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Partner vis-à-vis Capital Gains

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The taxation when a personal asset is contributed as capital to a partnership firm and the taxation of amounts received when the partner retires from the firm or the firm dissolves is quite a complex one and no straight answers can be found. There are conflicting judgments on the said aspects and one has to carefully study between the lines to make a conscious decision as regards to taxability. In this article, we would like to dwell on the major judgments which have contributed to the resolution (or complexity) of issue.

Before proceeding to analyse and understand the relevant judgments, it is necessary to understand the central issues and let us proceed to frame the same:

Issue #1	When a firm pays certain amounts to the retiring partner, can it be said that there is a transfer from partner in favour of continuing partners?
Issue #2	When a firm allocates certain assets to retiring partner, can it be said that there is a transfer of capital asset by such firm to the retiring partner?
Issue #3	When a firm distributes capital assets at the time of dissolution, can it be said that there is a transfer of capital asset by such firm to the persons?
Issue #4	When a personal asset is being contributed as capital to a partnership firm in which the contributor becomes a partner, can it be said that there is a transfer of capital asset by such person to the firm?

The bare text of relevant provisions would take us nowhere to answer the above issues. It is important to understand the various judgments surrounding the above issues to conclude the taxability. Though there are no single answers or sacrosanct views in taxation laws, we shall try to cull out the guiding light from the various judgments delivered in this context. At the end of the article, we shall summarise the responses to the above central issues by adopting the rationale delivered by various judgements.

The judgments which are going to be discussed in this article relate to period prior and post insertion of Section 45(3) and Section 45(4). Hence, there will be occasions where the courts would be dealing to answer the issues before them without referring to the said sections, since as on the date of such judgements, the relevant sections were not available on the statute book. While reading this article, the said aspect has to be made note of. Further, the judgments were dealt issue and chronological wise. Now, let us proceed to deal with the major judgments which revolve around the central issues framed above.

Dissolution of Firm:

In the matter of Malabar Fisheries Co[1] - Supreme Court:

(Dissolution – Recovery of Development Rebate – Dissolution is Not Transfer)

The facts of Malabar Fisheries Co were that the firm was originally constituted on 1st April 1959 consisted of four partners and carried on six different businesses. The firm got dissolved on 31st March 1963 and under the deed of dissolution executed by and between the partners, the business of erstwhile firm were taken by certain partners and one the partner has received a sum of money in lieu of his respective share in the assets. The firm when was alive and kicking has purchased certain machineries and installed them and by virtue of such installation was entitled for the development rebate under Section 33 of ITA. On dissolution, the ITO[2] took the view that Section 34(3)(b) has kicked in since the machineries were sold or transferred by the firm to the partners within the period of 8 years and accordingly, he withdrew the development rebate and proceeded to tax the firm on such amounts. The firm contended that distribution of assets by virtue of dissolution does not amount to sale or transfer and accordingly there is no violation of conditions mentioned in Section 34(3)(b) to occasion the recovery of development rebate.

The Tribunal placing reliance on Dewas Cine Corporation[3] held that there was no sale or transfer within the meaning of Section 34(3)(b) in a transaction involving the adjustment of rights of the partners of a dissolved firm. The Revenue preferred an appeal before the High Court, wherein the High Court stated that the order of Tribunal was erroneous, since it was based on the judgments of Supreme Court in the matter of Dewas Cine Corporation (supra) and Bankey Lal Vaidya's[4], which were given under the context of old income tax law, wherein the phrases 'sale' or 'transfer' have not been specifically defined and to be understood in the common parlance. However, after the introduction of new income tax law, the phrase 'transfer' has defined to include 'extinguishment' and 'relinquishment' and thereby, the firm extinguishing its right in the machineries amounted to 'transfer' and accordingly the development rebate allowed earlier becomes taxable.

The firm has appealed before the Supreme Court and pleaded that there is no change in law even after introduction of definition of 'transfer' to include extinguishment. The firm placed reliance on the judgment in the matter of R.M.Amin[5], where in it was held there would not be no transfer of capital assets in the meaning of Section 2(47) where a shareholder received money representing his shares on the distribution of net assets of company in liquidation, that must be regarded as having received that money in satisfaction of the rights which belonged to him by virtue of his holding shares and that transaction did not amount to any sale, exchange or relinquishment of capital assets or extinguishment of capital assets.

The Supreme Court after hearing both the parties, stated that the question that has to be answered is, whether the distribution, division or allotment of assets of firm consequent to its dissolution amounts to transfer of assets within the meaning of the words 'otherwise transferred' occurring in Section 34(3)(b), when the meaning of 'transfer' is read in light of section 2(47). In simple words, ***the question is whether the dissolution of a firm extinguishes the firm's right in the assets of the partnership so as to constitute a transfer of assets under section 2(47)?***

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[1] [1979] 120 ITR 049 (SC)
[2] Income Tax Officer
[3] [1968] 068 ITR 240 (SC)
[4] [1971] 079 ITR 594 (SC)
[5] [1977] 106 ITR 368 (SC)

The Supreme Court after placing reliance on Lindley on Partnership, Dewas Cine Corporation (supra) and Bankey Lal Vaiday (supra) has held that the position as regards to the nature of firm and its property in Indian law is similar to position in English law, being, that a partnership firm is not a distinct legal entity and the partnership property in law belongs to all the partners constituting the firm. The Court also referred the judgment of Bhagwanji Morarji Goculdas v. Alembic Chemical Works Co. Ltd[6] held that a partnership firm 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.

Hence, it is difficult to accept the contention that upon the dissolution of the firm's right in the partnership assets are extinguished, when the firm as such has no separate rights of its own in the partnership assets and accordingly upon the firm's dissolution, there would not be an occasion for extinguishment of assets in the hands of firm. The Court also stated that it is necessary that the sale or transfer of assets must be by the firm to a person and every dissolution must in point of time be anterior to the actual distribution, division or allotment of assets that take place after making up accounts and discharging the liabilities and debts due by firm. When the firm is dissolved, the firm ceases to exists and it cannot be said that distribution, division or allotment of assets is done by dissolved firm. In this sense, the court held that is no transfer of assets by the dissolved firm to any person. Accordingly, the court upheld the order of Tribunal.

Key Take-Aways:

The Supreme Court has opined that even after the introduction of definition of 'transfer' to include extinguishment in its ambit, the firm and partners being one and the same, it cannot be said that the firm has extinguished its rights in assets when it got dissolved, because it cannot extinguish rights which it does not have in first place. Accordingly, it held that there cannot be transfer of assets on dissolution of firm to the partners. The Supreme Court continued its reliance on its earlier judgments of Dewas Cine Corporation and Bankey Lal Vaidya and held so.

[6] AIR 1948 PC 100

Retirement of Partner:

In the matter of Mohanbhai Pamabhai[7] – Gujarat High Court (affirmed by Supreme Court[8]):

(Retirement – Settlement in Cash + Goodwill – Balance Settled as per Credit in Partners Account)

The facts involved herein were that the assessees and seven other partners carried on business in partnership in the firm name of Prajapati Tiles Company. The firm was floated on 13th January 1953 and certain disputes arose among the partners and as a result the assessees retired from the firm with effect from 18th February 1962, leaving the other seven as continuing partners of the firm. By virtue of deed of retirement deed, the outgoing partners were entitled to get their share in net assets of the firm and an additional amount towards goodwill. The deed also states that the said amounts were paid to outgoing partners in lieu of all their rights, interest and share in partnership firm and each of them voluntarily give up their right, title and interest in the firm.

The ITO took the view that the amount received by outgoing partners to the extent it included proportionate share in the value of goodwill represented capital gains chargeable to tax under Section 45 of ITA[9]. The assessees have contended that such amounts were not subject to capital gains on two grounds. One, the retirement is akin to dissolution and accordingly the said transaction is covered under Section 47(ii) and thereby not amounting to transfer. Two, the goodwill was a self-created asset which had cost nothing to the firm and its partners in terms of money and a transfer of it was, therefore, not within the ambit of charging provision contained in Section 45 and the proportionate share in value of goodwill received by each of assessee for transfer of his interest in goodwill is not taxable as capital gain. The Appellate Commissioner has rejected both the grounds confirming the order of ITO.

The Tribunal stated that the retirement is different from dissolution and accordingly rejected the first ground of assessee to take shelter under Section 47(ii). However, the Tribunal found reasoning with the second ground that since goodwill has no cost, the same cannot be subjected to tax. Apart from the above, the assessees have raised another plea before the High Court stating that what they have received is their share of goodwill which is akin to the share of the other assets they have received and accordingly no tax can be fastened on such amounts. The assessees have further stressed on their second ground dealing with cost of goodwill and stated that the objective of section 45 being taxing the gain, in absence of methodology to determine the cost of acquisition for goodwill, the tax authorities were trying to the gross receipt instead of gain. Hence, the levy has to be failed.

The High Court stated that the revenue's argument that when assessees retired from the firm, the interest in each of the assessee in partnership assets including the goodwill was extinguished and therefore amounts to 'transfer', though appears plausible, is fallacious in that it ignores the true nature of interest of partner in the firm and the legal consequences which flow when a partner retires.

The High Court referring to the decision of Supreme Court in the matter of Narayanappa v. Bhaskara Krishnappa[10], which dealt with issue under registration act vis-à-vis partnership law, wherein it was held that whatever may be the character of property which is brought in by the partners when partnership is formed or which may be acquired in the course of business by firm, it becomes the property of the firm and what a partner is entitled to is his share of profits, if any, accruing to the firm from the realisation of property, and upon dissolution of partnership to a share in the money

[7] [1973] 091 ITR 393 (Guj)
[8] [1987] 165 ITR 166 (SC)
[9] Income Tax Act, 1961
[10] AIR 1966 SC 1300

representing the value of property. The Supreme Court further held that during the subsistence of firm, however, no partner can deal with any portion of property as his own despite the fact the firm does not own the said properties nor can he assign his interest in a specific item of firm property to anyone and what he has only right to obtain such profits, if any fall, from time to time to his share and upon dissolution of the firm to a share in net assets.

The High Court then referred to the Supreme Court's decision in Dewas Cine Corporation (supra). The facts of the said matter were that two partners, each owing a cinema theatre, formed a partnership firm to carry on business of exhibition of films and they brought their respective theatres into the books of firm as its assets. The firm was in existence for some time, but thereafter, dissolved and it was agreed that the theatres should be returned to its original owners and in the books of the firm, the theatres were shown as taken over at the original price less depreciation allowed during the subsistence of firm. The revenue raised a contention that the firm has sold assets to the respective partners in consideration of their respective shares and difference between the price realised and the written down value should be included in the total income of the firm. The said contention was rejected by the Supreme Court stating that on dissolution of firm the only right of a partner is to have the property of the firm applied in payment of debts and liabilities of the firm and have the surplus distributed among the partners or their representatives according to their rights and this distribution of surplus is for the purpose of adjustment of rights of partners in the assets of firm and does not amount to transfer.

The High Court then made a reference to its own judgment in the matter of Velo Industries v. Collector, Bhavnagar[11], where the court was dealing with an issue under Bombay Stamp Act, 1958 vis-à-vis retiring partner. The High Court was seized with determining whether a partner who retires from the firm and take his share in the notional sale of assets would be falling under the ambit of 'conveyance on sale' so as to liable for stamp duty. The full bench of High Court stated that such a transaction does not involve any element of sale of interest of a partner in partnership assets and accordingly no stamp duty is required to be paid. The High Court after referring to all the above decisions stated that it clearly establishes that the interest of partner in the partnership is not interest in any specific item of partnership property, but a right to obtain his share of profits from time to time during the subsistence of firm and on dissolution to get his value in share of net assets and therefore when a partner retires from a firm and the amount of his share in the net partnership assets in form of money, after deduction of liabilities and prior charges is determined on taking accounts on the footing of notional sale of partnership assets and given to him, what he receives is his share in the partnership and not any consideration for transfer of his interest in the partnership to the continuing partners. The High Court stated that it is true the definition of 'transfer' includes the relinquishment or extinguishment, but even in such sense, there is no transfer of interest in the partnership assets involved when a partner retires from partnership, it is merely only adjustment of rights and did not involve relinquishment or extinguishment of the interest in the partnership assets. Accordingly, held that the goodwill received cannot be said against transfer of assesses right in partnership firm and in absence of transfer happening in terms of section 2(47), there cannot be any tax under section 45.

The High Court further held that assuming that the above conclusion is wrong, and assuming that when a partner retries, the rights in the partnership firm gets extinguished and such a transaction amounts to 'transfer', even in such case, the amount received as goodwill shall be out of scope of section 45 because there is no consideration which is received by retiring partner for such assumed transfer. The Court stated that the entitlement of retiring partner is the net partnership assets after

[11] [1971] 080 ITR 291

satisfaction of debts and liabilities and it is therefore not possible to predicate that a particular amount is received by retiring partner in respect of his share in a particular partnership asset or that a particular amount represents consideration received by retiring partner for his extinguishment of his interest in particular partnership asset and accordingly held that there was no transfer of interest of any of the assessees in the goodwill of the firm and no part of amount received by any of the assessee was assessable to capital gains.

Key Take-Aways:

The High Court after referring to various judgments of Supreme Court and following Dewas Cine Corporation and others has held that there does not exist any extinguishment or relinquishment of rights towards the firm by retiring partner and accordingly there cannot be a transfer in terms of Section 2(47). Even assuming that there is a transfer, there is no consideration accruing from such assumed transfer, since the what is the retiring partner realises is his share in net assets of the firm after satisfaction of liabilities and debts and such amounts cannot be said to be consideration for transfer of rights, if any exists. The retiring partner just works out his rights and accordingly such amount cannot be called as consideration for transfer. Incidentally, the court also dealt with aspect of cost of acquisition of goodwill and held that if there is no cost of acquisition for goodwill, the same would not be considered as failure of section 48 and consequently failure of section 45. If there is no cost of acquisition, the said parameter has to be taken as nil for the purposes of section 48 and accordingly proceed to arrive at capital gain but it would not be correct to say that there is a failure of valuation mechanism. However, this part of the judgment was overruled by Supreme Court in the matter of B C Srinivasa Setty[12].

In the matter of Tribhuvandas G Patel[13] – Bombay High Court:

(Retirement–Adhoc Payment – Not on Footing of Notional Sale – Transfer – Retirement v. Dissolution)

The facts in this matter were that Tribhuvandas G Patel (assessee) was a partner of the firm M/s Kumar Engineering Works. He continued as partner in the said firm upto 31st August 1961, thereafter he retired. On 5th December 1960, the assessee has served on remaining partners a notice of his intention to dissolve the firm. The remaining partners opposed the same and the assessee has filed a suit for dissolution for the firm. However, there went certain discussions among the partners and accordingly an out of court settlement was achieved among them. Vide such terms of settlement, the assessee in a whole was entitled for an amount of Rs 9 lakhs on occasion of such retirement. The settlement deed notes that Rs 1 lakh is paid as his share of profit for the broken period ended 31st August 1961, Rs 50,000 as his share of the value of goodwill and Rs 4.77 lakhs as his share in remaining assets of the firm (by appreciation in the value of assets). The other items received by assessee which were included in the total amount of Rs 9 lakhs are not material for the purposes of the consideration by the court.

In the above facts, the High Court was concerned with three important questions. The first one being that the assessee has received Rs 1 lakhs as share of his profits. However, the firm was also assessed for the same assessment year and accordingly the share of profit of assessee was arrived by the ITO as an amount greater than Rs 1 lakhs. The ITO has proceeded to tax such enhanced amount as share of profit in the hands of assessee. The assessee has objected for such assessment stating that when he has received Rs 1 lakhs, the ITO cannot bring into tax the enhanced amount (by virtue of conclusion of assessment of firm), which he has never received in the first place. The assessee placing reliance on

[12] [1981] 128 ITR 294

[13] [1978] 115 ITR 095 (Bom)

the judgment of N M Raji[14], wherein it was held that only the real income is taxable and in the instant case that would be Rs 1 lakhs and not the enhanced income. However, the High Court distinguished the facts of the said judgment to the instant facts and held that the rationale delivered in N M Raji (supra) would not apply and accordingly the assessee was liable to be taxed on the enhanced income.

The second issue that the court was seized with was, whether the assessee was liable to pay tax on the sum of Rs 50,000 which was received as his share of value of goodwill. The assessee contended that the goodwill is not subjected to tax since the same was a self-generated asset and there was no cost associated for its development and consequently the levy would fail. The High Court placing reliance on their recent judgment in the matter of Home Industries and Co[15], wherein it was held that goodwill not being a capital asset, there would not be any tax implications on its transfer and accordingly held that the same was also not subjected to tax in the hands of the assessee.

The third issue, the important among the lot, was, whether the sum of Rs 4,77,941/- or any part thereof which the assessee received on occasion of retirement is subjected to tax. The assessee contended that he has retired from the firm and accordingly there is no transfer as contemplated in section 2(47), when retirement takes place and there is no transfer of capital asset within the meaning of section 45, calling for the obligation provided therein. He placed reliance on the Supreme Court judgments in the matter of Dewas Cine Corporation (supra) and Bankey Lal Vaidya (supra) and also the decision of Gujarat High Court in Mohanbhai Pamabhai (supra) to buttress his view that retirement does not call for any obligation under section 45. He also in alternate contended that the aspect of retirement is akin to dissolution and accordingly, the said transaction, even assuming to be transfer, would be exempted from the purview of section 45 in light of section 47(ii) which provides that settlement in pursuance of dissolution does not amount to transfer. The assessee relied on the judgment of Addanki Narayanappa[16], wherein the Supreme Court made general observations treating the retirement and dissolution as one and the same.

The revenue contended that upon retirement from a firm the retiring partner transfers or assigns or releases his share or interest in the partnership and its assets to the continuing partners, who were permitted to use such partnership assets including the retiring partner's erstwhile interest therein for the purpose of carrying on partnership business and accordingly such transfer was subjected to tax. The revenue further contended that retirement and dissolution were two separate events and one cannot be read into another and accordingly the shelter provided under section 47(ii) cannot be applied for the cases of retirement, since the same was applicable only to the cases where firms were dissolved.

The High Court after listening to both the sides, framed the main question as what would be the real nature of the transaction when a partner retires from the partnership? Does the transaction amounts to relinquishment of his share or interest in the partnership in favour of continuing partners or does it stand on the same footing as adjustment of rights that results upon dissolution of firm?

The High Court stated that 'retirement' and 'dissolution' are separate events and cannot be read into each other. The reliance by the assessee on the judgment in the matter of Addanki Narayanappa (supra) was brushed away stating that the Supreme Court therein was not dealing with capital gains tax but on an aspect on registration requirement when a partner retires from the firm.

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[14] [1949] 017 ITR 180 (Bom)

[15] [1977] 107 ITR 609 (Bom)

[16] AIR 1966 SC 1300

The High Court then summarised that, if a retiring partner while going out and while receiving what is due to him in respect of his share:

- may assign his interest by a deed or
- he may instead of assigning an interest, take the amount due to him from the firm and give a receipt for the money and acknowledge that he has no more claim on his co-partners.

The Court then stated that the former type of transactions will be regarded as sale or release or assignment of his interest by a deed attracting stamp duty, while the latter type of transaction would not. **In other words, the High Court stated that question whether the transaction would amount to assignment or release of his interest in favour of continuing partners would depend upon what particular mode of retirement is employed? If instead of quantifying his share by taking accounts on the footing of notional sale, parties agreed to pay a lump sum in consideration of the retiring partner assigning or relinquishing his share or right in partnership and its assets in favour of continuing partners, the transaction would amount to transfer within the meaning of section 2(47).**

Since the assessee in the instant case has assigned his rights and taken an amount without quantifying his share by taking accounts on footing of notional sale, there exists a transfer within meaning of section 2(47) and accordingly the High Court held such transaction as transfer and subjected to tax.

Key Take-Aways:

The Bombay High Court arrived at conclusion qua the third issue without critically analysing the Gujarat High Court's decision in the matter of Mohanbhai Pamabhai (supra). To this extent, the conclusion arrived may be regarded as incomplete, especially when the facts of Mohanbhai Pamabhai (supra) are directly on the point of retirement which was also the facts in the matter before High Court.

In the matter of H R Aslot[17] - Bombay High Court:

(Dissolution v. Retirement – Retirement – Followed Tribhuvandas G Patel – Taxable)

In this matter, the Bombay High Court is called upon to examine whether amounts paid as a consequence of retirement of partners amount to transfer and accordingly be subjected to capital gains. The facts were that assesse H R Aslot was a partner with a firm known as Automobile and Agricultural Industries Corporation. The firm consist of 8 partners. The terms of partnership deed provide that in case of any disputes among the partners, the disputes would be referred to arbitrator and would be settled accordingly. There were some disputes in 1959 and accordingly the matter was referred to the arbitrator. The sole arbitrator has passed an award in 1960 and in substance, the effect of the award was that the assessee and other partner would retire from the firm with effect from 1st January 1960 and the other partner would continue the firm. The retiring partners would continue the earlier firm in the original name or any other name. The continuing partners were asked to pay Rs 5.6 lakhs to retiring partners in satisfaction of their respective shares and interest in partnership and the capital effects and goodwill thereof. The retiring partners were allowed to retain certain offices and also allowed to engage in sale of certain kind of agreed products. In pursuance of the award, all the partners have entered a deed of dissolution by recording the terms of the award and accordingly dissolved. In light of the terms agreed, the assessee has received an amount of Rs 4,67,529/-. The amount standing to the credit of the assessee in the books of the firm as on 31st Oct 1959 was

[17] [1978] 115 ITR 255 (Bom)

determined at Rs 2,33,535/-. The difference between the amount received by assessee and the credit to the capital account was treated as income by the ITO. An appeal was filed before Appellant Assistant Commissioner, who took the view that the excess amount received over and above the capital of the assessee was on account of his share of goodwill received in consideration of his relinquishing his rights to share the profits in future and, thereof the balance amount was chargeable to capital gains. On reference to Tribunal, it was held that there could not be any transfer by retiring partners to the continuing partners and transaction between the continuing partners and retiring partners was part and parcel of scheme of dissolution of the firm and by placing reliance on the Honourable Supreme Court judgment in the matter of Bankey Lal Vaidya (supra) held that there cannot be any transfer to attract capital gains tax.

The Revenue carried the matter to the High Court. The Court after referring to both the parties framed the question that whether what was brought by the award of arbitrator read with agreement entered consequent to the award, was a dissolution of partnership or that it brought about a mere retirement of two partners permitting the remaining partners to continue the business of partnership firm. The Court stated that though the agreement entered in consequence to the award is termed as 'deed of dissolution', what actually happened was retirement of two partners as against the dissolution as contended by assessee and agreed by Tribunal. The Court further stated on reading the other clauses of the agreement, it is evident that the firm continues and only the two partners has retired. Hence, this is a case of retirement and not case of dissolution. Since, this is a case of retirement, the Court held that judgment of Honourable Supreme Court in the matter of Bankey Lal Vaidya (supra) would not apply since the issue therein was dissolution of the firm. The Court after concluding that the said transaction is retirement has placed reliance on the judgment of Tribhuvandas G Patel (supra), wherein the Bombay High Court stated that in case of retirement, there exists transfer and accordingly depending upon the clauses of the deed and amounts received, the tax liability arises and stated that the said judgment equally applies to the facts of assessee. Since in the case, the deed of dissolution stated that the retiring partners have assigned and released all the rights in favour of the continuing partners, the Court stated that it cannot take a view differing with Tribhuvandas G Patel (supra). Accordingly, the Court held that assessee is subjected to capital gains tax.

Key Take-Aways:

The Bombay High Court by following its earlier judgment in Tribhuvandas G Patel has held that when a document is executed to assign interest in favour of continuing partners by retiring partner, there would be a transfer in terms of section 2(47) and accordingly taxable. Noting that the arbitrator award and deed of dissolution on holistic reading appears to be retirement of the partners and not dissolution as canvassed by assessees therein, stated the judgment of Supreme Court in Bankey Lal Vaidya does not apply since in that case the court is concerned with dissolution and not retirement. Since dissolution and retirement are different events, one cannot be read into another and accordingly held that the Bankey Lal Vaidya's rationale does not apply.

In the matter of L Raghu Kumar[18] – Andhra Pradesh High Court (affirmed by Supreme Court[19]):

(Retirement of Partner – No Transfer – Followed Mohanbhai Pamabhai)

The assessee herein in a karta of an HUF and partner in two firms. He has retired from both the firms with effective from 1st Jan 1971. On the date of retirement, his capital accounts were credited with a

[18] [1983] 141 ITR 674
[19] [2001] 247 ITR 801

sum of Rs 46,500 more than the amount due to him towards his capital and profits and the firms from which the assessee has retired were carrying on business with the remaining partners. The ITO has assessed the amount received from the firm by the assesse as capital gain. The assessee has initially raised the contention that the said transaction is covered under Section 47(ii) and accordingly not a transfer. Later before the Appellate Tribunal, the assessee has placed reliance on the judgment of Mohanbhai Pamabhai (supra) to contend that there is no transfer when a partner retires from the firm. The Appellate Tribunal has accepted the contention of the assessee and his reliance on Mohanbhai Pamabhai (supra) and accordingly held there does not exists any tax obligation in the hands of retiring partner.

The Revenue has preferred an appeal before Andhra Pradesh High Court. The High Court after setting out the facts referred to the judgment of Supreme Court in the matter of Narayanappa v. Bhaskara Krishnappa (supra) and Gujarat High Court's decision in the matter of Mohanbhai Pamabhai (supra) has held that there would not be any transfer when a partner retires from the firm since what happens on retirement is only working of the rights among the partners and nothing more. The High Court rejected the contention of Revenue that the decision of Narayanappa v. Bhaskara Krishnappa (supra) cannot be applied to the current facts for the reason that the issue involved therein was requirement to obtain registration under Registration Act and not a question under provisions of ITA, by stating that the language employed in Registration Act and ITA is analogous and accordingly the reliance has to be survived.

The High Court then distinguished Revenue's reliance on judgments of Bombay High Court in the matter of Tribhuvandas G Patel (supra) and HR Aslot (supra). The High Court stated that both the above judgments were rendered in the context of the facts involved therein and recognised that the Bombay High Court has not followed the decision of Gujarat High Court in Mohanbhai Pamabhai (supra) and has not accepted the principals enunciated by Supreme Court, where it had equated retirement and dissolution. The High Court stated that they are unable to accept the view as proposed by Bombay High Court. The High Court concluded that merely because Section 47(ii) excludes the application of Section 45, in case of dissolution of firms on the ground that no transfer is involved, it cannot be implied that a transfer is involved in case of retirement. The converse or the opposite does not follow.

The said order of High Court is challenged by Revenue before Supreme Court. The Supreme Court by following the decision of Mohanbhai Pamabhai (supra) as affirmed by it, held that there is no occasion to interfere in the order passed by High Court and concluded against Revenue.

Key Take-Aways:

The Andhra Pradesh High Court though made a reference to the judgments of Bombay High Court in the matter of Tribhuvandas G Patel and HR Aslot, has not distinguished in true sense the ratio held therein. The High Court has not tried to examine the contents of retirement deed or whether the partner has received only his share in net assets or lumpsum amount.

In the matter of NA Mody[20] - Bombay High Court:

(Dissolution v. Retirement – Retirement – Followed Tribhuvandas G Patel & HR Aslot – Taxable)

The assessee herein is an advocate and solicitor. The assessee is partner of solicitor firm Little and Co and for acquiring an interest in the assets, goodwill and profits of the firm, paid an amount of Rs 40,680/-. Certain disputes have arisen between partners and a suit was instituted in Bombay High Court against the assessee by other partners for dissolution and accounts. Consequent to the institution of suit, consent terms were arrived and vide clause 3 of such terms, that all partners except the assessee are entitled to continue the firm as if there had been no dissolution of the firm. The assessee was mentioned as retired from the firm and the share and interest in partnership and all its assets, including goodwill and outstanding have been taken by the continuing partners and paid in full satisfaction of assessee excluding profits for the certain period is fixed at amount of Rs 71,900/- (Clause 8). The said amount is agreed to be paid over a period time in instalments. Further, for the work done by the assessee prior to its dissolution, an amount of Rs 40,600/- is agreed to be paid over a period of time (Clause 12). The terms also stipulate that the decree operates as assignment of share, right, title, interest, claim and demand of assessee in Little and Co and all its assets, including goodwill and outstanding favour of continuing partners in proportion to the respective share and interest in Little and Co and the assessee do have no claim or demand of any nature whatsoever against the firm or any of its partners.

The assessee filed his return stating that amounts received from Little and Co under Clause 8 and 12 are not taxable. The ITO has rejected the said contention and held that the entire sum as taxable. The Appellate Assistant Commissioner held that amount taxable under clause 8 was Rs 31,220/- (Rs 71,900 – Rs 40,680/-) and the amount of Rs 40,600/- under Clause 12 should be taxed, but spread over different assessment years. The Tribunal confirmed the order of Appellate Assistant Commissioner.

The assessee argued before the High Court that the amounts received are not taxable because the same represents his interest in the partnership and no transfer has taken place. The High Court stated that the consent terms recorded reveals that the assessee has retired from the firm and there is no dissolution which has happened. In absence of any dissolution, the judgment of Honourable Supreme Court in Bankey Lal Vaiday (supra) does not apply and the matter has to be decided accordingly. Then the High Court made reference to the judgement of Tribhuvandas G Patel (supra) and held that since the consent terms indicate that the assessee has relinquished his rights and interest in the firm towards the continuing partners, the same shall be subjected to capital gains tax. The High Court further stated that the decision of Mohanbhai Pamabhai of Gujarat High Court is also considered while arriving the decision of Tribhuvandas G Patel (supra) and if the retiring partner is taking money instead of assigning his right to continuing partners, then the said transaction may not be called as transfer but in the instant case of assesse the same did not happen and accordingly held that such amount is subjected to tax.

Key Take-Aways:

The Bombay High Court by following its earlier judgment in Tribhuvandas G Patel has held that when a document is executed to assign interest in favour of continuing partners by retiring partner, there would be a transfer in terms of section 2(47) and accordingly taxable. Noting that reading of consent terms indicate there is retirement of the partner and not dissolution as canvassed by assessees therein, stated the judgment of Supreme Court in Bankey Lal Vaidya does not apply since in that case the court

[20] [1986] 162 ITR 420

is concerned with dissolution and not retirement. Since dissolution and retirement are different events, one cannot be read into another and accordingly held that the Bankey Lal Vaidya's rationale does not apply. Further, also held that the decision of Mohanbhai Pamabhai by Gujarat High Court is applicable to the instant facts, but there the retiring partners took what stood to the credit of their capital account and acknowledged the same and has not entered any document to relinquish their rights in firm to the continuing partners, which is not the fact in the instant case and accordingly held that the judgement of Mohanbhai Pamabhai cannot be applied.

In the matter of Tribhuvandas G Patel[21] – Supreme Court

(Retirement of Partner – No Transfer – Reversed Bombay HC Judgment - Followed Mohanbhai Pamabhai)

The assessee has appealed against the order of Bombay High Court (read '**In the matter of Tribhuvandas G Patel – Bombay High Court')**, wherein it was held that receipt of amount on occasion of retirement not on basis of notional sale of assets would be subjected to capital gains tax in the hands of retiring partner, as he has relinquished his rights to the continuing partners.

The Supreme Court by making reference to Sunil Siddharathbhai (supra) and Mohanbhai Pamabhai[22] (wherein the decision of Gujarat High Court was affirmed) held that on even where a partner retires and some amount is paid to him towards his share in the assets, it should not be treated as transfer since it falls under section 47(ii) and accordingly the matter is held against revenue and favourable to assesse.

Key Take -Aways:

However, an important observation herein in both the referred judgments namely Sunil Siddharathbhai (supra) and Mohanbhai Pamabhai (supra), there was no major discussion on whether the retirement falls under the purview of section 47(ii). The issues under such matters were different and the conclusions arrived are different. Hence, this particular judgment of Supreme Court has to be taken with appropriate caution. Since, this decision reverses the decision of Tribhuvandas G Patel (Bombay High Court), all such decisions which followed the above namely H R Aslot (supra) and N A Mody (supra) has to be re-looked and a judicious decision has to be taken.

In the matter of Shevantibhai C Mehta[23] – ITAT Pune

(Retirement – Transfer - Followed Tribhuvandas G Patel, HR Aslot & NA Mody – Taxable)

The facts of the matter was that assessee filed his return of income declaring a total income of Rs 26,813/-. Along with such return of income, a letter was filed by assessee stating that he has retired from the firm of M/s Mehta & Kakade Associates by a deed of retirement and he has received Rs 34,43,700/- on the said occasion. Since there is no transfer of capital assets from him to the firm, he was of the belief that said income is not subjected to capital gains. Further, he contended that in view of provisions of Section 45(4), such liability to capital gains, if any, arises in the hands of firm and not in case of partner. The Assessing Officer rejected the said contention and brough the said amounts under the tax. The Assessing Officer while rejecting stated that the provisions of Section 45(4) would apply only if there is allocation of assets by the firm to the partner and does not cover instances where

[21] [1999] 236 ITR 515 (SC)
[22] [1987] 165 ITR 166 (SC)
[23] 2003 (8) TMI 208 – ITAT Pune

consideration is paid for retaining the assets by the continuing partners. Further, the Assessing Officer taking support from the judgments of HR Aslot (supra) and NA Mody (supra) stated that the High Court therein has drawn a distinction between 'retirement' and 'dissolution' and held that Section 45(4) would apply only for dissolution and not otherwise. Since the instant case pertains to retirement and amounts paid to retiring partner also includes value towards appreciation of an immovable property and also payment being made is for foregoing the rights in the profits of the firm, their interest, title, the Assessing Officer has held that such amounts would be subjected to capital gains tax and does not fall under Section 45(4).

The assessee carried the matter to CIT (A), wherein he after referring to Clause 7 of retirement deed, the CIT (A) stated that there exists a relinquishment in favour of continuing partners and accordingly upheld the order of Assessing Officer following the judgment of NA Mody (supra). Against this order, assessee has reached the Tribunal.

The Tribunal after hearing both the parties, stated that the contention made by assessee that the judgment of Assessing Officer and CIT (A) is erroneous since the said orders have placed heavy reliance on NA Mody (supra). The assessee's contention that since the judgment of NA Mody (supra) relies on the judgments of Tribhuvandas G Patel (the Bombay High Court) (supra) and HR Aslot (supra) which were disapproved by Andhra Pradesh High Court in matter of L Raghu Kumar (supra), which was subsequently affirmed by Supreme Court, it would mean that the judgments of Tribhuvandas G Patel (supra) and HR Aslot (supra) gets overruled and therefore the judgement in NA Mody (supra) would be bad law and order passed by placing reliance on such bad law is erroneous.

The Tribunal observed that the Andhra Pradesh High Court in the matter of L Raghu Kumar has not disapproved the judgments of Tribhuvandas G Patel (supra) and HR Aslot (supra) but stated that the same are based on facts. The Tribunal stated that the Andhra Pradesh High Court disagreed with the view that Bombay High Court took in Tribhuvandas G Patel (supra) that dissolution and retirement are separate aspects. The Tribunal stated that Andhra Pradesh High Court by placing reliance on Supreme Court judgment in Narayanappa v. Bhaskara Krishnappa (supra) and Gujarat High Court in Mohanbhai Pamabhai (supra) has held that retirement and dissolution are one and the same and accordingly differed with Bombay High Court's judgment.

The Tribunal then placing reliance on Delhi High Court judgment in matter of Bishan Lal Kanodia[24], wherein it was held that since the judgment of Supreme Court in Narayanappa v. Bhaskara Krishnappa (supra) was not dealing with issue under capital gains but under Registration Act, the equating of retirement and dissolution as done for Registration Act cannot be applied for the purposes of Capital Gains, supported the judgment of Tribhuvandas G Patel (supra) and rejected the contention that said judgment got overruled by affirmation of Andhra Pradesh High Court's judgment in matter of L Raghu Kumar (supra).

The Tribunal stated that the reliance of assessee on Mohanbhai Pamabhai (supra) was distinguished in the matter of NA Mody (supra), wherein it was held that in facts of Mohanbhai Pamabhai (supra) the distribution happened on basis of notional sale and since the said facts do not appear in NA Mody (supra), the court therein stated that ratio of Mohanbhai Pamabhai does not apply. Similarly, the Tribunal held that since facts in the current case are different from Mohanbhai Pamabhai (supra), the said ratio does not apply to assessee and accordingly the reliance is misplaced.

The Tribunal after referring to various judgments concluded that the distinction between retirement and dissolution is irrelevant after removal of Section 47(ii) and insertion of Section 45(4) and stated

[24] AIR 1966 SC 1300

that the ratio as delivered by Bombay High Court in NA Mody (supra) that the mode of retirement would have an effect on taxability of capital gains is still relevant, since there is no direct disapproval of such ratio by Andhra Pradesh High Court or subsequent affirmation by Supreme Court in L Raghu Kumar. The Tribunal further stated that said ratio on the contrary is blessed by Delhi High Court in Bishan Lal Kanodia (supra).

The Tribunal then summarised the legal position as under:

a. Retirement of a partner could take either of two forms and the question whether the transaction would amount to an assignment or release of his interest in favour of the continuing partners or not would depend upon what particular mode of retirement was employed.

b. If, instead of quantifying his share by taking accounts on footing of notional sale, parties agree to pay a lumpsum in consideration of the retiring partner assigning or relinquishing his share or right in the partnership and its assets in favour of continuing partners, the transaction would amount to a transfer within the meaning of section 2(47).

c. A retiring partner while going out and receiving what is due to him in respect of his share might assign his interest by a deed or he might, instead of assigning his interest, take the amount due to him from the firm and give a receipt for the money and acknowledge that he has no claims on his co-partners.

d. If the retiring partner assigns his interest, then the same would be transfer and instead of assigning takes money and gives claim that he has no claims on co-partners, then the same would not be transfer.

Key Take -Aways:

The Tribunal has followed the view enunciated by Bombay High Court in NA Mody (supra) and stated that if an adhoc/lumpsum amount is paid to retiring partner, then such transaction would amount to transfer. Also, if he only states that he does not have any claims on co-partners and receives money and acknowledges thereof, then the said transaction could not be called as transfer. If he assigns his interest or rights to continuing partners and take an amount, then such transaction would be called as transfer.

In the matter of AN Naik Associates & Others[25] – Bombay High Court

(Family Settlement – Allocation of Assets on Retirement - Transfer – 45(4) also covers 'retirement')

The facts of the matter was 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

[25] [2004] 265 ITR 346 (Bom)

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.

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 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 and the judgments of Supreme Court in Malabar Fisheries Co (supra) and others will continue to hold the ground even after introduction of Section 45(4) with effect from 01st April 1988. The assessees 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 has to 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). It is submitted that the subject amendment of section 45 by insertion of sub-section (3) was to specifically overcome the judgment of Sunil Siddharathbhai (supra), wherein it was held that there exists a transfer when personal asset is converted to firm asset but in absence of mode of determination of consideration, the levy would fail. 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. It is submitted that even though the Bombay High Court has taken different view the same was reversed by the Supreme Court in Tribhuvan Das G Patel (Read - In the matter of Tribhuvandas G Patel – Supreme Court) following Mohanbhai Pamabhai (supra) and Sunil Siddharathbhai (supra).

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 has to 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. The High Court in conclusion stated that the contention of the assessee that the amendment has happened only in section 45 but no similar amendment was carried in definition of transfer under section 2(47) was brushed aside stating that definition of transfer was an inclusive one.

Key Take -Aways:

This can be considered as one of the landmark judgments for the reason that the phrase 'otherwise' appearing in the Section 45(4) has been interpreted to cover the retirement of partner from the firm as against the plain interpretation of Section 45(4) which covers dissolution. The Court stated that if the intention of the legislature is kept in mind and then the provisions of Section 45(4) are interpreted, it is evident that the said section covers retirement also. It is important to note that the Court in this case, is considering, whether allocation of assets on retirement of a partner is covered under the ambit of Section 45(4) and not whether there is any transfer from partner to firm against the consideration received by the partner from the firm on his retirement.

In the matter of Sudhakar M Shetty[26] – ITAT Mumbai:

(Retirement – Transfer - Followed Tribhuvandas G Patel, HR Aslot & NA Mody – Taxable)

The facts of the matter was that the assessee along with another individual has entered a partnership agreement to develop a property to be known as Unity Compound in Mumbai. The firm was named as DS Corporation and it was decided that among assessee and the other partner to contribute the money required for the development of property in a specified percentage and profit sharing ratios were also agreed upon. A deed of admission cum reconstitution was made and accordingly the wife of assessee has been admitted into the firm. The firm has purchased the subject property for Rs 6.5 Crores. Post purchase of property, another deed of admission cum reconstitution was made and two partners were further admitted and profit sharing ration was re-distributed.

Post such admission, the firm has applied to tourism development corporation for approval for construction of five star hotel in the said property. The corporation have granted the approval. Post to such, the assessee's wife for various reasons decided to retire. A registered valuer is appointed for valuation of the property and accordingly the property was revalued now at Rs 193 Crores (approx.). A retirement-cum-admission was made and the assesses 's wife got retired and four partners were admitted. Prior to retirement of assessee's wife, the profit and loss account was drawn and profits arising on revaluation of property was appropriated to the capital account of partners of the firm as per their profit sharing ratio. Post her retirement, the assessee also retired from the firm and was paid the sum which was standing to credit of his account.

[26] 2010 (9) TMI 746 – ITAT Mumbai | [2011] 130 ITD 197 (ITAT [Mum])

The Assessing Officer was of the belief that it was the case where instead of quantifying the assessee's share by taking accounts on the footing of the notional sale, parties agreed to pay a lump sum in consideration of retiring partner assigning or relinquishing his share or right in the partnership and its assets in favour of continuing partners. The capital account was artificially increased just to ensure that the retiring partner is paid consideration standing to credit of his capital account. The matter ultimately went to Tribunal and after setting out the facts and hearing the parties, the Tribunal held as under.

The Revenue contended that on reading of the retirement deed, it is evident that there is an extinguishment of the retiring partners rights on assignment of the retiring partners over the firm and its assets. Revenue contended that the mode of retirement in the instant case is similar to the retirement in case of Tribhuvandas G Patel (supra), HR Aslot (supra) and NA Mody (supra) and stated that following such judgements, the retirement is subjected to tax. The Tribunal stated that in the case of assessee, the clauses in retirement deed do convey interest in immovable property and further refers to the fact that the assessee will have any interest over the assets of the firm. The Tribunal thus stated that it was a case of lump sum payment in consideration of the retiring partner assigning or relinquishing his share or right in the partnership and its assets in favour of continuing partners and accordingly followed the decisions of Bombay High Court in Tribhuvandas G Patel (supra) and other judgments which followed them.

Key Take -Aways:

The Tribunal held that profit arising from revaluation of immovable property and sharing the same among the partners in their profit sharing ratio and taking the same amount at the time of retirement would amount to transfer since the same would be in the nature of lumpsum consideration. The Tribunal followed the judgments of Bombay High Court and Tribunal judgment in Shevantibhai C Mehta to hold that there exists a transfer and accordingly taxable.

In the matter of Savitri Kadur[27] – ITAT Bangalore:

(Retirement – Transfer - Followed Tribhuvandas G Patel, HR Aslot & NA Mody – Taxable)

The facts of the instant case was that assessee was a partner in a firm. The firm has admitted one more partner. Post such admission, the assessee has retired from the firm. On his retirement, she was paid an amount of Rs 3,39,50,000/-. Of the said amount, Rs 2,77,88,200/- was lying as credit in her capital account. The said balance is arrived after considering the opening balance, profits for the year, interest on her capital and profits arising on revaluation of land and building amounting to Rs 53,26,462/- and Rs 9,24,650/- and after reducing her drawings and other payments. The Assessing Officer held that the difference between Rs 3,39,50,000/- and Rs 2,77,88,200/- amounting to Rs 61,61,800/- was taxable under capital gains.

The matter was then taken to the CIT (A) by the assessee, wherein the later stated that the difference amounting to Rs 61,61,800/- is nothing but goodwill and the same is not taxable. The assessee placed reliance on the judgment of Karnataka High Court in Dynamic Enterprises[28]. The CIT (A), however following the decision of Bombay High Court in AN Naik & Associates (supra) held that the provisions of Section 45(4) also include instance of retirement and accordingly held that the said amounts were taxable.

[27] 2019 (7) TMI 593 – ITAT Bangalore
[28] [2013] 359 ITR 83 – Karnataka High Court

The assessee has preferred an appeal before the Tribunal. The Tribunal stated that the amendments in Section 45 by way of insertion of Section 45(3) and (4) have tried to eliminate the strategies adopted by partners and firms to avoid payment of tax. The Tribunal further stated that decision of AN Naik (supra), wherein it was held that retirement also is covered under the ambit of Section 45(4), in a way puts to end to tax abuse.

The Tribunal also stated that when a partner retires and retiring partner is paid for relinquishing all his rights, interest in firm as under:

a. On the basis of amount lying in his/her capital account
b. On the basis of amount lying in his/her capital account + additional amount
c. Lumpsum amount with no reference to amount lying in his/her capital account

The Tribunal stated in situation 'a', there is no doubt that the judgment of Supreme Court in Mohanbhai Pamabhai (supra) and accordingly there would not be any tax. The Tribunal also held that even such credit in capital account also includes amount arising on account of revaluation, there should not make the transaction taxable. For instances vide 'b' and 'c', the Tribunal held that the same would be taxable following Tribhuvandas G Patel (supra), HR Aslot (supra) and NA Mody (supra). The Tribunal set aside the aspect of reversal of decision of Tribhuvandas G Patel at Supreme Court stating that the decision was rendered when Section 47(ii) was in existence and now that such section is not available, the reversal does not impact in anyway. The Tribunal accordingly held that whether the retirement of partner would result in transfer or not depends upon the mode employed as held in Tribhuvandas G Patel (supra) and NA Mody (supra). The Tribunal also referred to judgement of Shevantibhai Mehta (supra) and Sudhakar M Shetty (supra) and held that taxability of retiring partner would depend upon so many situations. Finally, the Tribunal held that the books of accounts and retirement deed nowhere makes a reference to goodwill as Rs 61,61,800/- but makes only reference to Rs 38,38,200/-, the balance Rs 23,23,600/- was held taxable stating that said instance falls under 'b' above.

Key Take -Aways:

The Tribunal though followed Tribhuvandas G Patel (supra) and NA Mody (supra) has held that the goodwill on revaluation of assets which stands to the credit of the capital account would not be subjected to tax. The Tribunal stating that since assessee has retired more than what is there is in there capital account would be subjected to tax.

Contribution of Asset to Firm:

In the matter of Sunil Siddharathbhai & Kartikeya V Sarabhai[29] - Supreme Court:

(Contribution of Personal Asset to Firm – Transfer – Extinguishment of Exclusive Right – No Consideration)

The facts in both the matters were identical. For ease of understanding, we shall consider facts of one matter. The assessee, who was a partner in Suvas Trading Company, a partnership firm which was constituted on 27th Sept 1973, contributed to the capital of the firm, certain shares of limited companies which were held by him as capital assets. The book value of those shares were Rs 1,49,819 but on the date of contribution as capital to the firm, he revalued the shares at market value of Rs 1,60,279 and credited the resulting difference of Rs 10,460 to his capital account. The ITO took a view that the contribution of personal asset as capital to the firm resulted in transfer in terms of Section 2(47) and accordingly proposed to tax the difference between original value and market value as gains in the hands of partner.

The assessee contended that there is no transfer in terms of section 2(47), since the partner and firm being one and the same by pressing reliance on the judgment of Supreme Court in the matter of Malabar Fisheries Co (supra). The assessee also placed reliance on the judgment of Supreme Court in the matter of Hind Constructions Limited[30], wherein it was held that contribution of machinery by a partner to the firm does not amount to sale and assessee therein it did not derive any income.

The Supreme Court stated that the view that when a partner brings his assets as contribution as capital in the firm, he cannot be said to be effected a sale was also taken by Allahabad High Court in the matter of Dr Kackkar[31], Kerala High Court in the matter of Kunhammed[32] and by Madras High Court in Abdul Khader Motor and Lorry Service[33]. However, the Supreme Court stated that, while the transaction may not amount to 'sale', can it be described as transfer of some other kind?

The Court stated that 'transfer of property' connotes, the passing of rights in property from one person to another. In one case, there may be a passing of the entire bundle of rights from the transferor to the transferee. In another case, the transfer may consist of one of the estates only out of all the estates comprising the totality of the rights in the property. **In a third case, there may be a reduction of the exclusive interest in totality of rights of the original owner into a joint or shared interest with other persons. An exclusive interest in property is a larger interest than a share in that property.** To the extent to which the exclusive interest is reduced to a shared interest, it would seem that there is a transfer of interest. Accordingly, the Supreme Court held that when a partner brings in his personal asset into capital of the partnership firm as his contribution to its capital, he reduces his exclusive rights in the asset to shared rights in it with the other partners of the firm. The Court stated that while he does not lose his rights in the asset altogether, what he enjoys now is abridged right which cannot be identified with the fulness of the right which he enjoyed in the asset before it entered the partnership capital.

The Court further stated that 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 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 operation of future transactions of the firm, and it

[29] [1985] 156 ITR 509 (SC)
[30] [1972] 083 ITR 211 (SC)
[31] [1973] 092 ITR 087
[32] [1974] 094 ITR 179
[33] [1978] 112 ITR 360

may diminish in value depending on accumulated liabilities and losses with a fall in the prosperity of the firm. The Court also clarified the misconception that the right of partner arises at the time of retirement or dissolution by stating that the right exists at the time of admission as partner but gets settled at the time of retirement or dissolution. It was this settlement of a pre-existing right which was held not a transfer in the case of Malabar Fisheries Co (supra), Dewas Cine Corporation (supra), Bankey Lal Vaidya (supra) and Mohanbhai Pamabhai (supra). Accordingly, the court held that on introduction of personal asset into firm there will be an interest which will be created among with other partners and such interest will be settled at the time of retirement or dissolution and such introduction of personal asset by partner to the firm will fall under the ambit of 'transfer' in terms of section 2(47).

However, further the Supreme Court held that even though the introduction of personal asset into firm by partner amounts to transfer, the said transaction does not fall under the ambit of section 45, since the computation under section 48 fails, because the consideration for such transfer cannot be determined at the time of introduction of asset into the firm. The value at which the firm records the asset cannot be stated to be a true representation of consideration, because the same may be wiped off because of future losses and liabilities. The firm records the asset as notional value to give the credit to partner's capital account but the same cannot be taken as consideration for transfer. Accordingly, the court held that in absence of determination of consideration and the value fixed by firm does not represent true consideration, the charging section fails following its earlier judgment in the matter of B C Srinivasa Setty (supra).

Key Take-Aways:

The Supreme Court debunked the earlier theories of partner and firm being the same and firm cannot be called as distinct legal entity in this judgement. The holding by the court that contribution of asset by a partner to the firm as transfer is a significant step in the journey. However, the court's observation that in absence of consideration, there cannot be any tax, paved way for an amendment in Section 45(3), which we shall discuss at appropriate place.

Conclusion:

Now, taking clue from the above judgments, let us proceed to address the central issues framed at the beginning of this article.

Issue #	Issue	Response
Issue #1	When a firm pays certain amounts to the retiring partner, can it be said that there is a transfer from partner in favour of continuing partners?	• Gujarat HC judgement in Mohanbhai Pamabhai has held that on retirement, the partners settles out their rights and nothing more happens. Since the rights were worked out, it cannot be said that there is a transfer from the partner towards the firm or continuing partners. The said judgement was approved by Supreme Court (SC). • So, until the judgement of Bombay High Court (HC) in Tribhuvandas G Patel (supra), the view which continued is that at the time of retirement, the partners only settle their rights and no transfer can be inferred. However, the Bombay HC distinguished the judgment of Mohanbhai Pamabhai (supra) by stating that in such case, the settlement among the partners has taken on the basis of notional sale of assets, which was evident from the recording of the terms of retirement and so the judgment of Mohanbhai Pamabhai (supra) would apply only where the retiring partner was settled based on the footing of notional sale. • Since, in the facts of Tribhuvandas G Patel, the retiring partner was paid certain amount in addition to his credit in his capital account and there was a deed which stated that retiring partner relinquishes his rights in the firm towards continuing partners, the Bombay HC inferred that there is a transfer by a retiring partner towards the firm and accordingly the amount received minus amount lying in credit of capital account was subjected to tax. • The Bombay HC further stated that the retiring partner while going out and while receiving what is due to him in respect of share may assign his interest by a deed or take amount and give receipt and acknowledge that he has no more claim on his co-partners. In a case, where he assigns his interest by a deed, then it would be transfer and in the other case, where he states that he has no further claims on the co-partners, there would not be transfer. • The Bombay HC further rejected the plea of assessee that dissolution and retirement are one and the same and the decision of Malabar Fisheries Co (supra) should be applied even in case of retirement. The plea was taken to take shelter from Section 47(ii) which stated that distribution in terms of dissolution is not transfer. However, the Bombay HC stated that there was a difference between retirement and dissolution and instance of retirement was not provided in Section 47(ii) to take an exemption by the retiring partner. • The said judgment was followed subsequently in the matter of HR Aslot (supra) and NA Mody (supra), this too by Bombay HC. • Post this, the Andhra Pradesh (AP) HC in L Raghu Kumar (supra) has followed Mohanbhai Pamabhai (supra), which is also affirmed by Supreme Court by that time and held that there cannot be any transfer inferred when a partner retires from the firm. The Court has stated that the judgments of Bombay HC in Tribhuvandas G Patel (supra) and HR Aslot (supra) were based on facts and cannot be directly applied to facts in L Raghu Kumar (supra). The AP HC further stated that the view of Bombay HC stating that the retirement and dissolution are separate events was erroneous by referring Narayanappa v. Bhaskara Krishnappa (supra).

- The only shortcoming in judgment of L Raghu Kumar (supra) was that though the court has stated that the judgments of Tribhuvandas G Patel (supra) and HR Aslot (supra) were not applicable, it failed to apply the tests laid down. The Court has not took look about the mode employed for the retirement or what was the amount that was received by retiring partner, is it, lumpsum amount or amount lying credit to his account.

- When the matter was taken to SC by Revenue, the SC has affirmed the decision of AP HC in L Raghu Kumar (supra) by making reference to its earlier judgment in Mohanbhai Pamabhai (supra).

- The judgment of Bombay HC in Tribhuvandas G Patel (supra) was reversed by SC, when the matter was taken to them by assessee. The SC followed the decision of Sunil Siddharathbhai (supra) and Mohanbhai Pamabhai (supra) and held that the conclusion arrived by Bombay HC is erroneous.

- Since the judgement of Tribhuvandas G Patel (supra) was reversed by SC, all subsequent judgments which were delivered based on the Bombay HC judgment would be bad law. If such a view is taken, then it appears that the judgment of Mohanbhai Pamabhai of SC should be applicable even today and all retirements should be held as not transfers and accordingly should not be subjected to tax.

- However, it appears that the Tribunals post reversal of Tribhuvandas G Patel by SC, also follows the judgment of Bombay HC by stating that Tribhuvandas G Patel deals with the issue, whether retirement is also covered under Section 47(ii) and now that said section is omitted, the said judgement cannot be applied.

- The Pune ITAT in Shevantibhai C Mehta (supra), Mumbai ITAT in Sudhakar M Shetty (supra) and Bangalore ITAT in Savitri Kadur (supra) followed the decision of Tribhuvandas G Patel (supra), even after reversed by SC.

- From the perusal of the judgments of Tribunal, it can be inferred that as long as the settlement to retiring partner is happening to the extent of amount lying in his capital account, there cannot be any transfer. This is by following the judgement of Mohanbhai Pamabhai (supra). Where the settlement is more than credit in the capital account or lumpsum amount without reference to capital account, there exists transfer and difference between amount received and credit in capital account is treated as capital gain in the hands of retiring partner. The Bangalore ITAT in Savitri Kadur (supra) stated that even the credit in capital account is by reason of profits arising out of revaluation, said aspect should not bring any tax impact, thereby subtly distinguishing the judgment of Mumbai ITAT judgment in Sudhakar M Shetty (supra).

- From the above discussion, it is evident that there exists two different views regarding the taxation of amounts received by retiring partner. The same are listed as under:

<u>View #1 – Follow Mohanbhai Pamabhai:</u>

- By following the decision of SC in Mohanbhai Pamabhai, the retiring partner can take a stand that there exists no transfer, when he retires from the firm.

<u>View #2 – Follow Tribhuvandas G Patel:</u>

- If the retiring partner is settled only the credit lying in his capital account, then he can still follow View#1 and take a stand that there should not be any tax.

		• If the retiring partner is receiving an additional amount or lumpsum amount and there is a deed in place stating that retiring partner relinquishes his rights in assets of the firm to the continuing partners, such amounts may be taxed as capital gains. This was by following the Tribhuvandas G Patel (supra) despite it was reversed by SC. **<u>Conclusion:</u>** • As far as the amounts received are equivalent to credit lying in the capital account of retiring partner, there would not be any tax. The issue arises only if there is a lumpsum or additional amount. • Even in such cases, we are of the view that the judgment of SC in Mohanbhai Pamabhai still holds good even today. This is for the reason that though the ITA was amended to insert Section 45(3) and Section 45(4) to arrest the tax abuse strategies, there is no amendment to get the amounts received on retirement, which suggest that the legislature favours with the view of Mohanbhai Pamabhai.
Issue #2	When a firm allocates certain assets to retiring partner, can it be said that there is a transfer of capital asset by such firm to the retiring partner?	• In the above issue, we have discussed, what would be the taxability when the retiring partner is in receipt of amount. In this issue, we shall deal with taxability when the retiring partner is allotted a capital asset instead of money. • Ideally, the taxability should not be dependent upon the mode of discharge of consideration. Hence, irrespective of the fact, that retiring partner has received money or capital asset, the taxation should not change. • However, the Bombay HC in AN Naik & Associates (supra) held that allocation of capital asset to retiring partner would be taxable under Section 45(4) in the hands of the firm. The HC stated that the term 'otherwise' used in Section 45(4) covers 'retirement' because it has to be read in connection with 'transfer' used therein but not with 'dissolution'. • Accordingly, the Bombay HC held that the distribution of capital asset to retiring partner is taxable in the hands of the firm. The HC has come to such conclusion keeping the intention of legislature behind insertion of Section 45(4). The Court stated that if Section 45(4) is to be interpreted only to cover the cases of 'dissolution', then the entire intention to get Section 45(4) goes into drain. • We are of the view that subject to our comments above, the above decision lays down a good proposition.
Issue #3	When a firm distributes capital assets at the time of dissolution, can it be said that there is a transfer of capital asset by such firm to the persons?	• The SC in Malabar Fisheries Co (supra) has held that there exists no transfer when a firm dissolve. The SC stated that the firm and partners are not different and accordingly held that there cannot be transfer from firm to partners, when the firm dissolves. • However, this is fixed after insertion of Section 45(4). The said section was brought into the tax net only to override the above judgement. Hence, post 1988, when a firm distributes capital assets on its dissolution, the said transaction would be transfer in terms of Section 45(4) and accordingly taxable.
Issue #4	When a personal asset is being contributed as capital to a partnership firm in which the contributor becomes a partner, can it be said that there is a transfer of capital asset by such person to the firm?	• The SC in Sunil Siddharathbhai (supra) has stated that when a person asset is contributed to the firm, there exists a transfer for the reason that the contributing partner loses his exclusive right in the property, which earlier he has. However, the SC stated that the amount recorded in books of the firm may not represent the true value of consideration and accordingly stated that the charge fails in absence of methodology for determination of consideration. • In order to overcome this aspect, the legislature inserted Section 45(3) treating that said transaction as transfer and consideration as the amount that was being recorded in the books of the firm.

Snapshot of Judgments:

Judgment	Forum	Aspect	F	Period	Mode	Cash	Goodwill	Rev Profit	Deed	Approval by SC
Mohanbhai Pamabhai	Guj HC	Retirement	A	Prior	Capital	Y	Y	-	Y	Y
Tribhuvandas G Patel	Bom HC	Retirement	R	Prior	Lumpsum	Y	Y	Y	Y	N
HR Aslot	Bom HC	Retirement	R	Prior	Lumpsum	Y	Y	-	Y	-
L Raghu Kumar	AP HC	Retirement	A	Prior	Capital	Y	-	-	Y	Y
NA Mody	Bom HC	Retirement	R	Prior	Lumpsum	Y	Y	-	Y	-
Shevanthibhai C Mehta	ITAT Pune	Retirement	R	Post	Lumpsum	-	-	-	Y	-
AN Naik	Bom HC	Retirement	R	Post	Assets	-	-	-	Y	-
Sudhakar M Shetty	ITAT Mumbai	Retirement	R	Post	Lumpsum	Y	-	Y	Y	-
Savitri Kadur	ITAT Bang	Retirement	A & R	Post	Lumpsum	Y	Y	Y	Y	-

Judgment	Forum	Aspect	F	J1	J2	J3	J4	J5	J6	J7	J8	J9	J10
Mohanbhai Pamabhai	Guj HC	Retirement	A	F	F	-	-	-	-	-	-	-	-
Tribhuvandas G Patel	Bom HC	Retirement	R	NF	NF	NF	-	-	-	-	-	-	-
HR Aslot	Bom HC	Retirement	R	NF	NF	NF	F	-	-	-	-	-	-
L Raghu Kumar	AP HC	Retirement	A	F	F	F	NF	NF	-	-	-	-	-
NA Mody	Bom HC	Retirement	R	-	NF	NF	F	F	-	-	-	-	-
Shevanthibhai C Mehta	ITAT Pune	Retirement	R	-	-	NF	F	F	NF	F	-	-	-
AN Naik	Bom HC	Retirement	R	-	-	-	-	-	-	-	-	-	-
Sudhakar M Shetty	ITAT Mumbai	Retirement	R	-	-	NF	F	F	NF	F	F	F	-
Savitri Kadur	ITAT Bang	Retirement	A & R	-	-	D	F	F	NF	F	NF	F	F

Legends:

Acronym	Detailed
ITAT	Income Tax Appellate Tribunal
SC	Supreme Court
Y	Yes
N	No
F	Favourable
A	Assessee
R	Revenue
Prior	Prior to 1988
Post	Post to 1988
Capital	Credit lying in his/her capital account at the time of retirement
Lumpsum	Amount paid to retiring partner without reference to Capital
F	Followed
NF	Not Followed
D	Distinguished
J1	Dewas Cine Corporation
J2	Bankey Lal Vaidya
J3	Mohanbhai Pamabhai
J4	Tribhuvandas G Patel
J5	HR Aslot
J6	L Raghu Kumar
J7	NA Mody
J8	Shevanthibhai C Mehta
J9	AN Naik & Associates
J10	Sudhakar M Shetty