Revaluation of Assets of Partnership Firm – 'Transfer' under Section 45(4) – SC upholds Bombay HC Judgment in A N Naik Associates & Others

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The Supreme Court in the matter of Mansukh Dyeing and Printing Mills[1] has upheld the judgment of Bombay High Court in the AN Naik Associates & Others[2], which has interpreted the term 'otherwise' appearing in Section 45(4) of ITA[3] to include the instances of retirement of partners.

Before getting into the facts in the matter of Mansukh Dyeing and Printing Mills (supra), let us set us the context. The provisions of Section 45(4) were introduced through Finance Act, 1987. The said section stipulates that profits or gains arising from transfer of capital asset by way of distribution of capital assets on the dissolution of a firm or otherwise, shall be chargeable to tax as income of the firm of the previous year in which such transfer took place and for the purposes of Section 48, the fair market value of the asset as on the date of such transfer shall be the deemed to be full value of consideration.

Prior to introduction of Section 45(4), the distribution of capital assets by way of dissolution were exempted under Section 47(ii). However, the tax payers have distributed the revalued capital assets and used to take shelter of exemption under Section 47(ii). Hence, to plug the above abusive strategy, the provisions of Section 45(4) were brought in. As per the inserted sub-section (4) of Section 45, the firm is made taxable for the gain arising from transfer of capital assets that got distributed between the partners at the time of dissolution or otherwise.

Initially, the expression 'otherwise' appearing in Section 45(4) was not given due consideration. In a specific matter, the Bombay High Court in AN Naik Associates & Others (supra) had occasion to deal with that expression. The judgment in the above case assumes significance for understanding of the judgment of Supreme Court in Mansukh Dyeing and Printing Mills (supra) and let us proceed to understand the same.

In the matter of AN Naik Associates & Others – Bombay High Court:

The facts in AN Naik & Associates & Others (supra) were that by virtue of memorandum of family settlement, it is agreed between the parties thereto, that business of six firms would be distributed in terms of the family settlement as the parties desired that various matters concerning the business and assets thereto be divided separately and partitioned. Under the terms and conditions of the settlement, it was set out that the assets which are proposed to be divided in partition under family settlement are held by the firms and individual partners. With reference to the firms, the manner in which the firms were to be reconstituted by retirement and admission of new partners was also set out. It is also provided that such of those assets or liabilities belonging to or due from any of firms allotted to parties thereto in the schedule annexed to the family settlement 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 affected.

[1] 2022 (11) TMI 1180 – Supreme Court
[2] 2003 (7) TMI 46 – Bombay High Court
[3] Income Tax Act, 1961

In the above facts and consequent to family settlement, the subsequent deeds of retirement of partnership were executed, which formed the subject matter for the dispute before the Bombay High Court. The tax authorities have contended that the allocation of assets to retiring partner would constitute a transfer in hands of the firm and accordingly taxable under Section 45(4). The assessee contended that Section 45(4) deals with only dissolution and ***not retirement*** and accordingly allocation of assets to retiring partners is not covered therein.

The assessees in AN Naik & Associates & Others (supra) further contended that the phrase 'otherwise' used in Section 45(4) covers only cases which are similar to dissolution like deemed dissolution but does not intend to cover retirement. They have also contended that the retirement was carried by virtue of a family settlement and accordingly such family settlement would not result in transfer. The Assessing Officer rejected the above contention by stating that the firm was a device used to evade tax and the phrase 'otherwise' used in Section 45(4) covers retirement and accordingly held the assessee firm as taxable. The assessee approached the Commissioner (Appeals) who has rejected order of Assessing Officer. On subsequent appeal by Revenue, the Tribunal has held that the expression 'otherwise' has to be read ejusdem generis and would contemplate situations like deemed dissolution and consequently held that tax on capital gains was not chargeable, since on facts, the business continued and there was no dissolution to attract the obligation under section 45(4).

The Revenue further carried on the appeal before the High Court. The Court after setting the facts stated that the said question must be interpreted based on the jurisprudence available post insertion of section 45(3) and section 45(4). The Court stated that prior to the above insertions, it was understood the there is no distinction between partners and firm and accordingly the transactions between them cannot be said to fall under the ambit of transfer to attract any obligation under capital gains tax. The legislature by noticing that the firms were used to avoid taxes by taking the shelter of general principals of partnership, has inserted the section 45(3) to state that whenever a partner converts his personal asset to partnership asset, the said transaction falls under the definition of 'transfer' and accordingly tax has to be paid in terms of section 45(3). The Court stated, now by insertion of section 45(3), the said transaction is taxable and the consideration would be the amount recorded by the firm in its books.

In the same way, when a firm is dissolved/partner is retired and assets were allotted to the partners, the Supreme Court took the view that the same is working out the rights of the partners and there cannot be any transfer in such a situation to attract tax. It is submitted that this was the consistent view held by Supreme Court when it comes to transactions between firm/partner either at the time of retirement or dissolution, for which the provisions of Section 45(4) were introduced.

The High Court stated that the term 'otherwise' has to be interpreted keeping the intention behind the introduction of section 45(4) by the legislature. If the term 'otherwise' has to be interpreted only to mean dissolution and deemed dissolution, the entire reason why the subject section has been introduced gets otiose and accordingly held that the allocation of assets on retirement is also covered under the ambit of section 45(4). The Court stated that 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 firm.

The Court held that the expression 'otherwise' has not to be read ejusdem generis with expression 'dissolution of a firm or body or association of persons' ***but must be read with words 'transfer of capital asset' by way of distribution of capital assets. If such an interpretation is taken, it becomes clear that even when the firm is in existence and there is a transfer of capital assets it comes within***

the expression 'otherwise' as the object of amendment was to remove loophole which existed whereby capital gains tax was not chargeable.

With the above understanding of Bombay High Court in AN Naik Associates & Others (supra), let us proceed to understand the facts in Mansukh Dyeing and Printing Mills (supra).

In the matter of Mansukh Dyeing and Printing Mills – Supreme Court:

The Mansukh Dyeing and Printing Mills was formed with four partners (all brothers) namely Shri MH Doshi (MHD), Shri Manohar Doshi (MD), Shri VH Doshi (VHD) and Shri Hasmukhlal H Doshi (HHD). On 02.05.1991, vide a family settlement agreement, the ratio of MHD which used to be 25% in the firm was diluted to 12%. The balance 13% was given to three new partners Smt Rajan Doshi (RD), Shri Prakash Doshi (PD) and Shri Rajeev Doshi (RD). After certain time, MHD, MD and VHD retired and firm had HHD, RD, PD and RD as partners.

On 1.11.1992, the firm was again re-constituted and four more partners namely, Smt Vaishali Shah (VS), Smt Bhavana Doshi (BD), Smt Rupal Doshi (Rupal) and Ranjana Textile Private Limited (RTPL) were added and HHD and RD have retired.

On 1.01,1993, the assets of the firm were revalued, and an amount of Rs 17.34 Crores were credited to the accounts of the partners in their profit-sharing ratio. Two of existing partners, HHD and RD withdrew part of their capital (balance after the revaluation profit arising from the assets). The firm filed the return of income for Assessment Year (AY) 1993-94, showing income of Rs 3,18,760/-. The assessment was reopened and as a result of reassessment, an income of Rs 17.34 Crores was made towards the short-term capital gain under Section 45(4).

The Assessing Officer (AO) opined that since the firm has revalued the assets from Rs 21 lakhs to Rs 17.56 Crores, the gain arising from revaluation of assets, amounting to Rs 17.34 Crores, which was credited to capital accounts of partner were brought to tax under Section 45(4) as short-term capital gains, since the firm claimed depreciation on the said assets.

The Commissioner (Appeals) has confirmed the order of AO by stating that there is a clear distribution of assets as partners have also withdrawn amounts from the capital accounts. The Commissioner (Appeals) further stated that the value of assets which commonly belonged to all the partners have been irrevocably transferred in their profit-sharing ratio to each partner. The Commissioner (Appeals) has relied on the Bombay High Court judgment of AN Naik Associates & Others (supra) and distinguished the decision of Texspin Engg and Mfg Works[4].

When the matter reached the ITAT[5], by relying on the decision of Supreme Court in Hind Construction Limited[6] , the Tribunal stated that revaluation of assets and crediting to partners account did not involve any transfer. When the matter reached High Court, the decision of Tribunal was upheld for the same reason as stated by Tribunal.

Finally, the matter has been challenged before the Supreme Court by the Revenue. The Revenue contended that the judgment in Hind Construction Limited (supra) should not be applicable to the facts in the instant case, because the said judgment is prior to insertion of Section 45(4). Further, Revenue contended that the decision of Bombay High Court in AN Naik Associates & Others (supra)

[4] (2003) 263 ITR 345 (Bom)
[5] Income Tax Appellate Tribunal
[6] (1972) 4 SCC 460

lays down the law in correct manner and accordingly the same needs to be applied. On the other hand, the firm contended that, there cannot be transfer for the sole reason that the revalued amount is credited to the capital accounts of the partner. The accounting standards also stipulate the same methodology. Further, the firm contended that the provisions of Section 45(4) only cover the instances of dissolution and not retirement. Since in the instant facts, the firm was not dissolved, they cannot be brought to tax under Section 45(4).

Thus, the Supreme Court is seized with the question that, whether the distribution of capital assets at the time of retirement is also covered under the ambit of Section 45(4)? The Supreme Court after referring to the decision of Bombay High Court in AN Naik Associates & Others (supra) has stated that in the facts of the firm, the assets were revalued, and the revalued amount was credit to the partners capital account in their partner's profit-sharing ratio. The said credit of assets revaluation amount to capital accounts of partners can be said to be in effect distribution of assets valued at Rs 17.34 Crores. The Supreme Court has held that the assets so revalued and the credit to the capital accounts of respective partners can be said to be 'transfer' and falls under the ambit of 'otherwise' as specified in Section 45(4).

Accordingly, the Supreme Court upheld the judgment of Bombay High Court in AN Naik Associates & Others (supra) and stated that reliance on Hind Constructions Limited (supra) by ITAT and High Court is not correct, since the said judgment was prior to insertion of Section 45(4).

Concluding Remarks:

The concept of taxation of partners at the time of retirement or dissolution is quite an ambiguous one. The concept of taxation of distribution of assets to partners has been redrafted in order to provide much clarity on taxation of such transfers. The above concept of section 45(4) has been changed to section 9B which states that transfer of capital asset is taxable if there is any dissolution or 'reconstitution' of the firm. Further, the word reconstitution has been specifically defined under section 9B which *inter alia* includes change in shareholding of partners. Further, section 45(4) has been redrafted to deal with situation where the partner receives any amount at the time of reconstitution of the firm. We have made research on the aspects that surround both the above events, pre[7] and post insertion of Section 9B[8]. The Supreme Court following the decision of Bombay High Court in AN Naik Associates & Others is a strong blow to all the pending assessments, where the assessees have taken a stand that retirements are not covered under Section 45(4).

[7] Partner vis-à-vis Capital Gains | SBS | Pre Section 9B
[8] Partner vis-à-vis Capital Gain - Version 2.0 | SBS | Post Section 9B