

# What's New

## Tax Insights



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**Amount credited to partner's capital account on revaluation of assets can be said to be 'transfer', falling under the category of 'otherwise', liable to tax under erstwhile section 45(4) of the Act**

### In brief

The Supreme Court ruled<sup>1</sup> that the surplus on account of revaluation of assets credited to a partner's capital can be said to be 'transfer' falling under the ambit of 'or otherwise'. Therefore, the provision of section 45(4) of the Income-tax Act, 1961 (the Act) will be applicable.

### In detail

#### Facts

- The taxpayer was a partnership firm engaged in the business of dyeing, printing, processing, manufacturing and trading in clothing.
- The firm was reconstituted in May 1991 on account of family settlement. Thereafter, in November 1992, various partners were admitted with nominal capital contribution.
- In January 1993, the assets of the firm, being land and building, were revalued and the said amount was credited to the account of the partners in a profit-sharing ratio. Two of the original partners withdrew some amounts from their capital accounts.
- The taxpayer's case was re-opened, and the tax officer (TO) passed an order under section 143(3) read with section 147 of the Act making an addition of the revalued amount credited to partners account, as short-term capital gains.
- According to the TO, revaluation of assets and subsequent credit to the partner's capital account constitutes transfer, liable to tax under section 45(4) of the Act. Also, according to the TO, the taxpayer had claimed depreciation on the said assets, being land and building and therefore, the gain was short term capital gain under section 50 of the Act.

<sup>1</sup> Civil Appeal Nos. 8258-8259 of 2022 (SC)

## Issue before the Supreme Court

Whether section 45(4) of the Act as introduced by the Finance Act, 1987 would be applicable?

### Tax department's key contentions

- Credit of the revalued amount to the accounts of the partners is akin to distribution of the assets to the partners. Such distribution can be said to be 'transfer' under section 45(4) of the Act inserted w.e.f. 1 April 1988.
- The partners admitted in November 1992, were immediately benefited by credit of the revaluation amount to their capital account.
- Introduction of section 45(4) of the Act accompanied by omission of section 2(47)(ii) of the Act was aimed to plug the loophole which allowed taxpayers to revalue assets and then transfer and distribute them on dissolution without paying tax on capital gains.
- According to section 45(4) of the Act, the amount of revaluation of assets credited to the partner's capital account is deemed transfer liable to tax in the hands of the taxpayer.
- The word 'otherwise' to include not only the cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of the retiring partner as held in the case of A.N. Naik Associates and Ors.<sup>2</sup>

### Taxpayer's key contentions

- The provisions of section 45(4) of the Act would be triggered only if two conditions are met:
  - There is a transfer of capital asset by way of distribution.
  - Such transfer is either on account of dissolution of the partnership firm or otherwise.
- No dissolution of partnership firm and/ or revaluation on dissolution of the partnership firm had taken place in the relevant year.
- The surplus on account of revaluation of assets credited to the partner's capital account cannot be construed as transfer or deemed transfer as per section 45(4) of the Act. It was only a book entry of notional surplus accounted in the books of account.
- The decision of the Bombay High Court in the case of A.N. Naik Associates and Ors.<sup>2</sup>, was not applicable on facts. On facts, the case is covered under the decisions of Hind Construction Limited and Texspin Engg. and Mfg. Works<sup>3</sup>.

### Supreme Court's decision

- Clause (ii) of section 2(47) and section 47(ii) of the Act exempted the transfer by way of distribution of capital assets from the ambit of the definition of 'transfer'. The same helped the taxpayer in avoiding the levy of capital gains tax by revaluing the assets and then transferring and distributing the same at the time of dissolution. The said loophole came to be plucked by insertion of section 45(4) and omission of section 2(47)(ii) of the Act.
- The word used 'or otherwise' in section 45(4) of the Act is very important.
- In view of addition of words 'or otherwise' in section 45(4) of the Act, there is no substance in the submission of the taxpayer that section 45(4) of the Act is not applicable as in the instant case, there is no dissolution of the partnership firm and only transfer of the amount on revaluation of assets to the capital accounts of the respective partners.

<sup>2</sup> CIT v. A.N. Naik Associates and Ors. [Tax Appeal Nos. 50 and 55 of 2002]

<sup>3</sup> CIT v. Hind Construction Limited [1970] 78 ITR 664 (Calcutta) and CIT v. Texspin Engg. And and Mfg. Works [2003] 263 ITR 345 (Bombay)

- The credit to the partner's capital account of the revaluation amount can be said in effect to be distribution of assets to the partners.
- The newly admitted partners were benefitted by the huge credit to their respective accounts, immediately after joining the firm, which was available to the partners for withdrawal.
- The decision in the case of Hind Construction Limited<sup>3</sup> cannot be relied upon as the said decision was based on the provisions prior to the insertion of section 45(4) of the Act.
- Therefore, revaluation of the asset and the credit into the capital accounts of the respective partners can be said to be 'transfer' which falls in the category of 'otherwise' and therefore, the provision of section 45(4) inserted by Finance Act, 1987 w.e.f. 1 April 1988 will be applicable.
- The orders passed by the High Court and the Income-tax Appellate Tribunal were unsustainable and the addition made by the TO towards short-term capital gains was confirmed.

### **The takeaways**

The Supreme Court has clarified the meaning of the term 'otherwise', to include cases not involving transfer. However, going forward the decision may not have much impact as section 45(4) of the Act is already amended (*vide* Finance Act, 2021) and does not include the term 'otherwise'.

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