

IN THE HIGH COURT OF PUNJAB AND HARYANA AT CHANDIGARH

ITR No.424 of 1995 (O&M)

DATE OF DECISION: 24.08.2016

M/s Munjal Sales Corporation

....Applicant

versus

The Commissioner of Income-tax Central, Ludhiana

.....Respondent

CORAM:- HON'BLE MR.JUSTICE S.J. VAZIFDAR, CHIEF JUSTICE
HON'BLE MR. JUSTICE DEEPAK SIBAL

Present: Mr. Akshay Bhan, Senior Advocate with
Mr. Alok Mittal, Advocate for the applicant

Mr. Zora Singh Klar, Senior Standing Counsel,
for the respondent-Department
..

S.J. VAZIFDAR, ACTING CHIEF JUSTICE:

This is a reference by the Income Tax Appellate Tribunal pertaining to the Assessment Year 1984-85.

2. The Tribunal was of the opinion that the following questions of law raised by the applicant/assessee in their application under Section 256(1) of the Income Tax Act, 1961, do arise from its order:-

- "1) Whether on the facts and in the circumstances of the case, the Tribunal was right in holding that the applicant could not adopt cash system of accounting in respect of commission from M/s. Majestic Auto Limited, which was a new source of income?
2. Whether on the facts and in the circumstances of the case, the Tribunal was right in holding that the applicant was liable to interest u/s 215 of the Income-tax Act, 1961?"

3. The Tribunal accordingly proceeded to draw up a statement of case which states the following facts:

(A) The assessee, a registered firm, earned income by way of commission for the accounting period ending 31.03.1984 from M/s Hero Cycles (P) Limited, Mr. Highway Cycle Industries Limited, M/s Rockman Cycle Industries and M/s Majestic Auto Limited (MAL). This reference relates to the validity of the assessee's having changed their accounting system from the mercantile system to the cash system in the midst of the accounting period ending 31.03.1984.

The assessee had entered into an agreement dated 18.03.1981 with MAL titled "Sole Selling Agent". The terms and conditions thereof are contained in a letter addressed by MAL to the assessee dated 18.03.1981. The assessee endorsed its acceptance at the footnote of the letter. MAL agreed to avail the assessee's marketing services with effect from 01.04.1981 till 31.12.1982. The arrangement was to be reviewed thereafter. In consideration of a payment of Rs.30,000/- per month including expenses of TA, DA, postage, telephone, telegrams and other incidentals of the assessee's travelling agent and other staff members and executives, the assessee agreed to provide the services mentioned therein which included sending their representative to the dealers of MAL at various places throughout India. The assessee's representatives were required to forward to MAL daily reports of their visits to each dealer, inter alia, in respect of showroom condition, sale of any other brand by the dealer, stock position and any other matter felt necessary.

The assessee had been showing the commission derived pursuant to this agreement on accrual basis.

(B) MAL and the assessee thereafter entered into an agreement dated 01.10.1983. By clause-1, MAL appointed the assessee as sole selling agents for sale of all their products in India, Nepal and Bhutan. The agreement was for the period 01.10.1983 to 30.09.1988. MAL, however, reserved to itself the right to sell its products to its bulk buyers for which the assessee was not entitled to any commission. Clauses 4, 5, 6, 11, 12 and 13 of this agreement read as under:-

"4. The Selling Agents hereby agree to obtain or procure from financially sound buyers in India, orders for minimum 75% of total production of the Product of the Principals during any period at the prices and upon the terms specified herein and the event in of his failure to do so, the principals shall have right to terminate this agreement by notifying the selling agent of such termination. If any goods are left unsold at the time of termination of this agreement, they shall have to be lifted by selling agents at the selling price of the Principals, then in force.

5. That the selling agents will not engage or be interested either directly or indirectly as principal agent or employee, in selling goods of any description of kind similar to those of the company or designed to perform the like functions as those of the company, whether alone or in conjunction with any other goods, without obtaining the previous consent in writing of the company.

6. That the selling agents will use its best endeavours and shall employ necessary staff to promote and extend the sales of product to all potential buyers thereof.

11. That the selling agents shall be entitled to get commission @ 1.5% (including del-credere commission) upon the invoice price of the product issued by the Principals in India, other than Direct Sales made by the Principals as mentioned in column 3 above and sales to Government Departments or the companies owned by the Government. The selling agents shall also be not entitled to any commission on exports. The above rate of commission is inclusive of the del-credere commission.

12. The selling agents shall not be entitled to commission on the amount of any invoice such amount shall be wholly or partly lost by reasons of the

insolvency of the customers. The selling agents shall be responsible for making good the loss on account of bad debts arising out of sale of the products of the Principals made during the period of agreement.

13. That all the disputed bills shall be settled by the selling agents at their expenses and the loss on return of goods shall also be borne by them."

(C) After entering into the agreement dated 01.10.1983, the assessee changed its system of accounting from the mercantile to the cash basis. The change was only in respect of the commission received from MAL. The assessee continued showing the commission received from the other concerns on the mercantile/accrual basis.

4. The accounting year of the assessee was the first day of April each year to the 31st day of March of the following year. As we mentioned earlier, during the assessment year in question i.e. 1984-85, the assessee followed the mercantile system for the period 01.04.1983 to 30.09.1983 and the cash system for the period 01.10.1983 to 31.03.1984.

5. The Assessing Officer did not accept the change on the ground that the source of income in respect of all four concerns was the same. The Commissioner of Income Tax (Appeals) upheld the Assessing Officer's decision, as did the Tribunal. The Assessing Officer referred to the authorities relied upon by the parties some of which we will shortly deal with. He also referred to Section 145(1), which at the relevant time, read as under:-

"Method of accounting.

145. (1) Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with the method of accounting regularly employed by the assessee:

Provided that in any case where the accounts are correct and complete to the satisfaction of the Income-tax Officer but the method employed is such that, in the opinion of the Income-tax Officer, the income cannot properly be (sic) deduced therefrom, then the computation shall be made upon such basis and in such manner as the Income-tax officer may determine.

(2) Where the Income-tax Officer is not satisfied about the correctness or the completeness of the accounts of the assessee, or where no method of accounting has been regularly employed by the assessee, the Income-tax Officer may make an assessment in the manner provided in section 144."

The Assessing Officer was of the opinion that the income cannot be properly deduced on account of the change in the accounting system and, therefore, rejected the assessee's computation and proceeded to re-compute the assessee's income on the basis of the mercantile system in respect of the income from MAL.

6. The CIT(A) allowed the appeal only partly but on an issue that is not relevant to this reference. On the questions referred, the CIT(A) confirmed the decision of the Assessing Officer. The assessee sought to justify the change on account of their having entered into a fresh agreement with MAL dated 01.10.1983. The CIT(A), however, held that the nature of income was almost the same even after and in respect of the new agreement dated 01.10.1983 and that it is the same source of income. He upheld the Assessing Officer's opinion that the assessee cannot be allowed to adopt two different methods of accounting.

On behalf the department, considerable emphasis was placed on the following observations in the assessment order:-

"5.1

Further the income (net income) means the gross income less expenditure relevant for earning that gross income. In

the case under appeal the ITO has established beyond doubt while arguing the case before me that the appellant has shown all the expenses on accrual basis whereas the income is shown on receipt basis. It is definitely not a proper method of keeping the books of account. There is no consistency in maintaining of the accounts of income because the expenses have been claimed on mercantile basis and the gross income has been shown on receipt basis. Keeping in view the above discussion and also the forceful argument of the ITO I hold that all the case-laws quoted by the appellant are not relevant on the facts of this case and the arguments of the appellant's counsel also stand on no footing. I, therefore, further held that it is not a new source of income and keeping in view the dubious method of planning for evasion of tax, the ITO has rightly come to the conclusion that the income from this source should have been taken on mercantile basis. In these circumstances the addition of Rs.14,09,241/- made by the ITO under the head "Commission Income" is confirmed."

7. The Tribunal partly allowed the assessee's appeal on the questions referred by it. The Tribunal upheld the decision of the Assessing Officer and of the CIT(A). The Tribunal held that the assessee had not adopted the change in the accounting system from mercantile to cash in respect of their other three principals and that the four principals formed a class. The Tribunal, therefore, held that the assessee was not entitled to switch over from the mercantile to the cash system only in respect of its agreement with MAL. The Tribunal also held that the source of income remained the same in respect of all the principals but that it is only the income from MAL which had been subjected to this change.

8. Prior to 01.04.1999, i.e., even during the assessment year in question, an assessee was entitled to follow the mercantile/accrual system as well as the cash system which was commonly referred to as the hybrid system. This reference raises various issues relating to an assessee's right to switch over from one accounting system to another.

9. We will presume as contended by Mr. Zora Singh Klar, the learned counsel appearing on behalf of the respondent/department that by the word "source", the Tribunal actually meant the "nature" of income. We find that to be so for the source is admittedly different, namely, the four principals. The Tribunal meant that the nature of the income was the same. The Tribunal, however, observed that even assuming that the two agreements were different from each other, the question that remained was whether the change had been brought in respect of a specific source of income or a particular class of customers and held that from either point of view, there was no justification for making a change on the allegation that the payments were not received promptly and regularly from MAL. It was held that there was nothing on record to establish that arrears were due from MAL and that it was, therefore, to the detriment of the assessee on account of the income being shown on accrual basis.

10. There is nothing in the Act even as it stood at the relevant time that prevented an assessee from switching over from one system to the other. Further, at the relevant time, an assessee was entitled to follow a hybrid system, to wit, a different accounting system in respect of its various transactions. Even in respect of similar transactions, an assessee was entitled to follow either system. This, however, was subject to the Income Tax Officer's power under the proviso to Section 145(1) to prevent the assessee from doing so. Under the proviso, even where the accounts are correct and complete to the satisfaction of the Income Tax Officer but the method employed is such that in the opinion of the Income Tax

Officer, the income cannot properly be deduced therefrom, the computation is to be made upon such basis and in such manner as the Income Tax Officer may determine. The proviso, therefore, does not place a bar upon the assessee's switching over from one system to the other. Nor did it at the relevant time bar the assessee from adopting different systems of accounting in respect of different transactions even if they were similar in nature. Strictly, the proviso does not even prohibit the assessee from switching over from one system to the other in the middle of the accounting year. The assessee could do so subject to the Income Tax Officer's right to insist upon a particular basis of accounting in the event of his being of the opinion that income cannot properly be deduced on the basis of the system adopted by the assessee.

11. For the first accounting year, a party would, in any event, be entitled to follow any accounting system subject only to the Income Tax Officer's insisting upon a particular system in the event of the ingredients of the proviso to the section being satisfied. The word "regularly" in Section 145(1) indicates that having chosen a particular system of accounting, an assessee cannot switch over to another system unilaterally. A view to the contrary would render the word "regularly" otiose. The hypothetical situation where an assessee may switch over several times during the first accounting year or for that matter in any accounting year poses no difficulty. In such a case, the Income Tax Officer would be entitled to decide which system was regularly being followed within the meaning of that expression in Section 145(1). It would make no difference even if he comes to the

conclusion that neither system could be said to have been regularly followed. In such a case, the Income Tax Officer could and indeed would justifiably invoke his powers under the proviso to Section 145(1).

12. Our view is supported by a judgment of a Division of the Allahabad High Court in (1966) 61 ITR 124-Shiv Prasad Ram Sahai vs. Commissioner Income-Tax, Uttar Pradesh. The Division Bench held:-

"9. It was further held that it was open to the assessee in certain circumstances to claim that the system should be changed from the mercantile system to that of the cash basis.

.... .

11. In the absence of any direct authority, but on the first principles it is clear that, once the assessee has adopted the mercantile system of accounting, there is no alternative for the Income-tax Officer but to compute the assessee's income on that system, i.e., on the accrual and not the receipt basis. The choice is entirely that of the assessee. He may even choose to adopt the mercantile system for certain transactions and the cash basis for other transactions, but once having chosen and regularly employed that system, it is not open to him unilaterally at any time during an accounting year to say that he will not now follow that system in respect of a particular transaction. It would be open to the assessee to vary the terms of a particular contract but the variation must be by mutual agreement. It is not open to him to keep alive the contract and his rights thereunder, but, for the purposes of income-tax, to say that he will not debit the interest which may have accrued as a debt in its accounts for any reason whatsoever. This is the very evil on account of which section 13 in the Act of 1922 was brought on the statute book. If the assessee could at any moment of time say that he will not debit the interest because of some reason or the other, then it would open the floodgates of evasion. There is also no hardship as the legislature has expressly provided that, if the income on the accrual basis has been included in the assessee's total income and tax paid thereon but subsequently it is found that that income was not received or could not be received, then in the year when such debt was found to have become irrecoverable or bad, it could be claimed as a bad debt. This provision is to be found in section 10(2)(xi) of the Act. This provision also indicates that the legislature never intended an assessee to be able to resile from the mercantile system of accounting and the accrual basis at his sweet will and pleasure. In this view of the matter, it is wholly unnecessary to consider whether the

financial position of the debtor was good or not, and whether there was any justification for the assessee not to have made the debit of Rs.20,400 in the account of this particular debtor. That will be a matter which falls to be considered if and when the assessee claims the amount as a bad debt. It will not be right or proper to make any observations on that aspect of the case in these proceedings, as it may embarrass the assessee. For the reasons given above, the answer to the question will be in the affirmative and against the assessee. The assessee will pay the costs of this reference to the department, which we assess at Rs. 200. Counsel's fee is also assessed at Rs. 200."

We are in respectful agreement with the above observations. It must be noted that the Division Bench held that once an assessee chooses a regularly appointed system, it is not open to him, unilaterally, at any time, during an accounting year, to decide that he would not follow that system in respect of a particular transaction and that it would be open to the assessee to vary the terms of a particular contract but the variation must be by mutual agreement. Our view is not inconsistent with these observations.

13. A similar view was also taken by a Division Bench of the Calcutta High Court in *Commissioner of Income Tax vs. Kesoram Industries & Cotton Mills Ltd.*, (1993) 204 ITR 154. The Division Bench held as under:-

"6. The assessee has been consistently following this system in respect of bonus liability in the subsequent assessment years. Neither principle nor the authority bars an assessee from substituting one method of accounting for another at his choice. The assessee is entitled to change his method of accounting provided it is bona fide and it is regularly employed and not merely for the year in question."

14. Our view is also supported by the judgment of a Division Bench of the High Court of Gauhati in the case of *Commissioner of Income Tax vs. Doom Dooma India Ltd.*, (1993) 200 ITR 496. The Division Bench held as under:-

"It is for the assessee to adopt any recognised method of accounting for his business. The income shall be computed in accordance with the method of accounting regularly employed by the assessee. In other words, it is open to the assessee to opt for such method of accounting as he deems reasonable and appropriate. He may opt to adopt the manufacturing cost price method or the market price method provided the method is followed in regard to both the opening stock and the closing stock. It is not open to him to adopt one method for valuing the opening stock and a different method for valuing the closing stock so as to intentionally suppress the income derived or derivable in the particular previous year. Even where an assessee has adopted a particular method for a period of years, there is no provision of law which prevents him from changing to any other method, provided the change over is not made in the same assessment year."

We agree with these observations except to the effect that the change over is not permissible in the same assessment year. Section 145 does not prohibit the same. Our attention was not invited to any other provision of law that prohibits it either. As a matter of fact, a switch over in the same assessment year would be allowed far less readily for reasons we will furnish later. That, however, is an aspect that relates to the exercise of discretion in the facts of a case and not to an absolute legal bar.

15. The answer to the first question requires a consideration as to whether in the facts of this case, the Tribunal was right in holding that the assessee could not adopt a cash system of accounting in respect of the commission received from MAL. In our view, on facts, the question must be answered in favour of the department and against the assessee but only so far as the assessee sought to switch over from the mercantile to the cash system in the midst of the financial year. The decision to switch over is otherwise perfectly valid.

16. The entire nature of the two agreements i.e. the agreement dated 18.03.1981 and the agreement dated 01.10.1983 is different. While considering whether an assessee ought to be permitted to switch over from one accounting system to another, the source of income is not relevant and at least not always relevant. It certainly is not the only relevant consideration. The source may be the same but the nature of the remuneration, the terms and conditions for the receipt of the remuneration/income may and often is entirely different. It would depend upon the terms and conditions of the agreement between the parties. It is not possible to enumerate exhaustively cases where a switch over of accounting systems in such cases is permissible.

17. Under the agreement dated 18.03.1981, the assessee was entitled to a fixed income of Rs.30,000/- per month including all other expenses. In other words, the income did not vary depending upon the volume of sales or the extent of the marketing services provided. Further, although the title to this agreement was "Sole Selling Agent", the terms and conditions stipulated therein do not indicate that the assessee was a sole selling agency. There was no bar against MAL appointing other agents. Even if there was an implied bar on account of the title, it would make no difference. On the other hand, under the agreement dated 01.10.1983, the assessee's responsibilities and obligations were entirely different. Under clause-4, the assessee was to procure orders from financially sound buyers for a minimum 75% of the total production of MAL's products. Moreover, in the event of the assessee failing to do so, MAL was entitled to terminate the

agreement and the unsold goods were to be lifted by the assessee at MAL's selling price then in force.

18. Under clause-5, the assessee was not entitled to engage or be interested either directly or indirectly as principal, agent or employee in selling similar goods without MAL's consent in writing. There was no such bar under the earlier agreement. More important, whereas under the first agreement dated 18.03.1981, the assessee was entitled to a fixed remuneration of Rs.30,000/- per month, clause-11 of the agreement dated 01.10.1983 entitled the assessee to commission at 1.5% upon the invoice price. Equally important is the fact that under clause-13 the disputed bills were to be settled by the assessee at their expense and the loss on return of goods was also to be borne by them. Such stipulations were absent in the first agreement.

19. The two agreements were, therefore, entirely different in their scope and nature. The rights and liabilities of the parties thereunder were also entirely different. In respect of the first agreement the assessee knew exactly how much they were entitled to receive, namely, Rs.30,000/- per month. Under the second agreement, although the commission was fixed at 1.5%, the receipt thereof may well have been the subject matter of controversy and uncertainty, inter alia, on account of clauses 11 and 13. The controversy and the disputes could lead to litigation which in turn would be resolved only after years. The assessee, therefore, would not at any given point of time know with any degree of certainty as to the amount that they would be entitled to

during the financial year. The uncertainty of receiving the amount, the quantum of the amount and the time of receipt are crucial factors in the assessee's decision as to which of the accounting systems ought to be followed. The assessee was, therefore, entitled to switch over from one system to the other.

20. In these circumstances, the assessee was entitled to follow a different system of accounting in respect of their transactions under the new agreement although with the same party, namely, MAL.

21. The question now is whether the Income Tax Officer was justified in refusing to permit the assessee switching over from the cash to the mercantile system during the midst of the financial year. We think he was, for more than one reason. For instance, as recorded in paragraph 5.1 of the assessment order:-

"5.1

Further the income (net income) means the gross income less expenditure relevant for earning that gross income. In the case under appeal the ITO has established beyond doubt while arguing the case before me that the appellant has shown all the expenses on accrual basis whereas the income is shown on receipt basis. It is definitely not a proper method of keeping the books of account. There is no consistency in maintaining of the accounts of income because the expenses have been claimed on mercantile basis and the gross income has been shown on receipt basis. Keeping in view the above discussion and also the forceful argument of the ITO I hold that all the case-laws quoted by the appellant are not relevant on the facts of this case and the arguments of the appellant's counsel also stand on no footing."

Moreover, a switch over in the midst of an accounting year, especially in such cases, could lead to skewed results. An assessee could then avoid paying the correct advance tax by following the cash system at first and then justifying the

non-payment or short payment by switching over to the mercantile system. Further, the assessee could do this, theoretically at least, more than once leaving the entire assessment in a state of uncertainty and confusion. This would considerably fragment an assessment year. Apart from placing a burden on the Assessing Officer and the other authorities under the Act in carrying out the assessment in terms of time and resources, it would pose considerable difficulties in carrying out the assessment. The authorities would understandably be far more reluctant to accept a switch over in the midst of the financial year. Their decision to refuse to accept the switch over in the midst of financial year ought not be interfered with lightly. A switch over in the midst of financial year ought to be permitted by the authorities only in exceptional cases where the same poses no difficulty whatsoever in computing income and the switch over is justified. The burden to establish the same must rest heavily upon the assessee who desires the switch over in the midst of the financial year.

22. The reference to the first question, therefore, is answered in favour of the Revenue in so far as it relates to the assessee's right to switch over from the mercantile to the cash system in the midst of the accounting year.

23. It was agreed that the answer to the second question follows the answer to question No.1. Question No.2 is, therefore, also answered in favour of the Revenue in so far as it relates to the assessment year in question, namely, 1984-85.

24. The reference is accordingly answered.

(S.J. VAZIFDAR)
CHIEF JUSTICE

24.08.2016
parkash*

(DEEPAK SIBAL)
JUDGE

Note:

Whether ~~non-speaking~~/reasoned^v

Whether reportable: YES



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