

## Revaluation surplus paid to retiring partners isn't distribution of capital asset; firm not liable to tax

**Summary – The Mumbai ITAT in a recent case of Mahul Construction Corporation., (the Assessee) held that It is not retirement alone which triggers provisions of section 45(4), 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)**

### Facts

- The assessee, a partnership firm, was engaged in the business of construction and was a builder and developer. This firm vide an agreement acquired development rights over a piece of land for a consideration. Subsequently, this partnership deed was modified on and new partners were inducted.
- Subsequently, *vide* deed of retirement & reconstitution, three partners retired from the partnership firm and took the amount credited to their accounts including surplus on account of revaluation of asset.
- The A.O. had held that the assessee had not carried out any development work till 1-4-2008 and therefore land was a capital asset and not stock-in-trade and payment of cash/bank balance by the firm for settlement of retiring partner's revalued capital balances amounted to distribution of capital asset as contemplated in section 45(4).
- The Commissioner (Appeals) on both the issues confirmed the action of the Assessing Officer by holding that the land was a capital asset and not as Stock-in-trade and also taxable under section 45(4).
- On appeal:

### Held

- The assessee-firm or the continuing partners were not the beneficiaries as no new tangible income or asset had come to them rather the assessee firm and continuing partners had purchased the share of retiring partner by paying cash. Thus, it was the retiring partners who had been benefitted by receiving much more than actual capital contributed by them on account of revaluation and they had transferred their rights in the property to the continuing partners. The mode of retirement reveals that it clearly envisages an extinguishment and assignment of the retiring partners' rights over the partnership and its properties in favour of the continuing partners/firm and thereby the retiring partners were exigible to capital gains tax.
- 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). 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 account 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 account. It cannot be inferred that by crediting the surplus on revaluation to Capital account 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. A Partnership firm constituted of its partners is governed by the provisions of Partnership Act, 1932. The partnership firm is not a legal entity and property of the partnership vests in its partners in as much as all the partners have an interest in the partnership property. The partners of a partnership firm are entitled to a share in the profits of the business to the extent of their share ratio. During the subsistence of partnership, no partner has any assigned right or shares in the partnership property. During the continuance of the partnership the partners have only a right in the profits of the partnership and no partner can deal with any portion of the partnership property as his own during the continuance of the partnership firm. In a partnership amongst partners, each and every partner of the firm has an interest in each and every property of the partnership firm. Till the accounts are settled and the residue/surplus is not distributed amongst the partners, no partner can claim any share in such assets of the partnership firm. Each partner is entitled to its share of profits in the partnership firm but the entitlement of right in the assets/ property of the partnership firm arises only on dissolution. While the firm is subsisting, there cannot be any transfer of rights in the assets of the firm by any or all partners amongst themselves because during subsistence of partnership, the firm and partners do not exist separately. There can be no transfer to oneself. This could only happen when there is dissolution of the firm. Therefore, 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.

- During the continuation of the partnership, the partners have separate rights over the assets of the firm in addition to interest in share of profits because of the fact that the value of the interest of each partner *qua* an asset cannot be isolated or carved out front value of partner's interest in the totality of the partnership assets. When an asset of the firm is allotted to a partner on dissolution or retirement of the firm, the shared interest of all the partners in the said asset, is replaced by the exclusive interest of the partner for a consideration. Thus, there is an extinguishment of the "common interest" of all the partners of the firm in that particular asset and a resultant creation of "absolute ownership" of partner to whom it is allotted. Such a transaction would qualify as a "transfer" of capital asset within the meaning of section 2(47). In fact, after revaluation of asset, there is no change of ownership as no interest of partners in the alleged capital asset is transferred to the Retiring Partners on the date of retirement, but remained in the books of the firm. On the

contrary, it is not the assessee firm which has transferred its rights, but the Retiring Partners, who *vide* extinguishment of their shared rights in favour of the Continuing Partners, are liable to capital gains tax.

- In a case where surplus due to revaluation was credited to partner's capital account but none of the partners retire during that year, then it cannot be said that there is distribution of capital assets under section 45(4) by the firm because there is no transfer by distribution on account of notional or intangible profit on mere revaluation to continuing partners. In the same situation, where no partner retires but some partners withdraw the sum lying to credit in his capital account, then also it cannot be said that there is any distribution of any capital asset to partners because it is a case of mere withdrawal from capital account, thereby increasing the liability of partner to firm & other partners. Finally, in the same situation, if one of the partners retires and also withdraws the sum lying to credit in his capital account, then also there is no distribution of capital asset by firm to partner because it is not the retirement alone which triggers the provisions of section 45(4), rather it is the transfer by way of distribution of capital asset by the firm coupled with retirement or dissolution which triggers the provision of section 45(4). Hence if there is no transfer by way of distribution of asset then the mere fact that the retiring partners have withdrawn the sum lying to credit in their account will not bring the case within the sweep of section 45(4), one of the conditions for application of section 45(4) is that there should be distribution of capital asset either on 'dissolution' of the firm or 'otherwise'.
- In case of the assessee firm also neither there is any dissolution nor is there any other event taking place, which has an effect of allocation of exclusive interest in any capital asset to the retiring partner and hence the conditions of section 45(4) are not fulfilled.
- The Assessing Officer wants to tax the amount credited in capital account of retiring as well as continuing partners within the realm of section 45(4). So far as amount credited to capital account of retiring partners is concerned, notwithstanding the fact that there is no distribution by firm to retiring partners, the transferor and transferee are like two sides of the same coin. The capital gain is chargeable only on the transferor and not on the transferee. In this case, the transferor is the partners who on their retirement assign their rights in the assets of the firm and in lieu the firm pays the retiring partners the money lying in their capital account, meaning thereby that the firm becomes the transferee in this transaction. Hence, it is the firm and its continuing partners who have acquired the rights of the retiring partners in the assets of the firm by paying them lump sum amount on their retirement. So it cannot be said that the firm is transferring any right in capital asset to the retiring partner, rather it is the retiring partner who is transferring the rights in capital assets in favour of continuing partners. The firm or the continuing partners are not the beneficiaries as no new tangible income or asset had arisen to them, rather the firm and continuing partners had purchased the share of retiring partner by paying cash and it was the retiring partners who had been benefitted by receiving much more than actual capital contributed by them on account of revaluation, thus there could be no case of tax avoidance by colourable device by the firm on the

facts and circumstances of the assessee firm's case. Accordingly, the assessee firm is not liable to capital gains on the above transaction.