आयकर अपीलीय अधिकरण "जी" न्यायपीठ मुंबई में।

IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCH "G", MUMBAI

श्री डि. करुनाकर राव, लेखा सदस्य एवं

श्री अमित शुक्ला, न्यायिक सदस्य के समक्ष ।

BEFORE SHRI D. KARUNAKARA RAO, ACCOUNTANT MEMBER
AND SHRI AMIT SHUKLA, JUDICIAL MEMBER

ITA No. : 5363/Mum/2014
(Assessment year : 2010-11)

Electroplast Engineers, 142 Garuda House, Upper Govind Nagar, Malad (East), Mumbai -400 097 स्थयी लेखा सं.:**PAN: AAAFE 7927 N**	**Vs**	Asst. Commissioner of Income Tax -24(3), Pratyakshakar Bhavan, C-1, 7th Floor, Bandra Kurla Complex, Bandra (East), Mumbai -400 051
अपीलार्थी (Appellant		प्रत्यर्थी (Respondent)
Appellant by	:	Shri P Murlidhar Shri P C Jain
Respondent by	:	Shri Neil Philip

सुनवाई की तारीख /Date of Hearing : 04-08-2015

घोषणा की तारीख /Date of Pronouncement : 02-11-2015

आदेश
ORDER

अमित शुक्ला, न्या. स.:
PER AMIT SHUKLA, JM:

The aforesaid appeal has been filed by the assessee against impugned order dated 31.07.2014, passed by CIT(A)-34, Mumbai for the quantum of assessment passed u/s 143(3) for the assessment year 2010-11. In various grounds of appeal, the assessee has challenged the treatment of payment made to retiring partners of Rs. 3,75,08,859/- as transfer of capital assets by way of distribution & brining the same to tax as short-term-capital-gains in the hands of assessee firm.

2. Brief facts of the case are that, the assessee firm is engaged in the manufacturing of tube light fittings and other lighting

accessories for over a period of 13 years. The assessee firm came into existence vide partnership deed dated 16.11.1996, then consisting of two partners namely, Shri Ramratan Sohanlal Saraf and Shri Niraj Ramratan Saraf having share ratio of 75% and 25% respectively. During the year under appeal, i.e., on 15.01.2010, the constitution of the firm underwent a change in terms of "Deed of Reconstituted Partnership Deed" of the same date (15.01.2010) by which, 3 partners were admitted, wherein the profit sharing ratio underwent a change in the following manner :-

Ramratan Sohanlal Saraf	67.5%
Niraj Ramratan Saraf	17.5%
Pravin Kumar Agarwal	5%
Alok Kumar Agarwal	5%
Sudhir Kumar Agarwal	5%

Immediately thereafter, on 16.01.2010 a "Deed of Retirement-cum-Reconstitution of Partnership Deed" was made by which the earlier two partners, Ramratan Sohanlal Saraf and Shri Niraj Ramratan Saraf retired from the partnership firm and in the same deed, the continuing 3 partners have changed their sharing ratio in the following manner :-

Pravin Kumar Agarwal	40%
Alok Kumar Agarwal	30%
Sudhir Kumar Agarwal	30%

3. There was no dissolution or discontinuity of the firm or business. At the time of the retirement of the partners, the firm created an intangible asset in the books in the form of "Goodwill" for an amount of Rs.3,75,08,859/- and was distributed among the retiring partners amounting to Rs.2,97,86,447/- and Rs. 77,27,412/- between Shri Ramratan Sohanlal Saraf and Shri Niraj Ramratan Saraf, respectively. The AO observed that such a payment to the retiring partners amounts to distribution of capital asset on the dissolution of the firm which is taxable under section 45(4). Further, the firm, without revaluing the assets has created "goodwill" and paid the amount to the retiring partners, this also

tantamount to revaluation of the asset of the assessee firm at the time of the retirement of the partners. In response to the show cause notice as to why such a distribution of capital asset should be charged to tax as capital gain u/s 45(4), assessee submitted that the provision section 45(4) is not applicable to the assessee firm, because there is only change in the constitution of the firm and it is not a case of dissolution of the firm. However, the AO rejected the assessee's contention and held that the payment made to the partners is on account of transfer of a capital asset and same is chargeable u/s 45(4). While holding so, he has referred and relied upon the decision of Hon'ble Jurisdictional High Court in case of CIT vs. A.N. Naik Associates, reported in 265 ITR 346, wherein their Lordships have interpreted the expression "otherwise" as provided in section 45(4), which is to be read with the word transfer of capital assets by way of distribution, which not only includes cases of dissolution but also the case of subsisting partners of the partnership firm transferring the assets in favour of the retiring partners. Thus, he held that amount of goodwill created by firm at Rs.3,75,08,859/- is nothing but capital gain arising on distribution of capital asset of the firm by way of dissolution of firm or otherwise.

4. Before the first appellate authority, the assessee submitted that the decision of Hon'ble Bombay High Court in the case of CIT vs A N Naik Associates (*supra*) is not relevant to the present case, because in that case by way of Memorandum of family settlement, it was agreed that the business of those firms as set out therein would be distributed in terms of the family settlement and it was set out that all those assets or liabilities belonging to or due from any of the firm would be treated as "transfer", which here in this case, there is no transfer of any asset to the retiring partners. It was further brought to the notice of the Ld. CIT(A) that, Hon'ble Karnataka High Court in Full Bench decision in the case of CIT vs Dynamic Enterprises has distinguished the decision of Bombay

High Court in A.N. Naik Associates (supra) and disapproved its earlier decision in CIT vs Gurunath, Talkies, reported in [2010] 328 ITR 59. However ld. CIT(A), rejected the assessee's contention and held that payment of goodwill is nothing but payment on account of transfer of capital asset of the firm. He further held that creation of goodwill was a colourable device to camouflage the transaction. He also applied the principle of Mc Dowell & Co. Ltd [154 ITR 148] to confirm the addition made by the AO. The relevant observation and finding of the CIT(A) can be summarized in the following manner:-

firstly, the Ld. CIT(A), agreed with the contention of the assessee that neither there was any dissolution of the firm nor the firm was discontinued. The firm continued by its remaining partners with all its assets and there was no transfer of assets by way of distribution of capital asset, because no asset have gone out of the books of the firm whether tangible or intangible. However, he held that the rights and interest in the assets of the firm have been transferred to the new members on retirement of old partners and a new partners enjoyed the rights and interest in such a partnership, therefore, there is a transfer of capital asset within the meaning of the provisions of section 2(47) read with clause (b) (v) and (vi);

Secondly, Sub-section (4) of section 45 is clearly applicable as it was brought in the statute to take care of transfer of capital asset from the partners to the firm and form firm to its partners in certain situations. Here, in this case, the action of the firm by creating goodwill and by making payment in lieu thereof to the partners is nothing but distribution of assets to its retiring partners which has been done in an indirect manner by retaining the assets in the firm. Thus, he confirmed the order of the AO after detailed reasoning as given from pages 6 to 13 of the appellate order; and

Lastly, he strongly referred and relied upon the decision of Bombay High court in the case of A N Naik & Associates (*supra*) and Karntatka High Court decision in the case of Gurunath Talkies (*supra*).

5. Before us the Ld. Counsel, after referring to the Deed of reconstituted partnership and deed of retirement, submitted that, it is an undisputed position that there is no dissolution of the firm and the firm is continuing with the same name, brand, and business. There is no transfer of asset within the meaning of section 45(4). Even the goodwill continues with the assessee firm and it was created only for making the payment to the retiring partners on their respective share capital and there is no cost of acquisition of rights. The Ld. CIT(A) has failed to appreciate the correct position of law and also a decision of Full Bench of Karnataka High Court, wherein the decision relied upon by the CIT(A) have been distinguished or not accepted. In support, he filed a copy of the decision of the Karnataka High Court in the case of CIT vs. Dynamic Enterprises, judgment and order dated 16th February, 2013.

6. On the other hand, Ld. DR strongly relied upon the order of the CIT(A).

7. We have heard the rival contention, perused the relevant finding given in the impugned orders and also material placed on record. Here in this case, the basic facts which are undisputed are that, *firstly,* the original partnership firm continues and there is only reconstitution of the partners in the present assessment year; *secondly,* there is no dissolution of the firm as the firm is continuing by the remaining partners with the same business, hence there is no dissolution of the firm; *thirdly,* there is no transfer of asset by way of distribution of capital asset, because no asset has gone out of the books of account of the assessee firm;

and *lastly,* all the assets, tangible or intangible still continues with the assessee firm. All these facts have been noted and accepted by the CIT(A) in para 7 of the impugned order. What the assessee firm has done, it has created a "goodwill" account and distributed the amount among the retiring partners. It is not the case of the revenue that "goodwill" of the firm has been transferred, rather they have disputed the manner in which the goodwill has been created solely for the purpose of making the payment to the retiring partners. What the retiring partners have taken is, only money towards the value of their shares. Now in such a situation, whether it can be held that the assessee firm is liable to pay capital gain without there being any distribution of capital assets on dissolution of a firm, within the scope and meaning of section 45(4). Sub-section (4) of section 45 reads as under :-

> *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".*

From the plain reading of the aforesaid provisions, it is clear that, the condition precedents for attracting the chargeability of capital gain under sub-section (4) are as under:-

(1) *There should be a distribution of capital assets of a firm;*

(2) *Such distribution should result in transfer of a capital asset by firm in favour of the partner; and*

(3) *On account of the transfer there should be a profit or gain derived by the firm.*

(4) *Such distribution should be on dissolution of the firm or otherwise".*

Thus, the gain from transfer of a capital asset should be by way of a distribution of capital asset on a dissolution of a firm which shall

be chargeable to tax as an income of the firm, in other words, if there is no dissolution of the firm and resultant no distribution of capital asset, then there is no transfer of such asset by the firm in favour of a partner resulting into profits or gains to the firm, which can be said chargeable to tax as income in the hands of the firm. Here in this case, none of the conditions as given in sub-section (4) are applicable, because no capital asset of the firm has been extinguished or any transfer has been made in favour of the partner for acquiring any such interest on asset. Here in this case, the creation of a '*goodwill'* is merely a mode of making the payment to the retiring partners without having any impact of the capital asset 'tangible' or 'intangible'. There is no actual transfer of any asset from the firm to the retiring partners by which the firm ceases to have any right in the property tangible or intangible. There is no absolute title of any property acquired by the partners after being extinguished from the firm. Thus, it cannot be held that there is any transfer of asset chargeable to tax under the head "capital gain" within the ambit and scope of section 45(4).

8. Coming to the decision of Hon'ble Bombay High Court and decision of Karnataka High Court in the case of Gurunath (*supra*) as relied upon by the CIT(A), it is seen that Full Bench of the Karnataka High Court in the case of CIT vs Dynamic Enterprises, reported in [2013] 359 ITR 83 (Kar)(FB), has distinguished the case of the Bombay High Court on facts and dissented from the decision of its own Court in case of Gurunath Talkies (*supra*). In this case, the question of law referred for consideration of Full Bench was as under:-

"When a retiring partner takes only the money towards the value of his share, whether the firm should be made liable to pay capital gains even when there is no distribution of capital asset/assets among the partners under Section 45(4) of the I.T. Act?

Or

Whether the retiring partner would be liable to pay for the capital gains?"

Relevant facts and case of the revenue were as under :-

> *"4. M/s Dynamic Enterprises-the respondent herein is a partnership firm which came into existence on 09.01.1985 with Sri Anurag Jain and Sri Nirmal Kumar Dugar as its partners. The firm was engaged in the business of buying landed properties, constructions of buildings thereon, construction of industrial sheds, commercial complexes etc. On 13.04.1987, the firm was reconstituted by which Sir Nirmal Kumar Dugar retired from the partnership and L.P. Jain (father of Anrag Jain) entered the partnership as he showed his willingness to contribute capital for purchase of land to construct housing complex. The firm purchased land bearing Sy.No. 13/1, Jakkasandra Village, Begur Hobii, Bangalore South Taluk under a registered sale deed dated 13.5.1987 for a consideration of Rs. 2,50,000/-. Another reconstitution took place on 1.7.1991 by which Sri L.P. Jain retired from the firm and Smt. Pushpa Jain and Smt. Shree Jain were inducted as partners. The firm was reconstituted and five partners belonging to Khemka Group were inducted into the firm by a deed dated 28.04.1993. Before the reconstitution, the assets of the firm were revalued as per the report of the registered valuer on 28.03.1994. The three old partners retired through deed of retirement dated 01.04.1994. The old partners received the enhanced value of property in financial year 1994-95.*
>
> *5. As per the Assessing Officer there is transfer of property from old firm to the new firm on 01.04.1994. Hence, it is a transfer within the meaning of Section 2(47) of the I.T. Act. Accordingly, notice under Section 148 was issued on 27.03.2002. In reply to the said notice, the assessee-firm contended that it has paid the amount to the retiring partners standing on credit side in respect of capital accounts. There is no transfer of asset and therefore, they are not liable to pay any capital gains tax.*
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> *6. The Assessing Officer held that the land was purchased when the firm was having two partners, namely, Shri Anurag Jain and Shri L.P. Jain. The firm had done no business all through its existence. The receipt of rents and commission for assessment year 1994-95 were found as bogus. The immovable property was not utilized to earn paltry sums during the existence of the firm. The new partners were introduced and the old partners retired. This is a device adopted to transfer the immovable property. The incoming partners tried to evade capital gains tax as well as stamp duty and therefore, he held the capital gains tax is liable to be paid by the firm. In appeal, the appellate authority has affirmed the said order. The appellate authority held that the reconstitution of firm has taken place on 01.04.1994 i.e., nearly one year after the members of the Khemka family were introduced as partners. Therefore, it accepted the genuineness of the old firm as well as the new firm but it held it is a colourable device to evade payment of tax".*

9. Hon'ble Court after taking into consideration various decisions and analyzing the provisions of section 45 and sub-section (4) thereto; meaning of transfer as given in section 2(47);

section 14 of Indian Partnership Act; and also the various decisions of the Hon'ble Supreme Court, observed and held as under :-

> "24. *Therefore, in order to attract Section 45(4) of the Act, the capital asset of the firm should be transferred in favour of a partner, resulting in firm ceasing to have any interest in the capital asset transferred and the partners should acquire exclusive interest in the capital asset. In other words, the interest the firm has in the capital asst should be extinguished and the partners in whose favour the transfer is made should acquire that interest. Then only the profits or a gain arising from such transfer is liable to tax under Section 45(4) of the Act.*
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> 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 28.04.1993. Nearly a year thereafter on 01.04.1994 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 reaming five partners. There was no dissolution of the firm or at any rate there was no distribution of capital asset on 01.04.1994 when 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 01.04.1994. 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.*
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> 26. *It was contended on behalf of the revenue that five incoming partners brought money into the firm. Three erstwhile partners who retired from the partners on 01.04.1994 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 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.

27. In Gurunath's case (supra), the Division Bench of this Court followed the judgment of the Bombay High Court in the case of Commissioner of Income Tax vs A N Naik Associates – (2004) 265 ITR 346 (BOMBAy0. In Naik's case, the asset of the partnership firm was transferred to a retiring partner by way of a deed of retirement. A memorandum of family settlement was entered into and the business of those firms as set out therein was distributed in terms of the family settlement as the party desired that various matters consisting the business and assets thereto be divided separately and portioned. The term has also provided that such of those assets or liabilities belonging to or due from any of the firms allotted, the parties thereto in the schedule annexed shall be transferred or assigned irrevocably and possession made over and all such documents, deeds, declarations, affidavits, petitions, letters and alike as are reasonably required by the party entitled to such transfer would be effected. It is based on this document and subsequent deeds of retirement of partnership that the order of assessment was made holding that the assessee are liable for tax on capital gains.

28. In that context, the Bombay High Court held that when the assets 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 purpose and intent of amendment of Section 45. Once that be the case, the transfer of assets of the partnership to the retiring partners would be amount to the transfer of 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. In that context, it was held 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. It is in this context the Bombay High Court held that Section 45(4) was attracted. Therefore, to attract Section 45(4) there should be a transfer of a capital asset from the firm to the retiring partners, by which the firms ceases to have any right in the property which is so transferred. In order words, its right to property should stand extinguished and the retiring partners acquire absolute title to the property.

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 correct law".

10. Thus, in view of our discussion above and respectfully following the ratio, as discussed by the Full Bench of Hon'ble Karnataka High Court as aforesaid, we hold that there is no transfer of capital asset by way of distribution of capital asset at the time of making the payments to the retiring partners and therefore, no capital gain is chargeable to tax in hands of the assessee firm. Accordingly, order of the CIT(A) is set aside and addition made stands deleted. Thus, ground no. 1 as raised by the assessee is allowed.

11. In the result, appeal of the assessee is allowed.

Order pronounced in the open court on 2nd November, 2015.

Sd/-	Sd/-
(डि. करुनाकर राव)	(अमित शुक्ला)
लेखा सदस्य	न्याईक सदस्य
(D. KARUNAKARA RAO)	**(AMIT SHUKLA)**
ACCOUNTANT MEMBER	**JUDICIAL MEMBER**

Mumbai, Date: 2nd November, 2015

प्रति/Copy to:-

1) प्रत्यर्थी /The Respondent.
3) The CIT(A) -34, Mumbai.
4) The CIT -24, Mumbai.
5) विभागीय प्रतिनिधि "जी", आयकर अपीलीय अधिकरण, मुंबई/
The D.R. "G" Bench, Mumbai.
6) गार्ड फाईल \
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आदेशानुसार/By Order

उप/सहायक पंजीकार
आयकर अपीलीय अधिकरण, मुंबई
Dy./Asstt. Registrar
I.T.A.T., Mumbai

*चव्हान व.नि.स
*Chavan, Sr.PS