IN THE HIGH COURT OF KARNATAKA AT BANGALORE

DATED THIS THE 16TH DAY OF SEPTEMBER 2013

PRESENT

THE HON'BLE MR. JUSTICE N. KUMAR

AND

THE HON'BLE MR. JUSTICE S. ABDUL NAZEER

AND

THE HON'BLE MR. JUSTICE V. SURI APPA RAO

I.T.A.NO.1414/2006

BETWEEN:

1. THE COMMISSIONER OF INCOME TAX
   CENTRAL CIRCLE, C.R.BUILDING
   QUEENS ROAD, BANGALORE

2. THE INCOME TAX OFFICER
   WARD – 10(1), C.R.BUILDING
   QUEENS ROAD, BANGALORE ...APPELLANTS

(BY SRI K. V. ARAVIND, ADVOCATE)

AND:

M/s DYNAMIC ENTERPRISES
38/3, BLOCK – 2
SRI LAKSHMI INDUSTRIAL COMPLEX

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HOSUR MAIN ROAD, GARVEBHAVI PALYA
BOMMANAHALLI, MADIVALA POST
BANGALORE – 560068 ...RESPONDENT

(BY SRI G.SARANGAN, SR. COUNSEL FOR
SRI K.S.RAMABADRAN, ADVOCATE)

THIS ITA IS FILED 260-A OF I.T.ACT, 1961 ARISING OUT OR ORDER DATED 02.03.2006 PASSED IN ITA No.1295/BANG/2004, FOR THE ASSESSMENT YEAR 1995-1996, PRAYING THAT THIS HON'BLE COURT MAY BE PLEASED TO FORMULATE THE SUBSTANTITAL QUESTION OF LAW STATED THEREIN, ETC.

THIS ITA COMING ON FOR HEARING THIS DAY, ***N.KUMAR J.***, DELIVERED THE FOLLOWING:

J U D G M E N T

A Division Bench of this Court felt that there is a conflict between the proposition of law laid down in the case of ***Commissioner of Income Tax Vs. Mangalore Ganesh Beedi Works*** reported in ***(2004) 265 ITR 658*** and in the case of ***Commissioner of Income Tax And Another Vs. Gurunath Talkies*** reported in ***(2010) 328 ITR 59.*** In order to resolve the said conflict, this matter was referred to the Full Bench by order dated 31.07.2012. On such reference,

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Hon'ble Chief Justice has passed an order on 27.08.2013 directing the matter to be listed before this Bench.

SUBSTANTIAL QUESTION OF LAW

2. The substantial questions of law referred for our consideration are 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?"

FACTUAL MATRIX

3. Before we proceed to answer the said substantial questions of law, it is necessary to have a look at the factual background.

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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 Sri Nirmal Kumar Dugar retired from the partnership and L.P. Jain (father of Anurag 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 Hobli, 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.

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Before the reconstitution, the assets of the firm were revalued as per the report of the registered valuer on 28.03.1993. 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.

6. The Assessing Officer held that the land was purchased when the firm was having two partners, namely, Shri Anurag Jan and Shri L.P.Jain. The firm had done no

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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.

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FINDING OF THE TRIBUNAL

7. Aggrieved by the said order, the assessee preferred an appeal to the Tribunal. The Tribunal held that reconstitution of the firm has taken place on 01.04.1994 i.e., nearly one year after the members of the Khemka family were introduced as partners. The difference between the value determined on account of the revaluation and the book value was credited in the capital account of the partners in the profit share ratio on reconstitution of the firm as on 01.04.1994. The retiring partners have withdrawn their capital as standing in the books of accounts of the firm. As per Section 45 of the Income Tax Act, profit and gains arising from the transfer of a capital asset is chargeable under the head "capital gains". Hence to levy capital gains tax there should be an asset and there should be transfer in respect of that asset. The word 'transfer' is defined in Section 2(47) of the I.T. Act. As per this definition, transfer includes sale, exchange or relinquishment of the asset. It also includes extinguishment of any rights in the asset. Hence to complete

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the process of transfer there should be a person who is having a right in an asset and then such right is either sold, exchanged or relinquished to another person. In the instant case, the firm was reconstituted as on 01.04.1994 to continue the same business. The firm has not relinquished any right in the land. The land is being owned by the firm. The return filed by the firm for the assessment year 1995-1996 was of the reconstituted firm and not of the old firm and therefore, there is no transfer as on 01.04.1994 by the reconstituted firm. The revenue has charged capital gains tax in the hands of the reconstituted firm. Relying on the judgments of several High Courts as well as the Supreme Courts it held that the reconstituted firm cannot be termed as a transferor even for the arguments sake. There is no transfer and the firm is not liable to pay capital gains tax. Aggrieved by the said order the present appeal is filed.

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RIVAL CONTENTIONS

8. The learned counsel for the revenue contended that five partners brought money into the firm as their capital contribution and the erstwhile partners received the money and relinquished their interest in the capital asset in favour of the incoming partners, and accordingly it amounts to transfer of the capital asset, which results in capital gain as such they are liable to tax under Section 45(4) of the Act. The transaction falls within the ambit of the word "otherwise" in Section 45(4) of the Act. Even otherwise it is a devise adopted by the partners to evade payment of profits or gains and taxable.

9. Per contra, the learned counsel for the assessee contended that in order to attract Section 45(4), the condition precedent is that there should be a dissolution of the firm and distribution of capital asset in which the outgoing partners should acquire interest in the capital asset and consequently the firm should cease to have any interest

in the capital asset so transferred. The profit or gain arising from such transfer of a capital asset is taxable, under Section 45(4) of the Act, which is not the case on hand.

10. It is in this background we have to notice the conflicting judgments of this Court, which resulted in this reference and resolve the conflict.

CONFLICTING JUDGMENTS

11. Before the Division Bench reliance was placed on the judgment of this Court in the case of ***Commissioner of Income Tax and Another Vs. Gurunath Talkies*** reported in ***(2010) 328 ITR 59***. This Court in paras 24 to 28 has made the following observations:

> *"24. In this view of the matter we answer the first question in the affirmative in favour of the Revenue holding that there was a transfer of capital asset attracting the capital gain transaction in terms of s.45(4) of the Act.*

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25. The second question is answered in the negative in favour of the Revenue and against the assessee holding that the judgments which were noticed by the Tribunal were in the context of the law as it existed prior to its amendment in the year 1987. Finance Act of 1987 having expressly and with definite purpose brought about the amendment to IT Act reintroducing sub-ss. (3) and (4) to s. 45 of the Act, the Tribunal should have examined the appeal before it merely by applying the statutory provisions as it prevailed during the accounting period relevant to the assessment year 1994-95 and not merely by following the principles, the ratio of the judgment of the Supreme Court which had been rendered slightly in a different context. Though Mr.Shankaranarayana Rao, learned counsel for the assessee would submit that the assessee had not indulged in any suppression or mis-representation and that the transactions were genuine and has been clearly disclosed in the return and therefore in the situation never warranted a levy of penalty as it was proposed in the assessment order and also does not warrant levy of interest, as a consequence of this appeal

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being allowed, it automatically restores the levy of interest; we are afraid that the Tribunal having not looked into this aspect and having merely examined merits of the appeal before it as to there being loss and there being gain and as this question is now answered against the assessee, there is no scope for us to independently examine the question of levy of interest. It remains.

26. However, we notice the question of penalty is an independent proceeding and it is open to the assessee to urge such defence as is available to the assessee in an appropriate proceeding rather than to elicit a finding in this appeal.

27. Mr.Rao has brought to our notice that in respect of judgment of the Bombay High Court in A.N.Naik's case (supra)and also the judgment of our High Court in Suvardhan's case (supra) SLPs have been preferred by the assessee and leave has been granted to appeal and appeals are pending.

28. May be the position is that but on that premise we do not think we should keep this appeal

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pending without answering the questions raised in this appeal as the law which governs the field has been applied and questions are answered herein. There is no question of postponing the decision in this appeal any further."

12. Then the Division Bench noticed the judgment of this Court in the case of ***Commissioner of Income Tax Vs. Mangalore Ganesh Beedi Works*** reported in ***(2004) 265 ITR 658*** held at para-20 as under:

"20. In view of the above statutory provisions and the law laid down by the Supreme Court it appears reasonable to hold that though the firm stood dissolved on 5th December 1987, for a limited purpose of winding up of the affairs of the firm, it continued till its assets and business were sold as a going concern on 20th November 1994. Therefore, the firm continued to hold the properties as owner till 20th November 1994.

For the foregoing reasons, we hold that there was no distribution of capital assets of the firm despite its dissolution and, therefore, the firm could

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not have been made liable for paying capital gains tax in terms of s.45(4) of the Act."

13. In ***Gurunath's*** case (supra), this Court held in view of the series of transactions such as reconstitution of firm twice; once in July, 1994 and another in December, 1994 and the entire assets retained in the hands of the newly added two partners, results in transfer of assets of the firm in the sense that the assets of the firm as had been held by the erstwhile partners is transferred to the newly added two partners though all along the assets of the firm continued in the hands of the firm. Therefore, it was held that there is transfer of capital assets within the meaning of Section 2(47).

14. In ***Mangalore Ganesh Beedi Works's*** case (supra), after the dissolution of the firm, its business was continued by association of persons comprised of all the erstwhile 13 partners by using the assets as well as the name of the dissolved firm. Therefore, till the date of

dissolution, the name "Mangalore Ganesh Beedi Works" was of the partnership firm. Whereas, after the dissolution, it became the name of the association of persons comprised of all the erstwhile partners of the dissolved firm. In that context it was held though the firm stood dissolved on December 5th 1987, for a limited purpose of winding up of the affairs of the firm, it continued till its assets and business were sold as a going concern on November 20th 1994. Therefore, the firm continued to hold the properties as owner till November 20th 1994. In those circumstances, there was no distribution of capital assets of the firm despite its dissolution and therefore the firm could not have been made liable for paying capital gains tax in terms of Section 45(4) of the Act. It is in this background, we have to resolve the conflict between these two decisions.

STATUTORY PROVISIONS

15. In the instant case, the assessee is sought to be taxed under Section 45(4) of the Act on the ground that there

is a transfer of the properties of the partnership firm. Section 45(1), (3) and (4) of the Income Tax Act reads as under:

> *"45. **Capital Gains**.- [(1)] Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections [***] [54, 54B, [***] [[54D, [54E, [54EA, 54EB,] 54F [, 54G and 54H]]]]], be chargeable to income tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.*
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> *xxx xxx xxx*
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> *[(3) The profits or gains arising from the transfer of a capital asset by a person to a firm or other association of persons or body of individuals (not being a company or a co-operative society) in which he is or becomes a partner or member, by way of capital contribution or otherwise, shall be chargeable to tax as his income of the previous year in which such transfer takes place and, for the purposes of section 48, the amount recorded*

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in the books of account of the firm, association or body as the value of the capital asset shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.

(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 result of the transfer]"

16. The word 'transfer' has been defined in Section 2(47) of the Act as under:-

"Transfer", in relation to a capital asset, includes,-

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(i) *the sale, exchange or relinquishment of the asset; or*

(ii) *the extinguishment of any rights therein; or*

(iii) *the compulsory acquisition thereof under any law; or*

(iv) *in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment;][or]*

[(iva) *the maturity or redemption of a zero coupon bond; or]*

[(v) *any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882 (4 of 1882); or*

(vi) *any transaction (whether by way of becoming a member of, or acquiring*

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shares in, or co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

Explanation.- For the purpose of sub-clauses (v) and (vi), "immovable property" shall have the same meaning as in clause (d) of section 269UA;]"

17. Section 14 of the Indian Partnership Act, 1932 deals with the property of the firm, which reads as under:-

"14. The property of the firm – Subject to contract between the partners, the property of the firm includes all property and rights and interests in property originally brought into the stock of the firm, or acquired, by purchase or otherwise, by or for the firm, or for the purposes and in the course of the business of the firm, and includes also the goodwill of the business.

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Unless the contrary intention appears, property and rights and interest in property acquired with money belonging to the firm are deemed to have been acquired for the firm."

18. The Apex Court in the case of ***Narayanappa vs. Bhaskara Krishnappa*** reported in ***AIR 1966 SC 1300*** dealing with the concept of partnership held as under:-

"The Whole concept of partnership is to embark upon a joint venture and for that purpose to bring in as capital money or even property including immovable property. Once that is done, whatever is brought in would cease to be the exclusive property of the person who brought it in. It would be the trading asset of the partnership in which all the partners would have interest in proportion to their share. The person who brought it in would, therefore, not be able to claim or exercise any exclusive right over any property which he has brought in, much less over any other partnership property. He would not be able to exercise his right even to the extent of his share in the partnership. His right during the

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subsistence of the partnership is to get his share of profits from time to time as may be agreed upon among the partners and after the dissolution of the partnership or with his retirement from the partnership, of the value of his share in the net partnership assets as on the date of dissolution or retirement after a deduction of liabilities and other prior charges."

19. The Supreme Court in the case of ***Malbar Fisheries Co. vs. CIT*** reported in ***(1979) 120 ITR 49*** explaining the position of a partnership under the Partnership Act as well as Income Tax Act held as under:-

"A Partnership Firm under the Indian Partnership Act, 1932, is not a distinct legal entity apart from the partners constituting it and equally in law the Firm as such has no separate rights of its own in the Partnership Assets and when one talks of firm's property or the firm's assets all that is meant is property or assets in which all partners have a joint or common interest. It can not, therefore, be said that, upon

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dissolution, the firm's rights in the partnership assets are extinguished. It is the partners who own jointly or in common the assets of the partnership and, therefore, the consequence of the distribution, division or allotment of assets to the partners which flows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between partners and there is no question of any extinguishment of the firm's rights in the partnership assets amounting to a transfer of assets within the meaning of sec.2(47) of the IT Act, 1961. There is no transfer of assets involved even in the sense of any extinguishment of the firm's rights in the partnership assets when distribution takes place upon dissolution.

In order to attract S.34(3)(b) it is necessary that the sale or transfer of asset must be by the assessee to a person. Dissolution of a firm must, in point of time, be anterior to the actual distribution, division or allotment of the assets that takes place after making accounts and discharging the debts and liabilities due by the Firm. Upon dissolution the firm ceases to exist; then follows the making up of accounts, then the discharge of debts and liabilities and thereupon

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distribution, division or allotment of assets takes place inter se between the erstwhile partners by way of mutual adjustment of rights between them. The distribution, division, or allotment of assets of the erstwhile partners, it not done by the dissolved firm."

20. The Apex Court in the case of ***Sunil Siddharthbhai vs. Commissioner of Income Tax, Ahmedabad*** reported in ***(1985) Vol. 156 ITR 509 (SC)*** at pages 518, 519, 520 and 522 held as under:-

"When a partner brings in his personal asset into a partnership firm as his contribution to its capital, an asset which originally was subject to the entire ownership of the partner becomes now subject to the rights of other partners in it. It is not an interest which can be evaluated immediately. It is an interest which is subject to the operation of future transactions of the partnership, and it may diminish in value depending on accumulating liabilities and losses with a fall in the prosperity of the partnership

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firm. The evaluation of a partner's interest takes place only when there is a dissolution of the firm or upon his retirement from it. It has some times been said, and we think erroneously, that the right of a partner to a share in the assets of the partnership firm arises upon dissolution of the firm or upon the partner retiring from the firm. We think it necessary to state that what is envisaged here is merely the right to realise the interest and receive its value. What is realised is the interest, which the partner enjoys in the assets during the subsistence of the partnership firm by virtue of his status as a partner and in accordance with the terms of the partnership agreement.

What the partner gets upon dissolution or upon retirement is the realisation of a pre-existing right or interest. It is nothing strange in the law that a right or interest should exist in praesenti but its realisation or exercise should be postponed. Therefore, what was the exclusive interest of a partner in his personal asset is, upon its introduction into the partnership firm as his share to the partnership capital, transformed into an interest shared with the other partners in that asset. Qua that asset, there is a shared interest.

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During the subsistence of the partnership, the value of the interest of each partner qua that asset cannot be isolated or carved out from the value of the partner's interest in the totality of the partnership assets. And in regard to the latter, the value will be represented by his share in the net assets on the dissolution of the firm or upon the partner's retirement.

What is the profit or gain which can be said to accrue or arise to the assessee when he makes over his personal asset to the partnership firm as his contribution to its capital? The consideration, as we have observed, is the right of a partner during the subsistence of the partnership to get his share of profits from time to time and after the dissolution of the partnership or with his retirement from the partnership to receive the value of the share in the net partnership assets as on the date of dissolution or retirement after a deduction of liabilities and prior charges. When his personal asset merges into the capital of the partnership firm a corresponding credit entry is made in the partner's capital account in the books of the partnership firm, but that entry is made merely for the purpose of adjusting the rights of

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> *the partners inter-se when the partnership is dissolved or the partner retires. It evidences no debt due by the firm to the partner. Indeed, the capital represented by the notional entry to the credit of the partner's account may be completely wiped out by losses which may be subsequently incurred by the firm, even in the very accounting year in which the capital account is credited. Having regard to the nature and quality of the consideration which the partner may be said to acquire on introducing his personal asset into the partnership firm as his contribution to its capital it cannot be said that any income or gain arises or accrues to the assessee in the true commercial sense which a business man would understand as real income or gain."*

21. Under the provisions of the Partnership Act, 1932, the firm is not recognized as a legal entity. A Partnership Firm is not a distinct legal entity apart from the partners constituting it. In law the Firm as such has no separate rights of its own in the Partnership Assets. When one talks of firm's property or the firm's assets all

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that is meant is property or assets in which all partners have a joint or common interest. The Whole concept of partnership is to embark upon a joint venture and for that purpose to bring in as capital money or even property including immovable property. Once that is done, whatever is brought in would cease to be the exclusive property of the person who brought it in. It would be the trading asset of the partnership in which all the partners would have interest in proportion to their share. The property of the firm includes all property and rights and interests in property originally brought into the stock of the firm, or acquired, by purchase or otherwise, by or for the firm, or for the purposes and in the course of the business of the firm, and includes also the goodwill of the business. Property and rights and interest in property acquired with money belonging to the firm are deemed to have been acquired for the firm. When a partner brings in his personal asset into a partnership firm as his contribution to its capital, an asset which originally was

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subject to the entire ownership of the partner becomes now subject to the rights of other partners in it. When his personal asset merges into the capital of the partnership firm a corresponding credit entry is made in the partner's capital account in the books of the partnership firm, but that entry is made merely for the purpose of adjusting the rights of the partners inter-se when the partnership is dissolved or the partner retires. His right during the subsistence of the partnership is to get his share of profits from time to time as may be agreed upon among the partners and after the dissolution of the partnership or with his retirement from the partnership, of the value of his share in the net partnership assets as on the date of dissolution or retirement after a deduction of liabilities and other prior charges. Dissolution of a firm must, in point of time, be anterior to the actual distribution. Division or allotment of the assets that takes place after making accounts and discharging the debts and liabilities due by the Firm. The distribution, division, or allotment

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of assets of the erstwhile partners, is not done by the dissolved firm. It is the partners who own jointly or in common the assets of the partnership and, therefore, the consequence of the distribution, division or allotment of assets to the partners which flows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between partners and there is no question of any extinguishment of the firm's rights in the partnership.

22. However, the Income Tax Act recognizes the firm as a distinct assessable legal entity apart from its partners. Sub-sections (3) and (4) of Section 45 were introduced by Finance Act, 1987, which came into effect from 01.04.1988. In sub-section (3) what is sought to be taxed is the profits or gains arising from the transfer of a capital asset by a person to a firm or other association of persons or body of individuals. After such transfer, he is or becomes a partner or member, by way of capital contribution or otherwise. Then the said capital

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contribution shall be chargeable to tax as his income of the previous year in which such transfer takes place and, for the purposes of section 48, the amount recorded in the books of account of the firm, association or body as the value of the capital asset shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset. When a partner brings in his personal asset into a partnership firm as his contribution to its capital, an asset which was originally exclusively belonging to him, becomes the trading asset of the firm, in which all partners acquire interest in proportion to their respective share in the firm. His right during the subsistence of the partnership is to get his share of profits from time to time as agreed upon among the partners. On dissolution of the firm or on retirement from the firm to get the value of his share in the net partnership asset as on the date of dissolution or retirement. Therefore, this is a case of a partner bringing

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capital asset to a partnership firm as his capital contribution.

23. Sub-section (4) of Section 45 deals with a distribution of capital assets on the dissolution of a firm or other association of persons or body of individuals or otherwise. If in the course of such distribution of capital asset there is a transfer of a capital asset by the firm in favour of a person and it results in profits or gains to the firm, then the said profits or gains shall be chargeable to tax as income of the firm and again for computing such income, Section 48 is attracted. In other words, in the process of a dissolution of a firm, if a capital asset is transferred to a partner which results in profits or gains, then that income is chargeable at the hands of the firm under this provision. In order to attract sub-section (4) of Section 45, the condition precedent is,

(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*

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(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.

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 asset should be extinguished and the partners in whose favour the transfer is made should acquire that interest. Then only the profits or gains arising from such transfer is liable to tax under Section 45(4) of the Act.

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

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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 remaining 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

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for the profits or gains which did not accrue to them would not arise.

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 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

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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 ***Commissioner of Income Tax Vs. A.N.Naik Associate - (2004) 265 ITR 346 (BOMBAY).*** 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

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assets thereto be divided separately and partitioned. 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 assesses 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 the purpose and intent of the amendment of Section 45. Once

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that be the case, the transfer of assets of the partnership to the retiring partners would 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 other words, its right to the property should stand extinguished and the retiring partners acquires 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

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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.

30. We would like to add that several other aspects of Section 45(4) was addressed in the course of the arguments by both sides which are not relevant to adjudicate the present issue, as in the present case there is no distribution of assets and hence, one of the condition precedent for invoking Section 45(4) does not exist and hence Section 45(4) is not attracted to the facts of this case.

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ANSWER

31. The reference is answered as under:

> "When a retiring partner takes only money towards the value of his share and when there is no distribution of capital asset/assets among the partners there is no transfer of a capital asset and consequently no profits or gains is payable under Section 45(4) of the Income Tax Act?"

32. In so far as the substantial question of law "whether the retiring partner would be liable to pay capital gain" is concerned, the said question does not arise for consideration in the appeal as the only question which arose for consideration was, whether the firm is liable to pay capital gain tax. Therefore, the said question of law is not answered.

33. For the aforesaid reasons, we pass the following:

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ORDER

(i) The substantial question of law is answered in favour of the assessee and against the revenue.

(ii) Consequently, the appeal stands dismissed.

(iii) No costs.

Sd/-
JUDGE

Sd/-
JUDGE

Sd/-
JUDGE

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