

IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 01.12.2015

CORAM:

THE HONOURABLE MR.JUSTICE **M.JAICHANDREN**

and

THE HONOURABLE MRS.JUSTICE **S.VIMALA**

Tax Case (Appeal) No.2619 of 2006
and M.P.No.1 of 2007

M/s.CADD Centre,
No.25, Dr.Radha Krishna Salai,
Chennai – 600 004.

..

Appellant

Vs.

The Assistant Commissioner
of Income Tax,
City Circle II (2)
Chennai.

..

Respondent

PRAYER: Tax Case Appeal filed under Section 260A of the Income Tax Act, 1961, against the orders of the Income Tax Appellate Tribunal, 'A' Bench, in C.O.No.133/Mds/1997 and I.T.A.No.1457/Mds/1997 dated 29.09.2004.

For Appellant : Mr.D.Anand
for M/s.Pathy & Pathy

For Respondent : M/s.T.Ravi Kumar

J U D G M E N T

(Judgment of the Court was delivered by S.Vimala, J.)

When a Firm is succeeded by a Company, with no change either in the number of members or in the value of assets, with no dissolution of

the Firm and no distribution of Assets, with change in legal status alone, whether there is a "transfer" as contemplated under Section 2(47) and Section 45(4) of the Income Tax Act and whether the Assessee is liable to be taxed, are the issues canvassed in this case.

1.1. 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' under Section 45(4) of the Act?

1.2. Whether the expression "otherwise" occurring in section 45 of the Income Tax Act has to be read "ejusdem generis" with the expression "dissolution of a firm or body or association of persons" or it has to be read with the word "transfer of capital assets" by way of distribution of capital assets?

1.3. Whether omission of clause (2) of section 47 "any distribution of capital assets on the dissolution of a firm, body of individuals or other association of persons" by the Finance Act, 1987 with effect from 1-4-1988, would lead to the conclusion that any transaction resulting in distribution on dissolution of a firm would amount to 'transfer' in terms of section 47?

2. This Appeal has been preferred by the Assessee under Section 260(A) of the Income Tax Act, 1961, (hereinafter will be referred to as "the Act"), challenging the orders passed by the Income Tax Appellate Tribunal, in I.T.A.No.1457/Mds/1997 and C.O.No.133/Mds/1997, dated 29.09.2004.

Brief facts:

3. The Appellant, erstwhile Registered Firm, is engaged in the business of training and trading of software. The Appellant Firm was constituted in the year 1988, vide Deed of Partnership, dated 20.10.1988, and consisted of only two Partners, namely, V.Sathyamoorthy (son) and Chandra (mother), who were holding equal stakes in the Firm.

3.1. During the year 1991, the Partners of the Firm felt the necessity of having a corporate identity and therefore, decided to incorporate a Private Limited Company and vest the business of the Firm along with the assets in the newly formed Private Limited Company, M/s.CADD Centre India Pvt. Ltd. ***A Company by name M/s.CADD Centre India Pvt. Ltd. was incorporated on 21.11.1991*** and all the Partners of the Firm immediately before the succession, became the shareholders of the Company in the same proportion, in which, the

capital account stood in the books of the Firm on the date of succession. In the above pretext, ***the Appellant Firm revalued its assets as on 30.11.1991*** and the Partnership business was converted into the business of Private Limited Company as a going concern and all the assets of the firm got vested as assets of the Private Limited Company, in which, the same partners are interested. On succession of Firm by Private Limited Company, the shares were held in parity between V.Sathyamoorthy (son) and Chandra (mother), who were equal partners in the Firm CADD INDIA.

3.2. For the Assessment Year 1992-93, the appellant filed its return of income on 23.10.1992, declaring an income of Rs.1,85,000/-. From the records, the Assessing Officer found that the accounts of the appellant Firm was closed on 30.11.1991 and its existing business was taken over by a Company M/s.CADD Centre India Pvt. Ltd. The Assessing Officer came to the conclusion that the transfer of business assets of the appellant Firm to the Private Limited Company would constitute distribution of assets and would attract capital gains as contemplated under Section 45(4) of the Income Tax Act and that the Assessee is liable to pay tax on "capital gains".

4. Against the order of the Assessing Officer, the appellant preferred an Appeal before the Commissioner of Income Tax (Appeals)

VI, Chennai. The Commissioner of Income Tax allowed the appeal holding that when a Partnership Firm is transformed into a Private Limited Company, there is no transfer of capital assets as contemplated under Section 45(4) of the Act.

5. Against the order of the First Appellate Authority, the Revenue preferred an appeal, before the Income Tax Appellate Tribunal. The Income Tax Appellate Tribunal allowed the Appeal, holding that the transfer of assets of a Partnership Firm, without dissolution, to a Private Limited Company falls within the expression "**otherwise**" (as contemplated under Section 45(4) of the Act) and therefore, the Appellant is liable to pay tax. Challenging the same, the Assessee is on appeal, raising the following substantial questions of law:

(a) Whether the Income Tax Appellate Tribunal is right in law in holding that the capital gains is attracted, when existing business of the appellant Firm was taken over by a Company and the entire interest of the Partners in the Firm is converted into equity shares in proportion, in a newly formed Private Limited Company, in which, the Partners of the Firm are the only shareholders?

(b) Whether the Income Tax Appellate Tribunal is right in law in finding that Section 45(4) of the Act is attracted in case where the taking over of the Partnership Firm as a whole as a going concern by a Private Limited Company amounts to transfer of capital assets even

when no consideration has been received within the meaning of section 48 of the Income Tax Act, 1961?

(c) Whether the Income Tax Appellate Tribunal is right in law in not giving a finding on a legal issue of **re-opening of the assessment** which was raised by the appellant on a cross objection?

(d) Whether the Income Tax Appellate Tribunal is right in law in not adjudicating the issue of validity of reassessment since the same had not arisen out of the order of the First Appellate Authority, when a specific ground had been raised to the effect, before the First Appellate Authority and **the same not being adjudicated**?

(e) Whether the Assessing Officer is right in re-opening the assessment based on an expert opinion and not based on an additional material?

6. A preliminary objection has been raised by the Revenue stating that the substantial question of law, pertaining to re-opening of assessment, will not arise for consideration, as the issue was not raised before the Commissioner of Income Tax, that is before the First Appellate Authority. It is further submitted that the Income Tax Appellate Tribunal rightly declined to entertain that ground, (regarding re-opening of assessment) and therefore, that issue does not arise for consideration. In order to appreciate the justifiability of the preliminary objection, it is necessary to look into the observations made by the

Income Tax Appellate Tribunal, which reads as under:

*"In the cross objection, the Assessee is aggrieved in the reopening of assessment under Section 148 of the IT Act. The learned counsel for the Assessee submitted that there is no failure on the part of the Assessee to submit all the information required for the completion of the assessment before the Assessing Officer and all the information were available in the return of income and the balance sheet filed along with the return of income and hence the Assessing Officer was not justified in reopening the assessment. **We find that this issue does not arise out of the order of the Commissioner of Income Tax (Appeals) and hence, we decline to entertain this ground.**"*

7. The perusal of the grounds of appeal, filed before the Commissioner of Income Tax (Appeals), would reveal that the ground regarding the validity of re-opening of assessment has not been raised as a specific ground.

7.1. In the absence of issue having been raised before the Commissioner of Income Tax (Appeals), whether it can be raised before the Income Tax Appellate Tribunal, is the issue agitated by the Revenue, consequently, whether the Income Tax Appellate Tribunal is right in saying that, as the issue was not raised before Commissioner of Income Tax (Appeals), the Tribunal can decline to entertain this ground.

7.2. This issue is squarely answered by the decision of the Hon'ble Supreme Court reported in **1999 157 CTR 0249 (National Thermal Power Co. Ltd. vs. Commissioner of Income Tax)**, in which, it has been held that, the Tribunal is **not confined only to issues arising out of the appeal** before the Commissioner of Income Tax and that, it has jurisdiction to examine a question of law, which arises from the facts, as found by the Authorities below and having a bearing on the tax liability of the Assessee. Therefore, the finding of the Income Tax Appellate Tribunal that this issue (re-opening of assessment) does not arise out of the order of the Commissioner of Income Tax (Appeals) and hence, we decline to entertain this ground, is not correct. Therefore, there is no legal impediment to raise the substantial questions of law (c), (d) and (e), pertaining to re-opening of assessment.

8. However, the learned counsel for the Appellant submitted that at this stage, they are not pressing the issue, regarding the re-opening of the assessment. Hence, deciding issue Nos. (c) (d) and (e) have become unnecessary and it remains answered only to the extent of the right to raise the issue before this Court, in the absence of the issue, having not been raised, before the Commissioner of Income Tax (Appeals).

9. As a general principle, revenue gains are taxable under the scheme of Income Tax Act. As an exception to the above general principle, gains arising on account of transfer of a capital asset are considered as income and as such, are taxable. The charging section, namely, Section 45(1) provides that any profit or gain arising out of the transfer of a capital asset is chargeable, under the head "capital gains" in the previous year, in which, the transfer of capital asset took place. The capital gains are deemed to be income, under Section 2(24)(vi) of the Income Tax Act.

9.1. One of pre-conditions to be fulfilled is that there should be transfer of a capital asset for a gain to be taxed as capital gains. In other words, in order to bring a transaction under the ambit of capital gains, it is a must that the receipt or accrual must have originated in a "transfer" within the meaning of Section 45(1) read with Section 2(47) of the Act. The transfer presumes the existence of both the asset and the transferee, to whom, it is transferred, as held by the Supreme Court in the case of **CIT vs. Vania Skill Mills (P) Ltd.** reported in **(1991) 191 ITR 647 (SC)**.

10. It is an admitted fact that the Partnership Firm as on 01.04.1988 was converted into an incorporated Company as on

21.11.1991. Whether it would amount to transfer of capital asset, is the issue raised in this case.

10.1. It is an admitted case of both parties that originally, there was a Partnership Firm consisting of only two partners, and later, the Partners transformed the Partnership Firm into a Private Limited Company, by name, M/s.CADD India Pvt. Ltd., with the same two Partners becoming shareholders of the Company. The case of the Assessee is that all the assets of the Firm got vested with the Private Limited Company and on succession of the Firm by a private limited Company, there was no transfer of assets and therefore, capital gains as contemplated under Section 45(4) of the Income Tax Act, would not be attracted and therefore, the Assessee is not liable to pay any tax on capital gains. The further contention is that Section 45(4) will be applicable only when the Firm is dissolved or when there is distribution of assets and not otherwise.

12. The case of the respondent/revenue is that, when the Partnership Firm (without dissolution) get transformed into a Private Limited Company, the process involves the transfer of asset and that it would fall within the expression "otherwise", as contemplated under Section 45(4) of the Income Tax Act and therefore, the Assessee is liable to pay tax on the capital gains on the transfer of assets.

13. In order to appreciate, the contentions raised on both sides, it is necessary to look into the definition of transfer under Section 2(47), and also Section 45(4) and Section 47(13) of the Income Tax Act, dealing with capital gains.

13.1. Section 2(47) of the Income Tax Act, 1961 (as amended by Finance Act 2013), dealing with "transfer" reads as under:

2. In this Act, unless the context otherwise requires:

1 to 46.

47. "transfer", in relation to a capital asset, includes,-

(i) the sale, exchange or relinquishment of the asset; or

(ii) **the extinguishment of any rights therein**; or.....

(iii) the compulsory acquisition thereof under any law; or

(iv) (w.e.f.1-4-1985) in a case where the asset-

- is converted by the owner thereof into, or

- is treated by him as,

stock-in-trade of a business carried on by him, such conversion or treatment; or

(iva) (w.e.f.1-4-2006) the maturity or redemption of a zero coupon bond [as defined in s.2(48)].

(v) (w.e.f. 1-4-1988) any transaction involving the allowing of the possession of any immovable property (as defined) to be taken or retained in part performance of a contract of the nature referred to in Section 53A of the Transfer of Property Act, 1882 (4 of 1882); or

(vi) (w.e.f. 1-4-1988) any transaction (whether by becoming a member of, or acquiring shares in, a co-operative society,

company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property (as defined).

Before a levy on the capital gain can be imposed, it is a must to ensure that, such a gain has arisen from the disposal of the asset, by **any one of the mode**, referred to in the definition of the term “transfer” in Section 2(47).

13.2. Section 45(4) of the Income Tax Act reads as under:

“45(4) - The profits or gains arising from the transfer of a capital asset by way of distribution of capital assets **on the dissolution of a firm** or other association of persons or body of individuals (not being a company or a co-operative society) **or otherwise**, shall be chargeable to tax as the income of the firm, association or body, of the previous year in which the said transfer takes place and, for the purposes of section 48, the fair market value of the asset on the date of such transfer shall be deemed to be the full value of the consideration received or accruing as a result of the transfer.”

Under Section 45(4) of the Act, two conditions are required to be satisfied:

- (i) transfer by way of distribution of capital assets;
- (ii) such transfer should be on dissolution of the firm or otherwise.

13.3. Section 47 of the Income Tax Act deals with the ***transactions not regarded as transfer***. The opening sentence of Section 47 reads that, nothing contained in section 45 shall apply to the following transfers :—

(i) to (xii)

xiii) ⁵¹[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 ⁵²[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 :]

Proviso—(a) to (e)

Clauses (xiii) to (xv) of Section 47 of the Income Tax Act have been inserted by the Finance (No. 2) Act, 1998, w.e.f. 1-4-1999.

14. In support of the contention that there is no dissolution of the Partnership and therefore, there is no transfer of capital assets and hence, the Assessee is not liable to pay tax on capital gains, the learned counsel for the Assessee relied upon the following decisions:

(i) (2003) 263 ITR Bombay 345 (Commissioner Of Income-Tax vs Texspin Engg. & Mfg. Works)

".... 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.....

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. "

(ii) (1979) 120 ITR 0049 (Malabar Fisheries vs. Commissioner of Income Tax)

"13. it seems to us clear that ***a partnership firm under the Indian Partnership Act, 1932 is not a distinct legal entity apart from the partners constituting it*** and equally in law the firm as such has no separate rights of its own in the partnership assets and when one talks of the firm's property. Or firm's assets all that is meant is property or assets in which all partners have a joint or common interest. If that be the position, it is difficult to accept the contention that upon dissolution, the

firm's rights in the partnership assets are extinguished. The firm as such has no separate rights of its own in the partnership assets but it is the partners who own jointly in common the assets of the partnership and, therefore, the consequences of the distribution, division or allotment of assets to the partners which flows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between the partners and there is no question of any extinguishment of the firm's rights in the partnership assets amounting to a transfer of assets within the meaning of s. (47) of the Act. In our view, therefore, there is no transfer of assets involved even in the sense of any extinguishment the firm's rights in the partnership assets when distribution takes place upon dissolution."

(iii) (2012) 344 ITR 0544 (Commissioner of Income Tax vs. Rita Mechanical Works)

"17. The plea of applicability of Section 45(1) r/w. Section 2(47)(ii) of the Act was also negated with the following conclusion:

"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 counter-party 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 vest 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 the 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."*

(iv) (2014) 90 CCH 0170 AllHC (Commissioner of Income Tax vs. Ajanta Raj Dairy)

"a) where there was no transfer of assets of the Partnership Firm to a company, no capital gain tax is warranted b) where the shares were issued by the company not to the firms, but to the individuals, who were Partners of the erstwhile firm and became share-holders of the Company, the provisions of Section 45 of the Act will not be applicable."

(v) (2015) 372 ITR 0067 (AP) (Commissioner of Income Tax vs. United Fish Nets)

When there is no tangible act of physical transfer of properties and intangible act of conferring exclusive right vis-a-vis and item of property on the erstwhile shareholder, there is no transfer. The basic tenets of transfer of assets has been lighted in the decision which reads as under:

10. What constitutes distribution of assets under Section 45(4) of the Act was explained by the Bombay High Court in Texspin Engineering and Manufacturing Works's case (1 supra). Incidentally, the facts of that case are identical with those in the present case. There also an existing firm was transformed into a company under Part IX of the Indian Companies Act. When dealing with the identical situation, wherein the Assessing Officer proposed to levy capital gains tax, the Bomaby High Court held:

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. 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.

11. The underlined portion, in a way, signifies the basic tenets of transfer of assets. The distribution must result in some tangible act of the physical transfer of properties or the intangible act of conferring exclusive rights vis-a-vis an item of property on the erstwhile shareholder. Unless these or other legal correlatives take place, it cannot be inferred that there was any distribution of assets. In the

instant case, the shares of the respective shareholders in the respondent-company were defined under the partnership deed. The only change that has taken place on the respondent being transformed into a company was that the shares of the partners were reflected in the form of share certificates. Beyond that, there was no physical distribution of assets in the form of dividing them into parts, or allocation of the same to the respective partners or even distributing the monetary value thereof. In our view, the judgment of the Bombay High Court squarely covers the facts of the case and the orders passed by the Appellate Commissioner and the Tribunal accords with the same. The appeal is accordingly dismissed.

(vi) [2005] 57 SCL 362 (Mad.) (L.K.S. Gold House (P.) Ltd. vs. L.K.S. Gold Palace) (Application No. 376 of 2004 and C.S. No. 934 of 2003)

"The question arose in the above case was, whether inasmuch as plaintiff-company had come to be incorporated under Part IX, after complying with all relevant requirements and registered as such, there was a statutory vesting under section 575 of all assets of erstwhile partnership company into private limited company registered under Act, meaning thereby that no transfer was involved. It was held, there being, neither transferor nor transferee, whose presence alone would mean that there was a transfer, there was no transfer and that "Conversion of a firm into a private limited company, under Part IX of the Companies Act, 1956, statutorily vests all assets of such erstwhile firm into that

private limited company under section 575 of Act without involving any transfer.”

14.1. From the dictum laid down in the above cases, it is clear that when a Partnership Firm is transformed into a Private Limited Company, there is no distribution of assets and as such, there is no transfer and therefore, the assessee is not liable to pay any tax on capital gains.

15. But, the contention of the learned counsel for the respondent is that even though the transfer is not covered under the earlier part of Section 45(4) of the Act, the transfer would be covered under the phrase “otherwise” and therefore, the assessee is liable to pay tax on capital gains. It is pointed out that when the Partnership Firm becomes a Limited Company, the rights of Partners in those assets in the Partnership Firm, get extinguished and there is transfer of title in favour of the share-holders of the company, which fell within the expression “otherwise” and therefore, it is a “deemed transfer” attracting capital gains.

15.1. Further contention of the learned counsel for the respondent is that the legislature has used the expression 'or otherwise' and not 'and otherwise'; therefore, the intention of the legislature is to cover cases of capital gains even where there is no dissolution of the firm at all and when the transfer takes place in other mode also. In support of this

and other legal contentions, the following decisions are relied upon:

(i) (2008) 306 ITR 216 (Commissioner of Income Tax Vs. Southern Tube and another)

*We are unable to agree with the view taken by the Tribunal that [Section 2\(47\)](#) does not cover dissolution and distribution of assets of a firm because sub- clause (vi) of [Section 2\(47\)](#) covers every agreement or arrangement in whatever manner which has the effect of transferring or enabling enjoyment of any immovable property. In fact the transactions referred to in the latter part of clause (vi) are exhaustive and in our view the scope of the Section is such that if the result of arrangement or agreement of a transaction is a **transfer of assets** or enabling enjoyment of any immovable property, then the transaction which led to such result is a transfer.*

Even according to this decision, only if the transaction involves transfer of assets, the liability arises and not otherwise. Hence, this decision is not applicable to the facts of this case.

(ii) (2004) 265 ITR 346 (Bom) (Commissioner of Income Tax vs. A.N.Nayak Associates)

25. ...As noted earlier on behalf of the assessee it has been contended that the expression "otherwise" would have to be read "ejusdem generis" with "dissolution of partnership or body of individuals" and for that purpose reliance was placed on a judgment of the Division Bench in

CIT v. Trustees of Abdulcadar Ebrahim Trust [1975] 100 ITR 85 (Bom). Section 45 is a charging section. The purpose and object of the Act of 1987 was to charge tax arising on distribution of capital assets of firms which otherwise was not subject to taxation. If the language of Sub-section (4) is construed to mean that the **expression "otherwise" has to partake of the nature of dissolution or deemed dissolution, then the very object of the amendment could be defeated** by the partners, by distributing the assets to some partners who may retire. The firm then would not be liable to be taxed thus defeating the very purpose of the Amending Act.....Therefore, if the object of the Act is seen and the mischief it seeks to avoid, it would be clear that the intention of Parliament was to bring into the tax net transactions whereby assets were brought into a firm or taken out of the firm.

26. The expression "otherwise" in our opinion, has not to be read ejusdem generis with the expression, "dissolution of a firm or body or association of persons". The expression "otherwise" has to be read with the words "transfer of capital assets" by way of distribution of capital assets. If so read, it becomes clear that even when a firm is in existence and there is a transfer of capital assets, it comes within the expression "otherwise" as the object of the amending Act was to remove the loophole which existed whereby capital gain tax was not chargeable. **In our opinion, therefore, when the asset of the partnership is transferred to a retiring partner the partnership which is assessable to tax ceases to have a right or its right in the property stands extinguished in favour of the partner to whom it is transferred. If so read it will further the object**

and the purpose and intent of the amendment of Section 45. Once, that be the case, we will have to hold that the transfer of assets of the partnership to the retiring partners would amount to the transfer of the capital assets in the nature of capital gains and business profits which is chargeable to tax under Section 45(4) of the Income-tax Act. ***We will, therefore, have to answer question No. 3 by holding that the word "otherwise" takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of a retiring partner.***

This decision has been followed by the Honourable Madras High Court in the case of CIT vs. Nathan & Co. Trichy (TC (A) No.1458 of 2005 (Mad)).

In the reported case, there was a transfer of asset in favour of retiring partner. That is not the situation contemplated in the facts of this case. Hence, this decision is not applicable.

(iii) (2006) 287 ITR 0404 (Suvardhan vs. Commissioner of Income Tax)

". . . The Finance Act, 1987, with effect from 1-4-1988, omitted this clause, instead of amending section 2(47), the effect of which is that distribution of capital assets on the dissolution of a firm would be regarded as transfer... ."
(p. 347)

9. We are in respectful agreement with the judgment of the

Bombay High Court. When the Parliament in its wisdom has chosen to remove a provision, which provided 'no transfer', there is no need for any further amendment to section 2(47) of the Act as argued before us. In our view, despite no amendment to section 2(47), in the light of removal of clause (ii) to section 47, transaction certainly would call for tax at the hands of the authorities."

This decision is not applicable to the facts of this case. The Finance Act, 2001, has amended clause (xiii) of Section 47 of the Income Tax Act to provide that any transfer of a capital asset, from an association or persons or body of individuals to a Company, under a scheme of corporatisation of a recognized stock exchange, shall not be regarded as transfer for the purpose of capital gains tax. The proviso to clause (xiii) has also been amended to provide that this **one time exemption from capital gains tax** is available only if all the assets and liabilities of stock exchange immediately before the succession, become the assets and liabilities of corporatised stock exchange, and the scheme of corporatisation is approved by the Securities and Exchange Board of India.

The very purpose of one time exemption was towards facilitating corporatisation of stock exchange and therefore, the deletion of Section 47(xiii) will not have an impact, on the liability to pay capital gains tax, under Section 45(4) of the Income Tax Act.

(iv) (2010) 48 DTR (Ker) 44 (Hotel Luciya Drive-in-Restaurant Vs. Commissioner of Income Tax and another)

*"In other words, the execution of the transfer deed of the property on 24th April, 1995, the **reconstitution** of the partnership with purchasers on 28th April, 1995 and **subsequent retirement** by the two partners name, Sri Anto Thomas and his wife along with few others on 12th April, 1996 is a clear scheme of transfer of land and building and bar hotel with licence as a going concern on the specific consideration of Rs.83.5 lakhs. So much so, in our view, assessment was rightly made for capital gains as the transaction is a clear transfer of property within the meaning of Section 2(47) of the Act without reference to Section 45(3) or Section 45(4) of the Act. We, therefore, uphold in principle the order of the Tribunal holding that the transaction by the appellants amounts to transfer of capital asset which attracts liability for tax for capital gains."*

The transaction in this case involves sale of partnership business along with retirement of two partners. Therefore, this case is distinguishable on fact.

(v) (2015) 371 ITR 0056 (AP) (Ana Labs vs. Deputy Commissioner of Income Tax)

"10. An attempt is made to apply the concept underlying Clause (xiii) of Section 47 of the Act. Firstly, the

provision was not in vogue in the relevant assessment year. Secondly, assuming that the concept was in the offing and in a given case, it may be applied if the facts support. The case of the appellant does not fall into that. ***It was not a case of succession of the firm by the appellant firm by the transferee company***, much less there was any exercise of corporatisation or demutualization, which are essential to attract Clause (xiii) of Section 47 of the Act. The appellant is not able to demonstrate that the figures mentioned by the Assessing Officer are incorrect."

In the reported case, there is a factual finding that sale took place before the dissolution of the firm and therefore, there was an obligation to pay tax. It is not so in this case.

(vi) (2001) 117 Taxman 50 (AP) (Rajalakshmi Trading Company vs. Commissioner of Income Tax)

"In this case also, the Assessee Firm was dissolved and all its assets were taken over by one partner at book value."

(vii) (2010) 189 Taxman 171 (Kar.) Commissioner of Income Tax vs. Gurunath Talkies)

"This decision deals with the effect of reintroduction

*of sub-section 3 and 4 of Section 45 with effect from 01.04.1988 and that the assets held by the original partners vested in new partners and that the **amount invested by new partners paid to the retiring partners** was liable to capital gains under Section 45(4) and that there was a transfer of capital assets within the meaning of Section 2(47)”*

(viii) (2010) 328 ITR 600 (Commissioner of Income Tax vs. Kumbazha Tourist Home)

“In this case, on the dissolution of the partnership, the land and building were distributed among the partners of the dissolved firm and it was held that the transaction fell under Section 45(4) of the Act which attracted capital gains.”

So far as decision Nos.6, 7 and 8 are concerned, the portion extracted itself would reveal that the reported cases are distinguishable on facts.

15.2. There is no case law supporting the proposition that even in cases of subsisting Partners of a Partnership Firm transferring assets to a Private Limited Company, there would be a transfer, covered under the expression “otherwise”.

16. It is not in dispute that the Partnership Firm transformed into a Private Limited Company. The Partnership Firm and a Private Limited

Company are two different legal entities, with different legal liability. In other words, the liability of a Partner is different from that of the liability of a Director of a Company. The Company has an independent legal entity, *de hors* its share-holders, whereas the Partnership Firm has no such independent existence, *de hors* the partners. Therefore, when a Partnership Firm is transformed into a Limited Company with no change in the number of partners and the extent of property, there is no transfer of assets involved and hence, there is no liability to pay tax on capital gains.

17. It is strenuously contended that earlier, distribution of capital assets on dissolution of firm was not considered as transfer, but, on the Finance Act, 1987 (w.e.f., 01.04.1988), amending the said clause, the distribution of capital assets on the dissolution of firm will be a transfer. This proposition is not in dispute. The question here is, when there is no dissolution at all of the Partnership Firm, whether there is transfer of capital assets and consequently, whether there is a liability to pay tax on capital gains. On facts, the finding is that there is no dissolution of Partnership Firm. It is not in doubt that, in case of dissolution of Partnership Firm, there is transfer of assets and consequently, the Assessee is liable to pay tax on capital gains.

18. It would be appropriate to quote the decision reported in (2007) 106 TTJ Bang 1086 (The Asst. Commissioner of Income Tax vs Unity Care And Health Services), whereunder, in a similar fact situation, it has been held that when a partnership firm is transformed into a company, there is no transfer of capital asset, as the transfer is by operation of law and the relevant observation reads as under:

“6.3. When a conversion of a firm into company takes place under the provisions of Companies Law, such conversion can be construed only as occasioned by operation of law. Hence, no controversy can arise on the application of this principle even for purposes of capital gains Under Section 45(4) of the Act. By insertion of Section 47(xiii) in the Act, it cannot be said that the conversion of a firm into a company under Part IX is to be first treated as dissolution of firm within the meaning of Section 45(4) and only if condition as contained in Section 47(xiii) are complied, the exemption will be available. Section 47(xiii) applies only to a case of transfer by sale, but there is no authority for capital gain at all in the absence of a transfer under Part IX of the Companies Act in as much as such conversions do not fall within the definition of transfer Under Section 2(47) of the Act. Section 45(4) would have application only when there is distribution of assets to the partners so that its application cannot be justified, firstly because it can apply only, when there is transfer and secondly only when there is distribution of assets to the partners. This is neither in the conversion of

a firm into a company. It is also seen that Section 47(xiii) is also complied with if it is held that there is transfer of capital asset to a company, the clauses of Section 47(xiii) are fulfilled and thus even if it is held that there is a transfer of capital asset by a firm to a company as a result of succession, the same is not chargeable, as the condition prescribed therein are complied with. Thus, looking at either angle, the capital gain is not chargeable to tax.”

19. So far as this case is concerned, there is no transfer of asset as (a) no consideration was received or accrued on transfer of assets from the firm to the company; (b) the firm has only revalued its assets which will not amount to transfer; (c) the provision of Section 45(4) of the Act is applicable only when the firm is dissolved. In the instant case, there is no distribution of asset, but only taking over of the assets from the firm to the Company.

20. Therefore, it is clear that the vesting of the property in the Private Limited Company is not consequent or incidental to a transfer. There is no transfer of a capital assets as contemplated by Section 45 (1) of the Income Tax Act.

21. In the result, the appeal is allowed and the orders passed by the Income Tax Appellate Tribunal, in I.T.A.No.1457/Mds/1997, dated 29.09.2004, is set aside. Consequently, connected miscellaneous petition is closed.

(M.J.J.,) (S.V.J.,)
01.12.2015

Index : Yes / No
Web : Yes / No
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To

1. The Income Tax Appellate Tribunal,
'A' Bench.
2. The Assistant Commissioner of Income Tax,
City Circle II (2), Chennai.

M.JAICHANDREN, J.
and
S.VIMALA, J.

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Judgment in
Tax Case (Appeal) No.2619 of 2006

01.12.2015

Judgment in
Civil Miscellaneous Appeal Nos.1591 of 2009
and 474 & 475 of 2010

To
The Hon 'ble Mr. Justice **M.JAICHANDREN**

From

Justice S.Vimala