Bombay High Court Commissioner Of Income-Tax vs Texspin Engg. & Mfg. Works on 5 March, 2003 Equivalent citations: (2003) 180 CTR Bom 497, 2003 263 ITR 345 Bom, 2003 44 SCL 239 Bom Author: S Kapadia Bench: S Kapadia, J Devadhar JUDGMENT S.H. Kapadia, J. 1. Being aggrieved by the order of the Tribunal dated 11-12-2000 in Appeal No. 5814/Bom/99, the Department has come by way of appeal under Section 260A of the Income-tax Act for the assessment year 1996-97 with the following questions of law for our opinion : "1. Whether on the facts and in the circumstances of the case, the ITAT was justified in holding that the provisions of Section 45(1) and (4) are not attracted even though there was transfer of assets from the firm to the newly constituted company on conversion of firm to company and Part IX of the Companies Act, 1956 ? 2. Whether on the facts and in the circumstances of the case and in law, the ITAT was justified in directing to allow depreciation for the year even though the W.D.V. of the block of the assets at the end of the year was nil as per the provisions of Section 32 read with Section 43(6)(c)(i)(B) of the Act ?" Facts 2. A firm by the name M/s. Texspin Engineering & Manufacturing Works was engaged in the business of manufacturing ball bearings. The said firm filed its return of income for the period 1-4-1995 upto 7-11-1995 stating that it had been thereafter converted into a Limited Company. The return of the remaining period from 7-11-1995 to 31-3-1996 was filed by the Limited Company at Ahmedabad. While examining the return of income filed by the assessee, it was observed that the assessee-firm had filed its return of income upto 7-11-1995. On enquiry, the Assessing Officer was informed that the Partnership Firm was converted into a Limited Company under Part IX of the Companies Act, 1956. No capital gain was shown in the return of income. Therefore, the assessee-firm was asked to show cause why capital gain has not been shown under Section 45(4) of the Income-tax Act. The assessee-firm was also directed to submit market value of the assets for computation of capital gains under Section 45(4) of the Income-tax Act. In reply, the assessee-firm contended that in order to apply Section 45(4), two conditions were required to be fulfilled viz. (i) dissolution of the Partnership Firm, and (II) distribution of the assets of the Partnership Firm and since, there was no dissolution of the Partnership Firm, Section 45(4) was not attracted. This argument was rejected by the Assessing Officer, who took the view that there was a transfer of the capital assets by way of distribution and such transfer was on dissolution of the firm and, therefore, profits or gains from such transfer became chargeable to tax under Section 45(4) of the Act. Further, for the purposes of computation of capital gains under Section 48 of the Act, the Assessing Officer took into account written down value as on 1-4-1995 of the assets which stood transferred in favour of the company. Accordingly, the Assessing Officer computed the capital gains on the difference between the market value and the written down value of the assets transferred to the company to the tune of Rs. 9 lakhs. There is one more point which needs to be mentioned. During the assessment year in question, the assessee claimed depreciation of Rs. 27,67,000, which was disallowed on the ground that on vesting of the assets in the company, there was a sale. That, when the firm was converted into a Limited Company under Part IX of the Companies Act, there was a sale of assets and therefore, at the end of the accounting year ending 31-3-1996, no assets existed as the entire assets stood transferred and, therefore, the Assessing Officer disallowed the claim for depreciation. Being aggrieved by the assessment order, the matter was carried in appeal to the Commissioner of Income-tax (Appeals), who confirmed the order of the Assessing Officer. Being aggrieved, the assessee carried the matter in appeal to the Tribunal, which took the view on question No. 1 that Section 45(4) was not applicable as there was no distribution of capital assets amongst the partners of the firm on vesting of their capital assets of the firm in the company. That, Section 45(1) was also not attracted as no consideration was received by the assessee-firm on vesting of the capital assets in the Limited Company. On non-allowance of depreciation, the Tribunal took the view that vesting of capital assets in the company did not amount to sale and, therefore, the conditions of Section 43(6)(c)(i)(B) were not satisfied. In the circumstances, the Tribunal allowed the claim for depreciation. Being aggrieved by the decision of the Tribunal, the matter has come in appeal before us under Section 260A of the Income-tax Act. Arguments 3. Mr. R.V. Desai, learned senior counsel appearing on behalf of the Department contended that on vesting of the properties of the firm in the Limited Company, the partners of the erstwhile firm became shareholders of the company. That, on such vesting, the erstwhile firm stood dissolved. That, on such vesting, every asset of the firm was taken over by the Limited Company. That, on vesting, the firm ceased to exist. That, as a result of vesting, the company became the owner of all the properties of the firm and in lieu thereof, shares were allotted to the partners by the company. He, therefore, contended that, in this case, Section 45(4) was applicable. In the alternative, he contended that on dissolution of the firm, there was extinguishment of all the rights of the firm in the capital assets and, therefore, there was a transfer as contemplated under Section 2(47)(ii) read with Section 45(1) of the Income-tax Act. That, on dissolution of the erstwhile firm and on account of extinguishment of all rights in the capital assets of the firm, profits/gains arose. That, such vesting resulted in transfer of capital assets under Section 45(1) of the Act. He contended that on such vesting of the capital assets of the firm in the company, there was dissolution and extinguishment of all rights and since the firm's assets vested in the company, there was a transfer as contemplated by Section 45(1) of the Act. That, on vesting, the firm's existence came to an end. That on vesting, there was dissolution of the firm. He, therefore, contended that profits/gains arose from transfer of the capital assets under Section 45(1) of the Act. Mr. Desai contended further that once the conditions under Section 45(1) stood satisfied then, the Department was right in computing capital gains under Section 48 of the Act. In this connection, it was argued that the fair market value of the assets on the date of the transfer represented the full value of the consideration received/accrued under Section 48 of the Act. In the circumstances, it was argued that the value of the assets transferred to the Limited Company represented full value of the consideration which expression finds place in Section 48 of the Income-tax Act. He, therefore, contended that the Department was right in computing capital gains under Section 45(1) read with Section 48 of the Income-tax Act. He contended that the fair market value of the assets, on the date of vesting, represented full value of consideration from which the Assessing Officer has rightly deducted the written down value as on 1-4-1995 with additions made during the year and, therefore, the capital gains was rightly calculated as Rs. 9 lakhs on the basis of the difference between the market value of the assets on the date of vesting i.e. 7-11 -1995 and the written down value at the beginning of the year i.e., on 1-4-1995. On question No. 2, it was submitted that on 31-3-1996, the assessee-firm was not the owner of the assets as the assets stood sold during the accounting year ending 31-3-1996 and, therefore, the Assessing Officer was right in disallowing the assessee's claim for depreciation amounting to Rs. 27,76,000. 4. Mr. Patil, learned counsel for the assessee, submitted that under Section 45(4) of the Act, two conditions are required to be satisfied. Firstly, there must be a transfer by way of distribution of capital assets and secondly, that, such transfer should be either on account of dissolution of the firm or otherwise. Mr. Patil contended that in this case, there was no transfer because under Part IX of the Companies Act, the firm is merely treated as a company statutorily. He submitted that under Part IX of the Companies Act, the same entity viz. the firm is treated as a company and, therefore, there was no transfer as contemplated by Section 45(4) of the Act. He further contended that in this case, the first condition to attract Section 45(4) is that there should be a transfer by way of distribution of capital assets. He contended that vesting of capital assets in the Limited Company did not amount to distribution of capital assets. In the circumstances, Section 45(4) was not applicable. Mr. Patil further contended that even Section 45(1) was not attracted in this case because, Section 45(1) contemplates accrual of profits or gains from transfer of a capital assets. He contended that under Part IX of the Companies Act, the firm is treated as a company whereas, Section 45(1) pre-supposes existence of two parties between whom the transfer takes place. He contended that when the firm is treated as a company, there is no existence of two separate parties amongst whom the transfer takes place. In the circumstances, he contended that Section 45(1) of the Act is not applicable. He further contended that even assuming for the sake of argument that there was a transfer under Section 45(1) still, in the present case, one has to compute the capital gain, which in this case is not possible. He contended that the capital assets parted with by the firm in favour of the Limited Company cannot represent "full value of the consideration", which expression finds place in Section 48 of the Income-tax Act. He contended that the expression "full value of the consideration" connotes payment of actual consideration and "full value of the consideration" cannot cover assets parted with. In this connection, he placed reliance on the judgments of the Supreme Court in the cases of CIT v. George Henderson & Co. Ltd. [1967] 66 ITR 622 and CIT v. Gillanders Arbuthnot & Co. [1973] 87 ITR 407. He, therefore, submits that in this case Section 48 of the Income-tax Act fails even if one assumes transfer under Section 45(1) of the Act. Mr. Patil next contended that it is true that the partners of the erstwhile firm received shares of the Limited Company in whom capital assets vested but, the partners received shares because of the credit balance in the erstwhile firm. Therefore, there was no consideration received by the assessee-firm on vesting of the capital assets in the Limited Company. That, there was no co-relationship between receipt of shares by partners on one hand and the vesting of the assets in the Limited Company on the other hand. Under the circumstances, Mr. Patil contended that even if one assumes accrual of capital gains, computation of capital gains can be done only under Section 48, which as stated above, was not attracted. He, therefore, contended that there is no merit in this appeal. On question of depreciation, it was submitted that under Section 32, an assessee is entitled to depreciation once he makes use of the assets. That, there is no requirement that the assessee should continue to hold the capital assets till the end of the year. He contended that depreciation to be calculated on actual costs or written down value. He contended that in the present case, the Department has invoked Section 43(6)(c)(B) to justify its conclusion that in the case of Block of Assets, the written down value has got to be adjusted by deduction of monies payable in respect of any asset falling within the block of assets, which is sold, discarded, demolished or destroyed during the previous year. He contended that in the present case, none of the conditions are applicable. He contended that vesting was not as sale as construed by the Department. He, therefore, contended that Section 43(6)(c)(B) was not attracted. In this connection, he also relied upon the judgment of the Madras High Court in the case of A.M. Ponnurangam Mudaliarv. C/7[1997] 228 ITR 454 [1996] 88 Taxman 482 and the judgment of the Andhra Pradesh High Court in the case of CIT v. Bhanodaya Industries [2002] 253 ITR 3502, 122 Taxman 258. Findings [A] On Section 45(4) 5. In this matter, we are concerned with assessment year 1996-97. Section 45(1) is a charging section as far as capital gains is concerned. Under Section 45(4), profits arising from transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm is chargeable to tax as income of the firm in a previous year in which the transfer takes place and for the purposes of Section 48, the fair market value of the asset on the date of such transfer is deemed to be the full value of the consideration received or accruing as a result of the transfer. Section 48 deals with mode of computation. It, inter alia, lays down that the income chargeable under the head "Capital gains" shall be computed by deducting from the full value of the consideration, the expenditure incurred in connection with the transfer and the cost of acquisition of the asset. Therefore, under Section 45(4), two conditions are required to be satisfied viz. transfer by way of distribution of capital assets and secondly, such transfer should be on dissolution of the firm or otherwise. Once these two conditions are satisfied then, in that event, for the purposes of computation of capital gains under Section 48, the market value on the date of the transfer shall be deemed to be the full value of consideration received or accruing as a result of the transfer. Now, according to the Assessing Officer, in this case, on vesting of the properties of the firm in the Limited Company, there was a transfer by way of distribution of capital assets. Further, according to the Assessing Officer, on vesting of the properties of the firm in the company, there was a resultant dissolution of the firm. Therefore, according to the Assessing Officer, both the conditions under Section 45(4) stood satisfied and, therefore, he was entitled to take the fair market value of the asset on the date of the transfer to be the full value of the consideration received as a result of the transfer. It is for this reason that the Assessing Officer has computed the capital gains under Section 48 by referring to the comparative figures of the book value and the market value. As stated above, in this connection, the Assessing Officer has computed capital gains arising to the assessee-firm at Rs. 9 lakhs on the basis of the difference between the market value and the written down value. The Assessing Officer has taken the written down value as on 1st April, 1995 and he has taken the market value as on 8th November, 1995 (alleged date of transfer) and on that basis, he has computed the capital gains. However, as stated, computation under Section 45(4) read with Section 48 would arise only if the aforestated two conditions are satisfied to attract Section 45(4). In this case, the erstwhile firm has been treated as a Limited Company by virtue of Section 575 of the Companies Act. It is not in dispute that in this case, the erstwhile firm became a Limited Company under Part IX of the Companies Act. Now, Section 45(4) clearly stipulates that there should be transfer by way of distribution of capital assets. Under Part IX of the Companies Act, when a Partnership Firm is treated as a Limited Company, the properties of the erstwhile firm vests in the Limited Company. The question is whether such vesting stands covered by the expression "transfer by way of distribution" in Section 45(4) of the Act. There is a difference between vesting of the property, in this case, in the Limited Company and distribution of the property. On vesting in the Limited Company under Part IX of the Companies Act, the properties vest in the company as they exist. On the other hand, distribution on dissolution presupposes division, realisation, encashment of assets and appropriation of the realised amount as per the priority like payment of taxes to the Government, BMC etc., payment to unsecured creditors etc. This difference is very important. This difference is amply brought out conceptually in the judgment of the Supreme Court in the case of Malabar Fisheries Co. v. CIT[1979] 120 ITR 49 2 Taxman 409. In the present case, therefore, we are of the view that Section 45(4) is not attracted as the very first condition of transfer by way of distribution of capital assets is not satisfied. In the circumstances, the latter part of Section 45(4), which refers to computation of capital gains under Section 48 by treating fair market value of the asset on the date of transfer, does not arise. [B] On Section 45(1) 6. As stated above, in this case we are concerned with the assessment year 1996-97. Therefore, in this case, we are not concerned with clause (xiii) inserted by Finance (No. 2) Act, 1998 in Section 47 under which it is provided that where a Firm is succeeded by a company in the business carried on by it as a result of sale or otherwise, of any capital assets, then such transaction shall not be regarded as transfer. This clause was inserted with effect from 1st April, 1999. Therefore, we are not concerned with that amendment. However, it provides a clue to the legislative intent. In our opinion, this clause has been introduced with effect from 1st April, 1999 in order to encourage more and more Firms becoming Limited Companies. It also indicates the difference between transfer and transmission. Basically, when a Firm is treated as a company under Part IX, it is a case similar to transmission. This is amply made clear by clause (xiii) to Section 47, which states that where a Firm is succeeded by a company in the business, the transaction shall not be treated as a transfer. Now, this amendment has been made in Section 47 in view of the controversy arising on Section 45(1) read with Section 2(47)(ii). As stated above, Section 45(1) is a charging section. Section 45, read with the computation Section viz. 48 etc., form one composite scheme. This point is very important. Section 45(1) provides that where any profit, arising from transfer of a capital asset is effected in the previous year then such profit shall be chargeable to income-tax under the head "Capital gains". The expression "transfer of a capital asset" in Section 45(1) is required to be read with Section 2(47)(ii) which states that transfer in relation to a capital asset shall include extinguishment of any rights therein. The moot point which arose on interpretation of Section 45(1) in numerous matters was that on extinguishment of the rights in the capital assets, there was a transfer and in certain cases of reconstitution of firms and introduction of new partners, there was a resultant extinguishment of the rights in the capital assets proportionately. In order to get over this controversy, and keeping in mind the object of encouraging Firms being treated as Companies, the controversy is resolved by the Legislature by introducing clause (xiii) in Section 47 with effect from 1st April, 1999. Now, in the present case, it is argued on behalf of the department before the Tribunal, for the first time, that in this case, on vesting of the properties of the erstwhile Firm in the Limited Company, there was a transfer of capital assets and, therefore, it was chargeable to income-tax under the head "Capital gains" as, on such vesting, there was extinguishment of all right, title and interest in the capital assets qua the Firm. We do not find any merit in this argument. In the present case, we are concerned with a Partnership Firm being treated as a company under the statutory provisions of Part IX of the Companies Act. In such cases, the Company succeeds the Firm. Generally, in the case of a transfer of a capital asset, two important ingredients are : existence of a party and a counterparty and, secondly, incoming consideration qua the transferor. In our view, when a Firm is treated as a Company, the said two conditions are not attracted. There is no conveyance of the property executable in favour of the Limited Company. It is no doubt true that all properties of the Firm vests in the Limited Company on the Firm being treated as a Company under Part IX of the Companies Act, but that vesting is not consequent or incidental to a transfer. It is a statutory vesting of properties in the Company as the Firm is treated as a Limited Company. On vesting of all the properties statutorily in the Company, the cloak given to the Firm is replaced by a different cloak and the same Firm is now treated as a Company, after a given date. In the circumstances, in our view, there is no transfer of a capital asset as contemplated by Section 45(1) of the Act. Even assuming for the sake of argument that there is a transfer of a capital asset under Section 45(1) because of the definition of the word "transfer" in Section 2(47)(iii), even then we are of the view that liability to pay capital gains would not arise because Section 45(1) is required to be read with Section 48, which provides for mode of computation. These two sections are required to be read together as the charging section and the computation section constitute one package. Now, under Section 48 it is laid down, inter alia, that the income chargeable under the head "Capital gains" shall be computed by deducting from the full value of the consideration received or accrued as a result of the transfer, the cost of acquisition of the asset and the expenditure incurred in connection with the transfer. Section 45(4) is mutually exclusive to Section 45(1). Section 45(4) categorically states that where there is a transfer by way of distribution of capital assets and where such transfer is due to dissolution or otherwise of the firm, the Assessing Officer was entitled to treat the market value of the asset on the date of the transfer as full value of the consideration received. This latter part of Section 45(4) is not there in Section 45(1). Therefore, one has to read the expression "full value of the consideration received/accruing" under Section 48 de hors Section 45(4) and if one reads Section 48 with Section 45(1) de hors Section 45(4) then the expression "full value of consideration" in Section 48 cannot be the market value of the capital asset on the date of transfer. In such a case, we have to read the said expression in the light of the two judgments of the Supreme Court in the cases of George Henderson & Co. Ltd. (supra) and Gillanders Arbuthnot & Co. (supra) in which it has been held that the expression "full value of the consideration" does not mean the market value of the asset transferred, but it shall mean the price bargained for by the parties to the transaction. It has been further held that consideration for the transfer of a capital asset is what the transferor receives in lieu of the assets he parts with viz. money or money's worth and, therefore, the very asset transferred or parted with cannot be the consideration for the transfer and, therefore, the expression "full value of the consideration" cannot be construed as having a reference to the market value of the asset transferred and that the said expression only means the full value of the things received by the transferor in exchange of the capital asset transferred by him. In the circumstances, even if we were to proceed on the basis that vesting in the company under Part IX constituted transfer under Section 45(1), still the assessee ought to succeed because the Firm can be assessed only if the full value of the consideration is received by the Firm or if it accrues to the Firm. In the present case, the Company had allotted shares to the Partners of the erstwhile Firm, but that was in proportion to the capital of the Partners in the erstwhile Firm. That allotment of shares had no correlation with the vesting of the properties in the Limited Company under Part lX of the Act. Lastly, Section 45(1) and Section 45(4) are mutually exclusive. Under Section 45(4) in cases of transfer by way of distribution and where such transfer is as a result of dissolution, the department is certainly entitled to take the full market value of the asset as full value of consideration provided there is transfer by distribution of assets. In this case, we have held that there is no such transfer by way of distribution and, therefore, Section 45(4) is not applicable. This deeming provision, regarding full value of consideration, is not there in Section 45(1) read with Section 48. If one reads Section 45(1) with Section 48, it is clear that the former is a charging section and if that section is applicable, the computation has to be done under Section 48, which only refers to deductions from full value of consideration received or accruing. Section 48 does not empower the Assessing Officer to take market value as full value of consideration as in the case of Section 45. In the circumstances, even if we were to hold that vesting amounts to transfer, the computation is not possible because it has been laid down in the above judgment of the Supreme Court that full consideration cannot be construed to mean market value of the asset transferred. The Legislature, in its wisdom, has amended only Section 45(4) by which the market value of the asset on the date of the transfer is deemed to be the full value of consideration. However, such amendment is not there in Section 45(1). In the circumstances, neither Section 45(1) nor Section 45(4) stand attracted. [C] On disallowance of claim for depreciation 7. In this case we are concerned with assessment year 1996-97. Section 32 provides for allowance of depreciation in respect of assets owned by the assessee and used for the purpose of the business. Prior to 1st April, 1988, the allowance was subject to conditions prescribed in Section 34. At that time, Section 34(2)(ii) provided that no depreciation shall be allowed in respect of assets sold, discarded, demolished or destroyed. After 1st April, 1988, Section 34(2)(ii) is succeeded by Section 43(6)(c)(i)(B). There is no difference in the phraseology between Section 34(2)(ii) and Section 43(6)(c)(i)(B). According to the department, on 1st April, 1995, the assets stood in the name of the former Firm, but on 8th November, 1995, they stood transferred by virtue of vesting to the Limited Company and, therefore, on 31st March, 1995, the assets were not owned by the assessee, because they were transferred during the year to the Limited Company and in the circumstances, the assessee was not entitled to claim depreciation. An identical point arose before the Madras High Court in the case of A.M. Ponnurangam Mudaliar (supra). In that matter, Section 34(2)(ii) came for interpretation. As stated above, the language of Section 34(2)(ii) is similar to Section 43(6)(c)(i)(B). It was held that Section 34(2)(ii) provided that no depreciation was to be allowed in respect of assets sold; discarded, demolished or destroyed, whereas the term "transfer" in Section 2(47) is only in relation to capital assets as defined under Section 2(14). That the term "transfer" was in relation to computation of capital gains under Chapter IV-E of the Act and, therefore, Section 2(47) cannot be invoked for the purposes of Section 32, particularly because the words used in Section 34(2)(ii) were "sold, discarded, demolished or destroyed" and not "transfer". This judgment of the Madras High Court applies to the facts of our case. Lastly, there is no requirement for the Firm to remain owner for the entire year. Hence, disallowance by the Assessing Officer on this count was erroneous. Conclusion 8. Under the above circumstances, both the aforestated questions are answered in the affirmative i.e. in favour of the assessee and against the department. 9. Accordingly, the appeal is disposed of. No order as to costs.