

Assistant Commissioner of Vs. Associated Builders

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Court : Income Tax Appellate Tribunal ITAT Mumbai

Decided On : Feb-05-1999

Reported in : (2000)72ITD273(Mum.)

Judge : P Parikh, R Easwar

Appellant : Assistant Commissioner of

Respondent : Associated Builders

Judgement :

1. The appeals are by the revenue and the cross objection is by the assessee. Since they were heard together, they are disposed of by a common order for the sake of convenience.
2. The only effective ground taken by the revenue in this appeal is whether the CIT (Appeals) was right in deleting the addition of Rs. 1,42,290, representing the difference between the market value of an unsold flat and its cost price, on the dissolution of the firm.
3. The brief facts giving rise to the appeal are these. The assessee is engaged in the construction business. It is a partnership firm consisting of four partners. On 14th July, 1986, a deed of dissolution was entered into between the partners under which except Smt. Sufia Suleman, the other three partners retired. Sufia Suleman was to continue the business of the partnership firm. The dissolution was pursuant to a memorandum of family arrangement-cum-compromise dated 11th

July, 1986. According to the dissolution deed, the partnership firm stood dissolved by mutual consent with effect from 30th June, 1986 and the Continuing partner had agreed to continue the partnership business from 1st July, 1986. Clauses 4 and 5 of the partnership deed which have a bearing on the question before us read as under : "(4) Accounts in respect of the business assets stock-in-trade furniture, fixture and all other tangible and intangible rights and effects of the said business of the said partnership upto and inclusive of the 30th day of June, 1986 have been made to the satisfaction of the parties hereto.

(5) It is agreed by and between the parties hereto that the Continuing Partner shall pay to the Retiring Partners the sums standing to their credits in the books of the firm as on that date towards their share in the partnership business." 4. The previous year of the firm was 31-3-1987 and accordingly for the assessment year 1987-88 a return was filed by the dissolved firm. In the balance sheet attached to the return, on the assets side, the assessee disclosed the value of a flat which was used by it as office premises at the cost price of Rs. 43,710. This gave a rate of Rs. 94 per sq.ft. The assessing officer took the view that the value of the flat as on the date of dissolution should be treated as stock-in-trade and the market price thereof has to be taken as its value and the difference between the market price and the cost price has to be treated as the income of the firm for the year. The size of the flat was 465 sq.ft. The last sale transaction made by the firm was on 15-7-1985 @ Rs. 252 per sq.ft. The assessing officer was of the view that taking note of the appreciation in the market the value of the flat may be taken at Rs. 400 per sq.ft. The difference between the cost price of Rs. 43,710 and the market price adopted by the assessing officer came to Rs. 1,42,290 which was added as the income of the firm.

5. The assessee appealed and contended that the flat in question was used by the assessee as an office at site to cater to the needs of the purchasers who came to inspect the flats to be purchased, that the flat was in the ground floor and remained unsold and was being used as office premises till the time of dissolution, when it was taken over by the continuing partner for her personal use. It was further pointed out that the continuing partner stayed in the said flat, which had not been sold till date and thus the flat was never intended for sale. It was further

contended that at the time of dissolution of the firm the partners had agreed that the retiring partners would be paid the sums standing to their credit in the books of the firm as on that date which showed that there was no revaluation of the assets which included the unsold flat and under such circumstances the unsold flat cannot be treated as stock-in-trade and the fair market value thereof cannot be adopted in preference to the cost price at which the dissolution was agreed upon. In effect the submission was that the partners had agreed to settle their claims on the footing that the value of the unsold flat would be taken only at its book value and no appreciation was to be taken note of.

6. The CIT (Appeals) noted the decision of the Supreme Court in the case of *Sir Kikabhai Premchand v. CIT* [1953] 24 ITR 506 and observed that in the present case the flat in dispute had been used by the firm as office premises which was taken over by the continuing partner at cost price and the said flat has not been sold till date and therefore, applying the ratio of the judgment cited supra, he held that the addition of the notional or fictional profit of Rs. 1,42,290 was not justified.

7. The revenue is in appeal to contend that the CIT(A) failed to appreciate that on dissolution of the firm the unsold flat would be treated as stock-in-trade and valued at the price it would fetch in the open market and therefore if this principle is applied to the facts of the case, on the basis of the Judgment of the Supreme Court in the case of *A.L.A. Firm v. CIT* [1991] 189 ITR 285/55 Taxman 497, the assessing officer was justified in making the addition. Strong reliance was placed on the aforesaid judgment in support of the addition. It was further pointed out that the flat was never held as capital asset as was clear from the fact that the assessee had not claimed any depreciation on the same. It was submitted that the expenses on the construction of the flat was debited to the profit and loss account and therefore the mere user of the flat by the firm for its office purposes would not alter the character of the flat from stock-in-trade to capital asset. In this connection it was pointed out that the entries made by the assessee in the profit and loss account and the balance sheet regarding the construction cost of the flat had not been reversed to clearly show that the flat was not part of the stock-in-trade and under such circumstances the judgment of the Supreme Court in *A.L.A.Firm's* case (supra) squarely applied.

8. The learned counsel for the assessee on the other hand took up two contentions. The first was that the flat was a capital asset as would be seen by the entry made in the balance sheet as on 31-3-1987 which described the flat in the assets side of the balance sheet at book value, namely, Rs. 43,710. He submitted that the principle of the judgment of A.L.A. Firm (supra) would not apply to cases of capital assets, but should be confined to cases of stock-in-trade only. The alternative contention was that at any rate an agreement or contract could be spelt out between the partners under the circumstances which showed that they had agreed to value the flat, even assuming that the flat constituted the firm's stock-in-trade, at cost price only and not at the market price and if that is the agreement between the partners, it excluded the applicability of the A.L.A. principle. Strong reliance was placed on the observations of the Supreme Court in the aforesaid case as well as the judgment of the Madras High Court in N. Muhammad Ussain Sahib v. S. N. Abdul Gaffoor Sahib AIR 1950 Mad. 758. It was pointed out that this judgment and the judgment of the Supreme Court in A.L.A. Firm's case (supra) read together in the proper perspective, established the principle that even in the case of stock-in-trade, on dissolution of the firm, if there is a contract or agreement between the partners to value the same only at cost or book value, it is not open to the revenue authorities to discard the same and seek to tax the profit on the notional footing of the market price. In this connection the provisions of section 48 of the Indian Partnership Act were also relied upon as also the order of the Madras Bench of the Tribunal in ITO v. Preetham Pipe Syndicate [1993] 44 ITD 665. As regards the existence of the agreement between the partners to the effect that the unsold flat would be valued only at the book value, our attention was drawn to the dissolution deed, the relevant clauses - clauses 4 and 5 - of which have already been extracted by us in the earlier part of our order. Copies of the partners' capital accounts for the year ended 31-3-1987 were also filed and our attention was drawn to the fact that the accounts also exhibited the position that the settlement between the partners was only on the footing of book values of the assets and on the basis of the sums standing to their credit in the firm's books as on the date of dissolution. Our attention was also drawn to the letter dated 28-2-1990 filed before the Assessing Officer wherein it has been stated by the assessee as follows :- "Secondly on dissolution, what the partners agreed was that the outgoing partners

were paid their capital balance which did not include the so called increase in Market value. Hence the partners inter se have also agreed to settle their claims in the firm at the cost price. No appreciation is paid to the firm by the partner continuing the business. Nor have the other partners received the amount in respect of the so called increase in market value from the continuing partner. In absence of the consideration flowing from the continuing partner either to the firm or to the retiring partners, the question of taxing the notional profit in the firm's hands does not arise." 9. On a careful consideration of the rival contentions and the facts of the case, we are of the view that the decision of the CIT(A) cannot be reversed. The crux of the matter is whether, where there is a dissolution of a partnership firm, the stock-in-trade can be valued at the market rate by the income-tax authorities and whether the difference between the market rate and the cost price of the stock can be added as income of the firm. This involves the question as to whether the partners are bound to value the stock-in-trade at the market price at the time of the dissolution. The judgment of the Supreme Court in A.L.A. Firm's case (supra) does not, in our humble opinion, lay down the proposition that irrespective of an agreement or contract to the contrary, the stock-in-trade in such circumstances has to be valued only at the market price. A close look at the facts before the Supreme Court in the case of A.L.A. Firm (supra) shows that in that case the partners of the firm had revalued the stock-in-trade at the time of the dissolution for purposes of mutual adjustment. It may be noticed that in that case the firm was dissolved on 13th March, 1961.

Along with the return of income the firm filed a profit and loss account and certain other statements. In the profit and loss account, a sum of Malaysian Dollars 1,01,248 was shown as "difference on revaluation of estates, gardens and house properties" on the dissolution of the firm on 13th March, 1961. It was only, in the statement of income that the assessee claimed that the aforesaid sum was not assessable as revenue. Thus the facts in A.L.A. Firm's case (supra) unmistakably show that there the partners had revalued the assets of the firm on the date of dissolution and it was in this background that the Supreme Court had laid down that the difference between the market value and the cost price of the stock-in-trade was assessable as income of the dissolved firm. After posing the question for decision thus, namely, whether in making up the accounts of a firm up to the

date of dissolution, the closing stock of the firm at that point of time can be valued only on the basis of the market price, the Supreme Court went on to notice the well settled proposition that whilst the firm is continuing, the closing stock can be valued either at cost or at market price whichever is lower, and that during the continuance of the firm, the closing stock at the close of the year cannot be valued at the market price since anticipated or notional profits cannot be brought to tax. Thereafter the Supreme Court noticed the judgment of the Madras High Court in N. Muhammad Ussein Sahib's case (supra) where it was held that the settlement of the retiring partner or the partners upon dissolution of the firm must be not on a notional basis but on a real basis and that every asset of the partnership should be converted into money and the accounts of the partners should be settled on that basis and held that these observations of the Madras High Court apply equally well to assets which constitute stock-in-trade. The Supreme Court then proceeded to refer (page 306) to the normal practice of the partners, being commercial men, valuing the assets only on a real basis and not at cost or at the book value. Up to this observation there is nothing in the judgment, so far as our humble understanding goes, to indicate that even in the force of a contract or agreement or conduct between the partners to the effect that the stock-in-trade would be valued only at its cost or book value, the income-tax authorities can ignore the same and adopt the market value as the basis of assessment. In fact, at page 306 the Supreme Court proceeded to quote a passage from William Pickles on Accountancy (Third Edition, page 650). This passage was quoted approvingly and in this passage it has been stated that, it has been laid down judicially that, in the absence of contrary agreement, all assets and liabilities must be taken at a 'fair value' not merely a 'book value' basis, thus involving recording entries of both appreciation and depreciation of assets and liabilities". Since the aforesaid passage from Pickles has been quoted approvingly by the Supreme Court, it is clear that in the absence of a contrary agreement alone the income-tax authorities would be justified in adopting the market rate of the closing stock at the time of dissolution, for purposes of assessment.

10. There are other reasons as to why the judgment of the supreme Court in A.L.A. Firm's case (supra) cannot be understood as laying down the proposition that even in the face of a contrary agreement between the partners, the market

value can be adopted for assessment purposes. In N. Muhammad Ussain Sahib's case (supra) the question arose under section 48 of the Partnership Act. Now section 48 of the Partnership Act provides for the mode of settlement of accounts between partners upon dissolution. The section provides for certain rules which are expressly stated to be subject to agreement by the partners". In this decision it was held (head note) that in the absence of any provision in the articles of partnership itself or any agreement between the partners regarding the method by which accounts of the partnership are to be taken on its dissolution, the assets should be valued on the basis of the market value on the date of dissolution of partnership.

Book value cannot be adopted for that purpose even though during the subsistence of the partnership the assets were taken at their book value for the purpose of annual accounts. In that case, the articles of partnership did not provide the method of winding up the partnership after it was dissolved, nor was there any agreement between the partners as to the method by which the accounts should be taken of the assets if the partnership were to be dissolved or if the partners were to retire after some time. Therefore the general rule, namely, that the partnership assets will have to be valued at the market value was applied. It is noteworthy that in this decision the assets concerned were not merely stock-in-trade but all the assets of the firm including capital assets. It was under these circumstances that the Madras High Court held that every asset of the partnership should be converted on the basis of the market value at the time of the dissolution. The Supreme Court in A.L.A. Firm's case (supra) held that the aforesaid observation of the Madras High Court applies equally to assets which constitute stock-in-trade. The position which emerges is that whether the assets are capital assets or stock-in-trade, both are subject to the same legal principle, namely, that only in the absence of an agreement between the partners to the contrary, they can be valued on the basis of the market value at the time of dissolution. Section 48 of the Partnership Act in fact clarifies or makes the position very clear.

11. The other reason as to why it is difficult to understand the judgment of the Supreme Court as laying down the proposition which is canvassed before us on behalf of the revenue is that while noticing the judgment of the Madras High Court

in the case of G. R. Ramachari & Co.

v. CIT [1961] 41 ITR 142, the Supreme Court observed (at page 307, immediately after extracting the passage from Pickles on Accountancy), that the real rights of the partners cannot be mutually adjusted on any other basis, namely, any basis other than the market value and further proceeded to observe that in G. R. Ramachari & Co.'s case (supra) also the same thing had taken place. The import of these observations is that in the case of G. R. Ramachari & Co. (supra) also there was no contract between the partners to the contrary and therefore the closing stock was valued at the market price. Thereafter the Supreme Court proceeds to observe that in the case before them also, "this is exactly what the partners in this case have done and having done so it is untenable for them to contend that the valuation should be on some other basis". These observations clearly show that the facts in the case of G. R. Ramachari & Co. (supra) in the case of N. Muhammad Ussain Sahib (supra) and in the case before the Supreme Court were all the same, namely, that there was no agreement between the partners of the firm that the closing stock would be valued only at cost or book value at the time of the dissolution.

12. The judgment of the Supreme Court in the case of A.L.A. Firm (supra) is thus to be understood in the light of the facts before them and in the context of the precise controversy before them. The controversy was not whether even in the face of an agreement to the contrary between the partners of the dissolved firm, the closing stock could be valued on the basis of the market price. The question was whether in the absence of any such contract to the contrary, the closing stock could be valued at the market price. The question was answered in the affirmative by the Supreme Court.

13. The present case shows that the facts are different and that there was an agreement between the partners to the effect that the settlement between them upon dissolution would be on the basis of the book values in respect of all the assets of the firm. Clause 4 of the dissolution agreement states that accounts in respect of the business assets, stock-in-trade, etc. and all tangible and intangible rights up to 30-6-1986 have been made to the satisfaction of the parties thereto.

Clause 5 states that it is agreed between the partners that the continuing partner shall pay to the retiring partner the sums standing to their credit in the books of the firm as on that date towards their share in the partnership business. Reading both the clauses harmoniously, it is clear to us that the dissolution was made on the basis of the book value of the various assets of the firm and not on the basis of their market value. The effect of the stipulation in clause 5 is that the adjustment between the partners is to be made only on the basis of the amounts standing to their credit in the firm's books and this stipulation clearly rules out any notion of a market value being adopted in respect of any of the assets of the firm whether they are capital assets or whether they are stock-in-trade. The copies of the partners' accounts which have been furnished to us by the learned counsel for the assessee as on 31-3-87 also show the adjustment provided in clause 5 being given effect to on that basis only. There is no revaluation of any of the assets of the firm for the purposes of dissolution. Thus there is ample evidence in the dissolution deed itself as well as the manner in which the accounts have been settled between the partners to show that there was an agreement between them to the effect that the adjustment inter se would, be made upon dissolution only on the basis of the book values of the assets.

Therefore, in our humble opinion, the principle of A.L.A. Firm is not applicable.

14. It may be recalled that the learned counsel for the assessee had argued that the flat, which was used as office by the assessee, was not stock-in-trade at all but was a capital asset and therefore the principle of A.L.A. Firm would not apply. Our discussion in the preceding paragraphs would show that whether they are capital assets or stock-in-trade, they can be valued at the market price at the time of dissolution only when there is no agreement or contract between the partners to the contrary, which is also the position recognised by section 48 of the Indian Partnership Act. Therefore our decision is applicable equally to capital assets as well as stock-in-trade, provided there is a contract between the partners to value them at the time of dissolution at cost price or at book value. In view of this, we do not propose to examine the question whether the flat was in fact a capital asset as claimed by the assessee or it was a stock-in-trade as claimed on behalf of the department.

15. For the aforesaid reasons, we affirm the order of the Commissioner (Appeals) deleting the addition of Rs. 1,42,290 and dismiss the appeal filed by the department.

16. These appeals relate to penalties under section 271(1)(c) (concealment of income) and section 273(2)(aa) (filing of untrue estimate). Since we have confirmed the order of the Commissioner (Appeals) deleting the addition of Rs. 1,42,290, consequently we affirm his orders cancelling the penalty and dismiss the revenue's appeals.

17. It was stated by the learned counsel for the assessee that no specific relief has been asked for in this cross objection filed by the assessee. The same is therefore dismissed as infructuous.

18. In the result, all the appeals and the cross objection are dismissed.

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