(2010) 12 MAD CK 0139

Madras High Court

Case No: Tax Case (Appeal) No''s. 2209 and 2210 of 2006

Indo Tech Electric Co.		APPELLANT
	Vs	
The Deputy Commissioner of Income Tax		RESPONDENT

Date of Decision: Dec. 16, 2010

Acts Referred:

- Income Tax Act, 1961 - Section 260(A), 36(1), 45, 55, 55(2)

Citation: (2011) 196 TAXMAN 514

Hon'ble Judges: M.M. Sundresh, J; F.M. Ibrahim Kalifulla, J

Bench: Division Bench

Advocate: V.S. Jayakumar, for the Appellant; Patty B. Jeganathan, for the Respondent

Final Decision: Dismissed

Judgement

M.M. Sundresh, J.
In view of the fact that both the appeals have arisen from the same Assessment Year and order, coupled with the further fact that the parties are one and the same, they have been taken up together and a common order is passed.

2. T.C.(A) No. 2209 of 2006 has been filed by the Assessee, challenging the order of the Tribunal which in turn has reversed the order of the Commissioner of Income Tax (Appeals) by confirming the order of the Assessing Officer. T.C.(A) No. 2210 of 2006 has been filed by the Assessee, challenging the order of the Tribunal which confirmed the order of the Commissioner of Income Tax (Appeals) as well as the Assessing Officer. Both these two appeals are pertaining to the Assessment Year 1995-96.

3. The Tribunal has allowed the appeal filed by the revenue and dismissed the appeal filed by the Assessee and hence these two appeals have been filed by the Assessee by raising the following substantial questions of law:

3.1. The substantial questions of law raised in T.C.(A) No. 2209 of 2006 are as follows:

1. Whether the Tribunal was right in holding that a sum of Rs. 1,25,00,000/- representing the value of technical know-how is liable to tax under the head Long Term Capital Gain the context of Section 45 read with Section 55 of the Income Tax Act, 1961?

2. Whether the Tribunal was right in holding that a sum of Rs. 36,16,139/- lakhs representing the compensation received for pending orders was liable to Long Term Capital Gain Tax in the context of Section 45 read with Section 55 of the Income Tax Act, 1961?

3.2. The substantial question of law raised in T.C.(A) No. 2210 of 2006 is as follows:

Whether the Tribunal was right in upholding the additions made of Rs. 33,00,000/- received by the Appellant towards compensation for expected orders under negotiation as taxable under the head Long Term Capital Gain in the context of Section 45 read with Section 55 of the Income Tax Act, 1961?

4. Brief Facts:

4.1. The Assessee is a Manufacturer of Transformers being a partnership concern. For the Assessment Year 1995-96 it filed its return of income admitting a sum of Rs. 93,33,201/-. The partners of the Assessee firm are father and son. The business of the Assessee firm was taken over as a going concern by a limited company known as "Indo Tech Transformers Limited" by virtue of an agreement dated 15.07.1994. The partners of the Assessee firm are also the Directors of the limited company. The limited company made the following payments to the Assessee.

A. Technical Know-how	Rs.1,25,00,000/-
B. Compensation for pending orders that is not to compete and indulge in transfers business	Rs. 36,16,139/-
C. Compensation for expected order under negotiation i.e. not to compete and indulge in transformer business	Rs. 33,00,000/-
Total	Rs.1,94,16,139/-

4.2. The Assessee filed its return of income on 06.11.1995. A show cause notice was issued on 25.02.1998 as to why the amount shown as received for non-competition fee for pending orders, future orders and for the transfer of technical know-how will not be treated as capital gains, in as much as no amount has been shown under the head "Goodwill" even though the Assessee has been making good profit in the previous years.

5. Case of the Assessee:

5.1. The Assessee claimed that the entire sum of Rs. 1,94,16,139/- is not taxable. It was further claimed that the amount of Rs. 1,25,00,000/- is received by the Assessee for the transfer of technical know-how. It was the further case of the Assessee that the amount of Rs. 36,16,139/- and Rs. 33,00,000/- respectively are for compensation for pending orders and expected orders for not competing with the limited company. The Assessee has not received any money towards the goodwill from the limited company. In as much as for the Assessment Year 1995-96, a transfer of technical know-how is not taxable it cannot be termed as long term capital gain. It was the further case of the Assessee that a technical know-how is different from a goodwill involving skill.

6. Findings of the Assessing Officer:

6.1. The Assessing Officer found that no explanation was given by the Assessee as to why the disputed amount shall not be treated as the one received for the goodwill. No explanation has been given either for not receiving any amount for the goodwill inspite of the good profit made over the years and it has also not been quantified. The Assessee firm has been taken over as a going concern and therefore, the other assets cannot be differentiated and separated from the so-called technical know-how.

6.2. The receipt for technical know-how is nothing but a part of the composite receipt to cover the value of the intangible assets. There was no mention about the nature of the technical know-how in the agreement, no patent has been obtained and no earlier sale was effected for the technical know-how. In as much as ''goodwill'' is taxable u/s 55(2) of the Income Tax Act, 1961, an attempt is made to evade the payment of tax. The office of the assesee is continued by the new firm in the same place and the partners of the Assessee are its Directors. What was done in effect is a change in the character of the firm and therefore, the transaction is taxable as a long term capital gain. Accordingly, the Assessing Officer has held a sum of Rs. 97,59,426/- will have to be paid as tax.

7. Findings of the Commissioner of Income Tax (Appeals):

7.1. The Commissioner of Income Tax (Appeals) has held that it is not in dispute that the Assessee has been successfully running the business for the past 25 years. The Assessee has been in possession of the technical know-how in the form of drawings of technical data. The technology is a capital asset. Since it is a capital asset, the question of treating the same as profit or income would not arise. Technology is different from a goodwill since it involves skill. In as much as the technical know-how relates to production, the same cannot be treated as a long term capital gain treating the same as a goodwill.

7.2. Similarly, in so far as the compensation of pending orders is concerned, the same was also allowed on the ground that the same is a usual practice done in the field of business while transferring the asset for the purpose of not allowing the

other party to partake in the business. However, with regard to the payment of Rs. 33,00,000/- as compensation for future orders is concerned, the same was rejected by the Commissioner of Income Tax (Appeals) by holding that the said payment is speculative, imaginary and therefore cannot be granted. Accordingly, the appeal filed by the Assessee in so far as the sum of Rs. 1,25,00,000/- and Rs. 36,16,139/- were allowed and the remaining sum claimed towards the future compensation was rejected.

8. Findings of the Tribunal:

8.1. Both the Assessee as well as the revenue filed their respective appeals before the Tribunal. The Tribunal was pleased to hold that there was no indication of the value of the technical know-how in the balance sheet. It has come into existence only at the time of signing the transfer agreement. The agreement was for the transfer of entire business of a going concern. The fact that the Assessee was running its business profitably for the past 25 years is not in dispute. Admittedly, the Assessee has sold a profitable concern without fixing any value for the goodwill. The amount indicated as the payment for technical know-how is nothing but a goodwill amount which is a colourable device to evade tax. An authority can lift the corporate veil to find out the intention of an Assessee firm. The arrangement made by the Assessee is a make believe arrangement.

8.2. There was no material on record to establish the cost of the technical know-how other than what is mentioned in the deed of transfer. There was also no material to show the method of quantification of the technical know-how. The Assessee has not transferred any patented process, trade mark, etc. Accordingly, the Tribunal has held that a sum of Rs. 1,25,00,000/- shown as a payment made for the transfer of technical know-how was nothing but a goodwill.

8.3. The Tribunal has further held that there was no evidence to show that the consideration was not paid to the partners and it was paid only to the Assessee. In view of the taking over of the going concern, the Assessee firm has come to an end, more so when the partners are also the Directors and therefore, there is no question of paying the non-competing fees, in as much as there is no possibility to the Assessee firm doing the very same business again. What has been done was only a transfer for better utilisation of the assets.

8.4. The Tribunal also held that the reasoning assigned by the Commissioner of Income Tax (Appeals) for rejecting the payment for future orders is concerned, the same will have to be confirmed in as much as it is only imaginary, speculative and unascertained. Accordingly, the Tribunal has allowed the appeal filed by the revenue and dismissed the appeal filed by the Assessee. Challenging the said orders of the Tribunal, the Assessee has come forward to file these two appeals by raising the above mentioned substantial questions of law.

9. Heard Shri.V.S. Jayakumar, learned Counsel appearing for the Appellant and Shri. Patty B. Jeganathan, learned Counsel appearing for the Respondent.

10. Contentions of the learned Counsel for the Assessee:

10.1. Shri.V.S. Jayakumar, learned Counsel appearing for the Assessee submitted that while facts are not in dispute, the Tribunal has committed an error in not appreciating the fact that what was sold by the Assessee is the value fixed for the technical know-how produced by it. The technical know-how is a capital asset and therefore, the same cannot be treated as a long term capital gain.

10.2. The Assessee has produced drawings, designs, technical data, specifications etc. and sold them to the limited company. They form part of the technical know-how and therefore for such a transfer, the amount has been fixed and paid to the Assessee. The reasoning of the Tribunal that the technical know-how has not been shown in the balance sheet cannot be accepted, since the value will be fixed only at the time of sale and not otherwise. As per the provisions of the Income Tax Act, 1961 as it stood for the relevant assessment year, a sale of a technical know-how cannot be taxed. The Tribunal and the Assessing Officer have merely inferred that the payments were towards the goodwill when it is not the case of the Assessee.

10.3. The compensation towards the non-compete fee has been paid both for present and future orders, in order to compensate the Assessee. The said amount has been paid by considering the profit derived by the Assessee over the years. The payment of non-compete fee is known to the business transactions. In support of his submissions, the learned Counsel for the Assessee has made reliance upon the following judgments:

1. HINDUSTAN FORESTS CO. LTD. Vs. COMMISSIONER OF Income Tax, PUNJAB.,

2. Commissioner of Income Tax, Bangalore Vs. B.C. Srinivasa Setty,

3. Alembic Chemical Works Co. Ltd. v. Commissioner of income tax, Gujarat (1989) 177 ITR 377

4. Jonas Woodhead and Sons (India) Ltd. Vs. Commissioner of Income Tax,

5. Chemplant Engineers (P.) Ltd. Vs. Commissioner of Income Tax,

6. Commissioner of Income Tax Vs. Swaraj Engines Ltd.,

10.4. Therefore, the learned Counsel submitted that the appeals will have to be allowed by answering the substantial questions of law in favour of the Assessee and against the revenue.

11. Submissions of the Revenue:

11.1. Shri. Patty B. Jeganathan, learned Counsel appearing for the revenue submitted that considering the undisputed facts that the partners of the Assessee firm are the Directors of the limited company necessarily the corporate veil will have to be lifted to see the intention involved in the transaction. Accordingly, the Tribunal has found that the transaction is a colourable one in order to evade the payment of tax and such a factual finding borne out by the records shall not be disturbed by this Court by exercising its power u/s 260A of the Income Tax Act, 1961.

11.2. Considering the fact that the Assessee firm has been running profitably for the past 25 years, the Tribunal has correctly held that the amount of goodwill paid to the Assessee was actually shown as the payment made towards the compensation and the transfer of technical know-how. Therefore, in as much as the transaction is colourable to evade the payment of tax, the appeals will have to be dismissed.

12. Difference between technical know-how and goodwill:

12.1. The word "goodwill" has been defined by the Honourable Apex Court in Rustom Cavasjee Cooper Vs. Union of India (UOI), has held as follows:

Goodwill'' of a business is an intangible assets, it is the whole advantage of the reputation and connections formed with the customers together with the circumstances making the connection durable. It is that component of the total value of the undertaking which is attributable to the ability of the concern to earn profits over a course of years or in excess of normal amounts because of its reputation, location and other feature

12.2. Section 55 of the Income Tax Act, 1961 provides for the sale of goodwill after dissolution. The definition of ''goodwill'' as held by the Honourable Apex Court and as seen from the provisions contained u/s 55, it is very clear that after the dissolution of a firm it shall be included in the assets. Therefore, in as much as a goodwill can be quantified by way of a sum, the Assessee wanted to avoid the same by terming it as technical know-how and compensation. When a business is destroyed the goodwill goes with it. A goodwill is determined by the nature of business, character, name and reputation, its location, its impact on the contemporary market, the prevailing socio economy and the absence of competition. A goodwill can be sold along with the business or independently. "Goodwill" was brought into tax with effect from 01.04.1988. Therefore, in a commercial and trading parlance, goodwill plays a pivotal roll and that is the reason why it has been brought into the tax net.

12.3.''Technical know-how'' is defined as an intangible revenue producing asset which can be put to use so as to produce revenue in two ways. The manufacturer can use it himself to make things for sale and make profit in that way, or he can teach it to others, so that they can make their own things, in which case he gets paid for the knowledge and information which he imparts to them. His fees and rewards are then revenue in his hands. Under the income tax Act, transfer of Technical

know-how is subject to tax only from the Assessment Year 1998-99 by the amendment through Finance Act, 1997.

13. Conclusions:

13.1. The narration made above would exemplify the fact that there were only two partners in the Assessee firm which consisted of father and son. The Assessee has been making good profit over the years as seen from the assessment made for the Assessment Year 1993-94 onwards. It was a concern running for the past 25 years profitably. It was taken over as a going concern by the limited company. The partners of the Assessee firm are the Directors of the limited company. The limited company continues to function in the very same office in which the Assessee firm was functioning earlier. The entire assets have been taken over by the limited company. The agreement between the Assessee and the limited company does not make any mention about the payment received for the goodwill. The assesee was not involved in the sale of technical know-how.

13.2. Therefore, it is clear that in as much as the Assessee firm has been taken over as a going concern, it could not have been taken over without the so-called technical know-how. The Assessee could not have sold the other tangible assets keeping with it the so-called technical know-how. Hence, we are of the considered view that the receipts for technical know-how and the compensation for non-competing fees are nothing but a part of composite receipt to diminish the value of the assets of the Assessee firm. The Assessee has termed the said amount as technical know-how in order to escape from the clutches of the provisions of Section 55(2) of the Income Tax Act, 1961 under which a goodwill amount is taxable.

13.3. There was no material on record to establish the cost of the technical know-how as observed by the Tribunal. There was also no material to quantify the amount shown as paid to the Assessee for the transfer of the alleged technical know-how. As observed by the Tribunal and the Assessing Officer, there is no explanation as to why no amount has been received towards the goodwill considering the undisputed fact of the good performance of the Assessee firm over the years before the transfer. The Assessee has clearly attempted to evade tax by claiming the amount received as goodwill into one of technical know-how in order to evade tax. The Assessee has tried to sell the old wine in a new bottle by characterizing the receipt as technical know-how. It is not the case of the Assessee that it has been selling the technical know-how to any other third party. The agreement also does not provide a clause to the effect that the Assessee shall not indulge in the same business. This is for the precise reason that the Assessee has merely changed from being a partnership firm into one of a private company due to business and commercial expediency.

13.4. Similarly, the question of payment to be made as compensation by way of non-competing fee also would not arise, considering the fact that the Assessee firm

has been taken over as a going concern in its entirety by the new company. As observed earlier, the partners of the Assessee firm are the new Directors of the company. The consideration was paid to the Assessee firm and not to the partners. There was no competition as alleged between the Assessee firm and the new private limited company. There was also no contract between the partners of the Assessee firm and the new private limited company. Hence, considering the above said factual position, we are of the considered view that the findings of the Tribunal in holding that in as much as there was no competition between the partners of the Assessee firm and the new private limited company, coupled with the fact that the entire business of the Assessee company was transferred the same cannot be found fault with.

14. Applicability of the Decisions:

14.1. The judgments relied upon by the learned Counsel appearing for the Assessee, in our considered view have no application to the present cases on hand. The issue involved in Alembic Chemical Works Co. Ltd. v. Commissioner of income tax, Gujarat (1989) 177 ITR 377 was as to whether an acquisition of technical know-how to produce higher yield would be capital or revenue in nature. In the said case, the Honourable Apex Court was pleased to observe that there was no material to come to the finding that a "completely new plant" with a completely new process and a completely new technical know-how was obtained under the agreement. The Honourable Apex Court has considered the materials available on record including the provisions contained in the agreement and held that the receipt is a revenue receipt in as much as the technology was used to supplement the existing business.

14.2. Similarly, in Chemplant Engineers (P.) Ltd. Vs. Commissioner of Income Tax, , the Division Bench of this Court was dealing with an issue as to whether the restrictive clause in the agreement would amount to a revenue receipt or a capital receipt. The Honourable Division Bench on the facts of the case held that in as much as the compensation received by the Assessee did not affect or alter the capital structure and it was received for loss of earning the commission, the same would be revenue in nature. The Honourable Division Bench was pleased to observe that the compensation received when the loss is for capital structure then it would become a capital receipt. As observed earlier, the facts involved in the case is totally different to the cases on hand.

14.3. The judgment relied upon by the learned Counsel for the Assessee in Jonas Woodhead and Sons (India) Ltd. Vs. Commissioner of Income Tax, is not applicable to the facts of the case, in as much as in the said case, what was involved is only a transfer of technical know-how and not other assets as in the present cases on hand. Therefore, the judgments relied upon by the learned Counsel for the Assessee are not applicable to the facts involved in the present cases.

15. Lifting the Corporate Veil:

15.1. Both the Tribunal and the Assessing Officer have held that what was done by the Assessee firm is clearly an attempt to evade tax in order to get over the provisions contained u/s 55(2) of the Income Tax Act, 1961. It is a well settled principle of law that what is permissible is avoidance but not evasion. When an attempt is made by a company to evade tax it is the bounden duty of the authorities to lift the corporate veil and find out the real intention behind the same. It is the duty of the Court in every case, where ingenuity is expended to avoid taxing and welfare legislations, to get behind the smoke screen and discover the true state of affairs. The Court is not to be satisfied with form and leave well alone the substance of a transaction. The Honourable Apex Court in Workmen Employed in Associated Rubber Industry Ltd., Bhavnagar Vs. Associated Rubber Industry Ltd., Bhavnagar and Another, has held as follows:

Avoidance of welfare legislation is as common as avoidance of taxation and the approach in considering problems arising out of such avoidance has necessarily to be the same.

If we now look at the facts of the case, what do we find? A new company is created wholly owned by the principal company, with no assets of its own except those transferred to it by the principal company, with no business or income of its own except receiving dividends from shares transferred to it by the principal company and serving no purpose whatsoever except to reduce the gross profits of the principal company. These facts speak for themselves. There cannot be direct evidence that the second company was formed as a device to reduce the gross profits of the principal company for whatever purpose. An obvious purpose that is served and which stares one in the face is to reduce the amount to be paid by way of bonus to workmen.

15.2. Similarly, in K. Ramasamy Vs. Commissioner of Income Tax, , the Honourable Division Bench of this Court has held as follows:

For the purpose of deciding the true character of the payment made by the company to the brothers, one must take note of the aforementioned facts. Having regard to the totality of the circumstances, piercing the veil of the company was a permissible exercise which the Tribunal undertook. It is well settled that the formation of a company and registration under the Companies Act does not preclude the lifting of the veil, particularly, where matters of taxation are concerned, if the circumstances of the case so warrant.

The finding that the payment made by the company to these brothers is in the nature of revenue receipt in the hands of the brothers, would not negate the separate juristic existence of the company. The company continues to remain a legal entity with a right to hold property, to contract, etc. The true character of the payment made by it to these brothers who are shareholders and directors and who as partners of the firm own the buildings and the equipment used by the company

for running the hotel, has to be judged by looking at the reality after removing or piercing the veil of the company, as the circumstances of the case justify such an exercise. The purpose of the deed of compensation in reality was only to screen the payment made under that deed from liability to income tax in the hands of the Assessee.

The Supreme Court in the case of Juggi Lal Kamlapat Vs. Commissioner of Income Tax, U.P., held that in cases where the same persons entered into transactions though by introducing a corporate personality into some of those transactions, the income tax authorities are entitled to pierce the veil of the corporate personality and look at the reality of the transaction. The Court in that case observed (page 710):

It is true that from juristic point of view the company is a legal personality entirely distinct from its members and the company is capable of enjoying rights and being subjected to duties which are not the same as those enjoyed or borne by its members. But in certain exceptional cases the Court is entitled to lift the veil of the corporate entity and to pay regard to the economic realities behind the legal facade.

15.3. The Division Bench of this Court in Commissioner of income tax v. Indian Express Newspapers (Madurai) P. Ltd. (1999) 238 ITR 70 has observed as follows:

It is well settled that the corporate veil of a company can be lifted for the purpose of ascertaining the real character of a transaction, if that transaction was a fraudulent one or was intended to evade payment of tax. While legitimate tax avoidance is always permissible, devices adopted to evade payment of tax, however, are not permissible though the dividing line is not always easy to draw, such a line does exist. The true character of the transaction here clearly was one of an advance of Rs. 10 lakhs by the Assessee to the Bombay company for whose benefit that sum was obviously intended and had only been channelled through Ace Investments Private Limited. The Tribunal has failed to notice the facts which had been set out in the draft assessment order in annexure B, and has also erred in adopting the wrong approach for the purpose of deciding as to whether the amount disallowed was a sum which could properly fall within the ambit of Section 36(1)(iii) of the Act. The amount disallowed was the amount paid on amounts borrowed, but not used for the purpose of business or profession of the Assessee. Rupees 10 lakhs "invested" in Ace Investments Limited being in substance and reality an amount advanced to the Bombay company for financing the construction undertaken by it at Bombay, cannot be said to be an amount which formed part of the capital borrowed for the purpose of the Assessee''s business.

16. Applying the ratio laid down in the pronouncements referred above to the facts involved in the present cases on hand, we are of the clear view that what has been done by the Assessee is to evade tax and not to avoid.

17. Therefore, the appeals filed by the Assessee are dismissed and the substantial questions of law are answered against the Assessee and in favour of the revenue.

No costs.