

PRIVY COUNCIL.

THE COMMISSIONER OF INCOME-TAX, BOMBAY PRESIDENCY AND ADEN
 v. THE SARANGPUR COTTON MANUFACTURING Co. LTD. OF
 AHMEDABAD.

J. C*.
 1937
 November 5

[On Appeal from the High Court at Bombay]

Income-tax Act (XI of 1922), sections 10 and 13—Company's profits—Method of accounting regularly employed—True income not shown by method—Duty of Income-tax Officer.

Section 13 of the Income-tax Act relates to a method of accounting regularly employed by the assessee for his own purposes and does not relate to a method of making up the statutory return for the assessment to income-tax.

Secondly, the section clearly makes such a method of accounting a compulsory basis of computation, unless, in the opinion of the Income-tax Officer, the income, profits and gains cannot properly be deduced therefrom.

In view, therefore, of the provisions of section 13 of the Income-tax Act or otherwise the Income-tax Officer is not right in computing for the purpose of section 10 the income, profits and gains in accordance with the method of accounting regularly employed by the assessee, when that method in fact does not show the true income, profits and gains. It is his duty to consider whether the income, profits and gains can properly be deduced from the method and proceed according to his judgment on this question.

Income-tax Commissioner, Bombay Presidency v. Ahmedabad New Cotton Mills Co.,⁽¹⁾ referred to.

APPEAL (No. 77 of 1936) from a judgment of the High Court (March 28, 1935) on a reference by the Commissioner of Income-tax under section 66 of the Act (September 21, 1934).

The material facts are stated in the judgment of the Judicial Committee.

Millard Tucker, K. C. and *Hull*, for the appellant. Referred to sections 10 and 13 of the Act and to *Income-tax Commissioner, Bombay Presidency v. Ahmedabad New Cotton Mills, Co.*⁽¹⁾ and submitted that, though the Company's method of accounting had been accepted in previous years, the Income-tax Officer was not bound to accept it when he found that by reason of the

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*Present : Lord Thankerton, Lord Wright and Sir George Rankin.

⁽¹⁾ (1929) L. R. 57 I.A. 21, s. c. 54 Bom. 213.

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under-valuation of stock, the true income, profits and gains was not shown and he was entitled to accept the Balance Sheet as showing the profits of the Company and to assess the Company accordingly. The High Court is bound by the findings of fact by the Commissioner and, when it revised the question submitted, it should have sent back the revised question to the Commissioner for a finding thereon.

Hills, for the respondents. The computation must be the computation of the true income. The method of accounting in section 13 means the way in which the assessee keeps his accounts. It does not deal with the actual figures. A wrong salary every year is not to be a method of accounting. Reference was made to the Income Tax Manual, p. 157, paragraph 37, (5th ed.)=paragraph 50 (6th ed.). If stock is not stated at the true value, the correct profits cannot be ascertained. Reference was made to the decision of the High Court in *Commissioner of Income-tax, Bombay v. The Ahmedabad New Cotton Mills Co., Ltd.*⁽¹⁾

The true value was admittedly not given here. This is not a case in which a rough and ready calculation is made to arrive at the value of the stock. The figure given is taken.

Millard Tucker, K. C., replied.

The judgment of the Judicial Committee was delivered by LORD THANKERTON. This is an appeal from a judgment of the High Court of Judicature at Bombay, dated March 28, 1935, upon a question of law referred to the High Court by the present appellant under section 66 of the Indian Income Tax Act, 1922.

The question arises out of the assessment of the respondents to income-tax for the financial year ending March 31, 1932, and concerns the computation of the profits or gains of their business for the year of account ending on December 31, 1930, under section 10 of the Act.

⁽¹⁾ (1928) 52 Bom. 669.

The respondents are a limited liability company doing business at Ahmedabad as manufacturers of cloth and yarn. For the purpose of their assessment for the year ending March 31, 1932, they made a return under section 22 (1) of the Act on July 18, 1931, to the Income-tax Officer, which consisted of (a) a copy of the audited balance sheet and profit and loss account of the Company for the accounting year ending on December 31, 1930, which showed the profit for the year as Rs. 2,64,086, (b) a return of the total income of the Company for assessment, which included the income, profits and gains as per profit and loss account for the accounting year as Rs. 1,99,086, and (c) a covering letter which explained the adjustment of the figure in the profit and loss account so as to arrive at the figure of income in the return, and which was in the following terms :—

“ We herewith beg to enclose the Income-tax Form No. 4449 for the year 1931-32 duly filled in showing therein the profits as per statement shown below, which please receive and pass the receipts for the same.

Rs.	
2,64,086	<i>Profit</i> —as per Balance Sheet for the year ending 31st December 1930.
3,43,353	<i>Add</i> —Difference for the undervaluation in stock at the end of 1930 (at Market rate).
<hr/>	
6,07,439	
3,97,634	<i>Less</i> —Difference for the undervaluation in stock at the end of 1929.
<hr/>	
2,09,805	
10,710	<i>Less</i> —Premium received by sale of Government Bond of 1932.
<hr/>	
1,99,086	

The printed copy of the Balance Sheet for the year 1930 is enclosed herewith which please note.”

On receipt of the above return the Income-tax Officer issued a notice under section 23 (2) of the Act on the assesseees to produce evidence in support thereof, and, in compliance, the assesseees duly produced their closed accounts for the accounting year. The assesseees contended, before the Income-tax Officer,

(1) that the undervaluation of the closing stock of the assessee Company for the year 1929 disallowed by

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Rs. 3,97,634 in the assessment year 1930-31, should be allowed as an addition in the opening stock of the current year 1930, and that the undervaluation of the closing stock of the Company by Rs. 3,59,966, should also be added in the closing stock of the Company in the current assessment ;

(2) that the method of adopting the undervaluations of the opening as well as closing stocks was adopted by this office in previous assessments and that it should not be departed from in the current year's assessment ;

(3) that the ruling in the case of the *Ahmedabad New Cotton Mills Co. Ltd.*, is also in consonance with the method adopted by this office in considering the undervaluations of both the opening and closing stocks in computing the income of the Company for income-tax purposes.

In his assessment order of February 26, 1932, the Income-tax Officer states :—

“As regards above contentions, according to the Privy Council's decision in the *Ahmedabad New Cotton Mills Co. Ltd.*, I understand that, if the undervaluation of the closing stock of any assessee is considered in the assessment in any year, the undervaluation of the opening stock should also be considered in his assessment of that year; but if the undervaluation of the closing stock is not considered in the assessment, the undervaluation of the opening stock should also be left out of the same assessment. I accordingly set aside the question of the undervaluations of the opening as well as closing stocks of the assessee Company in the current year's assessment, and accept the profit of Rs. 2,64,086, shown in the statement of the profit and loss account of the Company. Under the circumstances, the claim of the assessee Company for Rs. 37,668, as a deduction from the current year's assessment is rejected.”

On an appeal by the assessees, the Assistant Commissioner of Income-tax confirmed the assessment by his order dated November 22, 1932. The assessees then applied to the present appellant to review the above orders under section 33 of the Act, or, alternatively, to make a reference of questions of law to the High Court under section 66 (2) of the Act. The appellant declined to review the orders, and, on the ground that no legal point was involved, he

also declined to make the reference. Thereafter the High Court, on an application by the assessee, under section 66 (3) of the Act, required the appellant to make a reference, and he made the present reference with the question of law as formulated by the High Court, viz. :—

“ Whether in view of the provisions of section 13 of the Income-tax Act or otherwise the Income-tax Officer was right in computing for the purpose of section 10 of that Act income, profits and gains in accordance with the method of accounting regularly employed by the assessee whether or not that method in fact shows the true income, profits and gains.”

The appellant suggested the substitution of another question, but his suggestion was not adopted by the High Court. The Court, however, without referring the case back, amended the question referred as follows :—

“ Whether, in the circumstances of the case the Income-tax Officer was entitled to compute the income, profits and gains of the assessee upon the basis of the printed copy of the profit and loss account sent with the letter of the assessee of the 18th July 1931, without regard to any undervaluation of the stock which may have been or may be proved to have been made.”

By their order, dated March 28, 1935, the High Court amended the question accordingly and answered the amended question in the negative. Their opinion was that the covering letter of July 18, 1931, formed part of the method of accounting employed by the assessee within the meaning of section 13 of the Act, and that the Income-tax Officer was not entitled to split up the method of accounting and to regard the profit and loss account apart from the covering letter; that the Income-tax Officer had only accepted a portion of the method, without taking the method as a whole which he was not entitled to do. They therefore held that the matter was still at large for the proper decision of the Income-tax Officer.

Their Lordships find themselves unable to agree with the view of the High Court as to the meaning of section 13 of the Act, which provides as follows :—

“ 13. Income, profits and gains shall be computed, for the purposes of sections 10, 11 and 12, in accordance with the method of accounting regularly employed by the assessee :

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“ Provided that, if no method of accounting has been regularly employed, or if the method employed is such that, in the opinion of the Income-tax Officer, the income, profits and gains cannot properly be deduced therefrom, then the computation shall be made upon such basis and in such manner as the Income-tax Officer may determine.

Their Lordships are clearly of opinion that the section relates to a method of accounting regularly employed by the assessee for his own purposes—in this case for the purposes of the Company's business—and does not relate to a method of making up the statutory return for assessment to income-tax. Secondly, the section clearly makes such a method of accounting a compulsory basis of computation, unless, in the opinion of the Income-tax Officer, the income, profits and gains cannot properly be deduced therefrom. It may well be that, though the profit brought out in the accounts is not the true figure for income-tax purposes, the true figure can be accurately deduced therefrom. The simplest case would be where it appears on the face of the accounts that a stated deduction has been made for the purpose of a reserve. But there may well be more complicated cases in which, nevertheless, it is possible to deduce the true profit from the accounts, and the judgment of the Income-tax Officer under the proviso must be properly exercised. It is misleading to describe this duty of the Income-tax Officer as a discretionary power.

Despite some statements in the reference, which will be referred to later, their Lordships agree with the High Court that the facts stated make clear that here the Income-tax Officer has never exercised his judgment under the proviso, and their Lordships are further of opinion that, if he had so exercised his judgment, the Income-tax Officer would not reasonably have come to any other opinion than that the profit shown in the profit and loss account could not be the true figure for income-tax purposes.

It is necessary now to consider some of the statements to be found in the reference, in addition to the passage already cited from the assessment order of the Income-tax Officer. In the order of the Assistant Commissioner on the appeal the following passages occur :—

“ It is only for the past five years that the opening and closing stocks have been revalued because they were found to be grossly undervalued, but the Income-tax Officer, now finding that the stocks (opening and closing) are being systematically and regularly valued at lower rates, he has deemed it fit to accept the profits as shown by accounts, as according to him the accounts do show real profits. Under section 13 of the Act ‘ income, profits and gains shall be computed for the purposes of sections 10 (business), 11 and 12, in accordance with the method of accounting regularly employed by the assessee.’ In this case the method of accounting has been found to be regularly and properly employed, hence the Income-tax Officer was *prima facie* entitled to accept the profits shown by the accounts. . . . At any rate, the Privy Council decision nowhere forbids the Income-tax Officer to accept the profits shown by the accounts in future, as a matter of fact, the decision relates to one year only, and if the Income-tax Officer has now accepted the accounts, I think he was quite within his powers to do so for the discretion vests in him and it is absolute.

“ Perhaps, I should also remark here that the Income-tax Officer has not in this case put any fictitious values of stocks of goods of his own, nor has he thus taken any fictitious profits. As a matter of fact, the Company admits that they do not keep proper cost accounts and that the cost price worked out for revaluation of stocks is also approximate. Thus the revalued stocks also do not show real profits. What strikes me rather strange is that while the *duly audited and certified balance sheet and profit and loss account* according to the accounts of the Company is presented to the shareholders as representing the true state of affairs and real profits of the Company, the Company say to the Income-tax Department that the profits shown by them in their accounts and certified and duly audited balance sheet and profit and loss account is unreal.”

Two important findings of fact are made in the letter of reference, viz., (1) the assessees have been found to have been regularly adopting all along the method of accounting which they followed for the year 1930, and (2) the method of valuation of stocks by taking some price under both cost and market price adopted for the year 1930 has been regularly employed by them for years past.

This makes clear that the method of accounting regularly employed by the respondents comes within the meaning of

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section 13, and it therefore became the duty of the Income-tax Officer to consider whether, in his judgment, the income, profits and gains for the purpose of section 10 could be properly deduced from the accounts. In their Lordships' opinion it is abundantly clear that he never applied his mind to this question, but held himself entitled to hold the respondents to the figures of profit brought out in these accounts. The Assistant Commissioner took the same view, although he recognised that these figures did not show real profits. The views expressed by these two officers make it impossible to accept three statements by the appellant in the letter of reference, viz. (a) in paragraph 4, "After examination of the accounts, the Income-tax Officer being satisfied that the accounts showed the true income, profits or gains, accepted them," (b) in paragraph 5, "The Income-tax Officer, however, accepted as correct the profit of Rs. 2,64,086 as shown in the assessee's profit and loss account and considered that there was no need to revalue the stocks," and (c) in paragraph 8, "The Income-tax Officer's finding was that the true income, profits and gains of the assessee could be properly deduced for the calendar year 1930 from the above method of accounts regularly employed by the assessee."

These statements are quite inconsistent with the statements already referred to, and, further, the facts would seem to show that the Income-tax Officer could not reasonably have come to the conclusion that the profit shown in the profit and loss account was the true profit for income-tax purposes. It is found that the undervaluation in the 1930 accounts is of the same nature and on the same basis as that in previous accounts, which is referred to by the Assistant Commissioner as gross undervaluation. This is confirmed by the actual figures; taking the undervaluation of the closing stocks in the previous assessments, which, except in the present year, have been taken as the

undervaluation of the opening stock in the succeeding assessment, the figures are as follows :—

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Year of Assessment.	Year of Account	Under-valuation.	Rs.
1927-28	1926	3,86,642	
1928-29	1927	4,15,208	
1929-30	1928	3,15,127	
1930-31	1929	3,97,634	

The last figure is that claimed by the assessee as the undervaluation of the opening stock in the accounting year of 1930, which is here in question. The Income-tax Officer could not reasonably conclude that the true profits could be properly deduced from a gross undervaluation. Lastly, if there were any doubt, the appellant himself has put the matter beyond possibility of doubt by the statement in his order of April 16, 1933, that the object of the undervaluation was the creation of a "secret" reserve, which involves the retention of profits, so as not to be included in the profits shown to the shareholders by the profit and loss account and balance sheet, but which constitute part of the taxable profits. This negatives any suggestion that these accounts show the true profit for income-tax purposes.

Their Lordships desire to add that the view of the Assistant Commissioner that the Income-tax Officer is *prima facie* entitled to accept the profits shown by the accounts, where there is a method of accounting regularly employed by the assessee, is not a correct view. It is the duty of the Income-tax Officer, where there is such a method of accounting, to consider whether the income, profits and gains can properly

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be deduced therefrom, and to proceed according to his judgment on this question. It is clear that the Income-tax Officer acted on the same view as that expressed by the Assistant Commissioner, and did not perform the duty above stated. The case of *Income-tax Commissioner, Bombay Presidency v. Ahmedabad New Cotton Mills Co.*⁽¹⁾ is of no assistance on the present question.

Their Lordships prefer the original question formulated by the High Court and embodied in the letter of reference, subject to the conclusion of their Lordships that the facts show that the method of accounting regularly employed by the assessee do not show the true income, profits or gains, and the question should therefore be amended as follows :—

“Whether in view of the provisions of section 13 of the Income-tax Act or otherwise the Income-tax Officer was right in computing for the purpose of section 10 of that Act income, profits and gains in accordance with the method of accounting regularly employed by the assessee, when that method in fact does not show the true income, profits and gains.”

This question falls to be answered in the negative. It will now be for the Income-tax Officer to proceed to the proper discharge of his duty under section 13, in light of the opinions above expressed, and, doubtless, his experience in the preceding years' assessments will assist him in reaching a proper decision.

Their Lordships will therefore humbly advise His Majesty that the order of the High Court of March 28, 1935, should be varied by substitution of the amended question above set forth, which should be answered in the negative, and that the appeal should be dismissed with costs.

Solicitor for the appellant : *The Solicitor, India Office.*

Solicitors for the respondents : Messrs. *Barrow, Rogers & Nevill.*

C. S. S.

⁽¹⁾ (1929) L. R. 57 I. A. 21, s. c. 54 Bom. 213.