INCOME-TAX REFERENCE

Before D. K. Mahajan and Gopal Singh, JJ.

RAMANLAL KHANNA,—*Applicant*

versus

THE COMMISSIONER OF INCOME-TAX,—*Respondent.*

Income- t Reference No. 17 of 1970.

February 24, 1971.

Income-tax Act (XLIII of 1961)—Sections 45 and 47 (ii)—Dissolution of a partnership firm—Partner of such firm receiving the value of his share in cash and not in species—Such receipt—Whether can be taxed as capital gain.

Held, that the common procedure in dissolution of a partnership firm is that one partner takes assets of the firm and pays the others value of the total assets representing the share of the outgoing partners. It is at times very impracticable to divide the assets of the partnership in species. When it is agreed between the partners on the dissolution of a partnership firm that an outgoing partner will receive the value in money of his share in the assets of the firm, what he receives consequent upon this agreement is merely a distributed share in the assets of the firm. There is no question of capital gain in such a case because section 47(2) of Income-tax Act, 1961, excludes such a gain from the purview of section 45 of the Act. In fact, in such circumstances there is no sale by the outgoing partners of the assets of the firm to the partner who continues the partnership business. It is merely a convenient mode of dividing the assets of the partnership. Hence when on dissolution of a partnership firm, one of the partners receives the value of his share in cash and not in species, such a receipt cannot be taxed as capital gain. (Para 3).

Reference made to this Court under section 256(1) of the Income-tax Act, 1961 by the Income-tax Appellate Tribunal, Delhi Bench C,—vide his order dated the 20th April, 1970 for opinion in R.A. No. 1 of 1969-70 on the following question of law arising out of I.T.A. No. 12851 of 1967-68 regarding the assessment year 1965-66 :

> *"Whether on the facts and in the circumstances of the case and on a proper interpretation of section 47 of the Income-tax Act, 1961 the Tribunal was right in holding that the sum of Rs. 30,000 could be correctly taxed as capital gain in the hands of the assessee ?"*

J. N. KAUSHAL, SENIOR ADVOCATE AND ASHOK BHAN, ADVOCATE, for the applicant.

D. N. AWASTHY AND B. S. GUPTA, ADVOCATES, for the respondent.

JUDGMENT

The Judgment of this Court was delivered by :—

MAHAJAN, J.—At the instance of the assessee the Income-tax Appellate Tribunal Delhi Bench 'C' referred the following question of law for our opinion under section 256(1) of the Income-tax Act, 1961 :—

> "Whether on the facts and in the circumstances of the case and on a proper interpretation of section 47 of the Income-tax Act, 1961 the Tribunal was right in holding that the sum of Rs. 30,000 could be correctly taxed as capital gain in the hands of the assesee?"

The dispute that has arisen in this reference relates to the assessment year 1965-66 corresponding to the previous year ending 31st March, 1965. The assessee is Ramanlal Khanna. He was the partner in M/s. Kohinoor Textile Printing Works, Bombay. The three other partners in this partnership were Brij Lal Khanna, Sharad Chand Khanna and Lajpat Rai Mehra. This partnership was dissolved under a deed of dissolution dated October 1, 1964. The assessee and the two other partners retired from the said firm. They received their respective shares on dissolution from the fourth partner who took over the entire partnership concern. On revaluation of the assets a credit of Rs. 30,000 was given to the assessee on October 1, 1964 being the shares in the increase on the revaluation of the building and land etc. on the date of his retirement. This amount of Rs. 30,000 was treated as capital gain by the Income-tax Officer. The Appellate Assistant Commissioner though agreeing with the decision in *Bankey Lal Vaidya, Aligarh* v. *Commissioner of Income-tax, U.P.* (1), all the same affirmed the decision of the Income-tax Officer. The assessee then preferred a second appeal to the appellate Tribunal. The Tribunal rejected the appeal basing itself on the decision of the Supreme Court in *James Anderson* v. *Commissioner of Income-tax, Bombay City* (2).

(1) (1965) 55 I.T.R. 400.
(2) (1960) 39 I.T.R. 123.

(2) The entire decision of this controversy depends on the true interpretation to be put on sections 45 and 47 of the Act. They are reproduced below for facility of reference :—

"45. Any profits or gains arising from the transfer of a capital asset affected in the previous year shall, save as otherwise provided in sections 53 and 54, 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."

"47. Nothing contained in section 45 shall apply to the following transfers :—

(i) any distribution of capital assets on the total or partial partition of a Hindu undivided family;

(ii) any distribution of capital assets on the dissolution of a firm, body of individuals or other association of persons;

(iii) any transfer of a capital asset under a gift or will or an irrevocable trust;

(iv) any transfer of a capital asset by a company to its subsidiary company, if—

(a) the parent company or its nominees hold the whole of the share capital of the subsidiary company, and

(b) the subsidiary company is an Indian Company."

One has necessarily to look to what happens on dissolution and for that purpose we may see the deed of dissolution particularly two of its clauses which are in the following terms :—

"(1) That the partnership between the parties hereto in the business of Printing, Processing piecegoods of all kinds, yarns, colours, chemicals and machinery etc. carried on by them in the firm name and style of Kohinoor Textile Printing Works and on the terms and conditions recorded in the herein above recited Partnership dated the 18th day

of January, 1957, is hereby declared to have been terminated by mutual consent so far as the retiring partners are concerned as and from the 1st day of October, 1964 and the said business shall from that day be deemed to have been taken over and carried on by the party of the fourth part.

(2) The party of the fourth part has paid to the retiring partners the amounts coming for their respective shares and interest in the said partnership business and the capital, effects and goodwill thereof and they the party of the first, the party of the second part and the party of the third part have accepted the said amounts in full discharge and satisfaction of their respective rights."

It is a well-known procedure in dissolution of partnership that one partner takes assets of the firm and pays the others value of the total assets representing the share of the outgoing partners. It is at times very impracticable to divide the assets of the partnership. To take an assumed case, the assets of a partnership is a motor-car. We have yet to see a method where by a motor-car could be divided. The moment it is divided into pieces, it would cease to be a motor-car. Examples of this type can be multiplied. Therefore, one has to refer to the usual mode of partition when a firm is dissolved. The distribution of the assets of the partnership in this case is not an uncommon mode that has been adopted. The matter is not *res integra.* Precisely the question with which we are concerned, fell for decision in the Allahabad High Court and the learned Judges in *Bankey Lal Vaidya, Aligarh* v. *Commissioner of Income-tax, U.P.* (1), on precisely the same facts came to the conclusion that there was no question of capital gain because section 47(2) excluded such a gain from the ambit of section 45. In fact, in such circumstances there is no sale by the partners of the assets of the firm to the partner who continues the partnership business. It is merely a convenient mode of dividing the assets of the partnership. The decision of the Supreme Court in *James Anderson* v. *Commissioner of Income-tax, Bombay, City* (2) was considered by the learned Judges. It will be profitable to reproduce their observations because we entirely agree with the same :—

"Now, what happened in the instant case was that the assets of the firm were taken over entirely by Devi Sharan Garg

who agreed to pay the assessee a sum of Rs. 1,25,000 in respect of a half share in the assets. The assessee did not receive a share in the assets in kind but instead a sum representing the value of that share. It is contended for the assessee that it was entitled to the benefit of the third proviso to section 12B (1) because what the assessee received was a distribution of capital, assets on the dissolution of the firm and by reason of the proviso this distribution could not be treated as a sale, exchange or transfer of capital assets, and that being so, the case did not fall within the mischief of section 12B(1). For the Commissioner, it is urged that the assessee did not receive a share in the assets of the firm but in lieu of that share received money value therefor. It is contended that, in order that the proviso should apply, the assessee should have received its share of the assets in specie, and that the proviso can apply when the distribution of the firm's assets is made in specie. Reference is made to the decision in *James Anderson* v. *Commissioner of Income-tax* (2) That was a case where, upon the death of one Henry Gannon, the assessee was appointed as an administrator of his estate. In the course of administration, the assessee sold some shares and securities belonging to the deceased for the purpose of distributing the assets amongst the legatees. The Income-tax Officer treated the excess of the sale price over the cost price of the share and securities as capital gains under section 12B. The Supreme Court held that the assessee was being taxed upon the sale proceeds and not upon any distribution of capital assets, and that it must be shown that capital assets were distributed in specie in order to escape the application of section 12B (1). The facts of that case are clearly distinguishable from the one before us.

In the instant case what the assessee received was the value in money of its share in the assets of the firm. There can be cases where it is not possible nor convenient to distribute an asset in specie. The goodwill of the firm cannot be divided between the partners. Apart from goodwill,

there may be a case where the firm owns intangible property, e.g., the copy right in respect of certain publications. Where a firm owns a machinery or a motor vehicle or some single piece of property, which is employed for the purpose of its business, it is not easy to say that, that property is capable of division between the partners. In all these cases it is not possible to conceive that the law contemplated distribution of the assets by physical division of the property. In the case of distribution of assets of a firm upon its dissolution, it is a recognised mode of ditributing the assets that one partner may be given the assets of the firm while the other receives its money value. In the absence of a clause in the partnership deed providing for the method of winding-up or where effect cannot be given to the method prescribed, and failing an agreement between the partners, it is well established that the assets may be put to sale and the sale-proceeds than divided between the partners. In either case, the receipt of money by a partner is nothing but a receipt of the distribution of the assets of the firm. In *Syers* v. *Syers* (3), Lord Cairns. L.C. observed :

'My Lords, it is very true, as was said at the Bar, that on dissolving a partnership of this kind the ordinary course would be for the court to direct a sale of the assets, and, if necessary, a sale of the concern as a going concern, and to give liberty for proposals to be made by either party to purchase it before the judge in chambers......'

and the terms of the decree which he proposed make it abundantly clear that he considered that a proper mode of distributing the firm's assets would be to value the share of the plaintiff-partner, if the business was sold as a going concern, that value being paid by the defendant-partner, and that, if the latter defaulted in payment. the properties would be sold as a going concern and 'a division of the assets of the partnership in the usual way' would be affected. The law has also been stated in Lindley on Partnership, 12th edition page 453 :

(3) (1876) 1 App. Cas 174.

'Having provided for the events upon which a partnership is to cease, the next point is to specify the method by which its affairs are to be wholly or partially wound up.

Where the articles have prescribed no method of winding-up, or where the method prescribed cannot be carried into effect, then, unless the partners can come to some agreement as to what is to be done, there must, as a general rule, be a conversion of all the partnership property into money; and this money. after payment of the partnership debts, must be divided amongst the partners in the shares in which they may be entitled to it.

Agreement for fair division.

An agreement that on a dissolution the partnership property shall be fairly and equally divided, after payment of its debts, has been held to mean that the property shall be sold, and that the money produced by the sale shall be divided after the debts have been paid. Even if the agreement be for the division of the partnership property in specie, the court may order a sale if that appears to be most beneficial to the parties.'

(3) It, therefore, appears to us that when it was agreed that the assessee would receive the value in money of its share in the assets of the firm, what it received consequent upon this agreement was merely a distributed share in the assets of the firm."

The view that the learned Judge of the Allahabad High Court took finds further support from the decision of the Supreme Court in *Commissioner of Income-tax, Madhya Pradesh Nagpur and Bhandara v. Dewas Cine Corporation* (4). Their Lordships held—

"That on the dissolution of the partnership each theatre had to be returned to the original owner in satisfaction partially or wholly of his claim to a share in the residue of the

(4) (1968) 68 I.T.R. 240.

> assets after discharging the debts and other obligations. But thereby the theatres were not in law sold by the partnership to the individual partners in consideration of their respective shares in the residue, and, therefore, the amount of Rs. 44,380 could not be included in the total income of the partnership under the second proviso to section 10(2) (vii)."

Therefore, we are clelarly of the view that the decision of the Allahabad High Court correctly lays down the law and with utmost respect to the learned Judges we follow the same.

(4) Mr. Awasthy, learned counsel for the department contends on the basis of the Supreme Court decision in *James Anderson* v. *Commissioner of Income-tax, Bombay City* (2) (supra), decision of the Bombay High Court in *Commissioner of Income-tax Bombay North* v. *Walji Damji* (5) and two decisions of the Madras High Court in ***Sri Kannan Rice Mills Ltd.*** v. ***Commissioner of Income Tax,*** *Madras* (6), and *Gowri Tile Works* v. *Commissioner of Income Tax, Madras* (7), that when the assets of a partnership are taken by one of the partners, it is sale of those assets. In our opinion, none of these cases is helpful. In all these cases the partnership assets were sold to a third party and then the sale proceeds were divided by the partners. Therefore, excess accretion in the sale proceeds would be a capital gain but it will not be so where the case fairly and squarely falls within the exception to section 45 and section 47(ii). The cases relied upon by the learned counsel are clearly distinguishable and do not cover the matter, in controversy.

(5) For the reasons recorded above, we answer the question referred to us in the negative, that is, in favour of the assessee and against the department. The assessee will be entitled to his costs which are assessed as Rs. 200.

N.K.S.

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(5) (1955) 28 I.T.R. 914.
(6) (1954) 26 I.T.R. 351.
(7) (1957) 31 I.T.R. 250.