IN THE HIGH COURT OF KARNATAKA AT BENGALURU

DATED THIS THE 5TH DAY OF OCTOBER 2020

PRESENT

THE HON'BLE MR. JUSTICE ALOK ARADHE

AND

THE HON'BLE MR. JUSTICE H.T.NARENDRA PRASAD

I.T.A. NO.154 OF 2014

BETWEEN:

M/S. PADMINI PRODUCTS (P) LTD.,
NO.157, K. KAMARAJ ROAD
BENGALURU – 560042
(REPRESENTED BY ITS DIRECTOR
SRI. PRABHU KIRAN, AGED ABOUT 60 YEARS
S/O LATE NAGARAJ N. VEMULKAR).

... APPELLANT

(BY SRI. K.K. CHYTHANYA, ADV.,)

AND:

THE DEPUTY COMMISSIONER OF INCOME TAX
CIRCLE-12(2), 14/3, 4TH FLOOR
RASHTROTHANA BHAVAN
NRUPATUNGA ROAD, BENGALURU-560001.

... RESPONDENT

(BY SRI. K.V. ARAVIND, ADV.)

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THIS ITA IS FILED UNDER SECTION 260-A OF I.T. ACT, 1961 ARISING OUT OF ORDER DATED 14.11.2014 PASSED IN ITA NO.242/BANG/2013, FOR THE ASSESSMENT YEAR 2009-10, PRAYING THAT THIS HON'BLE COURT MAY BE PLEASED TO:

(I) FORMULATE THE SUBSTANTIAL QUESTIONS OF LAW STATED ABOVE.

(II) ALLOW THE APPEAL AND SET ASIDE THE IMPUGNED ORDER OF THE ITAT, BENGALURU 'C' BENCH BEARING IN ITA NO.242/BANG/2013, DATED 14.11.2014

THIS ITA COMING ON FOR FURTHER HEARING, THIS DAY, **ALOK ARADHE J.,** DELIVERED THE FOLLOWING:

JUDGMENT

This appeal under Section 260A of the Income Tax Act, 1961 (hereinafter referred to as the Act for short) has been preferred by the assessee. The subject matter of the appeal pertains to the Assessment years 2005-06 to 2008-09. The appeal was admitted by a bench of this Court vide order dated 26.09.2014 on the following substantial question of law:

> *(i) Whether on the facts and in the circumstances of the case, the Honourable ITAT was right in law in upholding the action of Learned Respondent in re-opening the assessment for the assessment years 2005-06, 2006-07 & 2008-09 under Section 147 of the IT Act in the absence of any tangible material but merely on the basis of additions made in subsequent assessment year 2007-08?*

(ii) Whether on the facts and in the circumstances of the case, the Honourable ITAT was right in law in holding that the Appellant is eligible to claim depreciation only with reference to the written down value of transferred assets in the hands of predecessor firm and not with reference to actual cost incurred by it?

(iii) Whether on the facts and in the circumstances of the case, the Honourable ITAT was right in law in upholding the action of the Learned Respondent in invoking 5th proviso to Section 32(1) of the IT Act in the assessment years subsequent to the assessment year in which the succession took place?

(iv) Whether on the facts and in the circumstances of the case, the Honourable ITAT was right in law in upholding the action of the Learned Commissioner Appeals in invoking Explanation 3 to section 43(1)?

2. Facts leading to filing of this appeal in nut shell are that the assessee is a Private Limited Company

engaged in the business of manufacturing, dealing and exporting of incense sticks and allied products. The assessee succeeded to, in the business of partnership firm viz., 'Padmini Products' with effect from 01.02.2005. Before the firm was converted into private limited company, the partnership firm had revalued all its intangible assets and arrived at a value of Rs.65,26,40,150/- using standard valuation methods. All assets and liabilities of Padmini Products i.e., the erstwhile partnership firm, including the aforesaid intangible assets were transferred to the assessee. In consideration, the assessee allotted shares at the face value of Rs.1,000/- and premium of Rs.13,500/- per share each to the partners of the erstwhile partnership firm and no other consideration in any other form was paid by the assessee either to Padmini Products or to its partners. The assessee filed the returns of income for the Assessment Years 2005-06 and 2007-08 declaring a loss of Rs.14,98,22,351/- and Rs.12,08,55,111/-

respectively. The assessee filed return of income for Assessment Year 2006-07 and 2008-09 declaring the income as 'NIL'. The case of the assessee for the Assessment Year 2005-06 was reopened under Section 147 of the Act on the ground that during the course of the proceeding for Assessment Year 2007-08, it was noticed by the Assessing Officer that assessee had made claim of depreciation on intangible assets, which was not in accordance with Section 32(1) of the Act. Thereafter, a notice under Section 148 of the Act was issued. The assessee by a communication dated 17-02.2010 stated that return of income for Assessment Year 2005-06 already filed on 31.10.2005 be treated as return in response to the notice under Section 148 of the Act. Thereafter, a notice under Sections 143(2) and 142(1) of the Act was issued to the assessee. The Assessing Officer by an order dated 31.12.2010 inter alia held that intangible assets valued in the hands of the company at the time of succession, were valued as per assessee's

own valuation and not for any actual consideration. It was further held that assessee neither purchased / acquired intangible assets from any third party nor incurred any actual cost. It was further held that since, assessee has not actually acquired or purchased assets for actual consideration, therefore, value of the assets par takes the nature of notional value and not the real value and depreciation under Section 32(1)(ii) of the Act cannot be allowed. It was further held that depreciation is only allowable as per proviso (5) to Section 32(1) of the Act, which was actually existing in the earlier concern viz., the partnership firm. Therefore, the original assets, which were added in the company at the time of succession cannot be considered for the purposes of depreciation. Accordingly, the claim for depreciation on intangible assets was disallowed.

3. Being aggrieved, the assessee filed an appeal before the Commissioner of Income Tax (Appeals) who by an order dated 20.02.2013 dismissed the appeal. The

assessee thereupon approached the Income Tax Appellate Tribunal (hereinafter referred to as 'the Tribunal' for short) by filing an appeal. The Tribunal by an order dated 10.01.2013 inter alia held that transaction itself is not a transfer but is akin to succession and therefore, in view of sub-Clause (ii) to 5th proviso to Section 32(1), depreciation is not permissible. It was further held that Section 43(6) of the Act, defines the expression 'written down value' and provides for both the acquisition of assets during the relevant Previous year and acquisition of assets before the relevant Previous year and both the clauses mention actual cost to the assessee. Therefore, the claim for depreciation can be examined even in the Assessment Years subsequent to the Assessment Year, in which succession has taken place. It was also held that Commissioner of Income Tax (Appeals) has not invoked the provisions of Explanation 3 to Section 43(1) of the Act but has only justified the action of the Assessing

Officer in questioning the claim of depreciation by citing the provision of Section 43(1) and Explanation 3 thereof. The Tribunal therefore, dismissed the appeal preferred by the assessee. Being aggrieved, the assessee is in appeal before us.

4. Learned counsel for the assessee at the outset submitted that he does not want to press the substantial question of law No.1. It is submitted that the authorities grossly erred in holding that there is no transfer of intangible asset from one entity to another entity. Therefore, the assessee is not entitled for depreciation on the tangible assets. It is further submitted that valuation aspect was not questioned by any of the authorities and even the Assessing Officer in its remand report has not doubted the genuineness of the transaction. It is also submitted that revaluation of the intangible assets was done by the firm and not by the company and therefore, the case of the assessee was covered under Section 47(xiii) of the Act. It is

further submitted that 5th proviso to Section 32(1) of the Act would not apply to the fact situation of the case. It is also pointed out that with regard to Explanation 3 to Section 43 of the Act, the Assessing Officer neither mentioned anything in the order nor in the remand report. It is also argued that in any case the assessee was entitled to notice before invocation of provision contained in Explanation 3 to Section 43 of the Act. In support of aforesaid submissions, learned counsel for the assessee has placed reliance on decisions of Supreme Court in ***'COMMISSIONER OF INCOME-TAX, CENTRAL – III VS. HCL TECHNOLOGIES LTD.', (2018) 404 ITR 719 (SC), 'BHOR INDUSTRIES LTD. VS. COMMISSIONER OF INCOME-TAX', (1961) 42 ITR 57 (SC)*** and ***'GVK INDUSTRIES LTD. VS. INCOME TAX OFFICER', (2011) 332 ITR 130 (SC).***

5. On the other hand, learned counsel for the revenue submitted that as per Section 45 of the Act, transfer of entire business of firm to company amounts

to transfer of capital asset. It is further submitted that Section 47(xiii) only takes out succession of transfer of capital asset or intangible asset within the ambit of Section 45 of the Act. It is further submitted that conversion of intangible assets by a firm to a company does not amount to transfer. It is also argued that there was no occasion for the partnership firm to revalue the assets and in the light of 5th proviso of Section 32 of the Act if the asset is transferred, the depreciation has to be apportioned between the transferor and transferee and therefore, the question of depreciation does not arise. It is further submitted that Section 43(6) of the Act defines the expression 'written down value' and provides for acquisition of assets. However, in the instant case, is neither a case of acquisition nor transfer of intangible assets and notional valuation of intangible assets by the assessee is only a device to claim depreciation on non existent asset. It is further submitted that entire valuation has been done without any statutory provision

and all the authorities have rightly found that the assessee is entitled to depreciation on intangible assets only with reference to written down value of transferred assets in the hands of predecessor firm.

6. We have considered the submissions made by learned counsel for the parties and have perused the record. Before proceeding further, it is apposite to take note of relevant provisions viz., Section 32(1), 5th proviso to Section 32(1) of the Act, Explanation 3 to Section 43(1) and Section 47(xiii) of the Act, which read as under:

> ***32. (1)*** *In respect of depreciation of—*
>
> *(i) buildings, machinery, plant or furniture, being tangible assets;*
>
> *(ii) know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after the 1st day of April, 1998,*
>
> *owned, wholly or partly, by the assessee and used for the purposes of the business or*

profession, the following deductions shall be allowed—

Provided *also that the aggregate deduction, in respect of depreciation of buildings, machinery, plant or furniture, being tangible assets or know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets allowable to the predecessor and the successor in the case of succession referred to in clause (xiii), clause (xiiib) and clause (xiv) of section 47 or section 170 or to the amalgamating company and the amalgamated company in the case of amalgamation, or to the demerged company and the resulting company in the case of demerger, as the case may be, shall not exceed in any previous year the deduction calculated at the prescribed rates as if the succession or the amalgamation or the demerger, as the case may be, had not taken place, and such deduction shall be apportioned between the predecessor and the successor, or the amalgamating company and the amalgamated company, or the demerged*

company and the resulting company, as the case may be, in the ratio of the number of days for which the assets were used by them.

Explanation 1.—Where the business or profession of the assessee is carried on in a building not owned by him but in respect of which the assessee holds a lease or other right of occupancy and any capital expenditure is incurred by the assessee for the purposes of the business or profession on the construction of any structure or doing of any work in or in relation to, and by way of renovation or extension of, or improvement to, the building, then, the provisions of this clause shall apply as if the said structure or work is a building owned by the assessee.

Explanation 2.—For the purposes of this sub-section "written down value of the block of assets" shall have the same meaning as in clause (c) of sub-section† (6) of section 43.*

Explanation 3.—For the purposes of this sub-section, the expression "assets" shall mean—

(a) tangible assets, being buildings, machinery, plant or furniture;

(b) intangible assets, being know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature.

Explanation 3*- Where, before the date of acquisition by the assessee, the assets were at any time used by any other person for the purposes of his business or profession and the Assessing Officer is satisfied that the main purpose of the transfer of such assets, directly or indirectly to the assessee, was the reduction of a liability to income- tax (by claiming depreciation with reference to an enhanced cost), the actual cost to the assessee shall be such an amount as the Assessing Officer may, with the previous approval of the Deputy Commissioner, determine having regard to all the circumstances of the case.*

47*. Transactions not regarded as transfer Nothing contained in section 45 shall apply to the following transfers:-*

*(**xiii**) any transfer of a capital asset or intangible asset by a firm to a company as a result of succession of the firm by a company in the business carried on by the firm, or any transfer of a capital asset to a company in the course of demutualisation or corporatisation of a recognised stock exchange in India as a result of which an association of persons or body of individuals is succeeded by such company :*

Provided that—

(a) all the assets and liabilities of the firm or of the association of persons or body of individuals relating to the business immediately before the succession become the assets and liabilities of the company;

(b) all the partners of the firm immediately before the succession become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the succession;

(c) the partners of the firm do not receive any consideration or benefit, directly or indirectly, in any form or manner, other

than by way of allotment of shares in the company;

7. After having noticed the relevant statutory provisions, we may advert to the issues arising in this appeal. The business of manufacture and sale of incense sticks is built on an intangible experience of aroma which can rarely be secured in the form of trade name / trade mark. It is pertinent to mention here that Assessing Officer himself has found that the erstwhile partnership firm was the registered owner of various trade marks. It is also pertinent to mention here that valuation of the shares was made by the assessee as per the accounting standards 10 & 26. It is also noteworthy that none of the authorities have either questioned the valuation of the intangible assets or have doubted the genuineness of the transactions. Thus, the intangible asset of the assessee has a real money value. The aforesaid trademark viz., the intangible assets were transferred to the assessee for a valuable consideration.

Section 32(1) of the Act provides for depreciation in respect of trademarks owned wholly or partly by the assessee. In the instant case, the assessee succeeded to the business of the partnership firm, which had trademarks registered in its name. Therefore, the assessee under Section 32(1) of the Act was entitled for depreciation. It is also pertinent to note that under Section 47 of the Act, any transfer of capital asset or a intangible asset by a firm to a company as are result of succession of the firm by a company is a recognized mode of transfer. Admittedly, the assessee and the erstwhile partnership firm are different entities and there was transfer of intangible assets by the partnership firm to the assessee for a valuable consideration that is by way of allotment of shares. Thus, the aforesaid transaction is squarely covered under Section 47(xiii) of the Act and therefore, the assessee under Section 32(1) of the Act was entitled for depreciation with reference to actual cost incurred by it

with reference to intangible assets. Accordingly, the second substantial question of law is answered in favour of the assessee and against revenue.

8. It is noteworthy to mention here that 5th proviso to Section 32(1) of the Act restricts the total depreciation which can be claimed in case of succession etc. to the depreciation which would have been allowable had there been no succession. The 5th proviso (earlier 4th proviso) to Section 32(1) was inserted by Finance Act, 1996 to restrict the claim of aggregate deduction, which is evident from the memorandum to Finance Bill, 1996, which reads as under:

> *In cases of succession in business and amalgamation of companies, the predecessor of the business and successor the amalgamating company and amalgamated company as the case may be, are entitled to depreciation allowance on same assets which in aggregate exceeds depreciation allowance for Previous year at the prescribed dates. It is*

proposed to restrict the aggregate deduction in a year to the deduction computed at the prescribed rates and apportion the allowance in the ratio of number of days for which the assets were used by them.

9. Thus, it is evident that 5th proviso to Section 32 of the Act restricts aggregate deduction both by the predecessor and the successor and if in a particular year there is no aggregate deduction, the 5th proviso does not apply. Thus, it is axiomatic that until and unless it is the case of aggregate deduction, the proviso has no role to play. The 5th proviso in any case will apply only in the year of succession and not in subsequent years and also in respect of overall quantum of depreciation in the year of succession. Accordingly, the third substantial question of law is answered in favour of the assessee and against the revenue.

10. The prerequisite for invoking Explanation 3 to Section 43(1) of the Act is that the Assessing Officer

has to establish that the main purpose of the transfer of such asset was reduction of liability to income tax by claiming extra depreciation on enhanced cost. IN order to establish aforesaid fact, it has to be established that apart from claiming additional depreciation on enhanced cost there is no other main purpose for acquiring the asset in question and the Assessing Officer has to obtain the previous approval of the joint commissioner to disregard the enhanced price. The Assessing Officer, in the instant case, in the order of assessment has neither complied with the aforesaid conditions nor has recorded any finding in this regard. The Commissioner of Income Tax (Appeals) however, failed to appreciate the aforesaid aspect. Therefore, the Tribunal committed an error of law in upholding the order of Commissioner of Income Tax (Appeals) in invoking Explanation 3 to Section 43(1)of the Act. In the result, the aforesaid substantial question of law is answered in favour of the assessee.

In view of preceding analysis, the order passed by the Income Tax Appellate Tribunal dated 10.01.2014 is hereby quashed. In the result, the appeal is allowed.

Sd/-
JUDGE

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JUDGE

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