

Supreme Court Delivers a Landmark Judgement: Overrules High court Judgement and ruled in favour of the revenue that the amount credited to the partners' capital account pursuant to revaluation of asset is held to be capital gain u/s 45(4).

In its recent significant judgement delivered on 24.11.2022, the Supreme Court ruled in favour of the revenue that the amount credited in the capital accounts of the partners pursuant to revaluation of asset is held to be "transfer" and which fall in the category of "OTHERWISE" and therefore, the provision of Section 45(4) inserted by Finance Act, 1987 w.e.f. 01.04.1988 shall be applicable.

Facts of the Case

The respondent assessee, a partnership firm originally consisted of four partners (all brothers) engaged in the business of Dyeing and Printing, Processing, Manufacturing and Trading in Clothing. Under the Family Settlement dated 02.05.1991, the share of one of the existing partners – Shri M.H. Doshi having 25% profit share in the firm was reduced to 12% and, for his balance 13% share, three new partners were admitted namely, viz., Smt. Ranjan Doshi (11%), Shri Prakash Doshi (1%) and Shri Rajeev Doshi (1%). It appears that thereafter, Shri M.H. Doshi, Shri Manohar Doshi and Shri V. H. Doshi retired from the partnership and

reconstituted the partnership firm consisted of the partners namely, viz., Shri Hasmukh Lal H. Doshi, Smt. Rajan H. Doshi, Shri Prakash H. Doshi & Shri Rajiv H. Doshi.

The respondent filed its Return of Income for the relevant assessment years. The Return of Income was filed for A.Y. 1993-1994 @ Rs. 3,18,760/-. The same was accepted under Section 143(1) of the Income Tax Act, 1961. However, thereafter, the assessment was reopened under Section 147 of the Income Tax Act by issuance of the notice under Section 148. The assessment was reassessed under Section 143(3) read with Section 147 determining the total income of Rs. 2,55,19,490/-. Addition of Rs. 17,34,86,772/- was made towards short term capital gain under Section 45(4) of the Income Tax Act. Similar addition was made for A.Y. 1994-1995.

As per the A.O., the assessee revalued the land and building and enhanced the valuation from Rs. 21,13,225/- to Rs. 17,56,00,000/- for A.Y. 1993-1994 thereby increasing the value of the assets by Rs. 17,34,86,772/- and therefore the revaluing of the



assets, and subsequently crediting it to the respective partners' capital accounts constitutes transfer, which was liable to capital gains tax under Section 45(4) of the Income Tax Act.

On Further Appeal, the Commissioner of Income Tax (Appeals) [CIT(A)] by order dated 30.07.2004 confirmed the addition on account of Short-Term Capital Gains and held that there is a clear distribution of assets as partners have also withdrawn amounts from the capital account. CIT(A) also observed that value of the assets of the firm which commonly belonged to all the partners of the partnership have been irrevocably transferred in their profit-sharing ratio to each partner. To the extent that the value has been assigned to each partner, the partnership has effectively relinquished its interest in the assets and such relinquishment can only be termed as transfer by relinquishment.

Issue before the Hon'ble Supreme Court

The short question, which is posed for the consideration before the Court is whether amount credited on account of revaluation of fixed assets and credited to the partners' account is liable to be taxed u/s 45(4) of the Income-tax Act, 1961.

Arguments of the parties

Appellant

The Appellant vehemently submitted that the ITAT as well as the High Court have seriously erred in deleting the additions made by the A.O. towards short term capital gain. It is vehemently submitted that the assets of the firm were revalued to increase the value by an amount of Rs. 17.34 crores on 01.01.1993 relevant to A.Y. 1993-1994 and the revalued amount was credited to the accounts of the partners in their profit-sharing ratio and the credit of the asset's revaluation amount to the capital account of the partner was in effect distribution of the assets valued at Rs. 17.34 crores to the partners and that during the

years, some new partners were inducted by introduction of small amounts of capital ranging between 2.5 to 4.5 lakhs and these partners have huge credits to their capital accounts immediately after joining the partnership, which amount was available to the partners for withdrawal, the amount so revalued and credited in the capital accounts of the respective partners can be said to be "transfer" and therefore, the provisions of Section 45(4) inserted into the Income Tax Act w.e.f. 01.04.1988 shall be Applicable. It is contended that the Hon'ble High Court has not properly appreciated the object and purpose of introduction of Section 45(4). It is submitted that the introduction of Section 45(4) was accompanied by the omission of clause (ii) of Section 2(47). Section 47(ii) omitted, exempted transform by way of distribution of capital assets from the ambit of the definition of 'transfer'. It is submitted that this helped the assessee in avoiding the levy of capital gains tax by revaluing the assets and then transferring and distributing the same on dissolution. This loophole was sought to be plugged by insertion of Section 45(4) and omission of Section 2(47)(ii).

It is submitted that therefore, in the facts and circumstances of the case, the A.O. rightly made the addition towards the short-term capital gains invoking Section 45(4) of the Income Tax Act, which was not required to be deleted by the ITAT.

It is submitted that on the contrary, the decision of the Bombay High Court in the case of Commissioner of Income Tax Vs. A.N. Naik Associates and Ors., (2004) 265 ITR 346 (Bom.) shall be applicable with full force as the same was dealing with Section 45(4) wherein the court has interpreted the words "otherwise" used in Section 45(4) of the Income Tax Act and has observed and held that the word "otherwise" used in Section 45(4) takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favor of a retiring partner.



Respondent

Learned Counsel on behalf of the respondent, submitted that it was reconstitution of the partnership firm and on revaluation, the surplus amount on account of such revaluation was credited to the partners' capital account. It is submitted that the surplus on account of such revaluation credited to the partners' capital account cannot be said to be transfer as per the provisions of Section 45(4) of the Income Tax Act. It is submitted that as per the provisions of Section 45(4) of the Income Tax Act, two conditions were required to be fulfilled. Firstly, there must be a transfer by way of distribution of capital assets, secondly, that, such transfer should be either on account of dissolution of partnership firm or otherwise. It is submitted that in the present case, during the year there was neither any distribution of assets of the partnership firm nor dissolution or otherwise of the partnership firm has taken place. The surplus on revaluation of assets was notionally credited to the partners' capital account of all the partners. It is submitted that therefore as rightly observed and held by the ITAT confirmed by the Hon'ble High Court, it was not a case of transfer/deemed transfer under Section 45(4) of the Income Tax Act and therefore, both, the ITAT as well as the High Court have rightly deleted the addition made towards the short-term capital gains. Heavy reliance is placed on the decision of this Court in the case of Commissioner of Income Tax, West Bengal Vs. Hind Construction Ltd., (1972) 4 SCC 460, as well as decision of the Bombay High Court in the case of Commissioner of Income-Tax Mumbai Vs. Texspin Engg. and Mfg. Works, Mumbai, (2003) 263 ITR 345 (Bom.).

Ruling

Hon'ble Supreme Court held that the assets of the partnership firm were revalued to increase the value by an amount of Rs. 17.34 crores on 01.01.1993 (relevant to A.Y. 1993-1994) and the revalued amount

was credited to the accounts of the partners in their profit-sharing ratio and the credit of the assets' revaluation amount to the capital accounts of the partners can be said to be in effect distribution of the assets valued at Rs. 17.34 crores to the partners and that during the years, some new partners came to be inducted by introduction of small amounts of capital ranging between Rs. 2.5 to 4.5 lakhs and the said newly inducted partners had huge credits to their capital accounts immediately after joining the partnership, which amount was available to the partners for withdrawal and in fact some of the partners withdrew the amount credited in their capital accounts. Therefore, the assets so revalued and the credit into the capital accounts of the respective partners can be said to be "transfer" and which fall in the category of "OTHERWISE" and therefore, the provision of Section 45(4) inserted by Finance Act, 1987 w.e.f. 01.04.1988 shall be applicable.

As such, the court affirm the view taken by the Bombay High Court in the case of A.N. Naik Associates and Ors., (supra). In view of the above and for the reasons stated above, the impugned judgment and order passed by the High Court and that of the ITAT are unsustainable and the same deserves to be quashed and set aside and are accordingly quashed and set aside. The order passed by the Assessing Officer is hereby restored.

In light of the above rationale, the Court allowed the appeal of the revenue.

Source: Supreme Court in The Commissioner of Income-tax Vs Mansukh Dyeing and Printing Mills (Supreme Court). Vide Civil Appeal No. 8258 & 8259 of 2022 dated 24th November, 2022.



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