KERALA HIGH COURT

Commissioner of Income-Tax

Vs

E.C. Jacob

(T Raghavan, C.J. V B Eradi and N Namboodiripad, JJ.)

18.07.1972

JUDGMENT

(N.D.P. Namboodiripad, J.)

1. The question referred for the opinion of the court is:
" Whether, on the facts and in the circumstances of the case, the Appellate Tribunal is correct in law in holding that the amount of Rs. 32,000 cannot be subjected to tax as capital gains ? "

2. The reference arises out of an assessment for the year 1965-66. The assessee had been practising as a chartered accountant at Kottayam under the firm name "Jacob & Mathew" from the year 1951. During the accounting year relevant to the assessment year in question, the assessee took in as his partner, another chartered accountant, Sri. Venkatanarayanan, on July 15, 1965; and annexure "D" is the deed of partnership dated July 15, 1965, entered into between the two partners. The main item in the assets of the assessee which were taken over by the newly constituted firm was the goodwill which was valued at Rs. 32,000. As between the assessee and his partner, the net profit or loss of the business of the partnership was agreed to be divided in the proportion of 75% and 25%, respectively. Towards his share in the goodwill obtained by the firm, the partner paid the assessee an amount of Rs. 8,000. The firm continued only till October 19, 1965, when the assessee was appointed as Accountant Member of the Kerala Sales Tax Appellate Tribunal. There was a consequent dissolution of the firm; and the assessee received Rs. 24,000 towards his share of the goodwill of the firm.

3. Daring the assessment proceedings, the assessee took up the stand that the aforesaid Rs. 32,000 received by him in two instalments was not liable to be taxed. The Income-tax Officer, on the other hand, proceeded on the basis that with the formation of the partnership the assessee must be deemed to have transferred the goodwill of his profession and that the entire amount of Rs. 32,000 was taxable as "capital gains". In the appeal preferred by the assessee, the Appellate Assistant Commissioner substantially confirmed the assessment on somewhat different grounds. The assessee, thereupon, took the matter in appeal before the Income-tax Appellate Tribunal, where he reiterated the earlier contention and pressed into service Section 47(ii) of the Income-tax Act as well. The Tribunal held that the assessee was entitled to succeed on both grounds. With regard to the question whether the transfer of the goodwill would give rise to the levy of capital gains, the Tribunal followed the decision of the Madras High Court in *Commissioner of*

Income-tax v. Rathnam Nadar[1], and decided in favour of the assessee. On application by the revenue, the Appellate Tribunal has referred the question cited above for the advice of the court.

4. What is urged by the revenue is that the entire amount of Rs. 32,000 received by the assessee in the process of the formation and dissolution of his partnership with Shri Venkatanarayanan, should be treated as "capital gains " arising out of the transfer of his goodwill and hence assessable to tax. To appreciate the contention of the revenue, the relevant provisions of the Income-tax Act, 1961 (hereinafter referred to as "the Act of 1961"), may be briefly set out. The charging provision contained in Section 45 of the Act may be read as follows:

> "Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in, sections 53 54 and 54B shall be chargeable to income-tax under the head Capital gains', and shall be deemed to be the income of the previous year in which the transfer took place."

5. "Capital assets" is defined in Section 2(14) of the Act of 1961 as property of any kind held by an assessee whether or not connected with his business or profession, but excluding certain items specified therein. How the capital gains are to be computed is provided by Section 48, which is in the following terms :

> " The income chargeable under the head 'Capital gains' shall be computed by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely:--
> (i) expenditure incurred wholly and exclusively in connection with such transfer;
> (ii) the cost of acquisition of the capital asset and the cost of any improvement thereto."

6. The expressions " cost of improvement " and " cost of acquisition " are dealt with in Section 55 ; and the definitions so far as they are relevant for the purpose of this reference are extracted below:

Section 55(1):

> " For the purposes of sections 48, 49 and 50,--, ... (b) 'cost of any improvement', in relation to a capital asset,--
> (i) where the capital asset became the property of the previous owner or the assessee before the 1st day of January, 1954, and the fair market value of the asset on that day is taken as the cost of acquisition at the option of the assessee, means all expenditure of a capital nature incurred in making any additions or alterations to the capital asset on or after the said date by the previous owner or the assessee, and
> (ii) in any other case, means all expenditure of a capital nature incurred in making any additions or alterations to the capital asset by the assessee after it became his property.. . .
> (2) For the purposes of Sections 48 and 49, 'cost of acquisition', in relation to a capital asset,--
> (i) where the capital asset became the property of the assessee before the 1st day of January, 1954, means the cost of acquisition of the asset to the assessee or the fair market value of the asset on the 1st day of January, 1954, at the option of the assessee. ..."

7. As already mentioned, the Appellate Tribunal found support for its conclusion in the decision of the Madras High Court in Commissioner of Income-tax v. Rathnam Nadar. That decision was concerned with the interpretation of Section 12B of the Indian Income-tax Act, 1922 (hereinafter referred to as "the Act of 1922"), dealing with capital gains and its assessment. When the Act of 1922 was repealed and re-enacted in the Act of 1961, the matter covered by Section 12B of the Act of 1922 underwent (1) drastic changes both in form and content. The matter covered by Section 45 of the Act of 1961 was contained in Sub-section (1) of Section 12B of the Act of 1922, while Section 48 of the Act 1961 has its counterpart in clauses (i) and (ii) of Sub-section (2) of Section 12B of the Act of 1922. Consequently, a decision rendered with reference to Section 12B of the Act of 1922 can certainly be of some assistance in interpreting sections 45 and 48 of the Act of 1961. In the case decided by the Madras High Court, one of the questions raised was whether an amount of Rs. 65,898 received by the assessee therein towards the goodwill of the firm from which he retired was assessable to tax. After discussing the scope of Sub-section (2) of Section 12B, the court held as follows :

> " Sub-clause (ii) of Sub-section (2) may suggest that the capital gain arises only on the transfer of a capital asset which has actually cost to the assessee something in money. The actual cost in the context of the Income-tax Act can only be cost in terms of money. It cannot, it would appear, apply to transfer of capital assets (assuming that the goodwill is a capital asset, about which there was not much dispute), which did not cost anything to the assessee in terms of money in its creation or acquisition. What is the cost in terms of money in the creation or acquisition of goodwill ? It would appear that there is really no such cost. Goodwill is created by the trading activities of the assessee, and probably by the name he has earned and the goodwill he has created among his customers. Goodwill of a firm is an intangible asset. It is difficult to say that it costs anything in terms of money for its coming into existence. Goodwill of a firm can probably be compared to a seed which is planted on the day that the firm begins its business and sprouts and grows as the firm grows in its dealings, in its stature and in its reputation."

8. The court then proceeded to consider certain decisions which deal with " goodwill" and came to the following conclusion:

> " We have, therefore, to proceed on the basis that, while the British and the American taxation laws proceed on the footing that capital gains are assessable in the case of transfer of goodwill, the Indian Act did not have in contemplation, when enacting Section 12B, that self-created assets like copyright, patents and goodwill should be subjected to capital gains arising on their transfer. It is enough to say that, complex and difficult as this question is, we are not satisfied that either the legislature intended to include property of the kind now in question for the purpose, of taxation of capital gains, or that the wording of Section 12B supports such a contention. We therefore hold, though not without hesitation, that capital gains on the transfer of a goodwill are not liable to be taxed under Section 12B."

9. The decision of the Madras High Court was followed by the Calcutta High Court in *Commissioner of Income-tax v. Chunilal Prabhudas & Co.*[2], That was also a case where the goodwill of the assessee-firm at two places of business was transferred for an aggregate amount of Rs. 1,20,000. Certain observations of the court reported in the last paragraph of page 571

would indicate that the court was not inclined to treat "goodwill" as a " capital asset' in the usual sense. A similar question under Section 12B of the Act of 1922 came up for consideration of the Delhi High Court in *Jagdev Singh Mumick v. Commissioner of Income-tax*[3], While conceding that goodwill is an asset, the court observed that it is an intangible asset, and followed the decision of the Madras High Court for holding that it is not assessable under the Act.

10. Certain observations made in these decisions lend support to the assessee's contention that goodwill is practically outside the scope of section 12B of the Act of 1922 and consequently of Section 48 of the Act of 1961. Such a proposition, when examined with reference to the provisions of the Act dealing with capital gains, appears to be too wide for acceptance. Sale of the goodwill of a business came up for the consideration of the Supreme Court in *Devidas Vithaldas & Co. v. Commissioner of Income-tax*[4], The question raised in that case was whether the consideration paid for purchase of the goodwill by the assessee would be an admissible deduction under Section 10(2) of the Act of 1922. The Supreme Court held as follows :

> " Acquisition of the goodwill of the business is, without doubt, acquisition of a capital asset, and, therefore, its purchase price would be capital expenditure. It would not make any difference whether it is paid in a lump sum at one time or in instalments distributed over a definite period, (See In *re Ramjidas Jaini & Co.*[5], *and Kuppuswami v. Commissioner of Income-tax*[6], Where, however, the transaction is not one for acquisition of the goodwill, but for the right to use it, the expenditure would be revenue expenditure."

11. It is, therefore, well settled that goodwill is a capital asset and that the consideration paid for its transfer can attract certain provisions like Section 10(2) of the Act of 1922.

12. It is possible to envisage a case where a person purchases the goodwill of a business or profession for a definite amount and without any further addition to its value by his own efforts later on sells it for a higher price and thereby secures a determinate profit or gain. In such a case, goodwill is hardly distinguishable from any other capital asset and there is nothing in Section 45 or other relevant provisions of the Income-tax Act that excludes such profits or gains from liability to assessment. We may not, however, be understood as doubting the high persuasive value of the aforesaid decisions inasmuch as the reasoning adopted therein has considerable bearing on the taxability of the sale proceeds of one category of goodwill, of which the case on hand is a good illustration.

13. There cannot be any doubt that what is charged under Section 45 of the Act is the " profits or gains arising from the transfer of a capital asset" and not any and every amount received on such transfer. For the purpose of determining the liability, the " profit or gain" so accruing has to be computed in accordance with the provisions of Section 48 of the Act of 1961. Under that section, the tax shall be computed by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset, three items of expenditure, namely, (a) expenditure incurred wholly and exclusively in connection with such transfer; (b) the cost of acquisition of the capital asset; and (c) the cost of any improvement thereto. As we shall presently show, in the case of transfer of a goodwill of the present type, while the ascertainment of the first item of expenditure may be comparatively easy, the other two deductible items may not be capable of such easy ascertainment. Sub-section (2) of Section 55 of the Act of 1961 explains "cost of acquisition " in relation to a capital asset. Since the assessee in this case started

practice in 1951, it is apparently Clause (i) of Sub-section (2) that applies. That clause provides that where the capital asset became the property of the assessee before the 1st day of January, 1954, the expression " cost of acquisition " means "the cost of acquisition of the asset to the assessee or the fair market value of the asset on the 1st day of January, 1954, at the option of the assessee ". A reading of the relevant clause shows that the terms used therein do not throw any light as to what is meant by " cost of acquisition ". Consequently, as has been rightly pointed out in Commissioner of Income-tax v. Rathnam Nadar, in the context of the Income-tax Act, the expression " cost of acquisition " signifies some expenditure or outlay in terms of money by the assessee in the creation or acquisition of the concerned capital asset. It was by his personal effort spread over a number of years that the assessee built up the goodwill in dispute. It is well-nigh impossible to estimate even roughly the money he could have spent in building "up his professional reputation. Since the cost of acquisition is thus incapable of determination, the question of the assessee exercising the option given to him under Section 55(2)(i) does not arise.

14. Under Section 48(ii) of the Act of 1961, the assessee is also entitled to claim deduction for cost of improvement, if any, effected by him in respect of his capital asset. "Cost of improvement" is defined in Section 55(1)(b). It is not necessary to consider whether it is Sub-clause (i) or Sub-clause (ii) that applies to the present case, because in either case "cost of any improvement " means " all expenditure of a capital nature incurred by making any addition or alteration to the capital asset. " Here again, just as in the case of " cost of acquisition ", the expenditure contemplated is expenditure in terms of money. It cannot be disputed that, normally, "goodwill' also is an asset that gains in value by lapse of time; and in the case of the goodwill of a profession, such augmentation is essentially attributable to the personal efforts, skill or sacrifice of the owner. It is not possible in such cases to evaluate the increase in value in terms of money. Thus, in the case of certain categories of transfers of " goodwill ", it is not possible to determine the " cost of acquisition" and the " cost of improvement" referred to in Section 48(ii) for the purposes of computation of "capital gains " under Section 48. Without computation of " profits or gains ", no tax can be levied under Section 45 of the Act of 1961. That precisely is the situation obtained in relation to the goodwill in dispute.

15. We, therefore, hold that the amount of Rs. 32,000 received by the assessee towards the value of goodwill is not assessable to tax under Section 48 in so far as the profits or gains arising from the transaction in relation to the goodwill cannot be and has not been computed in accordance with the provisions of Section 48.

16. Our attention in this connection was drawn to a Division Bench decision of this court in *Haji Abdul Kader Sahib v. Commissioner of Income-tax*[7], That was also a case decided under Section 12B of the Act of 1922. From the question referred for the opinion of the court as extracted in the judgment, it would appear that the main dispute centered round the proposition that goodwill being an intangible asset will not come within the ambit of Section 12B. The court answered the question in favour of the revenue and held that the profit derived by the sale of goodwill Was assessable. The question whether the capital gain was capable of computation under Section 12B(2) does not appear to have been mooted in that case. We do not approve of the decision in that case to the extent to which it goes contrary to the conclusions reached by us in this case.

17. In view of the conclusions reached above, it is not necessary for us to consider whether any portion of the amount in question could claim exemption under Section 47(ii) of the Act of 1961.

The decision rendered by the Appellate Tribunal is, therefore, sustainable, though on different grounds.

18. In the result, the question referred for advice is answered in the affirmative and against the revenue. The assessee is entitled to his costs.

19. A copy of this judgment will be sent to the Appellate Tribunal under the seal of the High Court and the signature of the Registrar.

Cases Referred.

1[1969] 71 I.T.R. 433 (Mad.)
2[1970] 76 I.T.R. 566 (Cal.)
3[1971] 81 I.T.R. 500 (Delhi)
4[1972] 84 I.T R 277, 286 (S.C.)
5[1945] 13 I.T.R. 430 (Lah.)
6[1954] 25 I.T.R. 349 (Mad.)
7[1961] 42 I.T.R. 296 (Ker.)