IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED: 16.09.2019

CORAM :

The Hon'ble Dr.Justice Vineet Kothari
AND
The Hon'ble Mr.Justice C.Saravanan

Tax Case (Appeal) No.716 of 2015
and
M.P.No.1 of 2015

M/s. Vikas Academy,
Vikas School Compound,
Arapalayam Cross Road,
Ponnagaram, Madurai. .. Appellant

Vs.

The Income Tax Officer,
Ward - II(4),
Madurai. .. Respondent

Tax Case Appeal filed under Section 260A of the Income Tax Act, 1961, against the order passed by the Income Tax Appellate Tribunal Chennai 'D' Bench, dated 12.06.2015 in ITA.No.2323/MDS/2014,

against the order passed by the Commissioner of Income Tax (Appeal)I, Madurai, made in ITA No.0053/2013-14, dated 20/08/2014 and against the order passed by the Income Tax Officer, Ward II(4), Range, Madurai-2 made in PAN/GIR No.AADFT2762M, dated 28/03/2013.

For Appellant : Mr.R.Sivaraman
Mr.P.Ramesh Kumar

For Respondent : Mr.M.Swaminathan
(Senior Standing Counsel)
Ms.V.Pushpa
(Junior Standing Counsel)

Judgement

[Judgment of the Court was pronounced by Dr. VINEET KOTHARI,J.]

Heard Mr.R.Sivaraman & Mr.P.Ramesh Kumar, learned Counsels appearing for the appellant assessee and Mr.M.Swaminathan, learned Senior Standing Counsel assisted by Ms.V.Pushpa, learned Junior Standing Counsel appearing for the respondent Income Tax Department.

2. The assessee has filed the present Appeal under Section 260 A of the Income Tax Act, 1961, aggrieved by the order passed by the learned Income Tax Appellate Tribunal on 12.06.2015 for the Assessment Year 2009-2010.

3. The said appeal of the assessee was admitted by the Co-ordinate Bench of this Court on 29.07.2015 on the following substantial questions of law arising from the order of the learned Tribunal:-

> i. Whether in the facts and circumstances of the case, the Income Tax Appellate Tribunal is right in holding that there was a transfer within the meaning of clause (4) of Section 45 of the Income Tax Act, 1961?
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> ii. Whether in the facts and circumstances of the case, the Tribunal is right in holding that in the absence of an amendment of Section 2(47) of the Act, there is a transfer within the provisions of clause 4 of Sections 45 of the Income Tax Act, 1961?
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> iii. Whether on the facts and circumstances of the case, the Income Tax Appellate Tribunal was correct in law in sustaining the addition of interest under Section 234B of the Income Tax Act, 1961 since a charge was not created by the Assessing Officer as part of the order?

4. Both the learned counsels fairly agreed that the controversy involved in the present case is covered by a decision of a co-ordinate Bench of this Court, in which, one of us (Dr.Vineet Kothari,J.) was a party, decided on 08.04.2019 in T.C.A.Nos.365 and 366 of 2009 in “M/s. National Company Vs. The Assistant Commissioner of Income Tax”. The Cognate Bench of this Court, in that matter of M/s. National Company, on the issue whether on a reconstitution of a Partnership Firm, the asset transferred to the outgoing partner or amount paid to him attracts capital gains tax liability in the hands of the assessee/Partnership Firm or not in terms of Section 45(4) of

the Income Tax Act, The Division Bench of this Court held as under :-

> 20. It is also to be noted that on the retirement of a partner from the firm, there will be allotment of his interests in the firm. The interest of a partner in a partnership firm is a right to obtain share of profits from time to time during the subsistence of the partnership and further, on dissolution of the partnership, or on his retirement from the partnership, to get the value of his share in the net partnership assets which remain after deducting the debts and liabilities of the partnership. This could be in the form of immovable assets or in the form of cash in lieu of the immovable assets. Therefore, when a partner retires from a partnership and his share in the net partnership assets is determined and allotted to him, what he receives is his share in the partnership and not any consideration for transfer of his interest in the partnership to the continuing partners. His share in the partnership is worked out by taking accounts in the manner prescribed by the relevant provisions of the partnership law and it is this, namely, his share in the partnership which he receives in terms of money or as an asset. There is in this transaction no element of transfer of interest in the partnership assets by the retiring partner to the continuing partners.
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> 21. The transfer of a capital assets in order to attract capital gains tax must be one as a result of which consideration is received by the assessee or accrues to the assessee. When a partner retires from a partnership he receives his share in the partnership and this does not represent consideration received by him in lieu of relinquishment of his interest in the partnership asset.
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> 22. In Commissioner of Income Tax Vs. A.N.Naik Associates and Others reported in 2004 265 ITR 346 (Bom), the facts were that the respondents were parties to a family settlement dated 30.01.1997. Pursuant to the family settlement, there was a deed of reconstitution of various partnerships. One of the questions of law which had been formulated for consideration was whether the deed of reconstitution of partnership by the Assessee firm was a device to avoid tax. A further examination of the facts in that case reveal that it had been agreed between the parties that businesses of six firm would be distributed in terms of the family settlement, as the

parties desired that various matters concerning the business and the assets thereto be divided separately and partitioned. In the settlement, the manner in which the assets were proposed to be divided were set out. It was also provided that all such documents, deeds, declarations, affidavits as are reasonably required for effecting such transfer would be executed. The Assessment was based on the family settlement and the subsequent deeds of retirement of partnership. It is thus seen that there was a conscious decision taken prior to reconstitution of the firms to transfer assets and the liabilities by way of a family settlement. It was also consciously decided to execute all necessary deeds and documents to effect such transfer. A transfer of assets in such circumstances, though held was not a device to avoid tax was still held to be 'transfer' within the meaning of Section 2(47) of the Act.

23. In the light of the above facts, it was held in A.N.Naik Associates as follows:-

> "21. 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."

24. The above judgement was also referred in T.C.A.No. 1458 of 2005 decided on 31.10.2012, Commissioner of Income Tax, Trichy Vs. M/s. Nathan and Company, Trichy, by a Co-ordinate Bench of this Court. In that case, the Assessee was a firm constituted by six partners and running a printing press at Trichy and another at Chennai. They entered into an agreement on 28.04.1989 whereby two partners, were permitted to carry on the business under the same name at Chennai and four partners were permitted to carry on the business at Trichy in the same name. It is seen that in that case, there was definitely an element of transfer of assets since two of the partners gave up their interests in the business at Trichy and four of the partners gave up their interest in the business at Chennai. The facts are certainly distinguishable to the facts of the present case.

25. However a directly contrary view to the view taken in A.N.NaiK Associates have been expressed in Prashant S. Joshi Vs. The Income Tax Officer and Others reported in 2010 324 ITR 154 (Bom) wherein a Division Bench of the Bombay High Court, again dealing with a fact situation in respect of a partnership firm dealing with development of real estate, when a partner retired and agreed to receive sum of Rs.50 lakhs, in addition to the balance lying to his credit in the capital as reflected in the books of accounts as final settlement of his dues on account of retirement, held that the same was not a transfer and taxable under Section 45(4) of the Act. The reasoning of the Bombay High Court, is given below for better appreciation:-

> "13. During the subsistence of a partnership, a partner does not possess an interest in specie in any particular asset of the partnership. During the subsistence of a partnership, a partner has a right to obtain a share in profits. On a dissolution of a partnership or upon retirement, a partner is entitled to a valuation of his share in the net assets of the partnership which remain after meeting the debts and liabilities. An

amount paid to a partner upon retirement, after taking accounts and upon deduction of liabilities does not involve an element of transfer within the meaning of Section 2(47). Chief Justice P.N.Bhagwati (as the learned Judge then was) speaking for a Division Bench of the Gujarat High Court in Commissioner of Income Tax, Gujarat V. Mohanbhai Pamabhai MANU/GJ/0015/1971 : (1973) 91 ITR 393 dealt with the issue in the following observations:

... when, therefore, a partner retires from a partnership and the amount of his share in the net partnership assets after deduction of liabilities and prior charges is determined on taking accounts on the footing of notional sale of the partnership assets and given to him, what he receives is his share in the partnership and not any consideration for transfer of his interest in the partnership to the continuing partners. His share in the partnership is worked out by taking accounts in the manner prescribed by the relevant provisions of the partnership law and it is this and this only, namely, his share in the partnership which he receives in terms of money. There is in this transaction no element of transfer of interest in the partnership assets by the retiring partner to the continuing partners: vide also the recent decision of the Supreme Court in Commissioner of Income Tax v. Bankey Lal Vaidya. It is true that Section 2(47) defines “transfer” in relation to a capital asset and this definition gives an artificially extended meaning to the term “transfer” by including within its scope and ambit two kinds of transactions which would not ordinarily constitute “transfer” in the accepted connotation of that word, namely, relinquishment of the capital asset and extinguishment of any rights in it. But even in this artificially extended sense, there is no transfer of interest in the partnership assets involved when a partner retires from the partnership.

The Gujarat High Court held that there is, in such a situation, no transfer of interest in the assets of the partnership within the meaning of Section 2(47). When a partner retires from a partnership, what the partner receives is his share in the partnership which is working out by taking accounts and this does not amount to a consideration for the transfer of his interest to the continuing partners. The rationale for this is explained as follows in the judgement of the Gujarat High Court:

.... what the retiring partner is entitled to get is not merely a share in the partnership assets; he has also to bear his share of the debts and liabilities and it is only his share in the net partnership assets after satisfying the debts and liabilities that he is entitled to get on retirement. The debts and liabilities have to be deducted from the value of the partnership assets and it is only in the surplus that the retiring partner is entitled to claim a share. It is, therefore, not possible to predicate that a particular amount is received by the retiring partner in respect of his share in a particular partnership asset or that a particular amount represents consideration received by the retiring partner for extinguishment of his interest in a particular asset.

14. The appeal against the judgement of the Gujarat High Court was dismissed by a Bench of three learned Judges of the Supreme Court in Addl. Commissioner of Income Tax, Gujarat v. Mohanbhai Pamabhai : 165 ITR 166. The Supreme Court relied upon its judgement in Sunil Siddharthbhai v. Commissioner of Income Tax MANU/SC/0164/1985 : (1985) 156 ITR 509 (S.C.). The Supreme Court reiterated the same principle by relying upon the judgement in Addanki Narayanappa and Anr. Vs. Bhaskara Krishnappa and Ors. MANU/SC/0281/1966: (1966) SC 1300. The Supreme Court held that what is envisaged on the retirement of a partner is merely his right to realise his interest and to receive its value. What is realised is the interest which the partner enjoys in the assets during the subsistence of the partnership by virtue of his status as a

partner and in terms of the partnership agreement. Consequently, what the partner gets upon dissolution or upon retirement is the realisation of a pre-existing right or interest. The Supreme Court held that there was nothing strange in existing right or interest. The Supreme Court held that there was nothing strange in the law that a right or interest should exist in praesenti but its realisation or exercise should be postponed. The Supreme Court inter alia cited with approval the judgement of the Gujaraj High Court in Mohanbhai Pamabhai (supra) and held that there is no transfer upon the retirement of a partner upon the distribution of his share in the net assets of the firm. In Commissioner of Income Tax V. R.Lingmallu Raghukumar MANU/SC/0810/2001: (2001) 247 ITR 801, the Supreme Court held, while affirming the principle laid down in Mohanbhai Pamabhal that when a partner retires from a partnership and the amount of his share in the net partnership assets after deduction of liabilities and prior charges is determined on taking accounts, there is no element of transfer of interest in the partnership assets b y the retired partner to the continuing partners.

26. It is seen that Bombay High Court held in the above case that when a partner retires and there is transfer of his interests in the partnership assets to him towards his share in the assets, the same cannot be brought to tax as capital gain by transfer of capital asset.

27. In Sampath Iyengar's "Law of Income Tax" revised by S.Rajaratnam, 12th edition, it had been observed as follows:-

"134. Or otherwise.- There should ordinarily be no presumption of transfer in dissolution except to the extent directed under Section 45(4). Retirement is prima facie not covered by the sub-section. But the Departmental view is that the words "or otherwise" immediately succeeding "dissolution" under Section 45(4) would cover even retirement. "Or Otherwise" can only mean "before or after dissolution" in contradistinction to "on". Further Section 45(4) when understood in conjunction with Section 45(3) can refer to formations and dissolutions. Since change in constitution is a concept recognised in Chapter XVI-C of the Act, there is no reason why the law should not have referred to change in constitution along with dissolution, if that were the intent instead of the expression "or otherwise".

28. It is seen that even the learned author has expressed the view with that Section 45(4) of the Act would not apply on retirement of a partner from a partnership firm and when there is transfer of assets.

29. It may also be appropriate to refer to Commissioner of Income Tax Vs. R.Lingmallu Raghukumar reported in 2001 247 ITR 801 SC. The entire Judgement is quoted below:-

> "1. This appeal by the Revenue is directed against the Judgement of the Andhra Pradesh High Court dated July 21, 1982, (see (1983) 141 ITR 674), in Referred Case No. 28 of 1977, whereby the following question of law referred to the High Court was answered against the Revenue and in favour of the assessee (page 676):
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> "Whether, on the facts and in the circumstances of the case, the excess amount of Rs.46,500 received by the assessee on retirement from the two partnership firms is assessable to capital gains?"
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> 2. The High Court has held that there was no transfer of any assets as contemplated by the expression "transfer" as defined in Section 2(47) of the Income-tax Act. The High Court had placed reliance on the Judgement of the Gujarat High Court in CIT vs. Mohanbhai Pamabhai [1973] 91 ITR 393, wherein it has been held that where a partner retires from a partnership and the amount of his share in the net partnership assets after deduction of liabilities and prior charges is determined on taking accounts in the manner prescribed by the relevant provisions of the partnership law there is no element of transfer of interest in the partnership

assets by the retired partner to the continuing partners. The said Judgement of the Gujarat High Court has been affirmed by this Court in Addl.

CIT V. Mohanbhai Pamabhai [1987] 165 ITR 166. In view of the said Judgement we find no merit in this appeal and the same is, therefore, dismissed. No order as to costs."

30. It is thus seen that the Hon'ble Supreme Court had also held that on retirement, the settlement to a partner of his share in the assets of the partnership after deduction of liabilities is not assessable to capital gains.

31. In CIT Vs. Surendra Kumar Gupta reported in [2004] 270 ITR 325, the assets of the firm were taken over by one of the two partners on dissolution of the firm, on payment of an agreed amount to the other partner; it was held that the aforesaid transaction did not result in any transfer of asset as understood in common law.

32. In CIT Vs. Kunnamkulam Mill Board reported in [2002] 257 ITR 544 (Ker), it was held that on retirement of the partner of the firm, there is no transfer of the assets of the firm in favour of the continuing partners within the meaning of Section 45 (4) of the Act.

33. In the present case, very significantly, there was only a reconstitution of the partnership firm by retirement of two partners and admission of another partner. The partnership firm continued. It must also be further noted that the assets of the firm originally

belonged to the father of the retiring / continuing partners and there was only a division of the assets on retirement in accordance with their entitlement on the shares in the partnership. As pointed out earlier, the National Company was originally a sole proprietorship concern started by N.Munuswamy Mudaliar. It was in the business of construction and assets had been acquired even at that particular point of time. The two daughters and two sons-in-laws of N.Munuswamy Mudaliar were subsequently admitted as partners and on division of the assets, it can also be arguably pointed out that one daughter and one son-in-law were allotted a share which they were otherwise legally entitled to out of the holdings N.Munuswamy Mudaliar.

34. In view of the peculiar facts of the case in hand, we hold that the provisions of Section 45(4) would not be attracted on the retirement of the two partners and consequential allotment of their share in the assets in the Assessee Firm. We therefore answer the substantial question of law in favour of the Assessee and against the Revenue.

35. In the result, the Appeals of the Assessee are allowed. No costs.

5. The facts found by the learned Tribunal in the present case, are also quoted below for reference :-

"9. We have heard both the parties and carefully perused the materials available on record. The case of the assessee is very simple. During the year under consideration the assessee firm was reconstituted wherein one of the partners Mrs.Arunan Visvewar had retired and therefore reconstituted partnership deed was drawn on 30.05.2008 whereby the assessee firm has transferred one of its immovable asset being land to the retiring partner Mrs.Aruna Visvewar valued at Rs.9,04,10,000/- as mentioned in the partition deed entered between the firm and the outgoing partner. The question that arises before us is whether the transfer of land belonging to the firm to the retiring partner is liable to be taxed under the head "capital gains" and if so in whose hands. It is pertinent to mention here that the transfer of the asset is by the firm which is a "legal entity" to the retiring partner another distinct legal entity being an "individual". Therefore, it is crystal clear that capital gain will arise in the hands of the transferor viz. the assessee firm and not the transferee viz. the retiring partner Mrs.Aruna Visvewar. Provisions of Section 45(4) of the Act are reproduced herein below for reference:-

Section-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 purpose 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.

The words "OR OTHERWISE" have been elaborately explained in the following decisions:-

i) ACIT V. D.D.International (Global) [2009]125 TTJ (Asr.) 112

The word 'otherwise', used in Section 45(4) is not to be read ejusdem generis with dissolution of firm or AOP. The expression 'otherwise' has to be read with the words 'transfer of capital asset' by way of distribution of capital assets on the dissolution of a firm. The word 'otherwise' in Section 45(4) takes within its sweep not only cases of dissolution but also cases of subsisting partners of a partnership transferring assets to retiring partners.

(ii) New Gujarat Tin Printing Works V. ITO [2010] 8 taxmann.com 24/[2011] 128 ITD 182(Ahd.)

The word 'otherwise' as occurring in Section 45(4) covers a situation, where the capital asset of the firm is distributed to its partners otherwise than on dissolution of the firm.

(iii) CIT Vs. A.N.Naik Associates [2004] 136 Taxman 107/265 ITR 346(Bom.)

The expression 'otherwise' has not to be read ejusdem generis with the expression' dissolution of a firm or body of individuals 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 expression 'otherwise' as the object of the amending Act was to remove the loophole which existed whereby capital gain tax was not chargeable. Therefore, when the asset of the partnership is transferred to a retiring partner, the partnership which is assessable to tax cases 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 purpose and intent of the amendment of Section 45. Once that be the case, 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 are chargeable to tax u/s. 45(4). Therefore, 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.

(iv) Burlingtons Exports V. ACIT [1993] 45 ITD 424 (Bom. Trib.)

The words 'or otherwise' are used as an alternate to the words 'on dissolution' and therefore, in both the situations, i.e. on dissolution or otherwise, the distribution of a capital asset is a must.

From the above it is crystal clear that Section 45 (4) of the Act mandates the assessee firm to be liable for capital gain tax arising out of the transfer of its asset to the retiring partner even in the circumstances when the partnership is reconstituted on retirement of partner. Further, the loan taken by the assessee firm for purpose of the asset which is transferred cannot be factored because the loan does not alter the cost of the assets purchased or the value of the asset transferred to the transferee. Therefore, we do not have any hesitation to confirm the order of the Ld. CIT (A) as well as the order of the Ld. Assessing Officer.

10. In the result, the appeal of assessee is dismissed.

6. In view of the aforesaid agreement between the learned counsels, the present appeal of the assessee is also allowed in terms of judgment of this Court in the case of National Co. (supra) and the questions of law framed above are answered in favour of the assessee and against the Revenue. No costs. Connected miscellaneous petition is closed.

Sd/-
Assistant Registrar(CS VI)

//True Copy//

Sub Assistant Registrar

sni/sd

To

1. The Income Tax Officer,
 Ward - II(4), Range,
 Madurai.

2. Income Tax Appellate Tribunal,
 'D' Bench,
 Chennai.

3. The Commissioner of Income Tax (Appeal) I,
 Madurai.

+1cc to Mr.M.Swaminathan, Advocate Sr.79942

Tax Case (Appeal) No.716 of 2015

BS(CO)

srg 18/10/2019