HAND PICKED ARTICLES & UPDATES

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MCA's Condonation of Delay Scheme, 2018- Akin to a holy dip to clear sins

During October, 2017 the MCA had disqualified more than 3 lakh directors of companies who failed to submit their annual filings for 3 or more years. This move was a bit harsh on part of certain innocent and genuine directors of companies, as they were also barred from accessing the online registry, i.e., MCA21 portal.

On December 29, 2017 the MCA has come up with much awaited scheme, named *Condonation of Delay Scheme, 2018* for disqualified directors. This scheme would definitely prove to be a 'saviour' for the disqualified directors. They can save themselves from disqualification arisen from the defaulting companies.

Key takeaways from the Condonation of Delay Scheme, 2018

1.	**Effective date:** This Scheme 2018, will be effective from Jan 01, 2018.
2.	**Validity period of the Scheme:** The validity of Scheme, 2018 is for 3 months only which starts from Jan 01, 2018 till March 31, 2018.
3.	**Who can avail of the Scheme:** This Scheme, 2018 is available toall the defaulting companies other than the companies which have been stuck off or whose names have been removed from the register of companies. *A defaulting company means as company which has not filed its financials or annual returns for a continuous period of 3 years with MCA.*
4.	**Temporarily activation of DIN:** During the period of the Scheme, the DIN of disqualified directors will be temporarily activated for filing of the required documents/ E-formson MCA portal.
5.	**Scheme would apply to certain documents/e-forms**: MCA has specified the list of e-forms for which the Scheme, 2018 is applicable such as e-from 20B/MGT-7, 23AC, 23ACA, etc.
6.	**How to seek condonation of delay:** After filing of the required overdue documents/ e-forms on MCA portal, the defaulting companies have to file the e-CODS form for seeking the condonation of delay.
7.	**Fee for Condonation of Delay:** The fee for e-CODS will be Rs. 30,000. SRN (Challan No.) of overdue documents/E-forms has to be mentioned in the e-form CODS. The new-form will be available from Feb 02, 2018.

8. **Re-activation of DIN:** On filing the overdue annual returns and financial statements and form e-CODS 2018, the DINs of the disqualified Directors would be reactivated.

9. **Consequences of non-filing of overdue documents/ e-forms:** The Directors associated with such defaulting companies if they fail to file the overdue documents and E- CODS form with additional fee and penalty till the end of such scheme their disqualification will be made final for a period of 5 years and other penalties as prescribed under Companies Act 1956 and/or Companies Act, 2013 would apply.

Comments: This is a onetime opportunity for the disqualified directors to remove their disqualifications from the companies by filing the e-CODS form along with fee of Rs. 30,000. The disqualified directors should make most of this scheme and remove non-compliances relating to non-filing of financials & annual returns. The professionals such as CAs, CSs, should guide and assist directors in complying with the scheme.

Firm escapes Capital Gain tax by distributing revaluation reserve to retiring Partners

December 30, 2017[2017] 88 taxmann.com 298 (Article)

Introduction

1. There are 2 lines of thought based on 2 sets of decisions dealing with applicability of provisions of section 45(4) of the Income-tax Act (the Act) when the partners retire.- one decided by the Bombay High Court in the case of *CIT* v. *A.N. Naik Associates*[2004] 136 Taxman 107/256 ITR 346 (Bom.) and the second one rendered by the Full Bench of the Karnataka High Court in the case of *CIT* v. *Dynamic Enterprises* [2013] 40 taxmann.com 318/[2014] 223 Taxman 331/[2013] 359 ITR 83. The Bombay High Court in the case of *A. N. Naik Associates* (*supra*) held that the word 'otherwise' used in section 45(4) of the Act takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of a retiring partner. The Full Bench of the Karnataka High Court in the case of *Dynamic Enterprises* (*supra*) has held that where retiring partner took cash towards value of his share in partnership firm and there was no distribution of capital assets among partners, there was no transfer of capital asset and, therefore, no profits or gains chargeable to tax under section 45(4) arose in hands of assessee-firm.

In this article both these decisions as well as other decisions following one of these two decisions and taking one way or the other have been discussed.

It is opined that as the intention of the Legislature based on the earlier amendment by creation (insertion) of sections 45(3) and 45(4) by the Finance Act 1987 with effect from 1st April, 1988 is not to let off amount paid to retiring partners as tax exempt, it has been advised for Legislative amendment to section 45 of the Act to take care of such "leakage of income"

Decision of the Bombay High Court in the case of *A.N. Naik Associates* (*supra*) and basis of its decision

2. In the case which arose before the Bombay High Court in *A.N. Naik Associates* case (*supra*) the issue concerned was distribution of assets to a partner on reconstitution of the firm without dissolving the firm. Since the reconstitution in this case was consequent to a family settlement with reconstitution itself subsequent to amendment, the Bombay High Court held that the new provision was attracted. The argument of the Revenue, that the expression "or otherwise" would comprehend not only dissolution but also reconstitution of the firm, was accepted. The decision of the Kerala High Court in the case of *CIT* v. *Kunnamkulam Mill Board* [2002] 125 Taxman 802/257 ITR 544 (Ker.) which held in favour of the assessee was over/distinguished in the following words-

> "But this decision in *CIT* v. *Kunnamkulam Mill Board*[2002] 125 Taxman 802 (Ker.) the assessment was for the year 1989-90. In that case, the real controversy was whether by retirement of a partner of the firm there is a transfer of the assets of the firm in favour of the surviving partners within the meaning of section 45(4) of the Act. The Division Bench of the Kerala High Court answered the same in the negative by holding that there was no transfer of assets, by holding that as long as there is no change in ownership of the firm and its properties, there is no transfer of ownership on reconstitution of the firm. This is therefore, not a case, where the assets were allotted to a retiring partner."

In the case which arose before the Bombay High Court in *A.N. Naik Associates* case (*supra*) there was neither dissolution of the firm nor discontinuance of business at any point of time. The registration of the firm continued to be the same and the written agreement testified to the fact that the partnership continued without dissolution. The business of the firm continued without any closing and assets of the firm remained with the partners without any disruption.

Decision of the Full Bench of the Karnataka High Court in the case of *Dynamic Enterprises* (*supra*) and other related decisions

3. The Full Bench of the Karnataka High Court in the case of *Dynamic Enterprises* (*supra*) has held that where retiring partner took cash towards value of his share in partnership firm and there was no distribution of capital assets among partners, there was no transfer of capital asset and, therefore, no profits or gains chargeable to tax under section 45(4) arose in hands of assessee-firm.

The Karnataka High Court in the case of *CIT* v. *Karnataka Agro Chemicals* [2014] 49 taxmann.com 324/226 Taxman 202 (Mag.) following the decision of the Full Bench in the case of *Dynamic Enterprises* (*supra*) has held that where on retirement certain sum was paid to partners due to them as per books, and no portion of goodwill was paid to retiring partners, and goodwill remained with firm, section 45 was not attracted.

The decision of the Kerala High Court in the case of *Kunnamkulam Mill Board* (*supra*) was not followed by the Karnataka High Court in the case of *CIT* v. *Gurunath Talkies* [2010] 189 Taxman 171/328 ITR 59 with the following observations

> "Be that as it may, the Division Bench of this court has followed the view taken by the Bombay High Court in *A. N. Naik's* case [2004] 136 Taxman 107(Bom.), rather than to follow the view taken by the Kerala High Court in *Kunnamkulam's* case [2002] 125 Taxman 802 and, therefore, also we are bound to follow the view expressed by this court in *Suvardhan's* case [2006] 156 Taxman 229 (Karn.).".

With regard to the decision of the Karnataka High Court in the case of *Gurunath Talkies'* case (*supra*) this is what the Full Bench in *Dynamic Enterprises* case (*supra*) observed at para.27 of its order-

> "In *Gurunath Talkies'* case (*supra*), the Division Bench of this Court followed the judgment of the Bombay High Court in the case *CIT* v. *A.N. Naik Associates* [2004] 136 Taxman 107 (Bom.). In *A.N. Naik Associates'* case (*supra*), the asset of the partnership firm was transferred to a retiring partner by way of a deed of retirement. A memorandum of family settlement was entered into and the business of those firms as set out therein was distributed in terms of the family settlement, as the party desired that various matters consisting the business and assets thereto be divided separately and partitioned. The term has also provided that such of those assets or liabilities belonging to or due from any of the firms allotted, the parties thereto in the schedule annexed shall be transferred or assigned irrevocably and possession made over and all such documents, deeds, declarations, affidavits, petitions, letters and alike as are reasonably required by the party entitled to such transfer would be effected. It is based on this document and subsequent deeds of retirement of partnership that the order of assessment was made holding that the assessees are liable for tax on capital gains ".

The Full Bench in *Dynamic Enterprises'* case (*supra*) held at para.29 as under-

> "In the instant case, the partnership firm did not transfer any right in the capital asset in favour of the retiring partner. The partnership firm did not cease to hold the property and, consequently, its right to the property is not extinguished. Conversely, the retiring partner did not acquire any right in the property as no property was transferred in their favour. The Division Bench in *Gurunath Talkies'* case (*supra*) did not appreciate this distinguishing factor and by ***wrong application of the law laid down by the Bombay High Court*** held the assessee in that case is also liable to pay capital gains tax under Section 45(4). Therefore, the said judgment does not lay down the correct law."

The Madhya Pradesh High Court in the case of *CIT* v. *Moped & Machines*[2006] 150 Taxman 98 (MP) has held, though when one of the partners of the firm dies there is dissolution of the firm, yet where the surviving partner carries on the business as a going concern with all assets and liabilities, there is no "distribution" within the meaning of the Supreme guidelines as held by the Supreme Court in *Sakthi Trading Co.* v. *CIT* [2001] 250 ITR 871/118 Taxman 301, distinguishing its earlier decision in *A.L.A Firm* v. *CIT* [1991] 189 ITR 285/55 Taxman 497(SC)

At this juncture let reference be made to these 2 decisions of the Supreme Court in *A.L.A Firm's*case (*supra*) and *Sakthi Trading Co.'s* case (*supra*)

In the case decided by the Supreme Court in *A.L.A Firm's* case (*supra*) it was held that closing stock has to be valued at market value in the case of dissolution of firm. This decision of the Supreme Court was followed in number of cases by various Tribunal Benches and High Courts even in cases where there was no dissolution and no discontinuance of business but there had been only reconstitution of the firm. One such case was the one decided by the Madras High Court in *CIT* v. *Sakthi Trading Co*. [2000] 242 ITR 468/[2002] 125 Taxman 219 purportedly following the decisions of the Supreme Court in *A.L.A Firm's* case (*supra*) and *G.R. Ramachari & Co.* v. *CIT* [1961] 41 ITR 142 (Mad.) which was approved in *A.L.A. Firm's* case (*supra*), holding that market value of closing stock has to be adopted for determining income of the firm up to date of dissolution and continuation of business by reconstitution of firm is not relevant. When this case ultimately reached the Supreme Court [*Sakthi Trading Co.'s* case (*supra*)], the Supreme Court referred to the consideration which prevailed with the High Court in *A.L.A. Firm* v. *CIT* [1976] 102 ITR 622 (Mad.) as reflected in the following passage of the High Court's judgment (p. 305 of 189 ITR and page 147 of 41 ITR) -

> "It seems to us that none of these cases has any application to the facts of the present case. There is no authority directly in point dealing with this question, where a partnership concern dissolves its business in the course of the accounting year, what is the basis on which the stock-in- trade has to be valued as on the date of dissolution. We have, accordingly, to deal with the matter on first principles."

The Supreme Court in *Sakthi Trading Co.'s* case (*supra*) then went on to observe that

> "From the above, it is evident that in *A. L. A. Firm* v. *CIT* [1991] 55 Taxman 497/189 ITR 285, this court was considering the question of valuation of closing stock at market value in a case where there was dissolution and also discontinuance of the business of the firm. In that case after dissolution, two groups were carrying on separate businesses with the assets and liabilities which fell to their shares from the dissolution of the firm. In the present case, however, though there was dissolution on account of the death of one of the partners, there was no discontinuance of the business. The unchallenged finding recorded by the Tribunal is that there was no discontinuance of business. Even as per principles laid down in *A. L. A. Firm's* case [1991] 55 Taxman 497 (SC) in such a case the closing stock is to be valued at the cost or market price, whichever is lower. That is an established rule of commercial practice and accountancy. The High Court was clearly in error in relying upon the

> decisions of the Madras High Court in the cases of *G.R. Ramachari and Co.'s* case [1961] 41 ITR 142 and *A. L. A. Firm's* case [1976] 102 ITR 622 for coming to the conclusion that assets had to be valued at market value. As already noticed, in the present case, there was no cessation of business and, therefore, the closing stock could not be directed to be valued at the market rate."

However, the decision of the Madhya Pradesh High Court in *Moped & Machines* case (*supra*) was distinguished by the Karnataka High Court in the case of *Suvardhan* v. *CIT*[2006] 156 Taxman 229/287 ITR 404 by holding that " there is no reference to omission of clause (ii) of section 47 as it stood prior to April 1,1988. In the said judgment what was considered was section 45(4) and section 2(47), as it stood then. Therefore, the said judgment would not be applicable to the issue involved in the case on hand." The High Court preferred to follow the decision of the Bombay High Court in the case of *A.N. Naik Associates* (*supra*) wherein the Bombay High Court noticed the effect of Act of 1987 whereby clause (ii) of section 47 was omitted with effect from April 1, 1988.

The facts obtaining in this case [*Suvardhan's* case (*supra*)] and how the issues were decided are as stated as under-

> "The assessee-firm was dissolved on April 1, 1992, and the assets and liabilities were taken over by one of the partners. The Assessing Officer concluded the assessment for the assessment year 1993-94 under section 144 charging capital gains in the hands of the firm in respect of the assets transferred by the firm. The Commissioner (Appeals) held that this was a case of transfer by way of distribution of capital assets on dissolution of the firm in terms of section 45(4) and that the profits or gains therefrom were chargeable to tax. The Tribunal held that the assessee-firm was liable to capital gains under section 45(4) on the ground that there was transfer or distribution of capital assets on the dissolution of the firm. On a reference:
>
> Held, dismissing the appeal, that when Parliament in its wisdom had chosen to remove a provision, which provided "no transfer", there was no need for any further amendment to section 2(47).Despite no amendment to section 2(47), in the light of removal of clause (ii) of section 47, the transaction certainly would call for tax. Therefore, section 45(4) was applicable to this case."

Following this decision of the Karnataka High Court in the case of *Suvardhan* (*supra*) a later Bench of Karnataka High Court in the case of *Gurunath Talkies* (*supra*) held that "Section 47 of the Income-tax Act, 1961, was introduced to take out certain transactions which otherwise are transfers of capital assets and otherwise taxable under section 45 , from being taxed. On the re-introduction of sub-sections (3) and (4) by the Finance Act, 1987in section 45 clause (ii) of section 47 has been expressly omitted removing the protective umbrella. The legislative intent is quite clear and this takes care of any situation where in effect there is transfer of a capital asset, by any mode and to ensure the gain being taxed."

This later decision of the Karnataka High Court in the case of *Gurunath Talkies* (*supra*) was overruled by the Full Bench in *Dynamic Enterprises* (*supra*).

It is worth extracting the substantial questions formulated by the Full Bench as well as the answer rendered by the Full Bench in the case of *Dynamic Enterprises* (*supra*) in the following words-

> "The substantial questions of law referred for our consideration are as under
>
> "When a retiring partner takes only the money towards the value of his share, whether the firm should be made liable to pay capital gains even when there is no distribution of capital asset/assets among the partners under Section 45(4) of the I.T. Act?
>
> or
>
> Whether the retiring partner would be liable to pay for the capital gains?"

The reference is answered as under:

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

4. Other cases of relevance of the Supreme Court and the High Courts

4.1. The facts of the case obtaining in *Rajlaxmi Trading Co.* v. *CIT*[2001] 117 Taxman 50/250 ITR 581 (AP) were as the following-

> "The assessee, a registered firm, was dissolved on August 31, 1990. Upon dissolution one of the partners took over it assets at the book value of Rs. 2,17,555. The Assessing Officer applied the provisions of section 45(4) of the Income-tax Act, 1961, and held that the fair market value of the transferred property was Rs. 5,36,100 as determined by the District Registrar. The Assessing Officer added Rs. 3,18,545, i.e., the difference between the amount of book value and the fair market value, being the amount determined by the District Registrar, in the hands of the assessee-firm as short-term capital gain. The Commissioner of Income-tax (Appeals) and the Tribunal confirmed the addition."

On appeal the High Court following the decision of the Supreme Court in *A.L.A. Firm's* case (*supra*) held that-:

> "The provisions of section 45(4) clearly show that on distribution of capital assets, as a result of dissolution of the firm for the purpose of section 48, the fair market value of the asset on the date of transfer should be taken as the full value of consideration received or accruing as a result of transfer. Therefore, the Tribunal was right in taking the market value as determined by the District Registrar as the full value of the consideration received or accruing for the purpose of computing the capital

gain."

4.2.The Kerala High Court in the case of *CIT* v. *Southern Tubes* [2008] 171 Taxman 254/306 ITR 216 following the decision of the Andhra Pradesh High Court in the case of *Rajlaxmi Trading Co.*(*supra*) and distinguishing the decision of the Madras High Court in the case of *CIT v. Vijayalakshmi Metal Industries* [2003] 132 Taxman 49/[2002] 256 ITR 540 held that in the case of dissolution of firm with takeover of assets by a partner provisions of section 2(47)(vi) become applicable as this section covers every agreement or arrangement in whatever manner which has the effect of transferring or enabling enjoyment of any immovable property. It was noted by the High Court in this case that the dissolution deed provided that the land and factory building would devolve upon one of the partners on dissolution and in the case of other assessee also, one partner assigned his right in the assets in favour of other partners on taking consideration in cash on reconstitution of the firm which took place after dissolution of the firm. Based on these facts the High Court held that transactions in both the cases having resulted in dissolution of firm and the partner or partners getting rights over immovable property, there was transfer within the meaning of section 2(47)(vi) of the Act and capital gains were chargeable to tax under section. 45(4) of the Act.

4.3 In *Vijayalakshmi Metal Industries*' case (*supra*), the Madras High Court found that section 45(4) of the Act would have application only where there is distribution and not where the business of the firm continued apparently by the surviving partners with the legal heirs. The liability would be crystallized only when the firm's assets are transferred either to the surviving partners or legal heirs of the deceased partner. It is only in the year in which such transfer of the assets takes place, that there could be liability. In other words, if the distribution occurred only in a later year, the assessment can be made only in such later year. If there is no distribution at all and the business is carried on by the successor firm, there can be no occasion for liability under section 45(4) of the Act.

When the decision of the Madras High Court in the case of *Vijayalakshmi Metal Industries*(*supra*) was brought to the notice of the Hon'ble Judges in the case of *A.N. Naik Associates*(*supra*) this is what they observed-

> "The court held that on dissolution or on retirement what the partner gets is a shared interest in all the assets of the firm which is replaced by an exclusive interest in an asset of equal value. This judgment was in respect of an assessment before the amendment to section 45. In *Vijayalakshmi Metal Industries* [2003] 132 Taxman 49 (Mad.) the real issue before the learned single judge (sic.) was as to when capital gain is to be brought to tax. The learned judge (sic.) held that until such time such capital asset is transferred by way of distribution of the assets on the dissolution of the firm no occasion arises for bringing to tax any capital gain on a transfer which has not taken place. The section itself gives no room for doubt as the year in which the capital gain is to be brought to tax is the previous year in which the said transfer takes place."

4.4 The Bombay High Court in the case of *Prashant S. Joshi* v. *ITO* [2010] 189 Taxman 1/324 ITR 154 relying upon the observations of the Gujarat High Court in the case of *CIT* v. *Mohanbhai Pamabhai*[1973] 91 ITR 393 has held that an amount paid to a partner upon retirement, after taking accounts and upon deduction of liabilities, does not involve an element of transfer within the meaning of section 2(47) of the Act and, therefore, there is no transfer of capital asset by way of a distribution of the capital assets, on the dissolution of a firm or otherwise. The appeal against the judgment of the Gujarat High Court in the case of *Mohanbhai Pamabhai* (*supra*) was dismissed by a Bench of three learned judges of the Supreme Court in *Addl. CIT* v. *Mohanbhai Pamabhai*[1987] 165 ITR 166 relying upon its judgment in *Sunil Siddharthbhai* v. *CIT*[1985]/23 Taxman 14W/156 ITR 509. The Supreme Court in *Sunil Siddharthbhai* (*supra*) reiterated the same principle by relying upon the judgment in *Addanki Narayanappa* v. *Bhaskara Krishtappa*, AIR 1966 SC 1300 wherein it was held that "what is envisaged on the retirement of a partner is merely his right to realise his interest and to receive its value. What is realised is the interest which the partner enjoys in the assets during the subsistence of the partnership by virtue of his status as a partner and in terms of the partnership agreement. Consequently, what the partner gets upon dissolution or upon retirement is the realisation of a pre-existing right or interest." The Supreme Court in *Sunil Siddharthbhai* (*supra*) also held that there was nothing strange in the law that a right or interest should exist in praesenti but its realisation or exercise should be postponed. The Supreme Court, *inter alia*, in cited with approval the judgment of the Gujarat High Court in *Mohanbhai Pamabhai* (*supra*) and held that there was no transfer upon the retirement of a partner upon the distribution of his share in the net assets of the firm.

The conclusions arrived at para. 15 of the judgment by the Bombay High Court in *Prashant S. Joshi* (*supra*) are worth noticing-

> "*Ex facie* sub-section (4) of section 45 deals with a situation where there is a transfer of a capital asset by way of a distribution of capital assets on the dissolution of a firm or otherwise. Evidently, on the admitted position before the court, there is no transfer of a capital asset by way of a distribution of the capital assets, on a dissolution of the firm or otherwise in the facts of this case."

This decision of the Bombay High Court in the case of *Prashant S. Joshi* (*supra*) was followed by a subsequent Bench in the case of *CIT* v. *Riyaz A. Sheikh*[2014] 41 taxmann.com 455/221 Taxman 118 (Mag.) (Bom.) wherein through a brief judgment it has been held that amounts received on retirement by a partner are exempt from tax. It was noted in this decision that "the earlier decision of this court in the case of *Prashant S. Joshi* (*supra*) placed reliance upon the decision of the Supreme Court in the case of *CIT* v. *R. Lingamallu Raghukumar*[2002] 124 Taxman 127/[2001] 247 ITR 801 (SC), wherein it has been held that amounts received on retirement by a partner are not subject to capital gains tax."

5. Orders passed by the ITAT Benches

5.1 The Chennai Bench of the ITAT in the case of *Asstt. CIT* v. *P. Sivakumar (HUF)*[2014] 43 taxmann.com 211/63 SOT 0091 (Chennai - Trib.) ((URO)) following the decision of the Full Bench of the Karnataka High Court in the case of *Dynamic Enterprises* (*supra*) has held that additional amounts paid to retiring partners in excess of the capital account are not in nature of any profit or income; and, therefore, not taxable. The Tribunal in this case held that additional amounts paid to retiring partners represented share of retiring partners in worth and value of business in which they were partners and, therefore, such additional payments made to retiring partners were not in nature of any profit or income within meaning of section 28(va) of the Act, being non-taxable capital receipts.

5.2 The Cochin Bench of the ITAT in the case of *Purayannur Industries* v. *Asstt. CIT*[2010] 188 Taxman 34 (Mag.) has held that when remaining partners continue business as a going concern consequent to the retirement of a partner and there is no distribution of assets to continuing partners it is not a case of reconstitution resulting in liability to capital gains attracting the provisions of section 45(4) of the Act. The decision of the Madras High Court in the case of *Vijayalakshmi Metal Industries* (*supra*) was followed.

Now regarding the reliance placed by the Departmental Representative on the judgment of Bombay High Court in the case of *A.N. Naik Associates* (*supra*) the Bench held that "in our opinion it cannot be applied to the facts of the present case. In that case, the asset of the partnership firm was transferred to retiring partner by way of Deed of Retirement. It is based on this document and subsequent deeds of retirement of partnership that the order of assessment was made holding that the assessees are liable for tax on capital gains, in that context the Bombay High Court held that when the assets of the partnership is transferred to retiring partner, the partnership which is assessable to tax ceased to have a right or it is a right in the properties stand extinguished in favour of the partner to whom it is transferred."

5.3 The assessee-company in the case which arose before ITAT Chennai Bench in *Sharadha Terry Products Ltd.* v. *Asstt. CIT*[2016] 68 taxmann.com 282 apart from contributing towards its share of capital in partnership firm in which it was a partner, also advanced loans and when the assessee-company retired on 6th March,2009 from the partnership firm, the assets were revalued in the books of the firm in which the assessee was a partner and the increased value of the land as on the date of retirement was credited to the capital account of the assessee-company in the firm and the question which arose before the Tribunal was whether the surplus was taxable under section 45(4) of the Act under the head capital gains or as benefit accruing under Sec.28(iv) or Sec.28(v) or Sec.28(va) of the Act. When three other partners retired earlier on 31st January, 2009 no revaluation was done. The Chennai Bench identified the issue as "the situation with which, we are concerned in this appeal is a case where the retiring partner is paid consideration in cash and he gives up his rights as partner including his rights over the assets of the partnership." The Tribunal observed at para.6.2.14 of its order that "there is divergence of view on the question as to whether there is any transfer at all in such situation by the firm in favour of the retiring partner or by the retiring partner in favour of the firm and its continuing partners" and after considering all arguments put forth on behalf of both sides through an elaborate order dated 18th

March,2016,following the decision of the Hyderabad Bench of the ITAT in the case of *Asstt. CIT* v. *N. Prasad, Executive Chairman* [2014] 43 taxmann.com 253/[2015] 153 ITD 257 wherein precedents were cited, held that amount received by a partner on dissolution of the firm or on his retirement is an amount paid towards his share capital and no element of transfer of interest in partnership asset by retiring partner to continuing partner can be said to be involved. With regard to applicability of section 28(iv) of the Act, the Tribunal held that provisions of section 28(iv) of the Act are not attracted as there was no receipt of any value of any benefit or perquisite, whether convertible into money or not, arising from business or exercise of profession by the assessee. The Tribunal also held that as provisions of section 28(v) of the Act are confined to any interest, salary, bonus, commission or remuneration, by whatever name called, due to or received by, partner of the firm, from such firm and in revenue field the same was not applicable to the assessee. With regard to the applicability of provisions of section 28(va) of the Act, relying on the decision of its Co-ordinate Bench in the case of *P. Sivakumar (HUF)* (*supra*) the Tribunal held that "additional payment even if made to the retiring partner in excess of capital account is not in nature of any profit or income within the meaning of sec.28(va) of the Act and it cannot be brought to tax as business income."

With regard to non-applicability of the decision of the Bombay High Court in the case of *A.N. Naik Associates and another* (*supra*) the Tribunal adopted the following reasoning as appearing in para. 6.9.4. of its order-

> "Now regarding the reliance placed by the ld. D.R in the judgement of Bombay High Court in the case of *A.N. Naik Associates* (*supra*), in our opinion it cannot be applied to the facts of the present case. In that case, the asset of the partnership firm was transferred to retiring partner by way of Deed of Retirement. It is based on this document and subsequent deeds of retirement of partnership that the order of assessment was made holding that the assessees are liable for tax on capital gains. In that context the Bombay High Court held that when the assets of the partnership are transferred to retiring partner, the partnership which is assessable to tax ceased to have a right or it is a right in the properties stand extinguished in favour of the partner to whom it is transferred."

5.4 In the case which arose before the ITAT Mumbai Bench in *Electroplast Engineers* v. *Asstt. CIT* [2015] 45 CCH 0189 Mum. Trib., the firm consisted of 2 partners initially carrying on business over a period of 13 years and 3 new partners were inducted on 15th January, 2010 through a "Deed of Reconstituted Partnership Deed" and immediately thereafter on 16th January,2010 the earlier 2 partners retired through a "Deed of Retirement-cum-Reconstitution of Partnership Deed" whereby the continuing partners' sharing ratio underwent a change. There was no dissolution or discontinuity of the firm or business. But at the time of the retirement of the partners, the firm created an intangible asset in the books in the form of "Goodwill" for a certain sum and this was distributed among the retiring partners in a particular ratio. The issue which arose was whether the amount distributed to retiring partners' consequent to creation of goodwill was taxable under section 45(4) of the Act.

The Tribunal following the Full Bench's decision of the Karnataka High Court in the case of *Dynamic Enterprises* (*supra*) held that "that there is no transfer of capital asset by way of distribution of capital asset at the time of making the payments to the retiring partners and, therefore, no capital gain is chargeable to tax in hands of the assessee firm."

5.5 In the case which arose before ITAT Mumbai Bench in *Keshav & Co.* v. *ITO*[2016] 76 taxmann.com 18/161 ITD 798 the assessee-firm engaged in business of construction of housing and commercial projects consisted of two partners and one of them contributed land to the partnership business whereas the other partner contributed funds and expertise in the field of construction towards development of land. Subsequently, two new partners were admitted and all the four partners continued for around eight years and thereupon, one of the partners retired from the firm. In terms of agreement, retiring partner accepted amount of credit standing in its name and cash in lieu of agreed constructed area from stock-in-trade of firm. The revenue authorities invoked provisions of section 45(4) of the Act and computed capital gains chargeable to tax in hands of the assessee-firm. The Tribunal held that as no property or asset of assessee-firm had been handed over or given to the retiring partner by way of transfer of a capital asset from the firm to the retiring partners, by which firm ceased to have any right in the property which was so transferred, provisions of section 45(4)of the Act had no application in this case and capital gains tax levied on the firm was to be deleted.

Among other cases the Tribunal placed its reliance on the decision of the Full Bench of the Karnataka High Court in the case of *Dynamic Enterprises* (*supra*).

5.6 The Mumbai Bench of the ITAT in the case of *Mahul Construction Corporation* v. *ITO*[2017] 88 taxmann.com 181 through an illuminating and detailed order has held that it is not retirement alone which triggers provisions of section 45(4) of the Act, rather it is transfer by way of distribution of capital asset by firm coupled with retirement or dissolution which triggers provisions of section 45(4) of the Act.

The assessee, a partnership firm, was formed on 9th November 2005 with 3 partners to carry on business of construction besides acting as a builder and developer. The firm acquired development rights over a piece of land on 23rd November, 2005 for a consideration of Rs. 4.67 crores. The firm was reconstituted with 3 more partners on 3rd January, 2006. Subsequently, one more partner was inducted on 6th July, 2007 and the plot which was purchased on 23rd November, 2005 was valued at Rs.67.93 crores based on the market price. The partners' capital accounts arising as a result of revaluation were credited. Subsequently, on 27th May 2008 the three partners who joined the firm on 3rd January, 2006 retired and took the amount credited to their accounts including surplus on account of revaluation to this asset. The Assessing Officer on noticing the sequences of transactions entered into by the assessee-firm formed an opinion that it was a colourable device to defraud the Revenue and inferred that there had been a transfer of capital asset as per provisions of section 45(4) of the Act because retiring partners took their share of valuation gain and the partner who had joined on 6th July, 2007 had a major share of 45% in the firm without paying any tax. The Assessing Officer also took into account the work done by assessee in different years as well as work-in-progress and was of the view that the firm had not carried out any development work till 1st April, 2008 and, therefore, treated the land appearing in the balance sheet as a capital asset and not as stock-in-trade. Accordingly, the Assessing Officer by applying the provisions of section 45(4) of the Act, assessed the entire revaluation surplus of Rs. 67,69,60,000/-, already distributed to the retiring partners, as taxable in the hands of the assessee-firm. The Commissioner of Income-tax (Appeals) concurred with the views of the Assessing Officer and dismissed the appeal of the assessee after observing that the firm had permitted the partners to take the cash standing to their credit and such cash was not the property of the partners as such cash/bank balance of the firm was also an asset of the firm being displayed on the asset side of the Balance Sheet. The Commissioner of Income-tax (Appeals) thus held against the assessee after observing that "distribution of capital assets in the form of cash, bank balance, etc., which fell under the definition of capital asset as per provisions of section 2(14) of the Act would result in capital gain in the hands of the firm under section 45(4) of the Act, read with section 2(14) of the Act. This kind of distribution as a result of revaluation gain would be squarely covered within the ambit of definition of transfer under section 2(47) of the Act."

However, the Commissioner of Income-tax (Appeals), at the same time gave some marginal relief based on wrong adoption of gross figure by the Assessing Officer instead of net figure in respect of surplus arising out of revaluation.

The Tribunal, on second appeal by the assessee, referred to the decision of the Bombay High Court in the case of *A.N. Naik Associates* (*supra*) and observed that "when the asset of the partnership is transferred to a retiring partner, the partnership which is assessable to tax ceases to have a right or its right in the property stands extinguished in favour of the partner to whom it is transferred and if so read, it will further the object and the purpose and intent of the amendment to section 45 of the Act".

The Tribunal listed out the facts of the case extensively and made the following observations at para.12 of its order-

> "From the above clauses of retirement deed, it is clear that the retiring partners merely retired from the partnership firm without any distribution of assets of the firm amongst the original and new incoming partner. Since the reconstituted firm consists of 3 old partners and 1 new partner, it is not a case where firm with erstwhile partners was taken over by new partners only. That means the assessee-firm has acquired its right in the assets of the firm by paying lump sum consideration which is nothing but the cost of improvement within the meaning of section 48(ii) of the Act. It is not a case of distributing capital assets amongst the partners at the time of retirement and, therefore, provisions of section 45(4) are not applicable. For the sole and limited purpose of settlement of accounts of the Retiring Partners, the surplus on revaluation was notionally credited to the Partner's Capital A/c. of all the partners. After such mutual adjustment of rights amongst all the partners, the retiring partners were only paid the sum standing to the credit of their Capital A/c on 27.05.2008. It

> cannot be inferred that by crediting the surplus on revaluation to Capital A/c of 4 Continuing Partners and allowing the 3 Retiring Partners to take equivalent cash subsequently amounted to distribution of rights by the Continuing Partners to the Retiring Partners"

The Tribunal then agreeing with the distinction made on behalf of the assessee, between the jurisdictional High Court's decision in the case of *A.N. Naik Associates* (*supra*) and the Full Bench's decision of the Karnataka High Court in the case of *Dynamic Enterprises* (*supra*) held that it is not retirement ***alone*** which triggers provisions of section 45(4) of the Act, rather it is transfer by way of distribution of capital asset by firm coupled with retirement or dissolution which triggers provisions of section 45(4) of the Act, held in favour of the assessee.

The Tribunal also noted at para. 19 of its order that the jurisdictional High Court in the case of *A.N. Naik Associates* (*supra*) treating the allocation of assets of the firm to the retiring partner as the clinching factor for invocation of section 45(4) of the Act would mean that transfer or allocation of exclusive interest of retiring partner in a capital asset is a must for invoking provisions of Sec. 45(4) of the Act and in the case of *A.N. Naik Associates* (*supra*)***"the said outgoing partner was also given the assets of the firm on his retirement. It was in this context it was held by the Hon'ble Bombay High Court that, even though there was no dissolution but there was distribution of assets which would fall within the sweep of 45(4) of the Act"***

Concluding Remarks

6. Like the distinction brought out by the Supreme Court in the case of *Sakthi Trading Co.*(*supra*) between dissolution without discontinuance and dissolution with discontinuance, the Full Bench of the Karnataka High Court in the case of *Dynamic Enterprises* (*supra*) has clearly brought out the distinction between transfer of rights in the assets of the firm on one hand and payment of ***only*** money to retiring partners in case of realignment of shares on reconstitution of the firm consequent to the retirement of the partners on the other (hand). If such a distinction is clearly understood there can be savings of huge amount of tax, though in the considered opinion the leakage of income resulting in reduction of tax (by such loophole) in interpretation can be avoided, if the Legislature safeguards the interest of Revenue by taking proper steps to plug this loophole that has surfaced in the interpretation of relevant section (s) on account of the judgments and orders from judicial authorities by amending the section suitably.

The purpose of introduction of section 45(4) seems to be different as expressed in the following words-.

> "Prior to the Finance Act, 1987, in the case of a partnership it was held that the assets are of the partners and not of the partnership. Therefore, if on retirement a partner received his share of the assets, may be in the form of a single asset, it was held that there was no transfer and similarly on dissolution of the partnership. Another device resorted to by an assessee was to convert an asset held independently as an asset of the firm in which the individual was a partner. The decision of the

Supreme Court in *Kartikeya V. Sarabhai* v. *CIT*[1985] 156 ITR 509 took a view that this would not amount to transfer and, therefore, fell outside the scope of the capital gain. The rationale being that the consideration for the transfer of the personal asset was indeterminate, being the right which arose or accrued to the partner during the subsistence of the partnership to get his share of profit from time-to-time and on dissolution of the partnership to get the value of his share from the net partnership asset. The Parliament with the avowed object of blocking this escape route for avoiding capital gains tax by the Finance Act, 1987, introduced sub-section (3) to section 45. The effect of this was that the profits and gains arising from the transfer of a capital asset by a partner to a firm are chargeable as the partner's income of the previous year in which the transfer took place. On a conversion of the partnership assets into individual assets on dissolution or otherwise also formed part of the same scheme of tax avoidance. To plug in this loophole the Finance Act, 1987, brought on the statute book a new sub-section (4) in section 45 of the Act. The effect is that the profits or gains arising from the transfer of a capital asset by a firm to a partner on dissolution or otherwise would be chargeable as the firm's income in the previous year in which the transfer took place and for the purposes of computation of capital gains, the fair market value of the asset on the date of transfer would be deemed to be the full value of the consideration received or accrued as a result of the transfer. Therefore, if the object of the Act is seen and the mischief it seeks to avoid, it would be clear that the intention of the Parliament was to bring into the tax net transactions whereby assets were brought into a firm or taken out of the firm."

So, a suitable amendment in clear and unambiguous terms is suggested to section 45 of the Act to care of such "leakage of income."

Income Tax Updates

1. **Income tax department in tough spot as investors go all tech**

   Crypto currencies appear to be living up to their cryptic reputation. Days after the income-tax department issued about 5 lakh notices to high net-worth individuals (HNIs) who own bitcoins or any other crypto currency, investors are drafting replies that would show they have no dues to the authorities. On its part, the income tax department may also find it difficult to figure out whether wealthy investors actually hold any bitcoins, or the income earned from these instruments.

2. **Income Tax department can now send communication to more addresses**

   The central board of Direct Taxes has amended the rules relating to service of notice, summons, requisition or order. The step widens the scope of addresses that the I-T department can use for delivering any form of communication with the taxpayers. The I-T can now use address of the assessee as available with the banks, post office, insurer or that available in government/local authority records. It can also include communication address provided under PAN database, which is meant for filing statement of financial transaction.

GST Updates

3. **Taxman plans to match GST invoices to plug revenue leakage**

   The GST Council may move the sales and purchase invoice matching system to the back end. It will do so to keep tabs on missing transactions and check over-claim of input tax credits in the goods and services tax (GST). At present, assessees claim input credits themselves by filing summary input- output returns, and the tax authorities do not have any clue whether the claims are correct or not. The process of invoice matching was supposed to be done by the assessees, though it was deferred till March.

4. **Pre-GST credits soar to Rs 90,000 cr**

   Even after the tax department casting a critical eye on the unexpectedly high claims of transitional credits by businesses paying the goods and services tax (GST), such credits have soared to upwards of Rs 90,000 crore till the December 27 deadline, up nearly 40% from September, sources told FE. The facility to avail these credits — for the taxes like excise, service tax and state VAT paid in the year prior to the GST launch — has been staggered to avoid a big revenue impact in a shorter period.

5. **Government to implement e-way bill from February as tax mopup slips**

   Nearly six lakh taxpayers availing the simple composition scheme under the GST have paid a tax of only about Rs 250 crore for July-August, leading the government to suspect large scale evasion. The government fears lack of monitoring of cargo movement could have allowed cash dealing across the entire value chain to evade taxes, which could have been reason for the sharp decline in GST collections in past two months. Nationwide launch of the eway bill from February 1 is expected to check evasion by ensuring goods are tagged and tax paid, a government official said.

6. **Anti-profiteering body gets 169 complaints**

   The anti-profiteering authority set up to look into complaints of profiteering from the goods and services tax has so far received 169 complaints alleging that suppliers of goods/ services have not passed on the GST benefits to customers. Legal metrology department is also separately dealing with violations of its circular related to revision of MRP (maximum retail price) provisions following implementation of GST, the government informed the Lok Sabha in reply to a requisition on Friday.

7. **Government extends deadline to file final GST returns till January 10**

The government has extended by 10 days the last date for filing of final sales return GSTR-1 till January 10 under the Goods and Services Tax, sources said. Businesses with turnover of up to Rs 1.5 crore will have to file GSTR-1 for July-September by January 10, 2018, as against December 31, 2017 earlier. For businesses with turnover of more than Rs 1.5 crore GSTR-1 has to be filed for the period July-November by January 10.

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