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IN THE HIGH COURT OF JUDICATURE AT BOMBAY
ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX APPEAL NO. 137 OF 2017

Principal Commissioner of Income Tax-30,
Room No. 402, 4th Floor, Pratyaksh Kar Bhavan BKC, Bandra Mumbai 400 051 .....Appellant

V/s.

Electroplast Engineers,
143, Garuda House, Upper Govind Nagar, Malad (E), Mumbai 400097 .....Respondent

Mr. Arvind Pinto a/w Mr. N. C. Ranganayakulu
Mr. R. Murlidhar i/b Mr. Vaibhav Pandya for Respondent

CORAM : AKIL KURESHI &
SARANG V. KOTWAL, JJ.

DATE : 26th MARCH, 2019.

ORAL JUDGMENT: (PER AKIL KURESHI, J.)

This appeal is filed by the Revenue to challenge the Judgment of Income Tax Appellate Tribunal (ITAT for short). Following question was presented for our consideration:

> Whether in law and on the facts of the instant case, was the Tribunal correct in holding that there was no transfer of capital asset by way of

distribution at the time of making payment to the retiring partners.

2 Brief facts are as under.

(I) Respondent assessee a partnership firm, had filed return of income for the assessment year 2010-2011. The assessee was engaged in manufacturing of tubelight fittings and other lighting accessories for over 13 years. The firm was constituted under Partnership Deed dated 16/11/1996, originally consisting of two partners. On 15/01/2010, constitution of the firm underwent a change under a Deed of Reconstitution of partnership. Three new partners were admitted. On 16/01/2010, another Deed of Retirement cum Reconstitution of the partnership was executed by which the original two partners retired from the firm and the remaining three partners re-distributed their share in a partnership firm. The partnership created a goodwill account and a sum of Rs. 3.75 Crores (rounded of) was credited in the books of the firm in the said account. The retiring parters were paid sums of Rs. 2.97 Crores (rounded of) and 77.27 Lakhs (rounded of) respectively in proportion

of their shares in the partnership business.

(II) The Assessing Officer was of the opinion that in terms of section 45(4) of the Income Tax Act, 1961, (**the Act** for short) the firm had to pay short term capital gain tax on such amounts. The Assessing Officer was of the opinion that the goodwill credited by the firm of Rs. 3.75 Crores was nothing but the capital gain arising on distribution of the capital asset by way of dissolution of the firm or otherwise .

(III) The assessee carried the matter in appeal in which heavy reliance was placed on Full Bench Judgment of Karnataka High Court in the case of **Commissioner of Income-Tax and Another *v.* Dynamic Enterprises**[1]. The Commissioner agreed with the contention of the assessee that there was neither dissolution of the firm nor the firm was discontinued. He, however, held that the rights and interests in assets of the firm were transferred to the new members and in this manner there was transfer of capital asset. He was further of the opinion that Section 45(4) of the Act would apply

1 **[2013] 359 ITR 83 (Karn) [FB]**

in the present case which would cover even a case of transfer of capital asset otherwise than by dissolution of the firm.

(IV) The assessee carried the matter in further appeal before the Tribunal. The Tribunal by the impugned Judgment allowed the assessee's appeal. The Tribunal was of the opinion that the conditions required for applying section 45(4) of the Act were not satisfied in the present case. The Tribunal placed reliance on the decision of the Karnataka High Court in the case of Dynamic Enterprises (Supra). The Revenue has filed this appeal against the said Judgment of the Tribunal.

3 The counsel for the appellant submitted that decision of this Court in the case of **Commissioner of Income-Tax *v.* A. N. Naik Associates and Another**[2] would be applicable in the present case. The Tribunal has committed an error in proceeding on the basis that Section 45(4) of the Act would apply only in a case where there has been dissolution of the firm.

2 **[2004] 265 ITR 346 (Bom)**

4 On the other hand, the learned counsel for the assessee opposed the appeal contending that decision of this Court in the case of **A. N. Naik Associates** (Supra) concerned a question whether Section 45(4) of the Act would apply only in a case of dissolution of the firm and not in case of retirement of a partner. The Court was not concerned with the question of applicability of Section 45(4) of the Act without there being any transfer of capital asset. The Karnataka High Court in the case of **Dynamic Enterprises** (Supra) has noticed the decision of this Court in the case of **A. N. Naik Associates** (Supra) and held that when there is no transfer of capital asset, Section 45(4) will not apply.

5 Having thus heard the learned counsel for the parties, we may summarise the undisputed facts:

(I) Assessee firm was registered partnership firm, initially comprising of two partners. After carrying on the business for about 13 years, partnership was reconstituted to bring in three new partners. Almost immediately thereafter, a new Deed was executed

under which the original two partners retired. Newly inducted three partners of the firm continued the business of the firm and the assets were redistributed. While doing so, the partnership evaluated its goodwill. The retiring partners were paid their share in the goodwill in proportion of their existing shares in the partnership business.

(II) Section 45 of the Act pertains to computation of the capital gains. Sub Section 4 of Section 45 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 .*

6 As per this provision, profits or gains arising from transfer of capital asset by way of distribution of capital asset on dissolution of firm or otherwise shall be chargeable to tax as income of the firm. For application of this provision, thus, transfer of capital asset is necessary. Provisions of Section 45(4) of the Act came up for consideration before this Court in the case of **A. N. Naik Associates** (Supra). It was a case in which there was re-organization of the partnership in quick succession. The Court held that such re-organization would not amount to dissolution of the firm. The question in such background was whether Section 45(4) of the Act would apply in case there has been transfer of capital asset. The Court referred to legislative changes and observed that when the asset is transferred to the partner, that falls within the expression o therwise and the rights of the other partners in that asset of the partnership are extinguished. It was held that transfer of assets of the partnerhsip of the retiring partners would amount to transfer of capital assets.

7 This decision of the Court in the case of **A. N. Naik Associates**

(Supra) was considered by the Karnataka High Court in the Full Bench Judgment in the case of **Dynamic Enterprises** (Supra). The question considered by the court was when retiring partner takes only money towards value of his share, whether the firm should be made liable to pay capital gains even when there is no distribution of capital asset among the partners under section 45(4) of the Act. In the said case of **Dynamic Enterprises** (Supra), the partnership firm was engaged in the business of buying land and properties and construction of buildings thereon. The firm underwent reconstitution. Before such reconstitution the assets of the firm were revalued as per the report of the registered valuer. Three erstwhile partners retired. Retiring partners received enhanced value of the property upon retirement. In this context, the Court considered the above noted question. The Court held that after retirement of partners, the partnership continued and the business was also carried on by the remaining partners. There was thus no dissolution of the firm and there was no distribution of capital asset. What is given to the retiring partners was money representing the value of their share in the partnership. No capital asset was transferred on

the date of retirement. In absence of distribution of capital asset and in absence of transfer of capital asset in favour of retiring partners, no profit of gain arose in the hands of partnership firm. Following observations of the court may be noted:

> ***25.*** *In the instant case, the partnership firm had purchased the property under a registered sale deed in the name of the firm. The property did not stand in the name of any individual partners. No individual partners brought that capital asset as capital contribution into the firm. Five partners brought in cash by way of capital when the firm was reconstituted on April 28,1993. Nearly a year thereafter on April 1,1994, by way of retirement, the erstwhile three partners took their share in the partnership asset and went out of the partnership. After the retirement of three partners, the partnership continued to exist and the business was carried on by the remaining five partners. There was no dissolution of the firm or at any rate there was no distribution of capital asset on April 1,1994, when the three partners retired from the partnership firm. What was given to the retiring partners is cash representing the value of their share in the partnership. No capital asset was transferred on the date of retirement under the deed of retirement deed dated April 1,1994. In the absence of distribution of capital*

asset and in the absence of transfer of capital asset in favour of the retiring partners, no profit or gain arose in the hands of the partnership firm. Therefore, the question of the firm being assessed under Section 45(4) and charging them tax for the profits or gains which did not accrue to them would not arise.

26. *It was contended on behalf of the revenue that the five incoming partners brought money into the firm. Three erstwhile partners who retired from the partners on April 1, 1994, took money and left the property to the incoming partners. It is a device adopted by these partners in order to evade payment of profits or gains. As rightly held by this Court in Gurunath's case (supra) it is taxable. This argument proceeds on the premise that the immovable property belongs to the erstwhile partners and that after the retirement the erstwhile partners have taken cash and given the property to the incoming partners. The property belongs to the partnership firm. It did not belong to the partners. The partners only had a share in the partnership asset. When the five partners came into the partnership and brought cash by way of capital contribution to the extent of their contribution, they were entitled to the proportionate share in the interest in the partnership firm. When the retiring partners took cash and retired, they were not relinquishing*

their interest in the immovable property. What they relinquished is their share in the partnership. Therefore, there is no transfer of a capital asset, as such, no capital gains or profit arises in the facts of this case. In that view of the matter, Section 45(4) has no application to the facts of this case.

29. *In the instant case, the partnership firm did not transfer any right in the capital asset in favour of the retiring partner. The partnership firm did not cease to hold the property and consequently, its right to the property is not extinguished. Conversely, the retiring partner did not acquire any right in the property as no property was transferred in their favour. The Division Bench in Gurunath's case (supra) did not appreciate this distinguishing factor and by wrong application of the law laid down by the Bombay High Court held the assessee in that case is also liable to pay capital gains tax under Section 45(4). Therefore, the said judgment does not lay down the correct-law .*

8 The issue is thus similar to one considered by the Full Bench of Karnataka High Court and with which we are in respectful agreement. The decision of this Court in the case of **A. N. Naik Associates** (Supra) was rendered in slightly different background.

Central question was, would Section 45(4) apply even if there was no dissolution of the firm. Issue of transfer of capital asset was not the focal point. In the present case, admittedly there was no transfer of capital asset upon reconstitution of the firm. All that happened was the firm's assets were evaluated and the retiring partners were paid their share of the partnership asset. There was clearly no transfer of capital asset. Revenue has not argued that the reconstitution of the firm was a colourable device to avail tax liability.

9 In the result, we do not find any error in the view of Tribunal.

10 Income Tax Appeal is dismissed.

[SARANG V. KOTWAL, J.] **[AKIL KURESHI, J.]**