IN THE INCOME TAX APPELLATE TRIBUNAL
BANGALORE BENCHES **" C "** BENCH: BANGALORE

BEFORE SHRI N.V. VASUDEVAN, VICE PRESIDENT
AND SHRI CHANDRA POOJARI, ACCOUNTANT MEMBER

ITA No.365/Bang/2017
(Assessment Year: 2011-12)

Asst. Commissioner of Income Tax,
Circle 1, Tumakuru. ….Appellant.

Vs.

M/s. Thirumala Rice Industries,
Plot No.5A-2, Antharasanahalli Industrial Area,
Sirsa Road, Tumakuru-572 106 ……Respondent.
PAN AAEFT 7933K

C.O. No.70/Bang/2017
(In ITA No.365/Bang/2017)
(Assessment Year: 2011-12)
(By Assessee)

Assessee By:	Shri H. Guruswamy, I.T.P.
Revenue By:	Shri Pradeep Kumar, CIT (D.R)

Date of Hearing :	13.01.2020.
Date of Pronouncement :	04.02.2020.

O R D E R

PER SHRI CHANDRA POOJARI, AM :

This appeal filed by the Revenue and C.O. by the assessee is directed against the order of Commissioner of Income Tax (Appeals)-7, Bangalore dt.28.11.2016 for the Assessment Year 2011-12.

2. The Revenue has raised the following grounds :

" 1. The order of the learned CIT (Appeals) is opposed to law and facts of the case.

2. The learned CIT (Appeals) has erred in law in ignoring the fact that the rearrangement of partnership deed was anterior to revaluation of assets.

3. Whether on the facts and circumstances of the case the CIT (Appeals) is justified in law in holding that the assessee is not liable for capital gains on the amount of revaluation of assets as it is not a relinquishment of rights over the assets but credit balance of capital and current accounts ?

4. For these and other grounds that may be urged at the time of hearing, it is prayed that the order of the CIT (Appeals) in so far as it relates to the above grounds may be reversed and that of the Assessing Officer may be restored.

5. The appellant craves leave to add, alter, amend and/or delete any of the grounds mentioned above."

3. The C.O. filed by the assessee is in support of the order of CIT (Appeals) wherein the assessee has raised the following grounds :

" 1. The Appellate order dated 28-11-2016 passed by the Learned Commissioner of Income-tax (Appeals) - 7, Bangalore was in accordance with the law and facts of the case.

2. The Learned Commissioner of Income-tax (Appeals) - 7, Bangalore was justified in deleting the addition made by the Ld. AO u/s. 45(4) with due appreciation of the evidence relied upon by the Respondent in the course of the Appellate proceedings.

3. The Ground No. 3 of the Departmental Appeal is not maintainable in law in view of the clear finding of the Ld. CIT(A) that the Respondent was not liable for Capital Gains on the amount of revaluation of the assets as it did not amount to relinquishment of right by the retired partners.

4. The Respondent craves leave to add, alter, amend and delete any of the grounds of Cross-Objections at the time of hearing. For these and other grounds that may be urged at the time of hearing, it is respectfully prayed that your Hon'ble Authority be pleased to pass an order dismissing the Departmental Appeal and further be pleased to pass such other orders

granting such other relief that your Hon'ble Authority may deem fit in the interest of justice and equity."

4. The facts of the case are that the assessee is a Partnership Firm engaged in the Business of Paddy hulling and trading in paddy and rice and filed its return of Income through e-filing on 15-09-2011 for the A.Y 2011-12 declaring income of Rs. 4,71,670/- followed by a revised return filed on 04-04-2012 declaring the reduced income of Rs. 4,04,012/-. The Partnership deed of the Firm was executed on 22-02-2007 with three partners namely Sri. M.N Narasimhamurthy Naik, Smt. Mamatha Naik and Smt. S.R Asha and the said partnership deed was reconstituted on 12-08-2010 to admit two more new partners namely T.K. Nagaraj Shetty and Sri. T.K. Ramesh Babu. The assets of the Firm were revalued on 01-04-2010. Again the firm was reconstituted second time on 17-01-2011 admitting two more partners Sri. G.N Vivek and Sri. G.N. Vinod and the existing three partners namely Sri. M.N Narasimhamurthy Naik, Smt. Mamatha Naik and Smt. S.R Asha were retired by taking their respective share of capital amount. The AO has held that the WDV of the assets of the Firm as on 01-04-2010 was of Rs. 2,04,49,437/- and after revaluation, the WDV as on 31-03-2011 was of Rs. 8,02,21,617/-. The AO further held that the outgoing three partners have drawn the amounts from the Capital and retired from the firm. The AO was of the view that the whole process constitutes a deemed dissolution of the firm u/s. 45(4) of the Act and accordingly he has brought the difference of WDV as on 01-04-2010 and 31-03-2011 amounting to

Rs.5,97,72,180/- (WDV as on 31-03-2011 Rs. 8,02,21,607 minus WDV as on 01-04-2010 of Rs. 2,04,49,437 = Rs. 5,97,72,180/-) as income of the Respondent Firm from Long Term Capital Gains. The Authorized Representative has contended that there was neither a dissolution of the firm nor distribution of the assets and as such the provisions of Section 45(4) of the Act were not applicable. The AR of the relied upon the decision of the Hon'ble High Court of Karnataka in the case CIT V/s. Dynamic Enterprises, wherein it was held that Section 45(4) of the Act was not applicable in the case of reconstitution or retirement of partners. However, the AO has rejected the submissions of the AR and held that the same facts were involved in the case of M/s. Gurunath Talkies in which the Hon'ble High Court of Karnataka has held that the re-arrangements were not akin to dissolution of the firm and Section 45(4) of the Act was not applicable. The AR submitted that the Hon'ble High Court of Karnataka in the case of M/s. Dynamic Enterprises has held that in view of the conflicting decisions in the cases of M/s. Gurunath Talkies and M/s. Mangalore Ganesh Beedi Works, the case of M/s. Dynamic Enterprises was referred to a Larger Bench for adjudication. In this regard, the AO has held that the matter before the Larger Bench was pending and therefore he relied upon the decision in case of M/s. Gurunath Talkies and accordingly a sum of Rs.5,97,72,180/- was brought to tax as Long Term Capital Gains u/s. 45(4) of the Act. 5. The ld. AR submits that the AO has mis-lead himself and got mis-directed

himself to hold that the decision of M/s. Gurunath Talkies was applicable to the Respondent case as on 13-03-2014 being the date of Assessment Order without appreciating the fact that the Larger Bench of the Hon'ble High Court of Karnataka in the case of M/s. Dynamic Enterprises has decided the issue in favour of the Assessee in ITA No. 1414/2006 in its order dated 16-09-2013. The ld. AR submits that the Larger Bench decision referred to above of the Hon'ble High Court of Karnataka was applicable to the present case, but the AO has misguided himself to hold that the decision of the case of M/s. Gurunath Talkies was still applicable dis-regarding the later decision of the Larger Bench of the Hon'ble High Court of Karnataka in the case of M/s. Dynamic Enterprises. The Larger Bench of the Hon'ble High Court of Karnataka has held that the decision of the CIT V/s. M/s. Gurunath Talkies (2010) 328 ITR 59 (Kar) was over ruled by the Judgment dated 16-09-2013. In spite of such clear and unambiguous verdict of the jurisdictional High Court, the AO has relied upon an over ruled decision of M/s. Gurunath Talkies. The Assessment Order passed by the AO placing reliance on an over ruled Judgment sets out a bad precedent which in turn amounts to disobedience of the law laid down by the Hon'ble Jurisdictional High Court of Karnataka. The ld. AR submits that the Hon'be Supreme Court in the case of Hansraj Gordhandas AIR (1970) SC 755 held that it is well established fact that in a taxing statute there is no room for any intendment and if the tax payer is within the plain terms of the

exemption it cannot be denied its benefit by calling in AID any supposed intention of the Authority. In this view of the matter, the ld. AR submits that the AO has presumed himself that the provisions of Sec. 45(4) of the Act are applicable ignoring the Larger Bench Decision of the Hon'ble High Court of Karnataka in the case of M/s. Dynamic Enterprises wherein the decision in the case of M/s. Gurunath Talkies was over ruled. The Hon'ble Supreme Court time and again has held that citing of over ruled decisions is a matter of serious concern which leads to hazardous results and mis-carriage of justice. The AO ought to have not relied upon an over ruled decision of M/s. Gurunath Talkies dis-regarding the Larger Bench decision of the Hon'ble High Court of Karnataka in the case of M/s. Dynamic Enterprises. The ld.AR submits that the AO was not justified in bringing to tax a sum of Rs. 5,97,72,180/- assessable as Long Term Capital Gains u/s. 45(4) of the Act. The ld.AR further submits that the order so passed by the AO was not justifiable as it was opposed to law and facts of the case and especially in the light of the decision of the Hon'ble High Court of Karnataka in the case of M/s. Dynamic Enterprises which is squarely applicable to the facts of the present case and therefore, the assessee has filed an Appeal before the CIT(A) who in turn has allowed the assessee's Appeal and deleted the addition made by the AO u/s. 45(4) of the Act. Under these facts and circumstances the Appeal filed by the

Department against the order of CIT (Appeals). The C.O. filed by the Assessing Officer is in support of the order of CIT (Appeals).

5. The ld. DR submitted that in this case the firm was having 3 partners namely Shri M.N. Narasimhamurthy Naik, Smt. Mamtha Naik and Smt. S.R. Asha which was reconstituted on 12.08.2010 by admitting two new partners Shri T.K. Nagaraja Shetty and Sri T.K. Ramesh Babu. The assets of the firm was revalued as on 1.42010. The firm was once again reconstituted on 17.1.2011 and some more new partners namely Shri G.N.Vivek and Shri G.N. Vinod were admitted in the firm and three existing partners Shri M.N. Narasimhamurthy Naik, Smt. Mamtha Naik got retired after withdrawing the appreciated amount of the assets as Capital of retirement from the assessee's firm. Being so, the provision of Section 45(4) of the Income Tax Act, 1961 ('the Act') is applicable and this amount has to be assessed as Long Term Capital Gain of the firm.

5.1 The ld. DR has relied on the judgement of Hon'ble Karnataka High Court in the case of CIT Vs.GurunathTalkies 328ITR59(Kar)wherein it was held that-

Capital gains.

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.

(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 a result of the transfer.]

He also relied on the judgement of Bombay High Court in the case of CIT Vs. A N Naik Associates and Another 265 ITR 346 (Bom).

6. On the other hand, the learned Authorised Representative submitted that the judgement relied on by the ld. DR in the case of CIT Vs. Gurunath Talkies (supra) was over ruled by the judgment of Hon'ble Karnataka High Court in the case of CIT Vs. Dynomic Enterprises(supra) by the Larger Bench of Hon'ble High Court of Karnataka. However, as on the date of the assessment order, the Assessing Officer was under the impression that the matter was pending before the Larger Bench of Karnataka High Court. The assessment order was passed on 13.03.2014 though the judgment in the case of CIT Vs. Dynomic Enterprises (supra) was passed on 16.09.2013, the Assessing Officer failed to follow the binding direction of the jurisdictional High Court. He supported the order of learned CIT (Appeals) which is squarely covered by the judgment of Larger Bench of Karnataka High Court in the case of CIT Vs. Dynomic Enterprises (supra). Further he relied on the

Hon'ble Supreme Court judgment in the case of Sunil Siddharthbhay Vs. CIT (1985) 156 ITR 509 (SC) wherein it was held that when a partner retired from the firm and received his share of an amount calculated on the value of the net partnership asset including goodwill of the firm. There was no transfer of interest of the partner in the goodwill and not part of the amount received by the partner could be assessed as capital gain u/s. 45 of Income Tax Act wherein the Hon'ble Supreme Court followed the earlier decision in the case of Sunil Siddharthbhay Vs CIT (supra). The learned Authorised Representative also relied on the judgment of Hon'ble Supreme Court in the case of CIT Vs. R Lingmallu Raghu Kumar (2001) 247 ITR 801wherein it was held that there is no element of transfer of interest in the Partnership Assets by the retired partner to the continuing partners and the amount received by the retiring partner is not Capital Gain u/s. 45 of the Income Tax Act. According to him the addition made by the Assessing Officer was rightly deleted by the learned CIT (Appeals).

7. We have heard both the parties and perused the material on record. In this case, originally there were three partners in the firm namely Shri M.N. Narasimhamurthy Naik, Smt. Mamtha Naik and Smt. S.R. Asha. This firm was reconstituted on 12.08.2010 wherein Shri T.K.NagarajShetty and Shri T.K. Ramesh Babu as partners. The firm was again reconstituted on 17.10.2011 wherein two more partners were admitted namely Shri G.N. Vivek and Shri G.N.

Vinod on the same day, the original three existing partners were retired namely Shri M.N. Narasimhamurthy Naik, Smt. Mamtha Naik and Smt. S.R. Asha. The Assessing Officer invoked the provisions of Section 45(4) of the Act which reads as follows :

" Capital Gains

Section 45 (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 a result of the transfer."

Thus as per Section 45(4) of the Act, distribution of capital asset or dissolution of firm or otherwise was a "Transfer" and the profit and gains arising therefrom would be chargeable to tax. Now the question before us is whether the word "Otherwise" appearing in the phrase "Distribution of capital asset on dissolution of the firm or otherwise" would include retirement of partner also. This was considered by Kerala High Court in the case of CIT Vs. Kunnamkulam Mill Board 257 ITR 544 wherein it was held as under :

> *" As per sub-section (4) of Section 45 that distribution of capital assets on dissolution of the firm or otherwise was a "transfer" and then provides that profit and gains arising therefrom would be chargeable to tax. It is also whether the word 'otherwise' appearing in the phrase "distribution of capital assets on dissolution of the firm or otherwise" would include retirement of partner also.*

Even if retirement is assumed to be covered within he ambit of expression 'otherwise' section 45(4) will not apply to retirement where only money value of the partner's interest in the firm is paid to the outgoing partner and no specific asset is distributed or transferred to the outgoing partner, because the firm continues to own the asset and for section 45(4) to attract, the firm should cease to be the owner of the asset.

In CIT Vs. Kunnamkulam Mill Board (2002) 257 ITR 544 (Ker) the firm which originally consisted of five partners was reconstituted when two more partners joined the firm and at the time of reconstitution, the assets of the firm were revalued and difference was credited to the accounts of the five original partners. After two weeks these five partners retired and amounts standing to their credit were paid to them and the firm continued the business. The Assessing Officer held that s. 45(4) was attracted and brought the difference which had been earlier credited to five partners, account to tax as capital gains in the hands of the firm. It was held that s.45(4) was not attracted because what that provision contemplated was transfer by way of distribution of assets on dissolution of firm while in the case of retirement of partners, ownership of assets did not change with the change in the constitution of the firm and the firm, though reconstituted, continued to be owner of the assets as before and hence no capital gains arose to the firm."

7.1 Further in the case of CIT Vs. Dynamic Enterprises (supra) 359 ITR 83 held as under :

" 22. However, the Income Tax Act recognizes the firm as a distinct assessable legal entity apart from its partners. Sub-sections (3) and (4) of Section 45 were introduced by Finance Act, 1987, which came into effect from 01.04.1988. In sub-section (3) what is sought to be taxed is 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. After such transfer, he is or becomes a partner or member, by way of capital contribution or otherwise. Then the said capital contribution 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. When a partner brings in his personal asset into a partnership firm as his contribution to its capital, an asset which was originally exclusively belonging to him, becomes the trading asset of the firm, in which all partners acquire interest in proportion to their respective share in the firm. His right during the subsistence of the partnership is to get his share of profits from time to time as agreed upon among the partners. On dissolution of the firm or on retirement from the firm to get the value of his share in the net partnership asset as on the date of dissolution or retirement. Therefore, this is a case of a partner bringing capital asset to a partnership firm as his capital contribution.

23. Sub-section (4) of Section 45 deals with a distribution of capital assets on the dissolution of a firm or other association of persons or body of individuals or otherwise. If in the course of such distribution of capital asset there is a transfer of a capital asset by the firm in favour of a person and it results in profits or gains to the firm, then the said profits or gains shall be chargeable to tax as income of the firm and again for computing such income, Section 48 is attracted. In other words, in the process of a dissolution of a firm, if a capital asset is transferred to a partner which results in profits or gains, then that income is chargeable at the hands of the firm under this provision. In order to attract sub-section (4) of Section 45, the condition precedent is, (1) There should be a distribution of capital assets of a firm;

(2) Such distribution should result in transfer of a capital asset by firm in favour of the partner; and (3) On account of the transfer there should be a profit or gain derived by the firm.

(4) Such distribution should be on dissolution of the firm or otherwise.

24. Therefore, in order to attract Section 45(4) of the Act, the capital asset of the firm should be transferred in favour of a partner, resulting in firm ceasing to have any interest in the capital asset transferred and the partners should acquire exclusive interest in the capital asset. In other words, the interest the firm has in the capital asset should be extinguished and the partners in whose favour the transfer is made should acquire that interest. Then only the profits or gains arising from such transfer is liable to tax under Section 45(4) of the Act.

25. In the instant case, the partnership firm had purchased the property under a registered sale deed in the name of the firm. The property did not stand in the name of any individual partners. No individual partners brought that capital asset as capital contribution into the firm. Five partners brought in cash by way of capital when the firm was reconstituted on 28.04.1993. Nearly a year thereafter on 01.04.1994 by way of retirement, the erstwhile three partners took their share in the partnership asset and went out of the partnership. After the retirement of three partners, the partnership continued to exist and the business was carried on by the remaining five partners. There was no dissolution of the firm or at any rate there was no distribution of capital asset on 01.04.1994 when three partners retired from the partnership firm. What was given to the retiring partners is cash representing the value of their share in the partnership. No capital asset was transferred on the date of retirement under the deed of retirement deed dated 01.04.1994. In the absence of distribution of capital asset and in the absence of transfer of capital asset in favour of the retiring partners, no profit or gain arose in the hands of the partnership firm. Therefore, the question of the firm being assessed under Section 45(4) and charging them tax for the profits or gains which did not accrue to them would not arise.

26. It was contended on behalf of the revenue that five incoming partners brought money into the firm. Three erstwhile partners who retired from the partners on 01.04.1994 took money and left the property to the incoming partners. It is a device adopted by these partners in order to evade payment of profits or gains. As rightly held by this Court in Gurunath's case (supra) it is taxable. This argument proceeds on the premise that the immovable property belongs to the erstwhile partners and that after the retirement the erstwhile partners have taken cash and given the property to the incoming partners. The property belongs to the partnership firm. It did not belong to the partners. The partners only had a share in the partnership asset. When the five partners came into the partnership and brought cash by way of capital contribution to the extent of their contribution, they were entitled to the proportionate share in the interest in the partnership firm. When the retiring partners took cash and retired, they were not relinquishing their interest in the immovable property. What they relinquished is their share in the partnership. Therefore, there is no transfer of a capital asset, as such, no capital gains or profit arises in the facts of this case. In that view of the matter, Section 45(4) has no application to the facts of this case.

27. In Gurunath's case (supra), the Division Bench of this Court followed the judgment of the Bombay High Court in the case Commissioner of Income Tax Vs. A.N.Naik Associate - (2004) 265 ITR 346 (BOMBAY). In Naik's case, 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 assesses are liable for tax on capital gains.

28. In that context, the Bombay High Court held that when the assets 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. If so read, it will further the object and the purpose and intent of the amendment of Section 45. Once that be the case, the transfer of assets of the partnership to the retiring partners would amount to the transfer of capital assets in the nature of capital gains and business profits which is chargeable to tax under Section 45(4) of the Income Tax Act. In that context, it was held the word "otherwise" 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. It is in this context the Bombay High Court held that Section 45(4) was attracted. Therefore, to attract Section 45(4) there should be a transfer of a capital asset from the firm to the retiring partners, by which the firms ceases to have any right in the property which is so transferred. In other words, its right to the property should stand extinguished and the retiring partners acquires absolute title to the property.

29. 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's 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.

30. We would like to add that several other aspects of Section 45(4) was addressed in the course of the arguments by both sides which are not relevant to adjudicate the present issue, as in the present case there is no distribution of assets and hence, one of the condition precedent for invoking Section 45(4) does not exist and hence Section 45(4) is not attracted to the facts of this case."

7.2 Being so, even if the retirement is assumed to be covered within the ambit of expression 'otherwise' Section 45(4) will not apply to retirement where only money value of the partner's interest in the firm is paid to the outgoing partner and no specific asset is distributed or transferred to the outgoing partner, because the firm continues to own the asset and for Section 45(4) to attract, the firm should cease to be the owner of the asset. In the present case, the assets of the firm

continued to be owned by the same firm and the outgoing partners are not taken away any asset in its physical form. Being so, in our opinion, Section 45(4) of the Act could not be applied. Accordingly, we dismiss the ground of the appeal taken by the revenue.

8. Since we have dismissed the appeal of Revenue, the C.O. filed by the assessee become infructuous and dismissed accordingly.

9. In the result, both the appeal of Revenue and C.O. by assessee are dismissed.

Pronounced in the open court on the date mentioned on the caption page.

Sd/-	Sd/-
(N.V. VASUDEVAN)	**(CHANDRA POOJARI)**
VICE PRESIDENT	**ACCOUNTANT MEMBER**

Dated: 04.02.2021.

*Reddy GP

Copy to

1. The appellant
2. The Respondent
3. CIT (A)
4. Pr. CIT
5. DR, ITAT, Bangalore.
6. Guard File

By order

Assistant Registrar
Income-tax Appellate Tribunal
Bangalore