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### Compensation for reduction in profit sharing ratio of partner not chargeable to capital gains tax

The Mumbai Bench of the Indian Income-tax Appellate Tribunal (ITAT) rendered its decision that compensation received by a partner on reduction in profit sharing ratio is not chargeable to capital gains tax

#### Facts of the case:

- Anik Industries Ltd (the taxpayer)<sup>1</sup> is an Indian company engaged in manufacture and processing of milk products and also in the business of wind power generation, mining and trading in commodities. The taxpayer is also a partner in partnership firm M/s Mahakosh Property Developers (the firm).
- During the Financial Year (FY) 2009-10 corresponding to Assessment Year (AY) 2010-11, the taxpayer's share in the firm was reduced by 5% (i.e. from 30% to 25%) and was adjusted among other partners of the firm. The taxpayer received an amount of INR 40 million (~US\$ 0.5 million) in this regard from other partners (whose partnership share got increased), through an adjustment in the current account.
- The taxpayer relied on the case of A. K. Sharfuddin<sup>2</sup> and did not offer the receipt of INR 40 million (~US\$ 0.5 million) to tax. In the case of A. K. Sharfuddin, it was held that compensation received by a partner from another partner for relinquishing rights in the partnership firm was a capital receipt and there would be no transfer of asset as per Section 45(4) of the Income-tax Act, 1961 (the ITA).
  - Section 45(4) of the ITA amongst others, relates to taxation in the hands of partnership firm as capital gains, the profits or gains on distribution of capital assets on the dissolution of a partnership firm.
- The taxpayer's income-tax return was selected for audit. The Assessing Officer (AO), relying on the cases of Samir Suryakant Sheth<sup>3</sup> and Shri Sudhakar Shetty<sup>4</sup>, held that the reduction of partnership share represented the loss of share of partner in the goodwill of the firm. Thus, the AO taxed the receipt on reduction of partnership share as capital gains.
- On appeal by the taxpayer, the addition was confirmed by the Commissioner of Income-tax Appeals [CIT(A)] on the basis that the reduction in profit share was to be treated as relinquishment or extinguishment of the taxpayer's right over the profit share and the consideration received was for transfer of a capital asset.
- The taxpayer appealed against the order of the CIT(A) before the Income-tax Appellate Tribunal (ITAT).

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<sup>1</sup> 116 taxmann.com 385

<sup>2</sup> A. K. Sharfuddin vs CIT (1960 39 ITR 333)

<sup>3</sup> Samir Suryakant Sheth vs ACIT (ITA No.2919 & 3092/Ahd/2002)

<sup>4</sup> Shri Sudhakar Shetty (2011 130 ITD 197)

## Decision of the ITAT:

- At the outset, the ITAT held that the provisions of Section 45(4) of the ITA related to taxation as capital gains, in respect of the distribution of capital assets on dissolution of a firm. The current case was related to reduction of share of a partner and not dissolution of the firm and hence, the provisions of Section 45(4) of the ITA did not apply.
- The ITAT noted that the issue in the current case was whether the consideration received by a partner from other partners for reduction in profit sharing ratio would be chargeable to capital gains tax under the general category of Section 45(1) of the ITA.
- The ITAT relied on the case of P. N. Panjawani<sup>5</sup> and noted the following key principles relevant for the case under consideration:
  - The firm is not recognised as a legal entity under the Indian Partnership Act, 1932.
  - For the purposes of the ITA, the identity of the firm as well as that of the partners for taxability of income is separate and distinct. The firm is a separate taxable entity liable to pay tax on its income because of its own distinct set of income earning activities and factors. Accordingly, if there was a transfer of capital asset effected by a firm i.e. property held by the firm, the capital gains tax arises in the hands of the firm and not in the hands of the partners and vice versa.
  - The assets of the firm are owned by the firm and not by the partners. Hence, on reduction of partnership share, a question of relinquishment of interest in that asset or extinguishment of right in that asset, does not arise.
  - Section 45(3) of the ITA is with respect to a person who transfers a capital asset to a firm as capital contribution and becomes a partner of a firm. The income on transfer of capital asset in such a case is taxed as capital gains in the hands of the partner. Thus, the provisions of Section 45(3) of the ITA were not applicable for reduction of share in a partnership firm.
  - There is no specific provision in the ITA for levying capital gains on consideration received for reduction of share in a partnership firm.
- Further, the ITAT relied on the case of Prashant B. Joshi<sup>6</sup> and noted that:
  - During the subsistence of a partnership firm, a partner does not possess an interest in any particular asset of the partnership firm. The partner has a right to obtain a share in profits.
  - On a dissolution of a partnership or upon retirement, a partner is entitled to a valuation of his share in the net assets of the partnership which remains after meeting the debts and liabilities.
  - On retirement a partner gets his share in the partnership and not a consideration for transfer in his interest in the partnership to continuing partners. Accordingly, an amount paid to a partner upon retirement, after drawing the accounts and upon deduction of liabilities, does not qualify as transfer under Section 2(47) of the ITA.
- Based on the above, the ITAT held that the consideration received by the taxpayer from other partners for reduction in profit sharing ratio, was not taxable as capital gains under Section 45(1) of the ITA.

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<sup>5</sup> CIT v. P. N. Panjawani (356 ITR 676)

<sup>6</sup> Prashant B. Joshi vs ITO (324 ITR 154)

**Comments:**

- This ruling recognises an important principle that consideration received on reduction of partnership share is not subject to capital gains tax. The ruling will be relevant in case of reorganisation of partnership amongst partners.



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