

IN THE HIGH COURT OF JUDICATURE AT MADRAS**CORAM:**

THE HONOURABLE MR.JUSTICE T.S.SIVAGNANAM
and
THE HONOURABLE MRS.JUSTICE V.BHAVANI SUBBAROYAN

Tax Case (Appeal) No.1106 of 2008

Judgment reserved on 24.10.2018	Judgment pronounced on 16.11.2018
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M/s.G.H.Reddy & Associates,
45, B.N.Road, T'Nagar,
Chennai-600 017.

(A Partnership firm subsequently converted into
a Private Limited Company, M/s.G.H.Reddy &
Associates (Construction) Pvt. Ltd.
under Part IX of the Companies Act, 1956)

.. Appellant

-vs-

The Assistant Commissioner of Income-tax,
Business Circle-I,
Room No.309, III Floor, New Block,
121, Mahathma Gandhi Road,
Nungambakkam, Chennai-600 034.

.. Respondent

Tax Case Appeal filed under Section 260A of the Income Tax Act,
1961 against the order of the Income-tax Appellate Tribunal Chennai
Bench 'A', dated 08.02.2008 in I.T.A.No.2059/Mds/2006 for the
assessment year 2002-03.

For Appellant : Mr.R.Sivaraman

For Respondent : Ms.V.Pushpa,
Junior Standing Counsel
for Mr.M.Swaminathan,
Senior Standing Counsel

JUDGMENT

T.S.Sivagnanam, J.

This appeal, filed by the appellant/assessee under Section 260A of the Income-tax Act, 1961 ("the Act" for brevity), is directed against the order passed by the Income-tax Appellate Tribunal Chennai 'A' Bench ("the Tribunal" for brevity), dated 08.02.2008 in I.T.A.No.2059/Mds/2006 for the assessment year 2002-03.

2. The above appeal was admitted, by order dated 05.08.2008, on the following substantial question of law:-

"Whether on the facts and in the circumstances of the case, the Tribunal is right in law in holding that there was a dissolution of the firm as on 31st March 2002 and consequently there was liability to capital gains tax for the Assessment Year 2002-03?"

3. The assessee is a partnership firm carrying on three major lines of businesses viz., execution of civil contracts, real estate and computer education centres as franchise. For the assessment year under consideration, 2002-03, the assessee filed return of income on 22.10.2002 declaring a total income of Rs.10,08,64,490/-. The partners of the assessee firm entered into a Memorandum of Understanding (MOU) on 01.08.2002 deciding to re-organize their businesses whereby,

couple of partners retired, fresh partners were inducted and the firm stood re-constituted and the re-constituted firm was permitted to carry on business in the same name and style and essentially, the three lines of businesses were to be carried on by the newly re-constituted partnership.

4. From the Memorandum of Understanding, it is seen that all the assets and liabilities of the business of computer education and execution of real estate project as existing in the books of the assessee firm as on 31.03.2002, were transferred to the new firm with effect from 01.04.2002. The assessee firm after re-constitution, continued the business of execution of civil contracts. The Assessing Officer while completing the assessment, came to the conclusion that the assessee firm was dissolved on 31.03.2002, and two new firms evolved out of such dissolution with effect from 01.04.2002. Upon coming to such conclusion, the Assessing Officer applied the decision of the Hon'ble Supreme Court in the case of **A.L.A. Firm v. Commissioner of Income-tax, [1991] 55 Taxman 497 (SC)** and valued the closing work in progress as on 31.03.2002 at market value and added a sum of Rs.6,43,43,000/- to the income returned. Further, by deeming distribution of assets among the partners at the time of dissolution, the Assessing Officer invoked the provisions of Section 45(4) of the Act and computed long term capital gains at Rs.26,98, 202/-. Subsequently, the

Assessing Officer revised the assessment under Section 154 of the Act on 11.05.2005, and re-determined the income excluding long term capital gains at Rs.15,67,98,490/- as against Rs.16,52,07,490/-. Aggrieved by the order of assessment, the assessee preferred appeal before the Commissioner of Income-tax (Appeals)-IV ("the CIT(A)" for brevity).

5. It was contended that it is a case of re-constitution and not a case of dissolution and the Assessing Officer ought to have seen that as per the MOU dated 01.08.2002, the businesses continued in the existing partnership firm to be managed by the continuing partners. Further, factual details were placed in support of their contention.

6. The decision in the case of **A.L.A. Firm** (supra) was sought to be distinguished by stating that in the case of **A.L.A. Firm** (supra), the firm had been dissolved with the consent of all the partners and therefore, it is a case of dissolution whereas, in the assessee's case, the firm has not been dissolved and only some partners retired and some more joined. Therefore, it is a case of re-constitution.

6.1. Further, in **A.L.A. Firm** (supra), at the time of dissolution, partners re-valued the stock in trade for the purpose of mutual adjustment whereas, in the assessee's case, none of the assets were re-valued at the time of re-constitution, since there was no distribution of

assets and liabilities among the partners.

6.2. It was further contended that in **A.L.A. Firm** (supra), the dissolved firm ceased to exist with all the assets and liabilities having been distributed among the partners whereas, in the assessee's case, the re-constituted firm continued to exist as ever before carrying on the same business.

7. The CIT(A) agreed with the contentions advanced by the assessee and allowed the appeal by order dated 21.07.2006. Aggrieved by the same, the Revenue preferred appeal to the Tribunal contending that the business of the assessee was split up, and assets and liabilities were divided among the two newly constituted firms and in the decision relied on by the CIT(A), after the dissolution, there was division of business and the decision in the case of **A.L.A. Firm** (supra) was squarely applicable to the case of the assessee.

8. The Tribunal held that the MOU was prepared in lieu of dissolution deed, and the assets and liabilities were divided between the two groups and the business was also divided and it would be necessary to look into the surrounding circumstances to know the real position and intent of parties. Further, it was pointed out that the real right of the partners cannot be mutually adjusted on any other basis, *qua* the old firm, the business was discontinued in relation to real estate project to

computer education centres and the decision in the case of **A.L.A. Firm** (supra) is fully applicable to the facts of the case. Accordingly, the appeal filed by the Revenue was allowed.

9. Heard Mr.R.Sivaraman, learned counsel for the appellant and Ms.V.Pushpa, learned Junior Standing Counsel for Mr.M.Swaminathan, learned Senior Standing Counsel for the Revenue.

10. The short question, to be decided, is whether the assessee firm stood dissolved as on 31.03.2002 and consequently, whether there was any liability to capital gain tax for the assessment year 2002-03.

11. The Assessing Officer in his order stated that the assessee firm as constituted vide the original deed of partnership dated 27.11.2000, existed in its original form retaining its original assets and liabilities only till 31.03.2002 and on 01.04.2002, two new firms came into being by splitting the assets and liabilities and various business of the original firm and in effect, the original firm ceased to exist after 31.03.2002. There is a fundamental contradiction in what the Assessing Officer had observed. The understanding of the factual position by the Assessing Officer is that the original firm ceased to exist after 31.03.2002. If such is the understanding, we fail to understand as to how the Assessing Officer could have come to a conclusion that the firm stood dissolved as on 31.03.2002. Equally, the finding of the Assessing

Officer that since the original firm ceased to exist after 31.03.2002, the revaluation of the closing stock at market value has to be considered for 31.03.2002 only. These contradictions should enure in favour of the assessee.

12. A further reading of the assessment order shows that the Memorandum of Understanding entered into between the partners had weighed in the mind of the Assessing Officer to come to a conclusion that the dissolution of the firm had taken place on 31.03.2002. This is so because, the date 31.03.2002, as mentioned in the Memorandum of Understanding stating that the unaudited accounts of the original partnership firm as on March 2002, was agreed to be the basis for de-merging the business into an independent unit. Thus, the Assessing Officer took this as a positive indication to hold that the original firm stood dissolved on 31.03.2002. We find that the specific case of the assessee that there was only re-constitution and no dissolution and the business of the firm continued as such was not taken into consideration by the Assessing Officer.

13. Furthermore, the Assessing Officer also did not consider the specific case of the assessee that the re-constitution of the firm with effect from 01.04.2002 should not lead to valuation of the closing work in progress as on 31.03.2002 at net realisable value/market value, since

the Act recognises each year as a self-contained year and the happenings of later year should not be superimposed on the preceding year.

14. Considering the factual position, we agree with the assessee's stand that the decision in the case of **A.L.A. Firm** (supra) can have no application to the facts of the case, as we are convinced that there has been no dissolution in the assessee's case and only some partners retired and few partners were inducted and the firm continued with those businesses. Furthermore, there is no material to show that the assets were revalued at the time of re-constitution and as pointed out, re-constituted firm continued to exist as before and was carrying on the same business.

15. The learned counsel appearing for the Revenue referred to the findings recorded by the Assessing Officer and emphasised that there is a clear splitting up of the business of the original firm stood dissolved, and the finding of the Assessing Officer, as confirmed by the Tribunal, may be sustained.

16. We may point out that the CIT(A) not only considered the submissions made by the assessee and the Revenue but, also had examined various clauses in the Memorandum of Understanding more

particularly, clause nos.2, 6(A), 7(A) etc., and after elaborately discussing the same, has held that there is sufficient proof regarding the intention of the continuing partners to continue the appellant firm and also the continued existence of the assessee firm without ever being dissolved as stated by the Assessing Officer.

17. The CIT(A) referred to a decision of the Division Bench of this Court in the case of **Commissioner of Income-tax vs. Standard Printing Machinery, [2003] 260 ITR 268 (Madras)**. The Hon'ble Division Bench took note of the decision of the Hon'ble Supreme Court in **Sakthi Trading Co. vs. CIT, [2001] 250 ITR 871 (SC)** wherein, it was held that there is no cessation of business, the closing stock ought to be valued at cost or market price, whichever is lower. On the facts of the case, it held that the assessee having taken the costs which was lower than the market price, there was no scope for revising the value of the closing stock upward on the ground that the market price was higher.

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18. In **Sakthi Trading Co.** (supra), the question, which fell for consideration, was whether on dissolution of the firm the business is taken over by a partner without discontinuance and the value of the closing stock determined under the regular method of accounting is accepted by the partners in the settlement of accounts for dissolution

purposes, the Income-tax Officer can substitute the market value in respect of the closing stock alone for the purpose of determining the income of the firm up to the date of dissolution.

19. In the abovesaid case, the CIT(A) relied upon the decisions in **A.L.A. Firm** (supra) and **G.R.Ramachari & Co. vs. CIT, [1961] 41 ITR 142 (Madras)** and held that closing stock on dissolution of firm should be valued at its market rate as on the date of dissolution. In the said case, the Tribunal recorded a finding that the business was not discontinued and the decisions in **A.L.A. Firm** (supra) and **G.R.Ramachari & Co.** (supra) were distinguished stating that in both these cases, there was discontinuance of the business itself, which was not the case in the case of the assessee **Sakthi Trading Co.** (supra).

20. It was further pointed out that the principle of valuing the closing stock of a business at cost or market price at the option of the assessee firm is a principle that would hold good only as long as there is continuance of business and that where a business is discontinued, whether on account of dissolution or closure or otherwise by the assessee, then the profits cannot be ascertained except by taking the closing stock at market value. It was further held that when there is no cessation of business, the closing stock could not be valued at the market rate.

21. The decision in **Sakthi Trading Co.** (supra) was followed by the Hon'ble Supreme Court in **Commissioner of Income-tax, Gujarat-II vs. Kwaliti Steel suppliers Complex, [2017] 395 ITR 1.**

22. As pointed out by us earlier, the firm did not stand dissolved. The CIT(A), on perusal of the audited balance sheet of the partnership firm as on 31.03.2002, and the balance sheet of the de-merged as well as the existing business as on 1st April 2002, concluded that the audited accounts of the assessee firm as on March 31, 2002 shall be the basis for de-merging the business in to an independent unit and it is clear that the de-merger of business has not taken place on 31.03.2002. Further, the CIT(A) held that there is a mention of three balance sheets, i.e., the assessee's as on 31.03.2002 and the assessee's de-merged business as on 01.04.2002 and that the later two balance sheets came into existence only on 01.04.2002 and not on 31.03.2002.

23. Further, after appreciating the documents placed before it, the CIT(A) held that the assessee firm was never dissolved much less on 31.03.2002 and on the other hand, got itself re-constituted with three of the continuing partners and therefore, the case is squarely covered by

Section 187(2) of the Act. Further, the assets and liabilities relating to the civil construction business remained with the assessee firm and were not distributed among anybody. Even the assets and liabilities relating to the software education business and real estate project were not distributed among any partners but, were transferred to a new firm and transfer of a business should be construed as distribution of assets and liabilities among the partners.

24. In the light of the above factual position, we are of the clear view that the decision in the case of **A.L.A. Firm** (supra), which was heavily relied upon by the learned counsel for the Revenue, can have no application to the case on hand.

25. The learned counsel for the Revenue placed reliance on the decision of the High Court of Gauhati in the case of **Naveen Hardware & Electrical Stores vs. Commissioner of Income-tax, [2004] 140 Taxman 320 (Gua.)**. In the said decision, the Court held that the decision of the Supreme Court in the case of **Sakthi Trading Co.** (supra) will not apply.

26. We have perused the factual position in the said case and we find that the partnership firm therein was dissolved with effect from 31.03.1992; the business was closed down; final accounts of the firm

were settled as on 31.03.1992; and two of the four partners of the erstwhile firm took over the business. Thus, the business of the erstwhile firm came to an end on 31.03.1992 and there was complete cessation of business of the firm. In the said factual background, the Court applied the decision in the case of **A.L.A. Firm** (supra).

27. In the preceding paragraphs, we have pointed out the factual position as well as the factual finding recorded by the CIT(A) upon perusal of the documents placed by the assessee while arguing the appeal. Further, it is noteworthy to mention that the partnership firm deed dated 03.08.2005, is a good piece of evidence to show that the assessee firm continued to be in existence after re-constitution, that is, even after 31.03.2002 without getting dissolved.

28. Thus, for all the above reasons, we find that the Tribunal erred in reversing the order passed by the CIT(A) and therefore, the order passed by the Tribunal calls for interference.

29. In the result, the appeal filed by the assessee is allowed, the order passed by the Tribunal is set aside and the order passed by the Commissioner of Income-Tax (Appeals)-IV is restored and the substantial question of law, framed for consideration, is answered in favour of the assessee. No costs.

(T.S.S., J.) (V.B.S., J.)

16.11.2018

Index : Yes

Speaking Order

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To

1.The Assistant Commissioner of Income-tax,
Business Circle-I,
Room No.309, III Floor, New Block,
121, Mahatma Gandhi Road,
Nungambakkam, Chennai-600 034.

2.The Income-tax Appellate Tribunal Chennai 'A' Bench.

3.The Commissioner of Income-tax (Appeals)-IV,
No.121, Mahatma Gandhi Salai,
Nungambakkam, Chennai-600 034.

T.S.Sivagnanam, J.
and
V.Bhavani Subbaroyan, J.

(abr)



Pre-delivery Judgment made
in T.C.A.No.1106 of 2008

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