent-assessee. Subsequently, the Commissioner of Income Tax (CIT) in exercise of his revisional jurisdiction under section 263 of the Act issued show cause notice dated 27.02.1997 and directed the Assessing Officer to value the closing stock at the time of dissolution at the market price. He further observed in his order that the Assessing Officer had erred while passing the assessment order for the year 1993-1994. According to him, during the accounting year under consideration, the firm was dissolved, and therefore, the closing stock was to be valued at market rate in view of the decision of this Court in the case of '*A.L.A. Firm v. Commissioner of Income Tax* [(1991) 189 ITR 285]. So, he added the average gross profit of 15 per cent to the disclosed value of the closing of Rs.12 crores and the same resulted in addition of Rs.1,82 crores.

The respondent-assessee questioned the validity of the order passed under Section 263 of the Act taking the plea that revisional jurisdiction could not be exercised in this manner. However, the CIT rejected the contention of the assessee and set aside the assessment order with a direction to the Assessing Officer to pass fresh order in accordance with the direction given in the order passed by CIT. This order of CIT is dated 20.03.1997. The assessee challenged the said order dated 20.03.1997 by filing appeal before the Income Tax Appellate Tribunal (ITAT). ITAT dismissed the

appeal on 28.04.2000. This order of ITAT was challenged before the High Court in the form of statutory appeal under Section 260A of the Act. The High Court has accepted the contention of the assessee and, thereby, set aside the revisional order dated 20.03.1997 passed by CIT. Against this order, the instant appeal arises.

We have heard learned counsel for the parties. Though detailed submissions are made, it is sufficient to note that learned counsel for the Revenue has basically rested his arguments adopting the reasons given by the ITAT whereas learned counsel for the assessee submitted that having regard to the discussion contained in the judgment of the High Court, the same should be upheld.

It is clear from the above that this Court is concerned with the validity of exercise of jurisdiction by CIT under Section 263 of the Act. Whereas the CIT, while exercising this power, relied upon the judgment of this Court in *A.L.A. Firms* (supra), the High Court while upsetting the said order referred to the judgment of this Court in '*Sakthi Trading Co. v. Commissioner of Income Tax* [(2001) 250 ITR 871].

A perusal of the judgment of the High Court would reveal that two substantial questions of law were considered by the High Court, which are as follows:

- "i. Whether in the facts and circumstances of the case, the ITAT was right in law, in holding that the CIT has validly exercised revisional

jurisdiction under section 263 of the Income Tax Act, 1961?

- ii. Whether, in the facts and circumstances of the case, the ITAT was right in law, in holding that closing stock was to be valued at market price on the ratio of the decision of the Supreme Court in ALA Firm v. CIT reported in 189 ITR 285 though the business was continued after the dissolution of the firm?"

Since, validity of exercise of powers under Section 263 of the Act is involved, we reproduce that provision hereunder:

263. Revision of orders prejudicial to revenue.- (1) The Principal Commissioner or Commissioner may call for and examine the record of any proceeding under this Act, and if he considers that any order passed therein by the Assessing Officer is erroneous in so far as it is prejudicial to the interests of the revenue, he may, after giving the assessee an opportunity of being heard and after making or causing to be made such inquiry as he deems necessary, pass such order thereon as the circumstances of the case justify, including an order enhancing or modifying the assessment, or cancelling the assessment and directing a fresh assessment.

Explanation.-For the removal of doubts, it is hereby declared that, for the purposes of this sub-section,-

(a) an order passed on or before or after the 1st day of June, 1988 by the Assessing Officer shall include-

(i) an order of assessment made by the Assistant Commissioner or Deputy Commissioner or the Income-tax Officer on the basis of the directions issued by the Joint Commissioner under section 144A;

(ii) an order made by the Joint Commissioner in exercise of the powers or in the performance of the functions of an Assessing Officer conferred on, or assigned to, him under the orders or directions issued by the Board or by the Principal Chief Commissioner or Chief Commissioner or Principal Director General or Director General or Principal Commissioner or Commissioner authorised by the Board in this behalf under section 120;

(b) "record" shall include and shall be deemed always to have included all records relating to any proceeding under this Act available at the time of examination by the Principal Commissioner or Commissioner;

(c) where any order referred to in this sub-section and passed by the Assessing Officer had been the subject matter of any appeal filed on or before or after the 1st day of June, 1988, the powers of the Principal Commissioner or Commissioner under this sub-section shall extend and shall be deemed always to have extended to such matters as had not been considered and decided in such appeal.

Explanation 2.- For the purposes of this section, it is hereby declared that an order passed by the Assessing Officer shall be deemed to be erroneous in so far as it is prejudicial to the interests of the revenue, if, in the opinion of the Principal Commissioner or Commissioner,-

- (a) the order is passed without making inquiries or verification which should have been made;
- (b) the order is passed allowing any relief without inquiring into the claim;
- (c) the order has not been made in accordance with any order, direction or instruction issued by the Board under section 119; or
- (d) the order has not been passed in accordance with any decision which is prejudicial to the assessee, rendered by the jurisdictional High Court or Supreme Court in the case of the assessee or any other person.

(2) No order shall be made under sub-section (1) after the expiry of two years from the end of the financial year in which the order sought to be revised was passed.

(3) Notwithstanding anything contained in sub-section (2), an order in revision under this section may be passed at any time in the case of an order which has been passed in consequence of, or to give effect to, any finding or direction contained in an order of the Appellate Tribunal, National Tax Tribunal, the High Court or the Supreme Court.

Explanation.-In computing the period of limitation for the purposes of sub-section (2), the time taken in giving an opportunity to the assessee to be

reheard under the proviso to section 129 and any period during which any proceeding under this section is stayed by an order or injunction of any court shall be excluded."

This provision has come for interpretation time and again before this Court. Such a power given to the Commissioner to revise the order of the Assessing Officer is held to be constitutionally valid having regard to the fact that the Department has no right of appeal to the CIT (A) against any order passed by the Assessing Officer. It is for this reason, Section 263 is enacted to empower the Commissioner with the authority of revising the order of Assessing Officer, where the order is erroneous and the error has resulted in prejudice to the interests of the Revenue. As is clear from the language of the provision, there has to be a proper application of mind by the Commissioner to come to a firm conclusion that the order of the Assessing Officer is erroneous and prejudicial to the interests of the Revenue. Thus, two conditions need to be satisfied for invoking such a power by the Commissioner, which are:

- (i) the order of the Assessing Officer sought to be revised is erroneous; and
- (ii) it is prejudicial to the interests of the Revenue.

(See '*Malabar Industrial Co. Ltd. v. Commissioner of Income Tax*' [(2000) 243 ITR 83])

At the same time, this Court has also laid down that

this provision cannot be invoked to correct each and every type of mistake or error committed by the Assessing Officer. While interpreting the expression 'prejudicial to the interests of the Revenue', it is also held that order of the Assessing Officer cannot be termed as prejudicial simply because Assessing Officer adopted one of the courses permissible in law and it has resulted in loss of revenue, or where two views are possible and the Assessing Officer has taken one view with which the Commissioner did not agree.

(See *CIT v. Arvind Jewellers* [(2003) 259 ITR 502])

It is clear from the above that where two view are possible and the Assessing Officer has taken one view and the the CIT again revised the said order on the ground that he does not agree with the view taken by the Assessing Officer, in such circumstances the assessment order cannot be treated as an order erroneous or prejudicial to the interest of the Revenue. Reason is simple. While exercising the revisionary jurisdiction, the CIT is not sitting in appeal. This has been so eloquently explained in the case of '*Malabar Industrial Co. Ltd. v. Commissioner of Income Tax*' [(2000) 243 ITR 83] in the following words:

"A bare reading of this provision makes it clear that the prerequisite to the exercise of jurisdiction by the Commissioner suo moto under it, is that the order of the Income Tax Officer is erroneous in so far as it is prejudicial to the interests of the Revenue. The Commissioner has to be satisfied of twin conditions, namely, (i) the order of the Assessing

Officer sought to be revised is erroneous: and (ii) it is prejudicial to the interests of the Revenue. If one of them is absent if the order the Income Tax Officer is erroneous but is not prejudicial to the Revenue to if it is not erroneous but is prejudicial to the Revenue-recourse cannot be had to section 263(1) of the Act.

There can be no doubt that the provisions cannot be invoked to correct each and every type of mistake or error committed by the Assessing Officer, it is only when an order is erroneous that the section will be attracted. An incorrect assumption of facts or an incorrect application of law will satisfy the requirements of the order being erroneous. In the same category fall orders passed without applying the principles of natural justice or without application of mind.

The phrase 'prejudicial to the interests of the Revenue' is not an expression of art and is not defined in the Act. Understood in its ordinary meaning it is of wide import and is not confined to loss of tax."

"The scheme of the Act is to levy and collect tax in accordance with the provisions of the Act and this is entrusted to the Revenue. If due to an erroneous order of the Income Tax Officer, the Revenue is losing tax lawfully payable by a person, it will certainly be prejudicial to the interests of the Revenue. The phrase 'prejudicial to the interests of the Revenue' has to be read in conjunction with an erroneous order passed as a consequence of an order of the interests of the Revenue. For example, when an Income Tax and it has resulted in loss of Revenue; or where two views are possible and the Income Tax Officer has taken one view with which the Commissioner does not agree, it cannot be treated as an erroneous order prejudicial to the interests of the Revenue, unless the view taken by the Income Tax Officer is unsustainable in law."

In the instant case, as already noted above, the assessee-firm was constituted with two partners viz., mother and son and it came to be dissolved during assessment year because of the demise of one of the partners. The assessee

in the return had valued the closing stock at cost price. This method of valuation was accepted by the Assessing Officer. According to CIT, the aforesaid method could not be adopted in the case of a dissolved firm as in such a situation closing stock is to be valued at market rate. If the approach of the Assessing Officer in accepting the cost based valuation of closing stock was totally impermissible, then CIT was perhaps right inasmuch as in such a situation, order of the Assessing Officer becomes erroneous and also prejudicial to the interest of the Revenue.

The moot question therefore is as to whether the view taken by the Assessing officer in accepting the valuation of the closing stock at cost price was a plausible view in the circumstances of this case. If it was so, then CIT could not exercise his revisionary jurisdiction under Section 263 of the Act.

For this purpose, we may first discuss the judgment in the case of *A.L.A. Firm* (supra) which has been referred to by the CIT while revising the order of the Assessing Officer.

In *ALA Firm's* case, this Court discussed the judgment of the Madras High Court in '*Ramchari (G.R.) and Co. v. Commissioner of Income Tax* [(1961) 41 ITR 142] and pointed out that in the said case, the High Court had held that privilege of valuing the opening and closing stocks in a consistency manner is available only to continuing business

and that 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. The Madras High Court has also held that the partnership concern which dissolves its business in the course of the accounting year forms a close parallel to the case of a firm which goes into liquidation. In both the cases all the assets and stock-in-trade of business will have to be sold and their value realised for the purposes of ascertaining the true state of the profits to losses of the business.

Following discussion of this Court in *ALA Firm's* case, in the aforesaid process, becomes relevant:

"Even in a continuing business, the valuation at market value is permissible only when it is less than cost; it is not quite certain whether the rules permit an assessee if he so desires to value closing stock at market value where it is higher than cost. But, in either event, it is allowed to be done because its effect can be offset over a period of time. But here, where the business comes to a close, no future adjustment of an over or under valuation is possible".

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We, however, find substance in the second considerations that prevailed with the High Court. The decision in *Muhammad Ussain Sahib v. N. Abdul Gaffor Sahib*, AIR 1950 Mad 758; [1950] 1 ML J 81 correctly sets out the mode of taking accounts regarding the assets of a firm. While the valuation of assets during the subsistence of the partnership would be immaterial and could even be national, the position at the point of dissolution is totally different. (at p. 759):

But the situation is totally different when the firm is dissolved or when a partner retires. The

settlement of his account must be not on a national basis but on a real basis, that is every asset into money and the account of each partner settled on that basis... The assets have to be valued of course, on basis of the market value on the date of the dissolution..."

This applies equally well to assets which constitute stock-in-trade. There can be no manner of doubt that, in taking accounts for purposes of dissolution, the firm and the partners, being commercial men, would value the assets only on a real and not at cost or at their other value appearing in the books."

It is clear from the above that the judgment in *ALA Firm's* case proceeds on the basis that with the dissolution of the firm, the business of the firm comes to an end and in that situation, the cost method of valuing the stock was not permissible.

The question is as to whether this situation would apply in the instant case where the partnership firm stood dissolved by the operation of law in view of the death of one of the partners, i.e., the mother, but the business did not come to an end as the other partner, viz., son, who inherited the share of the mother, continued with the business. In a situation like this, there was no question of selling the assets of the firm including stock-in-trade and, therefore, it was not necessary to value stock-in-trade at market price.

The purpose of adopting a particular valuation of the closing stock is succinctly explained by this Court in the case of '*Sampatram v. Commissioner of Income Tax, West Bengal*' [1953 (24) ITR 481] as follows:

"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 accounts 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 transaction on which there have been actual sales in the course of the year showing the profit or loss actually realized on the year trading. As pointed out in paragraph 8 of the Report of the Committee Financial Risks attaching to the holding of the 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 sold at the incorrect figure... From this rigid doctrine one exception is very generally recognized on prudential grounds and is now fully sanctioned by custom, viz., the adoption of the 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 actual cost price of the good in question (extracted in paragraph 281 of the report Committee of 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 realization. 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, unrealized profits by legislative enactment, unrealized 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 realized."

It is this legal position which was reiterated in *Sakthi Trading Co.* (supra).

The position which emerges from the aforesaid is that when a business continues, it may not be necessary to follow the market rate to value the closing stock as the reasons because of which the same is to be done are not available.

When this position becomes clear, it follows that in the instant case the view taken by the Assessing Officer in accepting the book value of the stock-in-trade was a plausible and permissible view. In this scenario, the CIT could not exercise his powers under Section 263 of the Act.

We, thus, do not find any fault with the judgment of the High Court. The appeals are dismissed with costs.

....., J.
[A.K. SIKRI]

....., J.
[ASHOK BHUSHAN]

New Delhi;
March 21, 2017.

ITEM NO.21

COURT NO.8

SECTION IIIA

S U P R E M E C O U R T O F I N D I A
RECORD OF PROCEEDINGS

Civil Appeal No. 815/2007

COMMISSIONER OF INCOME TAX-GUJARAT-II

Appellant(s)

VERSUS

KWALITY STEEL SUPPLIERS COMPLEX

Respondent(s)

(With interim relief and office report)

WITH

C.A. No. 4923/2007

(With office report)

Date : 21/03/2017 These appeals were called on for hearing today.

CORAM :

HON'BLE MR. JUSTICE A.K. SIKRI

HON'BLE MR. JUSTICE ASHOK BHUSHAN

For Appellant(s)

Mr. Y. P. Adhyaru, Sr. Adv.

Mrs. Anil Katiyar, Adv.

For Respondent(s)

Mr. Haresh Raichura, Adv.

UPON hearing the counsel the Court made the following
O R D E R

The appeals are dismissed in terms of the signed
reportable judgment.

(Nidhi Ahuja)
Court Master

(Madhu Narula)
Court Master

[Signed reportable judgment is placed on the file.]