IN THE HIGH COURT OF DELHI AT NEW DELHI

% Judgment reserved on: 23.02.2011
Judgment delivered on: 21.03.2011

ITR No. 541/1992

MADHU RANI MEHRA .....Petitioner

Vs

COMMISSIONER OF INCOME TAX .....Respondent

Advocates who appeared in this case:

For the Petitioner: Mr.C.S.Aggarwal, Sr. Advocate with Mr. Prakash Kumar, Advocate
For the Respondent : Mr. Sanjeev Sabharwal, Advocate

CORAM :-

HON'BLE MR. JUSTICE SANJAY KISHAN KAUL
HON'BLE MR JUSTICE RAJIV SHAKDHER

1. Whether the Reporters of local papers may be allowed to see the judgment ? Yes

2. To be referred to Reporters or not ? Yes

3. Whether the judgment should be reported in the Digest ? Yes

RAJIV SHAKDHER, J

1. The Income Tax Appellate Tribunal (hereinafter referred to as the 'Tribunal') by its order dated 16.07.1992 has referred the following questions, which pertain to assessment year 1980-81 for adjudication of this court.

> "1. Whether on the facts and in the circumstances of the case, the Income-tax Appellate Tribunal was correct in law in taking the value of the opening stock in law in taking the value of the opening stock as on 11.11.1979 at Rs. 35,16,785/- which stock was received by the assessee on dissolution of the firm M/s Mehrae-Di-Hatti on 10.11.1979, at which point of the dissolution the said stock was valued at market price of Rs.49,19,491/-/
> 2. Whether, on the facts and in the circumstances of the case, the Income-Tax Appellate Tribunal was correct in law in valuing the opening stock at cost though the said stock was received on the dissolution of the firm as capital by the assessee, which was converted by her into stock-in-trade?"

2. The aforementioned questions of law arise for our consideration based on the following relevant facts which are culled out from the orders of the authorities below:-

3. The assessee, who is a petitioner before us, was a partner in a firm being run under the name and style of M/s. Mehrae-Di-Hatti (in short 'firm'). The said firm at the relevant point in time consisted of two partners; these being: Shri C.L.Mehra and Smt.Madhu Rani Mehra. Each partner held 50% share in the firm. The firm was constituted under the partnership deed dated 01.05.1971. It is pertinent to note that since both the firm as well as Smt Madhu Rani Mehra were assessed to tax, we would be referring to them in judgment as the firm and the individual, by her name.

3.1 On 10.11.1979, Shri C.L.Mehra chose to retire from the firm. Consequently, the firm was dissolved. A dissolution deed dated 10.11.1979 appears to have been drawn up, a copy of which is, however, not available on record. It appears that this was not even filed before the authorities below, as is demonstrable from the orders of the authority below; though some of the clauses of the dissolution deed have been reproduced in the assessment order.

3.2 It is not in dispute that Smt. Madhu Rani Mehra took over the assets and liabilities of the dissolved firm and carried on the same sort of business which related to gold and diamond jewellery.

3.3 On the date of dissolution of the firm i.e., 10.11.1979, the firm had in its possession stock, comprising of gold and diamond jewellery of a substantial value. The said stock was evidently valued at average cost price by the firm. As per the books the closing stock was valued by the firm as on 10.11.1979 at Rs 35,16,785/-. It is not in dispute that the market price of the firm's closing stock, as on 10.11.1979 was Rs 49,19,491/-

4. The matter with regard to both the firm and the proprietorship concern run by Smt.Madhu Rani Mehra ultimately reached the Tribunal.

4.1 Insofar as the firm was concerned, the Assessing Officer took the view that in order to work out the total income of the firm for the period 1.4.1979 to 10.11.1979 an

addition of Rs 14,02,700/- had to be made by taking into account the difference in the market price and book value of the closing stock. The market price, being: Rs 49,19,491/-, while the book value was pegged at Rs 35,16,785/-.

4.2 The aforementioned addition was confirmed by the first Appellate Authority.

4.3 The matter was carried in appeal to the Tribunal. The firm's appeal before the Tribunal was numbered as ITA No. 2374 (Del) of 1985.

5. As regards the proprietorship concern where Smt.Madhu Rani Mehra was assessed in her individual capacity, the matter, as in the case of the firm also reached the Tribunal, having lost before the authorities below. . The appeal of the proprietorship concern/Smt.Madhu Rani Mehra was registered as ITA No.2373 (Del) of 1985.

5.1 It is pertinent to note that the grievance, raised in ITA 2373 (Del) of 1985 before the Tribunal was, that the authorities below had accepted the stand of the revenue that the opening stock of the proprietorship concern should be valued at Rs 35,16,785/- and not at the market value amounting to Rs 49,19,491/- because there was a continuity of business in as much as the stock of gold and jewellery which had been shown as opening stock had been received from the dissolved firm at book value amounting to Rs 35,16,785/-

6. The Tribunal by a common judgment dated 16.12.1991 disposed of the aforementioned appeals i.e., ITA No.2373 (Del) of 1985 and ITA No.2374 (Del) of 1985.

6.1 As regards the addition towards income of the firm was concerned, the counsel appearing for the firm before Tribunal conceded the position that the addition made by the Assessing Officer in the sum of Rs 14,02,700/- had to be confirmed in view of judgment of the Supreme Court in the case of ***A.L.A. Firm Vs. CIT: (189) ITR 285***. This position finds a mention in paragraph 4 of the judgment of the Tribunal dated 16.12.1991. The Tribunal, on noticing the principle set forth in ***A.L.A. Firm*** *(supra)* and in the other judgment of the Madras High Court in ***G. R. Ramachari and Co. Vs. CIT: (1961) 41 ITR 142***, came to the conclusion that the option of valuing the opening

and closing stock in a consistent manner is available to an on-going business, and that this principle, would not apply where the business itself comes to an end. Accordingly, it held that stock-in- trade in so far as the firm was concerned, had to be valued at the market price prevailing on the date of closure or dissolution.

6.2. As regards the proprietorship concern, which as noticed above, is assessed through the individual Smt.Madhu Rani Mehra, the Tribunal came to the conclusion since the proprietorship concern had acquired the stock from the dissolved firm and continued the same business, the opening stock could not be valued at a price higher than the book value i.e., 35,16,785/-, as the assessee had not paid anything in excess of the said amount. The Tribunal went on to observe that since the proprietorship concern had taken over the stock from the firm, opening stock could not be valued at a figure other than the cost price, as the proprietorship was running the business of the dissolved firm. With these findings, the Tribunal confirmed the findings of the Assessing Officer that the opening stock, in the hands of proprietorship concern, had to be valued at Rs 35,16,785/-

7. It is in the aforesaid background the two questions of law, culled out by us in the opening para of the judgment, have been referred to us for adjudication.

8. Submissions on behalf of assessee, were advanced by Shri C.S.Agarwal, Sr.Advocate assisted by Shri Prakash Kumar, while those on behalf of the revenue, were made by Shri Sanjeev Sabharwal, Senior Standing Counsel.

9. Shri Agarwal contended as follows.

9.1 On the dissolution of the firm the stock, which had been received by the proprietorship concern /Smt.Madhu Rani Mehra had the characteristic of a capital asset. It is this capital asset which was converted into stock-in-trade for the purposes of carrying on business and hence, could only be valued at market price. He sought support, insofar as this contention was concerned, in the judgment of Supreme Court in the case of ***CIT Vs. Groz-Beckert Saboo Ltd. 116 ITR 125***. Based on this judgment it was submitted that when a capital asset is converted into stock-in-trade then the taxable

profits on its sales must be determined by deducting from the sale proceeds the market value of stock on the date of its conversion into stock-in-trade and not the original cost to the assessee, since this would be cost to the business.

9.2 The revenue by upholding the addition in the hands of the firm and not giving consequential deduction to the proprietor/Smt. Madhu Rani Mehra had brought about a situation where, in effect, a person would be taxed twice, in the first instance, in its capacity as the partner of the firm and, the second time over as an individual.

9.3 He further contended that the revenue having adopted the market value, in respect of the closing stock of the dissolved firm, for making an addition could not resort to the book value while, assessing the proprietor/Smt. Madhu Rani Mehra. In support of this submissions, Mr.Agarwal placed reliance on the judgment of the Madras High Court in the case of ***CIT Vs. Venkatachalam & Co. 256 ITR 113 (Mad)***. In addition he also relied upon the following judgments:-

(i) ***Sakthi Trading Co. Vs. CIT 250 ITR 871 SC***

(ii) ***Sunil Suddharthbhai Vs. CIT 156 ITR 509***.

10. As against this, Mr.Sabharwal largely relied upon the reasoning set out in the impugned judgment. Mr.Sabharwal submitted that since the business of the dissolved firm was carried on by the proprietorship concern, there was a continuity of business, and therefore, according to the well accepted principle of accountancy, the stock had to be valued at lower of the two values, which was cost or market price. He further submitted, that in any event, as the proprietor/Smt. Madhu Rani Mehra had not paid anything over and above the book value in respect of the closing stock of the dissolved firm, the opening stock of the proprietorship concern should be valued at the same value i.e., book value being: Rs 35,16,785/-. Interestingly, Mr. Sabharwal also placed reliance on the judgment of the Supreme Court in the case of ***Sakthi Trading Co.*** (supra).

11. We have heard the learned counsel for the parties and perused the judgment and the orders of the authorities below. The necessary facts, which have been extracted by

us from the record, are not in dispute. The issue boils down to a short point, which is, whether the opening stock of the proprietorship concern is to be valued at the book value of the closing stock of the dissolved firm or at the market value.

11.1. Before we proceed further, it would perhaps help if we pen down briefly the principles laid down in the judgments of the court cited before us.

12. First in line is the judgment of the Supreme Court in the case of ***A.L.A. Firm***(Supra). In this case, the issue which came up for consideration before the Supreme Court was that what would be the valuation of the closing stock of a partnership on the date of dissolution. This issue arose in the background of the following brief facts:

12.1 The appellant/assessee before the Supreme Court was a partnership firm. The assessee had been carrying on money lending business in Malaya. As an adjunct to the said business, the assessee also carried out the business of purchase and sale of house properties, gardens and estates. This business, the firm had been carrying on since 1949. However, by a deed dated 26.3.1960, the firm was reconstituted. The firm's accounts for the year 1960-61 which commenced on 13.4.1960 would, in the ordinary course, have come to a close on or about 13.4.1961; since the firm was dissolved on 13.3.1961 it chose to close its accounts on the said date. In the return filed for the assessment year 1961-62 it showed in its profit and loss account a sum of $101,248/-, being the "difference on revaluation of estates, gardens and house properties", arrived at on dissolution of the firm w.e.f. 13.3.1961. However, this sum was deducted by the assessee for the purposes of calculation of income tax payable, on the ground that revaluation of estates, gardens and house properties, resulted in neither revenue nor capital gain and hence, was not assessable to tax.

12.2 It is pertinent to note that, in that case, on the dissolution of the firm the partners carried on their respective businesses with the help of assets which had fallen to their share on the dissolution of the firm.

12.3 It appears that at the stage of assessment, the Assessing Officer took an objection in respect of that part of the return whereby, the assessee had excluded the revaluation difference in the sum of $ 101,248/- from the profit and loss account. In other words, the Assessing Officer was of the view that the said sum ought to have been brought to tax. In this regard, the Assessing officer placed reliance on the judgment of the Madras High Court in the case of ***G.R.Ramachari and Co.*** *(supra).* The assessee objected to the approach adopted by the Assessing Officer both in terms of procedure as well as on merits. The assessee's objection being, that the revaluation of assets did not lead to a profit or a loss and hence, nothing was payable by way of tax. The assessee went onto say, based on a circular of the Central Board of Revenue that since, it was in the process of winding up the business in Malaya, surplus received could be taxed only as capital gains. It was further urged that valuation had been at a market price prevalent since 01.01.1954 and, therefore, no capital gains was chargeable in the facts obtaining in the said case.

12.4 The Assessing Officer, however, issued notice to the assessee under Section 148 read with Section 147B of the Income Tax Act, 1961 (in short 'I.T. Act') as it then existed on the statute book. The Assessing Officer, however, overruled the objections raised and reassessed the income of the firm by adding the revaluation difference in the sum of $ 101,248/- (equivalent to its value in rupees) to the previously assessed income of the assessee. The assessee's endeavour to obtain a reversal failed before the first and the second Appellate Authorities. The assessee failed even before the High Court. Consequently, the matter reached the Supreme Court. The Supreme Court, in the ultimate analysis, came to the conclusion that the view taken by the High Court was right and hence, dismissed the appeal.

12.5 The Supreme Court in its judgment noted that in the reference before the High Court, three questions were raised. The first one pertained to, whether the reassessment carried out under the provisions of Section 147 of the I.T. Act was valid. We are not concerned with this issue in the instant case. Therefore, we need not dilate on this

issue. The other questions, as noticed in the judgment, pertained the taxability of the revaluation difference amounting to $ 101,248/-. The court after examining a plethora of judgments, appears to have laid down the following broad principles to our minds:_

(i). in order to determine the correct trading results, stock of unsold goods, both at the beginning as well as at the close of the financial year are taken into account;

(ii). entries pertaining to both, opening stock and closing stock, in effect, cancel each other out so that only those transactions are left, in respect of which, actual sales have taken place;

(iii). the steps indicated in clause (i) and (ii) above, assist in determination of actual trading profit realized during the course of the year;

(iv). therefore, ordinarily stocks should be valued at cost. On the other hand if, closing stock is shown at market value, which is, higher than the cost, it would result in the books recording notional profit which, the person concerned would not have earned. Inversely, if the market value of the stock is less than its cost; the closing stock shown at such a market value, will result in the books reflecting a notional loss which again the concerned person would not have incurred. However, having said so, the last method has received acceptability due customary practice, and perhaps adherence to the principle of conservatism, by the accountants, in drawing up accounts. Thus, the well accepted accounting principle which is applicable in most jurisdictions, is that, closing stock is valued at cost or market value whichever is lower;

(v). In drawing up accounts, in particular, in valuing stock, an entity should follow a consistent method . Furthermore, the Income Tax authorities should ordinarily accept books of accounts drawn up in accordance with well accepted accounting principles, unless the statute makes an exception or, they run contrary to the explicit provisions of the Act;

(vi). the aforesaid principle of consistency, when applied to valuation of stock is relevant qua a going concern. On dissolution of a firm closing stock has to be valued on the basis of real value i.e., market value. This is independent of the fact whether or not the erstwhile partners of a dissolved firm continue to do business with assets ***received on dissolution***.

13. This takes us to the next judgment which is ***Sakthi Trading Co.*** *(supra).* In this judgment the question of law which came up for consideration before the Supreme Court was as follows:-

> "Whether on the facts and in the circumstances of the case where on the dissolution of the firm the business is taken over by a partner without discontinuance and the value of the closing stock determined under the regular method of accounting is accepted by the partners in the settlement of accounts for dissolution purposes, the Income Tax Officer can substitute the market value in respect of the closing stock alone for the purpose of determining the income of the firm up to the date of dissolution?"

14. The facts in this case briefly were: the assessee was a registered firm. On account of death of one of the six partners, the firm stood dissolved on 06.02.1984. The assessee-firm was, however, reconstituted with effect from the very next day i.e., 07.02.1984 with the remaining partners. During the course of assessment, two assessment orders were passed, one for the period up to 06.02.1984 i.e., the date of dissolution and, the other for the period 07.02.1984 till the end of the financial year i.e., 31.03.1984. The Commissioner of Income Tax (in short CIT) exercising his powers under Section 263 of the I.T. Act questioned the first assessment order passed by the Assessing Officer by terming it as one, which was according to him, was both erroneous and prejudicial to the interest of the revenue, in as much as, the stock-in-trade as on 06.02.1984 was not valued market rate. The assessee being aggrieved by the order of the CIT had carried the matter in appeal to the Tribunal. The Tribunal returned a finding of the fact that the assessee-firm stood reconstituted with the remaining partners of the erstwhile firm, under the partnership deed dated 06.03.1984 w.e.f.

07.02.1984. The finding of the Tribunal was pivoted on the following clause contained in the partnership deed:

> "Whereas the above said parties were carrying on business in Erode in the name 'Sakthi Trading Company' along with one Shri P.Chenniappan S/o late Sri Palanippa Gounder, Erode and whereas the above said P.Chenniappan died on February 6, 1984, the parties hereto having decided to continue the business with all assets and liabilities in partnership from February 7, 1984, as orally agreed, this deed is drawn up reducing the oral agreement between the parties hereto taking effect from February 7, 1984, to carry on business in partnership upon the following terms and conditions."

14.1 Based on the above, the Tribunal came to the conclusion that, if the business itself is discontinued and the stocks are realized, then the value realized, would have to be substituted for the value given in the accounts, but where the business was not discontinued, though the firm was dissolved, the question of realizing the value of the stock does not arise and therefore, there was no necessity, to revalue the closing stock. In other words, the Tribunal was of the view that there was no need for revaluation of stock in a continuing business and that the Assessing Officer having accepted the principle adopted by the assessee for valuation of stock i.e., on cost or market value whichever was lower, which was the method regularly followed by it; no error had been committed. The Tribunal, therefore, was of the view that the exercise of revisionary power by the CIT under Section 263 of the I.T. Act was uncalled for.

15. Since the High Court had reversed the view of the Tribunal, the assessee had preferred the appeal to the Supreme Court.

15.1 The Supreme Court raised the following poser before it:-

> "In this appeal the question is not whether two assessment orders were required to be passed or not but is as to whether the value of the closing stock was required to be determined on the market value for dissolution purposes up to the date of dissolution when the business has been taken over by remaining partners without discontinuance."

15.2 The court went on to answer the said poser by holding that since a finding had been returned by the Tribunal that the business of the assessee-firm was not discontinued, the principle to be adopted was the usual principle, which was, that stock had to be valued at cost or market value whichever was lower. In other words, the

Supreme Court sustained the view of the Tribunal. The decisions of the Madras High Court in the case of ***G.R.Ramachari and Co.*** *(supra)* ***and A.L.A. Firm's case*** *(supra)* were distinguished by the Supreme Court. It is pertinent to note that the decision of the Madras High Court in the case of ***A.L.A. Firm*** *(supra)* was carried out to the Supreme Court. As noticed and discussed hereinabove it is reported in (1991) 189 ITR 285.

16. The third decision which was cited before us was ***Groz-Beckert Saboo Ltd****.(Supra).* This case arose in the background of the following facts:

16.1 The assessee-Groz-Beckert Saboo Ltd. had entered into a collaboration with a West German company, which resulted in setting up of a factory for fabrication and manufacture of hosiery needles. In furtherance of the said agreement, the assessee received a consignment of machinery costing Rs 9,45,545/- from the West German collaborator. Along with the said consignment, the West German collaborator dispatched to the assessee certain goods free of cost. These goods consisted partly raw-materials and partly semi-finished needles at various stages of manufacturing. In the invoice raised on the assessee, the West German collaborator made no reference to the goods which had been sent free of cost. On an objection being raised by the customs, a separate invoice was sent by the West German collaborator showing a sum of Rs 44,448.20/- towards value of raw materials, namely wire and strip, and Rs 30,000/- as the value of semi-finished needles supplied to the assessee. The assessee did not enter these invoices immediately in its books of accounts. The said invoice was entered in the books of account for the first time on 30.09.1961. At the stage of recording the transaction, the following entries were made, Rs 44,448.20 was debited to the account of wire and strip and credited to Wire and Strip Gift Account; while Rs 30,000/- was debited to the account of semi- processed needles and credited to Semi Processed Needles Gift Account.

16.2 The said goods, which were received as a gift from the West German collaborator were utilized by the assessee in the manufacture of finished products. The finished products were sold in the market and the sale proceeds received therefrom

credited to the trading account maintained by the assessee in its books of account. On the last day of the accounting year i.e., 31.03.1962, the assessee closed the "wire and strip gift account" and the "semi-processed needles gift account" by transferring the respective sums in each of these accounts to the credit of the Capital Reserve Account, and debited the aggregated sum of Rs 74,448.20/- to the trading account by making a corresponding entry in the accounts of "wire and strips" and "semi-processed needles". The net effect of these entries was that, the profit of the assessee was reduced by a sum of Rs 74,448.20. The Assessing Officer, however, concluded that since the assessee had not expended any money in acquiring the raw material and semi finished needles as they were received as gifts from the West German collaborator, the value of these goods was not deductible. In other words, the Assessing Officer was of the view that the apparent cost of material, received free of cost, could not be adjusted against the sale proceeds. The assessee being aggrieved carried the matter in appeal. The assessee, however, lost both at the first and second appellate stage. Consequently, a reference was made to the High Court. The High Court answered the questions in favour of the assessee though on a misapprehension of the true nature and scope of the controversy.

16.3 The Supreme Court, however, took the view that even though the raw material and the semi-finished goods had been received by the assessee as gifts from the West German collaborator; - once a capital asset is converted into stock-in-trade and the assessee starts dealing with the stock-in-trade, the taxable profit on sale must be determined by deducting from the sale proceeds, the market value of the goods in issue, as obtaining on the date of their conversion into stock-in-trade and not the original cost incurred by the assessee. The reason being that this would be the cost to business. According to the Supreme Court, when the assessee for the first time recorded the entries on 30.09.1961 it clearly showed that the goods in issue had been introduced in the business as part of its stock at their market value which was Rs 44,448.20/- and Rs 30,000/-. The court elucidated the principle by saying that the position would have been no different than, if instead of goods the West German collaborator had gifted

money equivalent to Rs 44,448.20 and Rs 30,000/- to the assessee who in turn were to introduce the said amount in the business and with that money the assessee had bought the goods in issue. The value of the goods thus purchased would have been deductable from the sale proceeds while determining the profits of the business as that would be cost to the business. The court also made an observation that merely because the initial entries had been made by the assessee i.e., on 30.09.1961 in the wire and strips gift account and semi processed gift account and the gains has been transferred to the credit of the capital account only on the last date of financial year, it would not make any difference to their conclusion since the court was obliged to draw the correct legal conclusion from a given set of the facts. The nomenclature of the account or accounts in which credit entries were made was not material. What was decisive is that amounts were debited to the respective accounts concerning wire and strip and semi- processed goods on 30.09.1961 at their real values.

16.4 The next case i.e., ***Sunil Suddharthbhai*** *(supra)* primarily dealt with the issue whether transfer of personal assets, being shares of two companies introduced by a partner in the firm by way of his capital contribution; would constitute a transfer in law and hence, be amenable to capital gains. The Assessing Officer took the view that not only did the transaction constitute a transfer within the meaning of sub-section 47 of Section 2 of the I. T. Act but also held that the assessee would be liable to capital gains, on the differential between the market price, at which shares were entered into books of the partnership firm, and the cost of said shares to the assessee. The matter reached the Supreme Court. The Supreme Court upheld the contention of the revenue in so far as whether the transaction constitute a transfer within the meaning of Section 45 read with Section 2(47) of the Income Tax Act. As regards whether the assessee had received any consideration, the court observed as follows:-

> "The second question is whether the assessee can be said to have received any consideration as that expression is understood in the scheme of capital gains under the Income Tax Act. In CIT v. B.C.Srinivasa Setty (1981) 128 ITR 294 (1981) 2 SCC 460 1981 SCC (Tax) 119) this Court observed that the charging section and the computation provisions under each head of income

constitute an integrated code, and when there is a case to which the computation provisions cannot apply at all it is evident that such a case was not intended to fall within the charging section. On the basis of that proposition learned counsel for the assessee has urged that Section 45 is not attracted in the present case because to compute the profits or gains under Section 48 the value of consideration received by the assessee or accruing to him as a result of the transfer of the capital asset must be capable of ascertainment in monetary terms. The consideration for the transfer of the personal assets is the right which arises or accrues to the partner during the subsistence of the partnership to get his share of the profits from time to time and, after the dissolution of the partnership or with his retirement from the partnership, to get the value of a share in the net partnership assets as on the date of the dissolution or retirement after a deduction of liabilities and prior charges. The credit entry made in the partner's capital account in the books of the partnership firm does not represent the true value of the consideration. It is a notional value only, intended to be taken into account at the time of determining the value of the partner's share in the net partnership assets on the date of dissolution or on his retirement, a share which will depend upon a deduction of the liabilities and prior charges existing on the date of dissolution or retirement. It is not possible to predicate before hand what will be the position in terms of monetary value of a partner's share on that date. At the time when the partner transfers his personal asset to the partnership firm, there can be no reckoning of the liabilities and losses which the firm may suffer in the years to come. All that lies within the womb of the future. It is impossible to conceive of evaluating the consideration acquired by the partner when he brings his personal asset into the partnership firm when neither the date of dissolution or retirement can be envisaged nor can there be any ascertainment of liabilities and prior charges which may not have even arisen yet. In the circumstances, we are unable to hold that the consideration which a partner acquires on making over his personal asset to the partnership firm as his contribution to its capital can fall within the terms of Section 48. And as that provision is fundamental to the computation machinery incorporated in the scheme relating to the determination of the charge provided in Section 45, such a case must be regarded as falling outside the scope of capital gains taxation altogether."

16.5 As regards the third aspect whether the assessee had earned any profit or acquired any gain, the court observations are contained in paragraph 19, the relevant portion of which is extracted hereinbelow:-

"What is the profit or gain which can be said to accrue or arise to the assessee when he makes over his personal asset to the partnership firm as his contribution to its capital? The consideration, as we have observed, is the right of a partner during the subsistence of the partnership to get his share of profits from time to time and after the dissolution of the partnership or with his retirement from the partnership to receive the value of the share in the net partnership assets as on the date of dissolution or retirement after a deduction of liabilities and prior charges. When his personal asset merges into the capital of the partnership firm a corresponding credit entry is made in the partner's capital account in the books of the partnership firm, but that entry is made merely for the purpose of adjusting the rights of the partners inter se when the partnership is dissolved or the partner retires. It evidences no debt due by the firm to the partner. Indeed, the capital represented by the notional

> entry to the credit of the partner's account may be completely wiped out by losses which may be subsequently incurred by the firm, even in the very accounting year in which the capital account is credited. Having regard to the nature and quality of the consideration which the partner may be said to acquire on introducing his personal asset into the partnership firm as his contribution to its capital, it cannot be said that any income or gain arises or accrues to the assessee in the true commercial sense which a businessman would understand as real income or gain."

17. In ***Venkatchalam*** *(supra)*, the Madras High Court held that value of opening stock of a reconstituted firm should be the same as that which obtained when the same stock was held as closing stock of the dissolved firm. This observation was made by the court in the background of the following facts : A partnership firm was dissolved on the death of one of its two partners. The Assessing Officer apparently, while concluding the dissolved firm's assessment made an addition of Rs.40,800/- to the closing stock. The dissolved firm was reconstituted; with the wife of the deceased partner joining the other remaining partner of the dissolved firm. The issue arose as to whether the opening stock of the newly constituted firm would be valued inclusive of the addition made to the closing stock of the dissolved firm or without it. Both Tribunal and the Madras High Court held that since the operative principle is that, the opening stock is carried at the same value as the closing stock, the addition made to the closing stock would remain included while arriving at the value of the opening stock of the reconstituted firm.

18. Before we proceed further, it may be pertinent to briefly refer also to the relevant accounting standard (in short, 'AS') issued by the Institute of Chartered Accountants of India (in short, 'ICAI'). Valuation of inventories is subject matter of AS-2 issued by the ICAI. AS-2 prescribes valuation of inventories at cost or net realisable value whichever is less. Amongst other aspects it mandates that inventories ought not to be carried in financial statements at values in excess of the value which is expected to be realized from their sale or use.

19. The Tribunal in the broad manner seems to have applied this principle. But would this principle apply when what is required to be done is to determine cost at which stock is introduced in the business. In that context referring to the stock introduced by Smt. Madhu Rani Mehra in the proprietorship concern as opening stock is a little but of misnomer, in the sense, it tends to connect that stock with the business of the dissolved firm. The moment one refers to it as opening stock (having its origin in the closing stock of erstwhile firm), it conjures up a scenario of continuation of business. Because, if that position obtains then Ms. Madhu Rani Mehra's stock in the proprietorship concern will have to be valued based on the principle of cost or market value, whichever is lower. The position in the instant case is different. The partnership firm was dissolved. One individual of the erstwhile firm continued to make a living out of a business, which by sheer coincidence happened to be again jewellery business, in which, distributed capital was introduced in the form of stock. The stock on introduction in the business, stood converted into stock-in-trade. The value of this stock will have to be the market value on the date of introduction. In the facts of this case, the undisputed market value of the stock is Rs.49,19,491.

20. The Tribunal's reasoning that Ms. Madhu Rani Mehra cannot value the stock introduced in the business at market value because that was not price she paid for it, is flawed and this flaw is apparent if one were to test the reasoning by carrying the given set of facts a little further. Suppose, Ms. Madhu Rani Mehra on having received her distributed share of stock of jewellery from the dissolved firm had sold it, and thereafter commenced her proprietorship business of jewellery again; within short span; by buying the jewellery from the market from the proceeds of stock sold on dissolution of the erstwhile firms. In such a situation, the stock of the proprietorship concern would without doubt be valued at market value. Therefore, would the principle be any different if, as in the present case, the proprietor Ms. Madhu Rani Mehra wishes to use her share of the stock obtained from the dissolved firm in the new business. To our

minds, the situation is no different and hence, the same principle ought to apply. A business has attributes of physicality as well as form. For continuation of business both have to remain intact, at least in large measure. In the instant case, the erstwhile firm disappeared on its dissolution. The proprietorship business gave birth to new business, in a different form. A somewhat similar situation obtained in ***ALA Firm's*** *(supra)* case, where the court was called upon to determine the value of the closing stock though of the dissolved firm. A converse situation arose in ***Sakthi Trading Co. Ltd.*** (supra) case where substantially both in terms of its physicality and form the business remained the same. We are thus of the opinion that the Tribunal's decision to value the stock at cost rather than the market value cannot be sustained.

21. For the aforementioned reasons, the impugned judgment is set aside. Both questions of law are answered in favour of the assessee and against the revenue. The appeal is thus allowed. Parties, however, shall bear their own costs.

RAJIV SHAKDHER, J.

SANJAY KISHAN KAUL, J.

MARCH 21, 2011
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