

EY Tax Alert

Supreme Court rules revaluation of capital assets of a firm by credit to partners' capital accounts post admission of partners taxable as capital gains

Executive summary

Tax Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

This Tax Alert summarizes a ruling, dated 24 November 2022, of the Supreme Court (SC) in the case of Mansukh Dyeing and Printing Mills¹ (Taxpayer) on taxability of revaluation of capital assets of a firm by credit to partners' capital accounts in their profit-sharing ratio (PSR) as a deemed transfer of such capital assets by the firm to the partners under old section 45(4) of the Indian Tax Laws (ITL) as it stood before substitution vide Finance Act, 2021. Old section 45(4) stated that, with effect from (w. e. f.) tax year (TY) 1987-88, profits or gains arising from the transfer of a capital asset by way of distribution on the dissolution of a firm or otherwise shall be chargeable to tax as income of the firm.

In the present case, in TY 1992-93, the Taxpayer admitted four new partners who contributed small amounts of capital to the Taxpayer. Shortly thereafter, the Taxpayer revalued land and building (held as capital assets) and credited huge gains on revaluation to capital accounts of all the partners in their PSR and two of the existing partners withdrew small amounts from their capital balance. The tax authority invoked old section 45(4) on the basis that huge gains on revaluation of capital assets credited to partners' capital accounts was "in effect" a distribution of those capital assets by the Taxpayer to the partners, as the enhanced capital balance immediately became available to all the partners for withdrawal.

¹ [TS-904-SC-2022]

The Taxpayer contended that old section 45(4) was inapplicable as there was neither a transfer by way of distribution of capital assets by the Taxpayer to the partners, nor any transfer on account of dissolution of the Taxpayer or otherwise. The Taxpayer contended that there can be no income just due to revaluation of capital assets in the books of the Taxpayer, unless the capital assets themselves are also transferred.

SC held that, in the present case, credit of revaluation gain to partners' capital accounts can be said to be in effect distribution of the capital assets valued at their fair market value (FMV). SC held that the partners' capital accounts stood enhanced upon revaluation, which became available for withdrawal and in fact some of the partners had withdrawn such amounts subsequently from their capital accounts. Therefore, as per SC, such revaluation could be said to be a "transfer", falling in the category of "or otherwise", in terms of old section 45(4). SC also affirmed a Bombay High Court ruling in case of A.N. Naik Associates², which held that the word "or otherwise" covers not only distribution of capital assets on dissolution but also subsisting partners transferring the firm's capital assets in favor of a retiring partner. SC distinguished its earlier ruling in case of Hind Construction³ which regarded revaluation of goods to be non-taxable as inapplicable to the present case, as its earlier ruling dealt with pre-amended provisions where the term "or otherwise" was absent.

Background

- ▶ Prior to TY 1987-88, under section 47(ii) of ITL, "any distribution of capital assets on the dissolution of a firm" was exempt from capital gains tax in the hands of the firm. Similarly, any distribution of capital assets by a firm to its partner on retirement was not chargeable to tax under the judge-made laws in the hands of the firm. Where retiring partner's capital account was settled by payment of monetary consideration, since no capital asset was transferred by the firm to such retiring partner, there was no taxation in the hands of the firm. The partner was also not liable to tax under any of the circumstances narrated above as what he/she received was something which always belonged to him/her, in the form of his/her share in the firm's assets.
- ▶ W. e. f. TY 1987-88, however, the aforesaid scheme underwent a change with the introduction of section 45(4) vide the Finance Act, 1987 (old section 45(4)). As per Explanatory Memorandum, section 45(4) was introduced "with a view to preventing misuse of entities such as partnership firms, etc., as escape routes for avoiding capital gains tax".

Old section 45(4) stated that "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 otherwise, shall be chargeable to tax as the income of the firm". For computing capital gains, FMV of such capital asset on the date of such transfer was deemed as consideration. As a sequel, section 47(ii) was withdrawn.

As per judicially settled proposition⁴, old section 45(4) was held to be inapplicable in case of revaluation of capital assets by the firm followed by monetary payments by the firm to a partner on the partner's retirement from the firm. There was, however, a controversy on trigger of old section 45(4) where a capital asset was distributed to the partner on its retirement. Bombay High Court in the case of A. N. Naik Associates (*supra*) held that, the term, "or otherwise" in old section 45(4) includes "retirement" and therefore, firm was chargeable to capital gains tax under old section 45(4) on distribution of capital asset to a retiring partner. As per Bombay High Court, the expression "or otherwise" has to be read not *ejusdem generis* with the expression "dissolution"; but has to be read with the words "transfer of capital assets" by way of distribution of capital assets. When a firm is in existence and there is a transfer of capital assets in favor of a retiring partner, the firm/existing partners cease to have a right in such asset and the same is extinguished in favor of the retiring partner. This interpretation furthers the object of introduction of old section 45(4) to remove the loophole which existed whereby capital gain tax was not chargeable earlier.

Contrary to that, Madras High Court in the case of National Company⁵ held that distribution of capital assets to a partner on its retirement is not chargeable to capital gains tax under old section 45(4).

- ▶ W. e. f. TY 2020-21, the aforesaid scheme again underwent a change with the substitution of old section 45(4) vide Finance Act, 2021 and introduction of section 9B⁶. The new section 45(4) now levies capital gains tax in the hands of the firm on receipt of (a) any money or (b) capital asset or (c) both by a partner from a firm in connection with reconstitution of firm. For this purpose, capital gains are computed by adding value of any money and fair market value of capital asset so received by the partner from the firm and subtracting therefrom partners' capital balance in the books of the firm at the time of reconstitution of the firm (ignoring the increase in value due to revaluation of any asset or due to self-

² [(2004) 265 ITR 346 (Bombay)]

³ [(1972) 83 ITR 211 (SC)]

⁴ Illustratively, refer Dynamic Enterprises [2013] 40 taxmann.com 318 (Karnataka); Karnataka Agro Chemicals [2014] 49 taxmann.com 324 (Karnataka); Electroplast Engineers (2019) 263 Taxman 120 (Bombay); Kunnamkulam Mill Board [2002] 125 Taxman 802 (Kerala)

⁵ [(2019) 263 Taxman 511 (Madras)]

⁶ Refer our Tax Alert dated 5 July 2021, "CBDT issues guidelines and notifies rules for taxation of receipt of cash or specified assets by partners in connection with reconstitution of firms"

generated goodwill or any other self-generated asset). Section 9B states that, if a partner receives any capital asset or stock-in-trade or both from the firm in connection with dissolution or reconstitution of such firm, the firm is deemed to have transferred such capital asset or stock-in-trade or both to the partner, and for this purpose, consideration chargeable in hands of the firm is deemed as FMV of such capital asset or stock-in-trade or both on the date of such receipt by the partner from the firm. While section 9B does not trigger if firm makes monetary payments to retiring partner on dissolution or on retirement without distribution of any capital asset or stock-in-trade, such taxation in respect of monetary payments is now governed by new section 45(4). The term, "reconstitution" means one or more partners ceasing to be partners or admission of new partners or change in PSR amongst existing partners.

which commonly belonged to all partners had been irrevocably transferred to each partner in their PSR. In the view of the first appellate authority, the Taxpayer had clearly distributed assets to its partners, as some of the partners had also subsequently withdrawn amounts from their capital accounts.

The taxpayer appealed to the Tribunal, which deleted this addition and held that revaluation did not involve any transfer. The Tribunal relied upon SC's ruling in case of Hind Construction (*supra*) which held that, if a person revalues his/her goods and shows a higher value for them in his/her books, he/she cannot be considered as having sold those goods and made profits therefrom. The Tribunal held that ratio of A.N. Naik's ruling was inapplicable to the present case as in that case, assets were allotted on retirement whereas in the present case, no asset was allotted to the outgoing partner. Tribunal held that to attract s.45(4), there should be physical distribution in specie and not symbolic distribution.

Facts of the case

- ▶ The Taxpayer was a firm, originally consisting of four partners (all brothers), engaged in dyeing, printing, processing, manufacturing and trading in clothing. On 2 May 1991, one of the brothers participated in a family settlement, which resulted in 25% share of that brother getting reduced to 13%, and his 12% share came to be allotted to three family members as new partners. Soon thereafter, three of the brothers retired from the Taxpayer, leaving the Taxpayer with four partners. SC in the present appeal was not concerned with this event.
- ▶ On 1 November 1992, four new partners were admitted by contributing capital of INR 1.15Mn. On 1 January 1993, the Taxpayer revalued land and building from INR 2.1Mn to INR 175.6Mn, and credited gain on account of revaluation of INR 173.4Mn to capital accounts of all the partners (including four new partners) in their PSR. Soon thereafter, two of the old partners withdrew roughly INR 2Mn to 2.5Mn standing to the credit of their capital account.
- ▶ For TY 1992-93 (relevant to 1 January 1993), the tax authority, in course of reassessment, held that, in terms of old section 45(4), revaluation constituted a transfer of capital assets by the Taxpayer to the partners. As building was a depreciable capital asset in the hands of the Taxpayer, gain on account of revaluation (representing FMV of such building as reduced by cost) was added as short-term capital gains under section 45(4) r. w. s. 50.

The first appellate authority confirmed this addition, and held that, the Taxpayer effectively relinquished its assets in favor of the partners, because value of such assets

The tax authority appealed to the Bombay High Court, where the tax authority sought to distinguish the taxpayer's reliance on SC's ruling in case of Hind Construction (*supra*) by contending that revaluation in the present case was done with a purpose of subsequent conversion of the firm into company under Part IX of Companies Act, 1956. The Bombay High Court dismissed the tax authority's appeal on the ground that there was no conversion in the TY under appeal, and in any case, Punjab & Haryana High Court ruling in case of Rita Mechanical Works⁷, held that a firm revaluing its assets by credit to partners' capital accounts, followed by conversion of such firm into company under Part IX does not trigger old section 45(4), because conversion results in statutory vesting of firm's assets in the company, and such vesting was not consequential or incidental to a transfer in the absence of co-existence of firm and company. The tax authority appealed further to the SC.

- ▶ In subsequent TY 1993-94, the Taxpayer got converted into a company under Part IX. The tax authority again applied old section 45(4) in this year, and computed capital gain of INR 203Mn. The first appellate authority deleted such addition on the ground that gain on account of revaluation had already been assessed to tax in the preceding TY 1992-93, and hence, the same gain could not again be taxed in TY 1993-94. Before the Bombay High Court, the tax authority supported such addition on the basis that revaluation was done with a view to transfer these capital assets to the company and therefore, capital gains tax was attracted. The Bombay High Court deleted such addition and held that conversion under

⁷ [(2013) 33 taxmann.com 525]

Part IX did not constitute a transfer. The tax authority appealed further to the SC.

- ▶ In the present decision, SC rendered its ruling for both TYs 1992-93 and 1993-94.

Tax authority's contentions

- ▶ Crediting revaluation gain to partners' capital accounts was "in effect" a distribution of capital assets by Taxpayer to partners, as the capital balance became available to the partners for withdrawal.
- ▶ The erstwhile section 47(ii) exempted from capital gains tax, transfer by way of distribution of capital assets by a firm. This provision helped firms avoid levy of capital gains tax by revaluing capital assets and distributing those on dissolution. This loophole was sought to be plugged vide Finance Act, 1987, by insertion of old section 45(4) and withdrawal of section 47(ii).
- ▶ SC ruling in the case of Hind Construction (*supra*) relied upon by the Taxpayer was inapplicable as that ruling was rendered prior to insertion of old section 45(4).
- ▶ The tax authority relied on Bombay High Court ruling in the case of A. N. Naik Associates (*supra*) which held that the words "or otherwise" in old section 45(4) would include not only cases of dissolution but also transfer of capital assets in favor of a partner on its retirement.

Taxpayer's contentions

- ▶ In the present case, admittedly, there was no dissolution of the Taxpayer. There was reconstitution (involving admission of four partners) and subsequently, gain on account of revaluation was credited to all the partners' capital accounts.
- ▶ Old section 45(4) required two conditions to be fulfilled. Firstly, there must be a transfer by way of distribution of capital assets. Secondly, such transfer should be either on account of dissolution of the firm or otherwise. In the present case, during the TY 1992-93, there was neither any distribution of capital assets nor any dissolution of the firm or otherwise.
- ▶ There can be no income due to revaluation of capital assets unless the capital assets are also transferred. Whenever an asset is revalued, even as per accounting norms, corresponding notional surplus due to revaluation is required to be credited to revaluation reserve account in the case of a company or credited to partners' capital account in the case of a firm. This is only a notional or book entry which is not represented by any additional tangible asset or

income. Once it is accepted that there is no profit or gain (or real income) accruing to the firm on revaluation, there can also be no distribution of such profit or gain.

- ▶ Bombay High Court ruling in the case of A. N. Naik Associates (*supra*) relied upon by the tax authority was inapplicable as in that case capital asset of firm was transferred to a partner on its retirement whereas in the present case, no transfer of capital assets has taken place.

SC's ruling

SC upheld tax authority's contentions to the effect that revaluation involving credit to their capital accounts could be said to be "transfer" falling in the category of "or otherwise", in terms of old section 45(4) for following reasons:

- ▶ SC held that object and purpose of introducing old section 45(4) and withdrawing section 47(ii) was to pluck the loophole by which firms avoided levy of capital gains tax by revaluing the capital assets and thereafter transferring and distributing those at the time of dissolution. The words "or otherwise" in old section 45(4) are very important.
- ▶ The Taxpayer sought to argue that old section 45(4) cannot apply unless there is a dissolution and transfer of capital assets to partners. There can be no income just due to revaluation of capital assets unless the capital assets are also transferred. However, in view of insertion of old section 45(4), by which, "or otherwise" was specifically added, SC held that such submission of the Taxpayer had no substance.
- ▶ SC expressed complete agreement with the Bombay High Court ruling in case of A.N. Naik Associates (*supra*), which held that the word "or otherwise" takes into sweep not only cases of dissolution but also cases of subsisting partners transferring firm's capital assets in favor of a partner on its retirement.
- ▶ SC held that in the present case, credit of revaluation gain to partners' capital accounts can be said to be in effect distribution of the assets valued at their FMV. Given that some new partners came to be admitted by introducing small amounts of capital and immediately had huge credits to their capital accounts upon revaluation, which became available for withdrawal and, in fact, some of the partners had withdrawn such amounts from their capital accounts, revaluation involving

credit to their capital accounts could be said to be “transfer” falling in the category of “or otherwise”, in terms of old section 45(4).

- ▶ SC held that earlier SC ruling in the case of Hind Construction (*supra*) relied upon by the taxpayer was inapplicable as in that case, SC had no occasion to consider old section 45(4) and the word “or otherwise”.

In the process, SC allowed appeals of both TYs 1992-93 and 1993-94 filed by the tax authority.

Comments

SC ruling is a very significant development and is the first ruling of SC on the scope of applicability of old section 45(4) to a partnership firm.

SC was concerned with two TYs. In first TY, basis admission followed by gain on account of revaluation of land and building being credited to capital accounts of all partners including newly admitted partners followed by some partners withdrawing small amounts from their capital accounts, SC held that such revaluation can be said to be “in effect” a transfer falling in the category of “or otherwise”, triggering capital gains tax in hands of firm under old section 45(4). SC distinguished its earlier ruling which regarded revaluation of goods to be non-taxable as inapplicable to the present case, as its earlier ruling dealt with pre-amended provisions where the term “or otherwise” was absent. It overrules a host of High Court rulings which had held that old section 45(4) was inapplicable in case of revaluation of capital assets by the firm followed by monetary payments by the firm to a partner on its retirement from the firm.

It may be significant to note that SC has elaborately referred to and explicitly affirmed Bombay HC’s ruling in case of A.N. Naik Associates (*supra*) wherein distribution of firm’s assets to retiring partner was regarded as transfer of capital asset otherwise than on dissolution. Despite noting the requirement of transfer of capital asset as a pre-requisite, SC, in the present case, upheld taxability basis mere revaluation of capital asset unaccompanied by transfer and where capital asset remained within the fold of taxpayer firm.

Further, it may be noted that, effective from TY 2020-21, post amendments to ITL vide Finance Act, 2021, cash receipt by the partners from the firm in connection with reconstitution of the firm in excess of their capital balance (ignoring revaluation) is taxable in the hands of the firm. Once such value appreciation is taxed in the hands of the firm at the stage of retirement/reconstitution of the firm, ITL provides for attributing such value appreciation to remaining capital assets of the firm, which is creditable as a reduction from sale consideration, as and when such remaining capital assets are transferred by the firm

post retirement/reconstitution, in future. This avoids double taxation. The Finance Act 2021 amendment supports that a specific provision coupled with a back-up provision of granting suitable adjustment to avoid double taxation is needed to tax monetary payments made to retiring partner representing revaluation of firm’s assets. To that extent, the present SC ruling may lead to a possibility of double taxation in absence of clear guidance about correlative adjustment on account of taxation as per old section 45(4) upon revaluation of firm’s assets.

In the context of second TY, SC ruling does not reveal any facts except for a statement that tax authority made similar addition as earlier TY. However, the underlying HC ruling reveals that in second TY, Taxpayer firm was converted into a company under Part IX of Companies Act, 1956, at revalued amounts including the revaluation covered in the first TY before SC. The tax authority assessed revaluation once again which Bombay High Court deleted on the ground of duplicated taxation as also on the legal proposition that Part IX conversion does not result in transfer by following ratio of its earlier ruling in *Texspin Engg. & Mfg. Works*^[8]. Unfortunately, appeal for second year also stands disposed of by SC against the Taxpayer, without dealing with it on merits. The SC perhaps proceeded on the basis that issue and facts in second TY are identical as that in first TY. This appears to be a clear error. It may be noted that in the context of conversion under Part IX, SC in *Chetak Enterprises*^[9] has held that conversion merely results in statutory vesting of assets involving no transfer and that, no two entities exist at the same point of time and company comes into existence post cessation of the firm.

The present SC ruling is of relevance also to the association of persons or body of individuals who are also governed by similar provisions as before SC. The impact of this decision will have to be carefully analyzed by the affected taxpayers. The ratio laid down by SC in the present case may govern the litigation pending before various appellate authorities.

[8] [(2003) 263 ITR 345 (Bombay)]

[9] [(2020) 423 ITR 267 (SC)]

Our offices

Ahmedabad

22nd Floor, B Wing, Privilon
Ambli BRT Road, Behind Iskcon
Temple, Off SG Highway
Ahmedabad - 380 059
Tel: + 91 79 6608 3800

Bengaluru

12th & 13th floor
"UB City", Canberra Block
No. 24, Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 6727 5000

Ground Floor, 'A' wing
Divyasree Chambers
11, O'Shaughnessy Road
Langford Gardens
Bengaluru - 560 025
Tel: + 91 80 6727 5000

Chandigarh

Elante offices, Unit No. B-613 & 614
6th Floor, Plot No- 178-178A
Industrial & Business Park, Phase-I
Chandigarh - 160 002
Tel: + 91 172 6717800

Chennai

Tidel Park, 6th & 7th Floor
A Block, No.4, Rajiv Gandhi Salai
Taramani, Chennai - 600 113
Tel: + 91 44 6654 8100

Delhi NCR

Golf View Corporate Tower B
Sector 42, Sector Road
Gurugram - 122 002
Tel: + 91 124 443 4000

3rd & 6th Floor, Worldmark-1
IGI Airport Hospitality District
Aerocity, New Delhi - 110 037
Tel: + 91 11 4731 8000

4th & 5th Floor, Plot No 2B
Tower 2, Sector 126
Gautam Budh Nagar, U.P.
Noida - 201 304
Tel: + 91 120 671 7000

Hyderabad

THE SKYVIEW 10
18th Floor, "SOUTH LOBBY"
Survey No 83/1, Raidurgam
Hyderabad - 500 032
Tel: + 91 40 6736 2000

Jamshedpur

1st Floor, Shantiniketan Building,
Holding No. 1
SB Shop Area, Bistupur
Jamshedpur - 831 001
Tel: + 91 657 663 1000

Kochi

9th Floor, ABAD Nucleus
NH-49, Maradu PO
Kochi - 682 304
Tel: + 91 484 433 4000

Kolkata

22 Camac Street
3rd Floor, Block 'C'
Kolkata - 700 016
Tel: + 91 33 6615 3400

Mumbai

14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400 028
Tel: + 91 22 6192 0000

5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: + 91 22 6192 0000

Pune

C-401, 4th floor
Panchshil Tech Park, Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 4912 6000

Ernst & Young LLP

EY | Building a better working world

About EY

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EYG member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is one of the Indian client serving member firms of EYGM Limited. For more information about our organization, please visit www.ey.com/en_in.

Ernst & Young LLP is a Limited Liability Partnership, registered under the Limited Liability Partnership Act, 2008 in India, having its registered office at 22 Camac Street, 3rd Floor, Block C, Kolkata - 700016

© 2022 Ernst & Young LLP. Published in India.
All Rights Reserved.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.



Download the EY India Tax Insights App

ey.com/en_in

[@EY_India](https://twitter.com/EY_India) [in](https://www.linkedin.com/company/ey) EY [YouTube](https://www.youtube.com/channel/UCv31111111111111111111) EY India [f](https://www.facebook.com/EY_Careers_India) EY Careers India [ig](https://www.instagram.com/ey_indiacareers) @ey_indiacareers