

TAX FLASH NEWS

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Revaluation of assets credited to a partner's account is taxable as capital gains under Section 45(4) – Supreme Court

Executive summary

Under the Income-tax Act, 1961 (the Act), a specific provision of Section 45(4) deals with the taxability of capital gains arising from the transfer of a capital asset by way of distribution on the dissolution of a firm or 'otherwise'. There has been considerable litigation with respect to its applicability in a case where assets were distributed to partners in cases other than dissolution, for example, retirement of a partner, reconstitution of a firm, etc. In some of the cases, it was held that there must be a transfer by way of distribution of capital assets, and such transfer should be either on account of the dissolution of the partnership firm or otherwise. In such cases, it was held that the distribution of assets on retirement is not covered under Section 45(4). However, in some of the cases, courts have interpreted the term 'otherwise' and held that Section 45(4) is applicable not only to cases of dissolution but also cases where assets are transferred in favour of a retiring partner. Thus, on the distribution of capital assets to a retiring partner, capital gains are taxable in the hands of the partnership firm.

Recently, the Supreme Court in the case of *Mansukh Dyeing and Printing Mills*¹ (the taxpayer) dealt with the interpretation of the term 'otherwise' and the issue of taxability of credit of surplus on account of revaluation of assets to the partners' accounts under Section 45(4). The Supreme Court held that the revaluation of assets credited to the capital accounts of the partners would fall within the category of 'otherwise' and, therefore, the provisions of Section 45(4) are applicable. The credit of the assets' revaluation amount to the capital accounts

of the partners is, in effect, a distribution of the assets to the partners.

Facts of the case

- The taxpayer, a partnership firm, originally consisted of four partners engaged in the business of dyeing, printing, processing, manufacturing and trading in clothing.
 - On 2 May 1991, under a family settlement, the share of one of the existing partners having 25 per cent profit share in the firm was reduced to 12 per cent and for his balance 13 per cent share, three new partners were admitted. Subsequently, existing three partners retired from the partnership.
 - Further, on 1 November 1992, the firm was again reconstituted and four more partners were admitted with the contribution.
 - On 1 January 1993, the assets of the firm were revalued and an amount was credited to the accounts of the partners in their profit-sharing ratio. Two of the existing partners withdrew part of their capital.
- For Assessment Year (AY) 1993-94, the Assessing Officer (AO) observed that the new partners were immediately benefited from the credit of the revaluation amount to their capital accounts. The revaluing of the assets and subsequently crediting it to the respective partners' capital accounts constituted transfer, which was liable to capital gains tax under the erstwhile Section 45(4)². The AO made similar kind of additions for AY 1994-95.

¹ CIT v. Mansukh Dyeing and Printing Mills (Civil Appeal No. 8258 and 8259 of 2022) – Taxsutra.com (This decision deals with the period prior to the amendment to Section 45(4) by the Finance Act, 2021)

² The Finance Act, 2021 amended Section 45(4) to provide that profit or gains from receipt of money or capital asset or both by the specified person from a specified entity on reconstitution of the specified entity shall be chargeable to income-tax as income of such specified entity under the head 'Capital Gains' International Limited, a private English company limited by guarantee. All rights reserved.

- The taxpayer argued that there was no dissolution of the partnership firm and/or revaluation on the dissolution of the partnership firm. Surplus on account of revaluation credited to the partners' capital accounts was not taxable as per the provisions of Section 45(4).
- The Tribunal relying on the decision of Hind Construction Ltd³ held that revaluation of the assets and crediting it to the partners' account did not involve any transfer. The Tribunal distinguished the decision of the Bombay High Court in the case of A.N. Naik Associates and Ors.⁴ Subsequently, the High Court upheld the order of the Tribunal.

Supreme Court's decision

- The object and purpose of introduction of Section 45(4) and omission Section 47(ii)⁵ was to pluck the loophole of avoiding the levy of capital gains tax by revaluing the assets and then transferring and distributing the same at the time of dissolution.
- Under Section 45(4), the word 'or otherwise' is used in addition to dissolution. The Bombay High Court, in the case of A.N. Naik Associates and Ors., had elaborately considered the word 'otherwise' used in Section 45(4). It was held that the word 'otherwise' used in Section 45(4) takes into its ambit not only the cases of dissolution but also cases of subsisting partners of a partnership transferring the assets in favour of a retiring partner.
- The credit of the assets' revaluation amount to the capital accounts of the partners can be said to be, in effect, a distribution of the assets to the partners. Further, some new partners were introduced with small amounts of capital and the said new partners had huge credits to their capital accounts immediately after joining the partnership, which was available for withdrawal. Even some of the partners withdrew the amount credited in their capital accounts.
- Therefore, the assets revalued and the credit into the capital accounts of the respective partners can be said to be a 'transfer'. It would fall within the category of 'otherwise' and therefore, the provisions of Section 45(4) were applicable.

³ CIT v. Hind Construction Ltd [1972] 83 ITR 211 (SC)

⁴ A.N. Naik Associates and Ors. [2004] 136 Taxman 107 (Bom) - The words 'or otherwise' in old section 45(4) would include not only cases of dissolution but also the transfer of capital assets in favor of a partner on its retirement.

⁵ Section 47(ii) – exemption to the transfer by way of distribution of capital assets

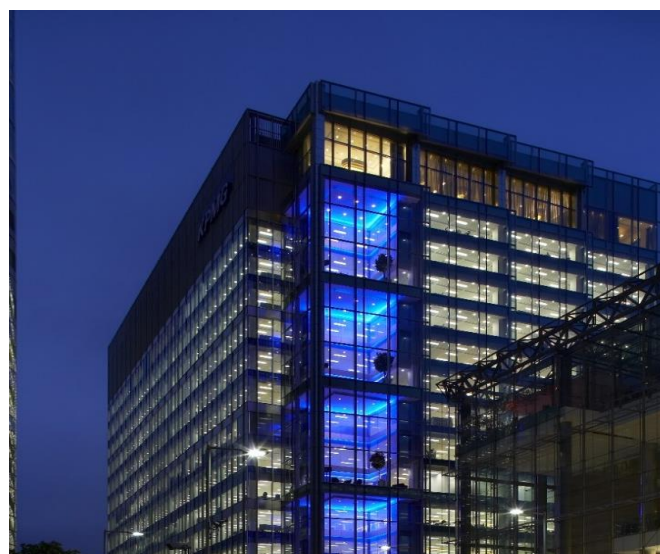
- In the case of Hind Construction Ltd., the Supreme Court had no occasion to consider Section 45(4) and the word 'otherwise'; therefore, that decision was not applicable.

Our comments

The Supreme court has upheld the Bombay High Court's decision in the case of A. N. Naik Associates and Ors, where it was held that the word 'otherwise' used in Section 45(4) is not restricted to the case of dissolution. It is also applicable to cases of transferring assets in favour of a retiring partner. The Supreme Court applied this ratio to revaluation cases and held that credit of the assets' revaluation amount to the capital accounts of the partners could be said to be, in effect, a distribution of the assets to the partners and covered under the word 'otherwise' under Section 45(4).

It is important to note that since there was an uncertainty regarding the applicability of Section 45(4) to a situation where assets are revalued or self-generated assets are recorded in the books of accounts and payment is made to a partner or member which is in excess of his capital contribution, the Finance Act, 2021 amended Section 45(4). The amended Section 45(4) provides that profit or gains from receipt of money or capital asset or both by the partner from a firm on reconstitution are chargeable to tax as income of such firm under the head 'Capital Gains'.

Taxpayers should carefully analyse this decision to determine the impact of this decision vis-à-vis Section 45(4) to their cases.



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