

IN THE HIGH COURT OF KARNATAKA AT BANGALORE

DATED THIS THE 12TH DAY OF MARCH 2012

PRESENT

THE HON'BLE MR.JUSTICE N.KUMAR

AND

THE HON'BLE MR.JUSTICE RAVI MALIMATH

ITA.NO.1317 OF 2006

C/W

ITA.NO.1316 OF 2006

C/W

ITA.NO.1318 OF 2006

ITA.NOS.1317/2006 & 1316/2006 :
BETWEEN:

1. The Commissioner of Income Tax
C.R.Building, Attavara,
Mangalore.
2. The Income Tax Officer
Ward-1(1), C.R.Building,
Bangalore.

...APPELLANTS
COMMON

(By Sri G.Kamaladhar, Advocate)

AND:

Sri P.N.Panjawani
L/H of late Sri Kartar Panjawani
No.3, Clifton Apartments,
No.51/11, III Floor,

✓

Richmond Road, Bangalore.

Deceased by LR's

1. Kamala P.Panjawani
Aged Major,
W/o late P.N.Panjawani.
2. Ajay K.Panjawani
Aged Major,
S/o late P.N.Panjawani.
3. Sanjay P.Panjawani
Aged Major,
S/o late P.N.Panjawani.
4. Renu M.Mansigani
Aged Major,
D/o late P.N.Panjawani.

Amended as per Court
Order dated 01.03.2012

All are residing at
No.8, Cliston Apartments,
No.51/11, Richmond Road,
Bangalore - 560 0025.

...RESPONDENTS
COMMON

(By Sri A.Shankar & M.Lava, Advocates)

This ITA.No.1317/2006 filed under section 260-A of I.T.Act, 1961 arising out of order dated 31.03.2006 passed in ITA.No.1227/Bang/2003, for the Assessment year 1996-1997, praying to formulate the substantial questions of law stated therein, allow the appeal and set aside the order passed by the ITAT, Bangalore in ITA.No.1227/Bang/2003 dated 31.03.2006 confirming the order of the Appellate



Commissioner & confirm the order passed by the Income Tax Officer, Ward-1(1), Bangalore.

This ITA.No.1316/2006 filed under section 260-A of I.T.Act, 1961 arising out of order dated 31.03.2006 passed in ITA.No.1226/Bang/2003, for the Assessment year 1996-1997, praying to formulate the substantial questions of law stated therein, allow the appeal and set aside the order passed by the ITAT, Bangalore in ITA.No.1226/Bang/2003 dated 31.03.2006 & the order passed by the Income Tax Officer, Ward-1(1), Bangalore.

ITA.NO.1318/2006:

BETWEEN:

1. The Commissioner of Income Tax
C.R.Building, Attavara,
Mangalore.
2. The Income Tax Officer
Ward-1(1), C.R.Building,
Bangalore.

...APPELLANTS

(By Sri G.Kamaladhar, Advocate)

AND:

Smt.Usha K.Panjawani
L/H of Late Sri Kartar Panjawani,
No.8, Cliston Apartments,
No.51/11, III Floor, Richmond Road,
Bangalore.

...RESPONDENT

(By Sri A.Shankar & Sri M.Lava, Advocates)



This ITA filed under section 260-A of I.T.Act, 1961 arising out of order dated 31.03.2006 passed in ITA.No.1228/Bang/2003, for the Assessment year 1996-1997, praying to formulate the substantial questions of law stated therein, allow the appeal and set aside the order passed by the ITAT, Bangalore in ITA.No.1228/Bang/2003 dated 31.03.2006 & the order passed by the Income Tax Officer, Ward-1(1), Bangalore.

These ITAs coming on for orders this day, N.KUMAR J., delivered the following:-

JUDGMENT

As a common question of law is involved in all these three appeals, they are taken up for consideration together and disposed off by this common order.

2. The firm M/s.Kamal Industries was dealing in manufacturing and marketing of audio and video cassettes. The partnership was constituted on 05.04.1961. The firm owned property in the form of land situated at 6/2 and 6/3, Doddanakundi Industrial Road, Tubbarahalli village, Marathahalli measuring 1,67,765 sq.ft. The firm filed its return of income for the assessment year 1992-93. Afterwards, no returns were filed on the ground that the firm had stopped its activities and there was no income.



In the books of accounts, the value of the land shown is at Rs.25,747/-, the value at which it was purchased in the year 1967. The value of the borewell, dining room and factory building along with the value of the land were shown at Rs.1,93,510/-. The firm revalued the assets as on 01.04.1995 and the opening value was at Rs.7/- crores. As on 31.03.1995, the firm consisted three partners each having equal share. The said partnership was reconstituted by a partnership deed dated 12.10.1995 admitting four more new partners. The four new partners contributed Rs.3.50 crores towards their share of capital. As a result of reconstitution of the firm, the assets hitherto owned by the firm of three partners were made over to the reconstituted firm, of seven partners. The result was that the interest of the three partners of the erstwhile firm which in the immovable property was reduced from $1/3^{\text{rd}}$ to $1/6^{\text{th}}$ or 16.67%. Therefore, the Assessing Authority held that there was a relinquishment of right and interest in so far as 50% of the interest of each of the partners in

✓

the erstwhile firm by means of assets made over to the reconstituted firm which amounted to transfer within the terms of Section 2(47) of the Income Tax Act, 1961 (for short hereinafter referred to as 'the Act'). The erstwhile three partners after reconstitution of the firm have withdrawn a sum of Rs.1,16,66,666/- each on 14.10.1995. According to the Assessing Authority, this amount represented the capital gain for relinquishment of their 50% of the right in the erstwhile partnership firm and its assets. Therefore, he framed an assessment order and accordingly held that Rs.3,46,84,942/- is the capital gain and accordingly, apportioned the same from each of the partners at Rs.1,16,66,666/- and called upon them to pay income tax on long term capital gain of Rs.23,04,329/- with interest under Section 234 (A) and 234(B), in all in a sum of Rs.59,56,689/-. Aggrieved by the said order, the assessee preferred an appeal to the Commissioner of Income Tax (Appeals). The Appellate Authority after referring to Sections 45 (1), 45(3) and 45(4) of the Act



held that the facts of the case clearly suggest that the property in the form of the land or the landed property was certainly not held by the assessee partners in their own personal capacity. This landed property was actually an asset of the firm in its capacity as legal owner. This landed property belonged to the firm and stood in its name in the relevant legal documents of ownership and was reflected as such in its books of accounts also. Therefore, if at all there was a transfer of these assets or landed property from the firm to the incoming partners in which event it is the firm, which is to be taxed, and not the individual partners. It also held that reduction in the share of profit and loss of the firm on account of induction of new partners qualifies to be categorized as "capital gains" in the hands of the old and continuing partners, is not correct. None of the provisions of the Income Tax Act specifically envisages a situation where capital gains would be chargeable on account of reduction in the share of a partner in the firm following the reconstitution of the firm



by way of induction of new partners. Therefore, a reduction in the share in a partnership firm on account of reconstitution of the firm by way of induction of new partners cannot be said to have effected a transfer of any kind even by an act of extinguishment. In view of the judgment of the Apex Court in the case of *Malbar Fisheries Co. vs. CIT* reported in (1979) 120 ITR 49, where it has been held that there is no transfer of assets even when distribution takes place upon dissolution of the firm. Therefore how can it be justified that there is a transfer of asset merely on reconstitution of the firm through induction of new partners and therefore, the Appellate Authority set aside the order passed by the Assessing Authority taxing the assessee for the capital gain. Aggrieved by the said order, the revenue preferred an appeal to the Tribunal. The Tribunal after taking note of the relevant provisions of the Income Tax Act as well as the Indian Partnership Act, 1932 and the judgments of the Apex Court held that the judgments relied on by the



revenue would apply to a case where the firm, the assessee is not genuine and the action taken by the firm should lead to a situation of tax evasion. In the instant case, it is nobody's case that the firm is not genuine. The firm even after the induction of new partners, continues to exist. Merely because, they did not carry on any business after induction of new partners is no ground to hold that it is not a genuine firm. Further held that the admission of a partner to the firm results in the reduction of the share of interest from the profit of the firm by virtue of reduction in the share of profit, but it is not the same as in transfer of property for valuable consideration in favour of the newly admitted partners. Therefore, in the instant case, it is not a case of transfer of property by the three partners because the firm is still subsisting and has not been dissolved. Therefore, it declined to interfere with the well-considered order passed by the Appellate Authority. Aggrieved by the said order, the revenue is in appeal.



3. The learned Counsel for the revenue assailing the impugned order contended that it is not disputed that the partnership firm was reconstituted by induction of four partners on 12.10.1985 who brought in Rs.3.50 crores towards share of capital. Prior to their induction, the three partners had 1/3rd share in the partnership firm and consequently, the property was owned by the partnership firm. After reconstitution, within two days i.e., on 14.10.1985 all the three assesseees who are erstwhile partners of the old firm have withdrawn a sum of Rs.1,16,66,666/- each, as their drawings i.e., the entire Rs.3.5 crores brought in by the incoming partners. After such reconstitution, the firm is not carrying on any business. Under these circumstances, the amount withdrawn by the partners represents the consideration for the reduction of their share capital percentage in the partnership and therefore, it falls within Section 45 (1) of the Act and they are liable to pay capital gains. In support of their contention, they relied on two judgments, one is of



the Apex Court and another of this Court and contended that the impugned orders are liable to be set aside.

4. Per contra, the learned Counsel appearing for the assessee submitted that the aforesaid facts are not in dispute but it does not constitute transfer as defined under Section 2(47) read with Section 45 (1) of the Act. Assuming it is to be treated as a transfer, then, the tax is to be levied at the hands of the firm and not on individual partners. Admittedly, the partnership continues and the erstwhile partners continue to have interest in the partnership assets. Merely because, they have withdrawn money from the partnership firm, it does not constitute consideration for proportionate reduction in their share in the firm. Both the appellate authorities on a careful consideration of the facts and the law on the point have rightly upheld the contention of the assessee and it does not call for any interference and therefore, he submits that there is no merit in these appeals and are liable to be dismissed.



5. These appeals were admitted to consider the following substantial question of law

"Whether the appellate authorities were right in holding that the admission of the new partners and assignment of right in the firm to the new partners out of the rights of the assessee for consideration does not amount to transfer in the hands of assessee under Sec. 2(47) of the Act and consequently not liable to tax under Sec.45 of the Act?"

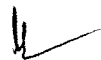
6. The Assessing Authority relying on the judgment of the Apex Court in the case of *Malbar Fisheries Co.*, has proceeded on the assumption that the partnership firm has no legal existence. The partnership property will vest in all the partners and in that sense, every partner has an interest in the property of the partnership. The partnership firm under the Indian Partnership Act, 1932 is not a distinct legal entity apart from the partners constituting it and equally in law, the firm as such has no separate rights on its own in the partnership assets and



when one talks of the firm's property or firm's assets all that is meant is properties or assets in which all the partners have a joint or common interest. Therefore, he was of the view that the ownership of the properties vest in all the partners of the firm and no partner of a firm has got any independent interest in respect of the assets of the firm. But at the same time, the firm as such has no will of its own although, it is an assessable entity under the provisions of the Act. Therefore, he was of the view that when the existing three partners having a share of $1/3^{\text{rd}}$ each in the assets of the firm have relinquished their 50% share i.e., from $1/3^{\text{rd}}$ to 16.67% in favour of the four new partners on account of which each of the three partners were able to gain a sum of Rs.1,16,66,666/- each. By the said relinquishment of their share by 50% it has resulted in a capital gain accrued even though the firm continued after its reconstitution. Further, he held that the capital gains arising in the hands of the partners of the erstwhile firm computed on the basis of reduction in their respective



shares consequent to the admission of the new partners has to be brought to tax by holding that the reconstitution of the firm had the effect or relinquishment of the part of the rights of the old partners. He further relied on the judgment in *Mc.Dowell Co. Ltd., vs. CIT*, reported in *AIR 1986 SC 649* wherein it was held that tax planning may be legitimate, provided it is within the frame work of law. Colourable devices cannot be a part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay taxes honestly without resorting to subterfuges. Therefore, according to him, the assessee being one of the partners of the erstwhile firm having derived a gain in the process of revaluation and reconstitution of the firm is liable to capital gain tax to the extent of relinquishment of his rights in the assets of the erstwhile firm in favour of the four partners of the reconstituted firm. It is the correctness of this finding, which is before us.



7. The assesseees are sought to be taxed under Section 45(1) of the Act on the ground that there is a transfer. The word transfer has been defined in Section 2(47) of the Act as under:-

"transfer", in relation to a capital asset, includes,-

- (i) the sale, exchange or relinquishment of the asset; or*
- (ii) the extinguishment of any rights therein; or*
- (iii) the compulsory acquisition thereof under any law; or*
- (iv) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment;][or]*
- [(iva) the maturity or redemption of a zero coupon bond; or]*
- [(v) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the*

✓

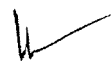
nature referred to in section 53A of the Transfer of Property Act, 1882 (4 of 1882); or

- (vi) *any transaction (whether by way of becoming a member of, or acquiring shares in, or co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.*

Explanation.- For the purpose of sub-clauses (v) and (vi), "immovable property" shall have the same meaning as in clause (d) of section 269UA;J"

8. Section 14 of the Indian Partnership Act, 1932 deals with the property of the firm, which reads as under:-

"14. The property of the firm - Subject to contract between the partners, the property of the firm includes all property and rights and interests in property originally brought into the



stock of the firm, or acquired, by purchase or otherwise, by or for the firm, or for the purposes and in the course of the business of the firm, and includes also the goodwill of the business.

Unless the contrary intention appears, property and rights and interest in property acquired with money belonging to the firm are deemed to have been acquired for the firm."

9. The Apex Court in the case of *Narayanappa vs. Bhaskara Krishnappa* reported in *AIR 1966 SC 1300* dealing with the concept of partnership held as under:-

"The Whole concept of partnership is to embark upon a joint venture and for that purpose to bring in as capital money or even property including immovable property. Once that is done, whatever is brought in would cease to be the exclusive property of the person who brought it in. It would be the trading asset of the partnership in which all the partners would have interest in proportion to their share. The person who brought it in would, therefore, not be able to claim or

✓

exercise any exclusive right over any property which he has brought in, much less over any other partnership property. He would not be able to exercise his right even to the extent of his share in the partnership. His right during the subsistence of the partnership is to get his share of profits from time to time as may be agreed upon among the partners and after the dissolution of the partnership or with his retirement from the partnership, of the value of his share in the net partnership assets as on the date of dissolution or retirement after a deduction of liabilities and other prior charges."

10. The Supreme Court in the case of *Malbar Fisheries Co. vs. CIT* reported in (1979) 120 ITR 49 explaining the position of a partnership under the Partnership Act as well as Income Tax Act held as under:-

"A Partnership Firm under the Indian Partnership Act, 1932, 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 and when one talks of firm's property or

the firm's assets all that is meant is property or assets in which all partners have a joint or common interest. It can not, therefore, be said that, upon dissolution, the firm's rights in the partnership assets are extinguished. It is the partners who own jointly or in common the assets of the partnership and, therefore, the consequence of the distribution, division or allotment of assets to the partners which flows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between partners and there is no question of any extinguishment of the firm's rights in the partnership assets amounting to a transfer of assets within the meaning of sec.2(47) of the IT Act, 1961. There is no transfer of assets involved even in the sense of any extinguishment of the firm's rights in the partnership assets when distribution takes place upon dissolution.

In order to attract S.34(3)(b) it is necessary that the sale or transfer of asset must be by the assessee to a person. Dissolution of a firm must, in point of time, be anterior to the actual distribution, division or

✓

allotment of the assets that takes place after making accounts and discharging the debts and liabilities due by the Firm. Upon dissolution the firm ceases to exist; then follows the making up of accounts, then the discharge of debts and liabilities and thereupon distribution, division or allotment of assets takes place inter se between the erstwhile partners by way of mutual adjustment of rights between them. The distribution, division, or allotment of assets of the erstwhile partners, it not done by the dissolved firm."

11. The Apex Court in the case of *Sunil Siddharthbhai vs. Commissioner of Income Tax, Ahmedabad* reported in (1985) Vol. 156 ITR 509 (SC) at pages 518, 519, 520 and 522 held as under:-

"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 the 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 the operation of future transactions of the partnership, and it may diminish in value depending on accumulating liabilities and losses with a fall in the prosperity of the partnership firm. The evaluation of a partner's interest takes place only when there is a dissolution of the firm or upon his retirement from it. It has some times been said, and we think erroneously, that the right of a partner to a share in the assets of the partnership firm arises upon dissolution of the firm or upon the partner retiring from the firm. We think it necessary to state that what is envisaged here is merely the right to realise the interest and receive its value. What is realised is the interest, which the partner enjoys in the assets during the subsistence of the partnership firm by virtue of his status as a partner and in accordance with the terms of the partnership agreement.

What the partner gets upon dissolution or upon retirement is the realisation of a pre-existing right or interest. It is nothing strange in the law that a right or interest should exist in praesenti but its realisation or exercise

✓

should be postponed. Therefore, what was the exclusive interest of a partner in his personal asset is, upon its introduction into the partnership firm as his share to the partnership capital, transformed into an interest shared with the other partners in that asset. Qua that asset, there is a shared interest. During the subsistence of the partnership, the value of the interest of each partner qua that asset cannot be isolated or carved out from the value of the partner's interest in the totality of the partnership assets. And in regard to the latter, the value will be represented by his share in the net assets on the dissolution of the firm or upon the partner's retirement.

What is the profit or gain which can be said to accrue or arise to the assessee when he makes over his personal asset to the partnership firm as his contribution to its capital? The consideration, as we have observed, is the right of a partner during the subsistence of the partnership to get his share of profits from time to time and after the dissolution of the partnership or with his retirement from the partnership to receive the



value of the share in the net partnership assets as on the date of dissolution or retirement after a deduction of liabilities and prior charges. When his personal asset merges into the capital of the partnership firm a corresponding credit entry is made in the partner's capital account in the books of the partnership firm, but that entry is made merely for the purpose of adjusting the rights of the partners inter-se when the partnership is dissolved or the partner retires. It evidences no debt due by the firm to the partner. Indeed, the capital represented by the notional entry to the credit of the partner's account may be completely wiped out by losses which may be subsequently incurred by the firm, even in the very accounting year in which the capital account is credited. Having regard to the nature and quality of the consideration which the partner may be said to acquire on introducing his personal asset into the partnership firm as his contribution to its capital it cannot be said that any income or gain arises or accrues to the assessee in the



true commercial sense which a business man would understand as real income or gain."

12. From the aforesaid judgments, it is clear that under the provisions of the Indian Partnership Act, 1932, the firm is not recognised as a legal entity. However, the Income Tax Act recognises the firm as a distinct legally assessable entity apart from its partners. This is clear from Sections 45(1), (3) and (4), of the Income Tax Act which reads as under:-

*"45. [(1)] Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections [***] [54, 54B, [***] [54D, [54E, [54EA, 54EB,] 54F [, 54G and 54H]]]], be chargeable to income tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.*

[(1A) Notwithstanding anything contained in sub-section (1), where any person receives at



any time during any previous year any money or other assets under an insurance from an insurer on account of damage to, or destruction of, any capital asset, as a result of-

- (i) flood, typhoon, hurricane, cyclone, earthquake or other convulsion of nature; or*
- (ii) riot or civil disturbance; or*
- (iii) accidental fire or explosion; or*
- (iv) action by an enemy or action taken in combating an enemy (whether with or without a declaration of war),*

then, any profits or gains arising from receipt of such money or other assets shall be chargeable to income-tax under the head "Capital gains" and shall be deemed to be the income of such person of the previous year in which such money or other asset was received and for the purposes of section 48, value of any money or the fair market value of other assets on the date of such receipt shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of such capital asset.

✓

Explanation,- For the purposes of this sub-section, the expression "insurer" shall have the meaning assigned to it in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938).]

(2) xxxx

[(3) The profits or gains arising from the transfer of a capital asset by a person to a firm or other association of persons or body of individuals (not being a company or a co-operative society) in which he is or becomes a partner or member, by way of capital contribution or otherwise, shall be chargeable to tax as his income of the previous year in which such transfer takes place and, for the purposes of section 48, the amount recorded in the books of account of the firm, association or body as the value of the capital asset shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.

(4) The profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution



of a firm or other association of persons or body of individuals (not being a company or a co-operative society) or otherwise, shall be chargeable to tax as the income of the firm, association or body, of the previous year in which the said transfer takes place and, for the purposes of section 48, the fair market value of the asset on the date of such transfer shall be deemed to be the full value of the consideration received or accruing as result of the transfer]”

13. Section 2(31) of the Income Tax Act defines 'person' as follows:-

(31) " person" includes-

- (i) an individual,*
- (ii) a Hindu undivided family,*
- (iii) a company,*
- (iv) a firm,*
- (v) an association of persons or a body of individuals, whether incorporated or not,*
- (vi) a local authority, and*

✓

(vii) every artificial juridical person, not falling within any of the preceding sub- clauses;

[Explanation - For the purposes of this clause, an association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not such person or body or authority or juridical person was formed or established or incorporated with the object of deriving income, profits or gains;]"

14. Therefore, from the aforesaid provisions, it is clear that in the context of the Income Tax Act, the identity of the firm as well as that of the partners for taxability of income are separate and distinct. The firm is a separate taxable entity liable to pay tax on income arising or accruing to it because of its own distinct set of income earning activities and factors. Similarly, in the case of individual partners also. If there is a transfer

✓

effected by a firm of capital assets i.e., property held by the firm, the capital gain tax arises in the hands of the firm and not in the hands of the partners and vice versa.

15. Section 45(3) of the Act, which was inserted by the Finance Act, 1987, which came into effect from 01.04.1988, deals with a person who transfers a capital assets to a firm as a capital contribution and becomes a partner of a firm. The income so derived is liable to be taxed at the hands of such member or partner. Whereas sub-Section 4 of Section 45 deals with profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm chargeable to tax as the income of the firm. Therefore, a clear distinction has been made between the income of the firm and income of the partner and the person who is transferring the capital assets being liable to pay capital gains.

✓

16. It is in this background if we look at the background of this case, the landed property was not owned by the erstwhile partners. It was owned by the partnership firm. May be the erstwhile partners had 1/3rd share each in all the partnership assets including this assets. On reconstitution of the firm, four more partners were inducted, who contributed Rs.3.50 crores as their capital contribution. Thus, the inducted partners also became partners in the firm and the firm continue to assets own, including this landed property. The erstwhile partners withdrew the money brought in by the incoming partners as drawings. They did not retire from the partnership firm. They continued to be the partners of the firm. However, their share got reduced. In other words, 50% of their share held before reconstitution became the share of the incoming partners. As the property was not owned by this erstwhile partners, it cannot be said they transferred 50% in favour of incoming partners and any amount represents the consideration received for such

✓

transfer and as such it is liable for payment of capital gains under Section 45 (1) of the Act. It is because they did not transfer the capital assets. In so far as arguments with regard to the reconstitution, their share got reduced and the amount which was withdrawn and partnership represents inducted partners along with erstwhile partners. As rightly pointed by the appellate authorities in the scheme of the Income Tax Act, there is no provision for levying capital gains on such consideration received for reduction of the share in the partnership firm. The provisions of Section 45(3) or 45(4) is not applicable to the facts of the case. In so far as the contention that this is a colourable device adopted by the firm as well as the assesseees to avoid payment of tax is concerned, it has no substance because tax planning is legitimate. However, it has to be done within the frame work of law.

17. The partnership firm came into existence in the year 1962. It acquired property in the year 1967. It carried on business upto 1992-93 and returns were filed

✓

from time to time. It is only in the year 1995, revaluation was done, four new partners inducted who brought in cash and the firm was not dissolved, the incoming partners did not retire from the firm and it only reduced their share in the partnership firm. The erstwhile partners only reduced their share in the partnership firm and continued to be the partners of the reconstituted firm also. Therefore, it cannot be said that either the firm is a dubious one or the entire transaction is a colourable device and the only object is to avoid payment of tax. Therefore, the law laid down by the Apex Court in the case of *Mc.Dowell Company Limited's* case has no application to the facts of this case.

18. The learned Counsel for the revenue relied on the judgment of the Apex Court in the case of *Kartikeya V.Sarabhai vs. Commissioner of Income-tax* reported in [1997] 228 ITR 0163, where it was held as follows:

"Section 2(47) of the Income-tax Act, 1961, defines "transfer" in relation to a capital asset. It is an inclusive definition which, inter



alia, provides that relinquishment of an asset or extinguishment of any right therein amounts to a transfer of a capital asset. It is not necessary for a capital gain to arise, that there must be a sale of a capital asset. Sale is only one of the modes of transfer envisaged by Section 2(47) of the Act. Relinquishment of the asset or extinguishment of any right in it, which may not amount to sale, can also be considered as a transfer and any profit or gain which arises from the transfer of a capital asset is liable to be taxed under section 45 of the Act."

19. In the instant case, as the assessee was not the owner of this capital asset, the question of relinquishing their interest in that asset or extinguishment of their right in their asset would not arise. The assets belong to the firm. The incoming partners paid money to the firm by way of their capital contribution. The firm as such has not relinquished its interest in favour of the incoming partners. On the contrary, by inducting them,

✓

they are also entitled to interest in the said assets and therefore, the said judgment has no application to the facts of this case.

20. Further, reliance was placed on the judgment of this Court in the case of *Commissioner of Income-tax vs. Gurunath Talkies* reported in [2010] 328 ITR 0059, where it was held as follows:-

"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 reintroduction of sub-sections (3) and (4) by the Finance Act, 1987 in 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."

21. In the aforesaid case, a reconstitution of the firm took place in July 1994 by addition of two partners to



the firm, who brought in about Rs.17 lakhs towards their capital contribution to the firm. Thereafter, again the firm was reconstituted with the erstwhile four partners retiring from the partnership and newly added partners remaining in the firm and continuing the firm. It is in that context, it was held that the series of transactions such as reconstitution of firm twice; once in July 1994, and again in December 1994 and entire assets retained in the hands of the newly added two partners, resulted in transfer of assets of the firm in the sense that the assets of the firm as had been held by the erstwhile partners were transferred to the newly added two partners though all along the assets of the firm continued in the hands of the firm. Therefore, it was held that there was transfer of capital assets within the meaning of Section 2 (47) attracting capital gains tax in terms of Section 45(4) of the Act.

22. In the instant case, the firm is not taxed. It is the individual partners who are taxed. More over, in the



instant case, the erstwhile partners have not retired, they also continued to be the partners along with the incoming partners. All that has happened is that the shares of the erstwhile partners are reduced. Therefore, the said judgment also has no application to the facts of this case.

23. For the aforesaid reasons, we do not see any merit in these appeals. The substantial question of law is answered in favour of the assesseees and against the revenue. Consequently, the appeals are dismissed.

Parties to bear their own costs.

Sd/-
JUDGE

Sd/-
JUDGE

Prs*