

IN THE HIGH COURT OF KERALA AT ERNAKULAM

PRESENT

THE HONOURABLE MR. JUSTICE C.K.ABDUL REHIM

&

THE HONOURABLE MR. JUSTICE R. NARAYANA PISHARADI

TUESDAY, THE 25TH DAY OF JUNE 2019 / 4TH ASHADHA, 1941

ITA.No.18 of 2014

AGAINST THE ORDER IN ITA 446/Coch/2013 of I.T.A.TRIBUNAL, COCHIN
BENCH DATED 27-09-2013

APPELLANT :

K.T.C. AUTOMOBILES
Y.M.C.A.ROAD, CALICUT-673001, PAN:AADFK4576C.

BY ADVS.
SRI.JOSEPH MARKOSE (SR.)
SRI.ABRAHAM JOSEPH MARKOS
SRI.ABRAHAM VARGHESE THARAKAN
SRI.BINU MATHEW
SRI.TOM THOMAS (KAKKUZHIYIL)
SRI.V.ABRAHAM MARKOS

RESPONDENT :

THE DEPUTY COMMISSIONER OF INCOME TAX
CIRCLE-2 (1) ,CALICUT-673001.

BY ADVS.
SRI.P.K.R.MENON, SENIOR COUNSEL, GOI (TAXES)
SRI.JOSE JOSEPH, SC, FOR INCOME TAX
SRI.P.K.R.MENONSR.COUNSEL GOITAXES

THIS INCOME TAX APPEAL HAVING BEEN FINALLY HEARD ON 11.06.2019,
THE COURT ON 25.06.2019 DELIVERED THE FOLLOWING:

**C.K.ABDUL REHIM
&
R.NARAYANA PISHARADI, JJ.**

I.T.A.No.18 of 2014

Dated this the 25th day of June, 2019

J U D G M E N T

R.Narayana Pisharadi, J

A partnership firm was converted into a private limited company. Before such conversion, the land which belonged to the firm, was revalued and the enhanced value of the land was credited to the current account of the partners of the firm. On conversion of the firm as a company, the enhanced value of the land, which was shown in the current account of the partners, was shown as loan from the partners in the hands of the company.

2. The Assessing Officer treated the enhanced value of land as capital gains of the firm and brought it to tax. The assessee firm filed appeal before the Commissioner of Income Tax (Appeals) against the assessment order but it was dismissed. The further appeal filed by the assessee before the Income Tax Appellate Tribunal was also dismissed. The

assessee has challenged the order of the Tribunal in this appeal.

3. The following substantial questions of law, as reframed by us, arise for consideration in this appeal:

i) Whether revaluation of a capital asset of the assessee firm before its conversion as a company and crediting the enhanced value of the asset to the current account of the partners and treating it as loan from the partners in the account of the company amounts to violation of clause (c) of the proviso to Section 47(xiii) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act') and if so, whether the transaction amounts to transfer of a capital asset within the purview of Section 45 of the Act?

ii) Whether, on the facts and circumstances of the case, revaluation of a capital asset of the assessee firm before its conversion as a company and crediting the enhanced value of the asset to the current account of the partners, thereby creating a liability on the firm and transferring such liability to the company amounts to violation of clause (a) of the proviso to Section 47(xiii) of the Act and if so, whether the transaction

amounts to transfer of a capital asset within the purview of Section 45 of the Act?

iii) Whether the enhanced value of the capital asset credited to the current account of the partners of the firm, if treated as capital gains, can be brought to tax payable by the erstwhile firm?

4. We have heard learned counsel for the appellant and the learned Standing Counsel, Government of India (Taxes) and also perused the records.

5. The assessee firm was in existence till the date 20.04.2004. The firm was converted as a private limited company on 21.04.2004. Before such conversion, the land which belonged to the company, which was valued at Rs.1,81,63,856/- was revalued at Rs.7,72,20,840/- and the enhanced value of the land was credited to the current account of the partners of the firm. When the company came into existence on 21.04.2004, the enhanced value of the land was shown as loan from the partners of the erstwhile firm in the account of the company as a liability. There is no dispute with regard to these facts.

6. Section 45 of the Act provides that any profits or gains arising from the transfer of a capital asset effected in

the previous year shall 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 of capital asset took place. However, Section 47 of the Act mentions certain transactions which shall not be regarded as transfer and it provides that nothing contained in Section 45 of the Act shall apply to such transactions.

7. Section 47(xiii) of the Act reads as follows:

"Nothing contained in section 45 shall apply to the following transfers:-

(xiii) any transfer of a capital asset or intangible asset by a firm to a company as a result of succession of the firm by a company in the business carried on by the firm, or any transfer of a capital asset to a company in the course of demutualisation or corporatisation of a recognised stock exchange in India as a result of which an association of persons or body of individuals is succeeded by such company:

Provided that--

(a) all the assets and liabilities of the firm or of the association of persons or body of individuals relating to the business immediately before the succession become

the assets and liabilities of the company;

(b) all the partners of the firm immediately before the succession become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the succession;

(c) the partners of the firm do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company; and

(d) the aggregate of the shareholding in the company of the partners of the firm is not less than fifty per cent of the total voting power in the company and their shareholding continues to be as such for a period of five years from the date of the succession;

(e) the demutualisation or corporatisation of a recognised stock exchange in India is carried out in accordance with a scheme for demutualisation or corporatisation which is approved by the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);”

8. Inviting our attention to Section 47(xiii) of the Act, learned counsel for the appellant has contended that there was no transfer of capital asset effected by revaluation of the asset of the firm before its conversion as a company and by crediting the enhanced value of the land in the current account of the partners and by showing it as a loan from the partners in the accounts of the company.

9. We are unable to accept the aforesaid contention. The contribution towards a fixed asset would stand enhanced in case of its revaluation. No doubt, revaluation of the land before the conversion of the firm as a company was not illegal. But, crediting the enhanced value of the asset to the current account of the partners instead of the capital account and treating it as loan in the hands of the company would amount to receipt of a benefit indirectly by the partners, other than by way of allotment of shares in the company. The reason is that the partners could withdraw this amount from the company at any time. Therefore, there was violation of the provision contained in clause (c) of the proviso to Section 47(xiii) of the Act.

10. It is pertinent to note that, in order to take the transfer of a capital asset by a firm to a company, as a result

of succession of a firm by a company, out of the purview of Section 45 of the Act, one of the conditions to be satisfied is that the partners of the firm shall not receive any consideration or benefit otherwise than by way of allotment of shares of the company. If the partners receive any benefit, other than by way of allotment of shares, it would amount to non-compliance of the provision contained in clause (c) of the proviso to Section 47(xiii) of the Act. Receipt of any benefit by the partners need not be made directly. Receiving any benefit, in any form or manner, even indirectly would result in violation of the provision contained in clause (c) of the proviso to Section 47(xiii) of the Act and it would bring the transfer within the ambit of Section 45 of the Act.

11. By revaluation of the land of the firm and crediting the enhanced value of the land to the current account of the partners, there was avoidance of the transfer of the capital of the firm to the company, without treating the same as consideration for the shares of the company. As rightly pointed out by the Tribunal, by adopting an accounting technique, a capital asset of the firm was transferred to the company and by revaluation of the asset and crediting the enhanced value of the asset to the current account of the

partners, the consideration was distributed to the partners by showing it as loan advanced by partners in the accounts of the company.

12. Learned counsel for the appellant contended that the partnership firm was converted into a company on 21.04.2004 and all the assets and liabilities of the firm as on the date 20.04.2004 were transferred to the company and therefore, there was no violation of clause (a) of the proviso to Section 47(xiii) of the Act, as found by the Tribunal. We find no merit in this contention. What is mentioned under clause (a) of the proviso to Section 47(xiii) of the Act is that all the assets and liabilities of the firm immediately before the conversion of the firm as a company shall become the assets and liabilities of the company. Crediting the enhanced value of the land, just before the conversion of the firm into a company, to the current account of the partners of the firm thereby creating a liability on the firm and showing it as liability of the company, on conversion of the firm as a company, was only a device adopted by the partners of the firm for evasion of tax. There was no such liability actually in existence immediately before the conversion of the firm into the company. Such a liability on the firm was created only by

crediting the enhanced value of the land to the current account of the partners instead of the capital account of the firm. By adopting such a method, there was violation of the condition provided under clause (a) of the proviso to Section 47(xiii) of the Act because a new liability was created on the firm which in turn created a new liability on the company.

13. The proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it. It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is up to the Court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of emerging techniques of interpretation to expose the devices for what they really are and to refuse to give judicial benediction. Tax planning may be

legitimate provided it is within the framework of law. Colourable devices cannot be 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 (See **McDowell & Company Limited v. Commercial Tax Officer : AIR 1986 SC 649**).

14. In the aforesaid circumstances, we are of the considered view that by crediting the enhanced value of the land, which belonged to the firm, to the current account of the partners of the firm and by treating it as loan from the partners in the accounts of the company, there was violation of the provisions contained in clauses (a) and (c) of the proviso to Section 47(xiii) of the Act. Therefore, the aforesaid transaction amounts to transfer of a capital asset within the purview of Section 45 of the Act and the profits or gains obtained by the transfer of the asset by the firm to the company has to be treated as capital gains. The first and the second substantial questions of law raised are answered in favour of the revenue and against the assessee.

15. Learned counsel for the appellant invited our attention to Section 47(A)(3) of the Act and contended that

even if the enhanced value of the land is treated as capital gains, it should have been brought to tax liable to be paid not by the assessee firm but by the successor company. We find merit in this contention.

16. Section 47(A)(3) of the Act provides that where any of the conditions laid down in the proviso to clause (xiii) of Section 47 of the Act are not complied with, the amount of profits or gains arising from the transfer of such capital asset or intangible asset not charged under Section 45 by virtue of the conditions laid down in the proviso to clause (xiii) of Section 47 shall be deemed to be profits and gains chargeable to tax of the successor company for the previous year in which such requirements are not complied with. It is evident from this provision that on violation of the conditions provided in the proviso to clause (xiii) of Section 47 of the Act, when the transfer of the capital asset is brought within the ambit of Section 45 of the Act, the liability to pay tax on the profits and gains of such transfer of capital asset, falls not on the erstwhile firm but on the successor company.

17. Learned Standing Counsel for the department would contend that, applicability of Section 47A(3) of the Act would arise only at a stage subsequent to the assessment of

tax, when it is later discovered that there was violation of the provisions contained in the proviso to Section 47(xiii) of the Act. We are not impressed with this contention. It is true that exemption already granted can be withdrawn by virtue of the provision contained in Section 47A(3) of the Act on discovery of violations of the conditions provided in the proviso to Section 47(xiii) of the Act. But, if the assessing authority finds at the time of assessment, that there is violation of the provisions contained in the proviso to Section 47 (xiii) of the Act, then transfer of capital assets made in that manner, comes within the ambit of Section 45 of the Act and assessment has to be done accordingly. In making such assessment, the authority concerned is obliged to take note of the provisions contained in Section 47A(3) of the Act and then the liability to pay tax has to be imposed not on the erstwhile firm but on the successor company.

18. On the basis of the discussion above, we find that the assessee firm is not liable to be assessed for the capital gains brought within the ambit of Section 45 of the Act as a result of violation of the conditions provided in clause (xiii) of Section 47 of the Act but the tax liability in that regard had fallen on the successor company. The third substantial

question of law raised is answered in favour of the assessee and against the revenue.

19. In view of the finding above, the appellant firm is not liable to be assessed to tax on capital gains.

20. Consequently, the appeal is partly allowed. Annexure-A order of assessment, which stands confirmed by the orders passed by the Commissioner of Income Tax (Appeals) and the Income Tax Appellate Tribunal respectively, is set aside. No costs in the appeal.

(sd/-)

C.K.ABDUL REHIM, JUDGE

(sd/-)

R.NARAYANA PISHARADI, JUDGE

jsr/14/06/2019

APPENDIX

EXHIBITS OF APPELLANT

ANNEXURE-A;- TRUE COPY OF ASSESSMENT ORDER DATED 6.12.2010 PASSED BY THE RESPONDENT FOR ASSESSMENT YEAR 2005-06.

ANNEXURE-B: TRUE COPY OF GROUNDS OF APPEAL DATED 7-1-2011 FILED BY THE APPELLANT BEFORE THE COMMISSIONER OF INCOME TAX (APPEALS)

ANNEXURE-C: TRUE COPY OF ORDER DATED 1-3-2013 PASSED BY THE COMMISSIONER OF INCOME TAX (APPEALS), CALICUT.

ANNEXURE-D: TRUE COPY OF GROUNDS OF APPEAL DATED 06-06-2013 FILED BY THE APPELLANT BEFORE THE INCOME TAX APPELLATE TRIBUNAL, COCHIN BENCH.

ANNEXURE-E: CERTIFIED COPY OF ORDER DATED 27-9-2013 PASSED BY THE APPELLATE TRIBUNAL.

ANNEXURE-F: TRUE COPY OF MISCELLANEOUS PETITION DATED 14.10.2013 UNDER SECTION 254(2) FILED BY THE APPELLANT BEFORE THE INCOME TAX APPELLATE TRIBUNAL.

ANNEXURE-G: CERTIFIED COPY OF ORDER DATED 6-12-2013 PASSED BY THE INCOME TAX APPELLATE TRIBUNAL IN MISCELLANEOUS PETITION M.P.NO.116/Coch/2013 FILED BY THE APPELLANT.

RESPONDENT'S EXHIBITS: NIL

TRUE COPY

PS TO JUDGE