

अपीलीय अधिकरण, 'सी' न्यायपीठ, चेन्न
IN THE INCOME TAX APPELLATE TRIBUNAL 'C' BENCH, CHENNAI
श्री जॉर्ज जॉर्ज के, उपाध्यक्ष एवं श्री जगदीश, लेखा सदस्य के समक्ष
BEFORE SHRI GEORGE GEORGE K, VICE PRESIDENT AND
SHRI JAGADISH, ACCOUNTANT MEMBER

आयकर अपीलसं./ITA No.:1088/CHNY/2025

निर्धारण वर्ष/Assessment Year: 2017-18

&

S.A. No. 48/Chny/2025 [In ITA No. 1088/Chny/2025]

Gokulakrishna,
D 401, Purva Jade, Arcot Road,
Valasaravakkam, Chennai 600 087.

The Deputy Commissioner of
Income Tax,
Non Corporate Circle 8(1),
Chennai.

[PAN: AOKPG-1579-A]

(अपीलार्थी/Appellant)

(प्रत्यर्थी/Respondent)

अपीलार्थी की ओर से/Appellant by : Shri R. Sivaraman, Advocate

प्रत्यर्थी की ओर से/Respondent by : Ms. R. Anita, Addl. CIT

सुनवाई की तारीख/Date of Hearing : 13.06.2025

घोषणा की तारीख/Date of Pronouncement : 17.06.2025

आदेश/ ORDER

PER GEORGE GEORGE K, VICE PRESIDENT:

This appeal filed at the instance of the assessee is directed against the order of the Commissioner of Income Tax (Appeals), National Faceless Appeal Centre (NFAC), Delhi dated 28.02.2025 passed under section 250 of the Income Tax Act, 1961 (hereinafter called 'the Act') for the assessment year 2017-18. The assessee also filed stay application in S.A. No. 48/Chny/2025 in the above appeal. First, we shall take up the main appeal for adjudication.

2. The solitary issue argued on merits is with regard to confirmation of addition made under short term capital gain on the amounts credited to the partners' current account as a consideration against the sacrificing ratio on admission of new partner.

3. Brief facts of the case are as follows:

4. The assessee is one of the partners in M/s. CRCL LLP [CRCL], a Limited Liability Partnership (LLP). The firm was incorporated on 15.07.2016 with an objective to carry on-site and off-site contract catering services. For the AY 2017-18, the assessee filed his return of income on 06.11.2017 declaring total income at ₹.10,06,350/-. Subsequently, the return of income was revised on 15.03.2019 declaring the total income at ₹.9,98,850/-. On the basis of information collected during the course of assessment proceedings in the case of CRCL, where the assessee is a partner, the Assessing Office reopened the assessment for AY 2017-18 under section 147 of the Act by recording reasons as reproduced under para 2 of the assessment order. Against statutory notices, the assessee furnished the details called for. The Assessing Officer asked the assessee to furnish the purpose of receipt of ₹.2,98,29,315/- from the CRCL during AY 2017-18 along with supporting documentary evidence and to provide the treatment of the amount in assessee's ROI. Against various queries raised by the Assessing Officer, the assessee has furnished the replies and

are reproduced under para 3.3 & 3.4 from page 2 to 6 of the assessment order.

5. The assessee furnished the Investment Agreement dated 17.11.2016 and the salient features noted by the Assessing Officer and given under para 3.5 are reproduced herein below:

a. *That the Investment Agreement dt.17.11.2016 has been entered by the firm, M/s. CRCL LLP as well as the partners in their individual capacity along with Satyabhama Enterprises, Manikandan Catering Services, CR Caterers India Pvt. Ltd and the investor Elior India Catering LLP.*

b. *that the Investment Agreement dt.17.11.2016 has been signed not only by the firm but by each and every partner individually.*

c. *That the investor M/s. Elior India Catering LLP is interested in acquiring 100% of the Partnership Interest in the firm M/s. CRCL LLP by investing the capital contribution in the CRCL LLP.*

d. i. *that as per clause 12.2 and 12.3 of the Investment Agreement dt.17.11.2016, the investor, M/s. Elior India Catering LLP shall increase its Partnership Interest to the extent of the Residual interest i.e. the balance 49% of the partnership interest currently held by the partners of the firm, M/s. CRCL LLP or such Partnership Interest that is held by the partners, pursuant to the terms of the Investment Agreement dt.17.11.2016 such that the Investor, M/s. Elior India Catering LLP acquires the entire Partnership Interest of the firm M/s. CRCL LLP in three immediately succeeding financial years following expiry of the initial period. (Initial period as defined in the Investment agreement dt. 17.11.2016 at 1(1.1) (ff) Definitions and Interpretation)*

d.ii. *that the acquisition of the entire Partnership Interest in the firm, M/s. CRCL LLP by the investor, M/s. Elior India Catering LLP shall be effectuated by the partners transferring their Remaining Partnership Interest to the investor M/s. Elior India Catering LLP on receipt of payment for the relevant Tranche by the relevant partner.*

e. *that as per clause 19 of the Investment Agreement dt.17.11.2016, each of the partner has to individually undertake that he and his Affiliates shall not for two years from being ceased to be the partner of M/s. CRCL LLP either directly or indirectly or through any other person participate, carry on or be engaged or interested in, whether financially or otherwise, in Non-compete Business in any form or invest in. hold direct or indirect interest in or otherwise benefit economically from, facilitate or enter into any arrangement or agreements with any person that competes directly or indirectly with the Non-compete business.*

f. as per clause 11.3 of the Investment Agreement dt. 17.11.2016 which is reproduced here under:

“The designated Partners and Working Partners will enter into fixed term employment agreements with the LLP in substantially the form attached herewith as Annexure 2 at Closing.....”

the partner has to enter into an Executive Employment Agreement wherein the partner who is an Executive has to agree to comply with the Non-compete and Non Solicitation clause and the same is reproduced hereunder:

“..... The Executive agrees to comply with the obligations set forth in Clause 19 of the Investment Agreement and Schedule H of the LLP Agreement during the period the Executive is in the employment of the LLP and during the Restricted period.....”

6. On perusal of the Amended and Restated Agreement of LLP dt.02.02.2017, the Assessing Officer gathered information and narrated under para 3.5.2 are reproduced herein under:

a. *M/s. Elio India Catering LLP has been inducted into the existing LLP i.e. M/s. CRCL LLP in consideration of M/s. Elio India Catering LLP contributing Rs.31,76,03,000/- towards the capital of M/s. CRCL LLP.*

b. *that the capital ratio of the assessee was 12% and the contribution to capital account of M/s. CRCL LLP was Rs. 12,000/-.*

c. *subsequent to the induction of new partner, M/s. Elio India Catering LLP, the capital ratio of the assessee has been reduced to 5.88% and the contribution to capital account of M/s. CRCL LLP was Rs. 12,000/-.*

d. *that capital contribution from M/s. Elio India Catering LLP to the extent of Rs.13,86,72,100/- was to be credited to the current account of the existing partners of M/s. CRCL LLP.*

e. *that capital contribution from M/s Elio India Catering LLP to the extent of Rs.5,94,30,900/- shall be credited to the current account of the existing partners of M/s. CRCL LLP after fulfilment of the "Conditions Subsequent" as per clause 7 of the Investment Agreement dt.17.11.2016 to the satisfaction of M/s. Elio India Catering LLP.*

f. *that the assessee has undertaken with M/s. Elio India Catering LLP that he and his affiliates shall not for two years from being ceased to be the partner of M/s. CRCL LLP either directly or indirectly or through any other person participate, carry on or be engaged or interested in, whether financially or otherwise, in Non-compete Business in any form or invest in, hold direct or*

indirect interest in or otherwise benefit economically from, facilitate or enter into any arrangement or agreements with any person that competes directly or indirectly with the Non-compete business.

7. In view of the above observations, the Assessing Officer did not accept the contention of the assessee that the amount of ₹.2,38,63,452/- is not taxable for the following reasons:

- *The assessee has stated in his response dt.07.09.2021 that on admission of a new partner, profit sharing ratio changed and the goodwill was calculated and distributed amongst the existing partners including the assessee and the assessee received an amount of Rs. 2,38,63,452/- in his current account held in M/s.CRCL LLP.*
- *The assessee vide his response dt.07.09.2021 has stated that on the basis of mutual agreement between the partners it was decided that M/s. Elinor India Catering LLP would have 51% stake in M/s. CRCL LLP.*
- *That there was no valuation report to support the basis for contribution of Rs.31,76,03,000/- against taking over 51% share in the firm, M/s. CRCL LLP. Hence no basis for arriving at the amount of Rs.31,76,03,000/- to be paid by M/s. Elinor India Catering LLP.*
- *That the assessee's profit sharing ratio has changed from 12% to 5.88% on induction of new partner, M/s. Elinor India Catering LLP and thus the assessee relinquished 6.12% of the profit sharing ratio as well as the share in the goodwill of the firm.*
- *The contention of the assessee that the profit sharing ratio has remained in the same proportion to the capital infused into the firm is nothing but camouflaging his reduction in the profit sharing ratio and the share in the goodwill of the firm.*
- *The assessee has not justified as to why he received Rs.2,38,63,452/- when his contention is that his profit sharing ratio has remained in the same proportion to the capital infused and there is no change in his capital in the firm M/s. CRCL LLP.*
- *In this case of the assessee, there is admission of a new partner and the share of the assessee in profit of firm got reduced from, 12% to 5.88% and in lieu of this reduction of his right to receive profit and goodwill, he had received payments from the new incoming partner which has been subsequently withdrawn from the current account by the assessee.*
- *That the amount of Rs.2,38,63,452/- received by the assessee is nothing but a payment in lieu of reduction of assessee's right to receive profit and share in the goodwill. There is no references / relation shown of the payment with the assets of the firm.*
- *That on perusal of Investment Agreement dt.17.11.2016 as well as the Amended and Restated Agreement of LLP dt.02.02.2017, it can be concluded that the assessee has released his partnership interest in the firm, M/s. CRCL LLP in favour of M/s. Elinor India Caterers LLP acquiring the partnership interest in the firm, M/s. CRCL LLP.*

- *Further, perusal of the Investment Agreement dt.17.11.2016 as well as the Amended and Restated Agreement of LLP dt.02.02.2017, it can be seen that it is a composite agreement where the partners are foregoing their rights as a partner in the firm and the liabilities of non-compete undertaking as per clause 19 of the Investment Agreement dt.17.11.2016 and as per para 7 to 11 given in Schedule F- "Duties of Partners" in the Amended and Restated Agreement of LLP dt.02.02.2017 were tied to each of the partner. The payment credited to the assessee is against forgoing of the interest by the assessee.*
- *As per sec 2(14) "capital asset" means property of any kind held by the assessee whether or not connected with his business or profession. Further, property has wide connotation and it signifies every possible interest which a person can acquire, hold and enjoy. Therefore, business can be considered as property. Thus, the right to receive profit in a partnership firm is a capital asset under section 2(14) of the Act and relinquishment of the right to receive profit is a transfer within the definition of section 2(47) of the Act.*
- *That reduction clearly indicated that there was diminishment in the assessee's capital asset to the extent of 6.12%. In lieu thereof, the assessee has been paid compensation of Rs.2,38,63,452/-. Thus, the share in the partnership firm which was an income-yielding asset got reduced to that extent. The compensation for the same would, therefore, partake of the character of a capital receipt in the hands of the assessee.*
- *It is now well-settled that when the shareholding of an assessee gets reduced in any partnership business, that reduction without special features as were noted by the Supreme Court in Gangadhar's case [1972] 86 ITR 19, would reflect impairment in assessee's capital asset, meaning an income-yielding apparatus which the assessee had with him prior to such reduction.*
- *It cannot be doubted that, because of reduction of the share of the assessee in the reconstituted firm from 12% to 5.88% the trading structure of the assessee was impaired and such cancellation would result in proportionate loss of an income-yielding asset. Consequently, the payment made to him as compensation for such impairment has to be treated as a capital receipt.*

8. In view of the above observations, the Assessing Officer was of the opinion that the right to receive profit in a partnership firm is a capital asset under section 2(14) of the Act and relinquishment of the right to receive profit is a transfer within the definition of section 2(47) of the Act. Accordingly, the Assessing Officer treated the amount of ₹.2,38,63,452/- received from Elior India as income from short term capital gains and

added to the total income of the assessee. On appeal, the CIT(A) confirmed the order of the Assessing Officer.

9. On being aggrieved, the assessee is in appeal before the Tribunal.

10. The Id. Counsel for the assessee Shri R. Sivaraman, Advocate has submitted that the assessee is one of the partners in CRCL with a 12% profit sharing ratio. Consequent upon induction of Elixir India as a partner with 51% stake by contributing ₹.31.75 crores into CRCL of which ₹.19.88 crores has been credited to the existing partners' current account in their respective sacrificing ratio. The assessee got 12% profit-sharing ratio before admission of Elixir India as a partner in CRCL and the same has been reduced to 5.88% after induction of Elixir India and ₹.2,38,63,452/- has been credited to the assessee's current account held in CRCL towards sacrificing profit share. However, the Assessing Officer erroneously held that the amount credited to the current account of the assessee is in the nature of goodwill on admission of new partner and treated the same as income chargeable to tax. The Id. Counsel for the assessee vehemently argued that the assets belonging to CRCL are not transferred from the assessee on account of admission of a new partner as the assets continue to be held by the CRCL and no partner has got any independent or specific interest in respect of the assets of the firm. He further argued that the assessee's share in the partnership firm's assets of CRCL, inter alia,

goodwill would be crystallized only on dissolution of the LLP of retirement of the assessee and in the event of admission of Eliar India, the goodwill did not exist. Thus, the assumption of the Assessing Officer that the credited amount represents goodwill does not hold good.

11. The Id. Counsel for the assessee has further submitted that the reconstitution agreement indicates that none of the existing partners retired or there was any distribution of assets, thereby, the credit amount represents goodwill is not correct. He further submitted that the relationship between partners is governed by section 23 of the LLP Act, 2008, which allows parties to agree on mutual rights and duties without requiring the determination of goodwill upon reconstitution. By referring to the Investment Agreement dated 17.11.2016 as well as the Amended and Restated Agreement of LLP dated 02.02.2017, the Id. Counsel for the assessee has submitted that the said agreement does not specify that the income of partner's contribution is towards goodwill and moreover there was no revaluation. To support his arguments, the Id. Counsel relied on the following case law:

1. CIT v. Kunnamkulam Mill Board 257 ITR 544 (Kerala)
2. CIT v. P.N. Panjawani 356 ITR 676 (Kar.)
3. ITO v. Smt. Paru D. Dave [2008] 110 ITD 410 (Mum.)
4. ITO v. Fine Developers [2013] 55 SOT 122
5. Radhu Palace v. Addl. CIT 148 ITD 424 (Delhi)

12. He further argued that there is no legal requirement to obtain a valuation report between two unrelated parties when there is an agreement

for the price. He argued that there is no element of transfer so as to attract the provision of section 2(47) of the Act and hence there cannot be any levy of tax on capital gain under section 45 of the Act on the event of introduction of a new partner. He has further submitted that even if the amount of ₹.2,38,63,452/- is considered as goodwill, the same cannot be treated as income in the hand of the assessee as a partner does not have any right over the assets of the firm when the firm is still in existence and at best, the said transaction could be envisaged under section 45(4) of the Act to tax in the hands of the firm and not in the hands of the partners of the firm.

12. Per contra, the Id. DR Ms. R. Anita, Addl. CIT has submitted that the contention of the Id. Counsel for the assessee that there was no legal requirement to obtain a valuation report in case of transaction between related parties is correct, then how it can be ascertained what are the assets of the firm and how the said assets have been valued whether on a slump sale basis or on individual asset wise values have been arrived at. To support her contention, the Id. DR relied on the judgement of the Hon'ble Supreme Court in the case of JCIT v. Vatsala Shenoy [2016] 74 taxmann.com 143 (SC), wherein, it was upheld the principle that extinguishment/transfer of interest in partnership firm's assets for a consideration that results in transfer of capital asset liable to tax. The Id. DR has further submitted that the case on hand is not a distribution of

assets/value of the assets by the firm for section 45(4) of the Act to be made applicable, but a sale/transfer of partnership interest being the ownership interest held by the old partner in the partnership firm to the new partner for a consideration. The ownership interest represents as stated above the right to receive profits and the right to receive net assets. As in the case of a corporate set up, wherein, a shareholder sell his/her stake in the company to a third party, the same is liable to capital gain, even though the shareholder does not own the assets of the company as the same belong to the company and the shareholder is entitled to the dividend and share of assets on winding up of the company net liabilities. Similar is the case in hand, wherein, the assessee being a partner of an LLP has transferred part of his ownership to the new partner. The LLP is a new form of organization and as per section 42 (1) of the LLP Act, what is transferred in this case is the economic rights of the assessee partner and the same is an asset under section 2(47) of the Act and the transfer is liable to capital gains under section 45(1) of the Act and relied on the following case law:

1. Sudhakar M Shetty v. ACIT [2011] 130 ITD 197 (Mumbai)
 2. Samir Suryakant Seth v. ACIT in ITA Nos. 2919 & 3092/Ahd/2002 dt. 25.01.2012.
 3. B. Raghurama Prabhu Estate v. JCIT [2012] 20 taxmann.com 390 (Karnataka).
13. We have heard both the sides, perused the material available on record and gone through the orders of authorities below as well as case law relied by both the parties. The assessee is one of the partners in M/s.

CRCL LLP with a 12% profit- sharing ratio. M/s. Elier India Catering LLP has been inducted into assessee's partnership firm as a partner with 51% stake by contributing ₹.31.75 crores into CRCL of which ₹.19.88 crores has been credited to the existing partners' current account in their respective sacrificing ratio. The assessee got 12% profit-sharing ratio before admission of Elier India as a partner in CRCL and the same has been reduced to 5.88% after induction of Elier India and ₹.2,38,63,452/- has been credited to the assessee's current account held in CRCL towards sacrificing profit share. The Assessing Officer erroneously held that the amount credited to the current account of the assessee is in the nature of goodwill on admission of new partner and treated the same as income chargeable to tax, which was confirmed by the CIT(A) on further appeal.

14. In this case, the contention of the Id. Counsel for the assessee is that no goodwill existed at the time of Elier India's investment in CRCL, making it impossible for the assessee to receive a share of non-existent goodwill. In fact, CRCL was a nascent organisation when Elier India was admitted and if at all the Department treat it as goodwill, the same cannot be treated as income in the hands of the assessee as one of the partners in the partnership firm, the assessee does not have any right over the assets of the firm when the firm is still in existence. Admittedly, consequent upon the induction of Elier India into CRCL, there is reduction in the shares of existing partners, in assessee's case, the profit-sharing ratio has been

reduced from 12% to 5.88%, thereby, the Assessing Officer held that it amounts to transfer within the meaning of section 2(47) of the Act. It is also an admitted fact that the erstwhile partners have not retired and they continued to be the partners along with the income partners. The assessee has relied on the decision of the Hon'ble High Court of Karnataka in the case of CIT v. P.N. Panjawani (supra), wherein, the Hon'ble High Court examined whether the admission of new partners and the consequent reduction in the share of existing partners constituted a taxable event under section 2(47) of the Act. By considering various judgements of the Apex Court and the Hon'ble High Court, held that the reduction in the share of the existing partners due to the admission of new partners did not amount to a transfer of capital assets and hence was not taxable. The observations of the Hon'ble High Court of Karnataka and the ruling are reproduced below:

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 judgement of the Apex Court in the case of Malbar Fisheries Co., (supra) 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 1/3rd each in the assets of the firm have relinquished their 50% share i.e., from 1/3rd to 16.67% in favour of the four new partners on account of which each of the three partners were able to a sum of 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 McDowell & Co. Ltd. v. CTO [1985] 22 Taxman 11 (SC) 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 assessee is 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 Addanki Narayanappa v. Bhaskara Krishnappa 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 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 Malabar Fisheries Co. (supra) 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 cannot, 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, if not done by the dissolved firm.”

11. The Apex Court in the case of *Sunil Siddharthbhai v. CIT* [1985] 156 ITR 509/23 Taxman 14W 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) ******

[(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:-

"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.2.50 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. Insofar 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. Insofar as the contention that this is a colourable device adopted by the firm as well as the assessee 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 up to 1992-93 and returns were filed from time to time. It is only in the year 1995, revaluation was done, four new 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 McDowell Co. Ltd.'s case (supra) 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. Sarsbhai v. CIT [1997] 228 ITR 163 / 94 Taxman 164 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 CIT v. Gurunath Talkies [2010] 328 ITR 59/189 Taxman 171, 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. Moreover, 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 assessee and against the revenue. Consequently, the appeals are dismissed.*

15. The Id. DR could not controvert the above judgement of the Hon'ble High Court of Karnataka in the case of CIT v. P.N. Panjawani (supra). The judgement of the Hon'ble Karnataka High court has not been reversed by the Hon'ble Apex Court. The judgement of Hon'ble Karnataka High Court in

the case of CIT v. P.N. Panjawani (supra) is squarely applicable to the facts of the present case.

16. We have also considered the contention of the Id. DR that pursuant to reconstitution of assessee's partnership firm, assets of assessee were revalued and revalued amount was credited to partners account in their profit-sharing ratio, the asset so revalued and credited into capital accounts could be said to be "transfer" which would attract the provisions of section 45(4) of the Act and the said amount would be chargeable to capital gains. For the above proposition, the Id. DR placed reliance on the judgement of the Hon'ble Supreme Court in the case of CIT v. Mansukh Dyeing and Printing Mills 449 ITR 439 (SC). We have carefully gone through the above judgement of the Hon'ble Supreme Court and find that on admission of three new partners, their existing partners have retired and thereafter reconstituted the partnership firm, whereas, in the present case, on induction of new partner, erstwhile partners continued in the partnership firm along with new partner. In the case law relied on by the Id. Counsel for the assessee in the case of CIT v. P.N. Panjawani (supra), the Hon'ble High Court noted that the erstwhile partners in that case have not retired and they also continued to be the partners along with the income partners, thereby, held that reduction in the share of existing partners due to admission of new partners did not amount to a transfer of capital assets and was not taxable. Thus, the judgement of the Hon'ble Supreme Court

relied on by the Id. DR has no application to facts of the present case, as well as the order of the Mumbai Benches in the case of Sudhakar M. Shetty v. ACIT 130 ITD 197, being on similar facts, has no application. Moreover, the reliance placed on record by the Id. DR in the case of B. Raghurama Prabhu Estate v. JCIT 335 ITR 394 (Karnataka) as well as judgement of Hon'ble Supreme Court in the case of Vatsala Shenoy v. JCIT reported in AIR 2016 SUPREME COURT 5299 [Civil Appeal No. 1234 of 2012 & Ors dated 18.10.2016] (partners of MGBW), in both partners' cases of same partnership firm, the erstwhile partnership firm MGBW has been winded up and the amount received by the outgoing partners has been treated as "transfer", chargeable to capital gain tax under section 45 of the Act. Thus, the case law relied on by the Id. DR has no application to the facts of the present case. Further, in the case of Samir Suryakant Sheth v. ACIT in ITA Nos. 2919 & 3092/Ahd/2002 dated 25.01.2012, the facts are entirely different, wherein, the newly admitted partner Ciba had privately made two separate payments to the old partners for reduction in profit share in the firm and non-competition agreement, thus, the case law has no application to the facts of the present case.

17. Now, coming to other case law placed on record by the Id. Counsel for the assessee in the case of ITO v. Smt. Paru D. Dave 110 ITD 410 (Mumbai), we find, the Mumbai Benches of the Tribunal held that on introduction of new partners, there is realignment of sharing ratio between

partners only to an extent of sharing profit and loss of firm, on such realignment of profit sharing ratio, there is no relinquishment of any non-existent share in partnership assets as assets remained with firm and therefore, no capital gain arises on alignment of a part of profit sharing ratio on introduction of new partners in firm. Further, in the case of ITO v. Fine Developers in ITA No. 4630(Mum)/2011 dated 12.10.2012 reported in 55 SOT 122 (Mumbai), the Tribunal held that mere admission of new partner into partnership firm without there being any transfer of asset of firm in his favour would not attract provisions of section 45(4) of the Act. In the case of Anik Industries Ltd. v. DCIT [2020] 116 taxmann.com 385 (Mumbai), by following the decision in the case of CIT v. P.N. Panjawani (supra) and distinguishing the orders in the case of Sudhakar M. Shetty v. ACIT (supra), Samir Suryakant Sheth v. ACIT (supra) & other case law, the Mumbai Benches of the Tribunal held that compensation received by assessee-partner from other existing partners for reduction in profit sharing ratio would not tantamount to capital gains chargeable to tax under section 45(1) of the Act.

18. In the case on hand, the asset of the partnership firm was revalued by the partners and the difference on account of revaluation of asset was credited to the partners' account. The revaluation of partnership firm's asset was anterior to the introduction of new partners. Thus, in view of our above discussions as well as judicial precedents, we are of the considered

opinion that the revaluation of assets by CRCL does not attract capital gains. The revaluation of assets of CRCL and the credit of revalued amount to the capital account of partners in their respective share ratio does not entail any transfer as defined under section 2(47) of the Act. The induction of Elio India to CRCL and the amount received from Elio India towards 51% of shares and consequent reduction in the share ratio of present partners does not entail any relinquishment of their rights in CRCL. On introduction of Elio India, there is realignment of share ratio *inter se* between the partners only to the extent of sharing the profits or losses, if any, of CRCL LLP. When any new partner is introduced into an existing partnership firm, the profit sharing ratios undergo a change, which does not amount to transfer as defined under section 2(47) of the Act, as there is no change in the ownership of assets by the partnership firm. As during the subsistence of the partnership firm, the partners have no defined share in the assets of the partnership firm and thus on realignment of profit-sharing ratio, on introduction of new partners, there is no relinquishment of any non-existent share in the partnership firm's assets as the asset remained with the firm. Such an arrangement is not covered by the provisions of section 45(4) of the Act, which covers the case of dissolution of partnership firm. Accordingly, no capital gains arise on such relinquishment of share ratio in the partnership firm.

19. However, we find that in order to bring the profit or gains from receipt of money or capital asset or both by the specified person from a specified entity on reconstitution of the specified entity shall be chargeable to income-tax as income of such specified entity under the head “Capital Gains”, the legislation amended the provisions of section 45(4)] vide Finance Act, 2021, shall come into force on the 1st day of April, 2021, which is prospective in nature. Similarly, the provisions of section 9B of the Income Tax Act has been inserted w.e.f. A.Y. 2021-22 vide Finance Act, 2021 to bring under the tax net the income on receipt of a capital asset or stock in trade by a specified person from the specified entity in connection with the dissolution or reconstitution of such specified entity, shall come into force on the 1st day of April, 2021, which is prospective in nature. In fact, transfer of capital asset is common in both section 9B and section 45(4) of the Act. In the present case, the assessment year under consideration is 2017-18 and accordingly, the amendments vide Finance Act, 2021 have no application in the present case.

20. Under the above facts and circumstances of the case as well as judicial precedents, the addition made by the Assessing Officer towards levy of short term capital gains tax at ₹.2,38,63,452/- and confirmed by the CIT(A) stands deleted. Thus, the grounds raised by the assessee are allowed.

21. The Stay Application filed by the assessee in S.A. No. 48/Chny/2025, was also heard along with the main appeal. Since we have adjudicated the main appeal by setting aside the CIT(A)'s order and deleting the addition made by the Assessing Officer, the stay application filed by the assessee become infructuous and accordingly, the same stands dismissed.

22. In the result, the appeal filed by the assessee is allowed and the stay application is dismissed.

Order pronounced in the open court on 17th June, 2025 at Chennai.

Sd/-
(जगदीश)
(JAGADISH)

लेखा सदस्य/ACCOUNTANT MEMBER

Sd/-
(जॉर्ज जॉर्ज के)
(GEORGE GEORGE K)
उपाध्यक्ष /VICE PRESIDENT

चेन्नई/Chennai,
दिनांक/Date: 17.06.2025
Vm/-

आदेशकीप्रतिलिपिअग्रेषित/Copy to:

1. अपीलार्थी/Appellant,
2. प्रत्यर्थी/ Respondent,
3. आयकर आयुक्त/CIT, Chennai/Madurai/Coimbatore/Salem
4. विभागीय प्रतिनिधि/DR &
5. गार्डफाईल/GF.