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Reduction in share of partners on reconstitution of firm is not relinquishment of right and hence, not a taxable transfer

In brief

In a recent ruling in the case of Sri P.N. Panjawani[1], the Karnataka High Court (HC) has held that the reduction of share in partnership after the reconstitution of the firm does not amount to the extinguishment of rights of the old partners over the assets of the firm, so as to give rise to taxable capital gain in the hands of old partners.

Facts

- Kamala Industries, a partnership firm, was established in the financial year (FY) 1961-62 with three individuals.

- In the FY 1995-96, four new partners were admitted to the partnership with a total contribution of INR 35 million towards their share of capital. This reconstitution reduced the share of each of the old partners from one-third in the old firm to one-sixth in the reconstituted firm. This contribution was withdrawn by the old partners within two days of reconstitution.

- The assessing officer (AO) alleged and held the following:

[1] [1] CIT *v.* P N Panjawani [TS-351-HC-2012(Kar)]

- Reduction of 50% in the share of partnership is a relinquishment by the old partners of their rights and, hence, amounts to a transfer as per section 2(47) of the Income-tax Act, 1961 (the Act).

- The amount withdrawn by old partners is to be considered as the full value of consideration received by the partners for relinquishment of 50% of their rights in the assets of the firm.

- Both the Commissioner of Income-tax (Appeals) (CIT(A)) and the Income-tax Appellate Tribunal (the Tribunal) reversed the order of the AO. Hence, the revenue authorities preferred an appeal before the HC.

Issue

The following question was framed for the consideration of the Karnataka HC:

- Whether the revenue authorities were right in holding that the admission of the new partners and assignment of rights 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 section 2(47) of the Act and consequently not liable to tax under section 45 of the Act?

Revenue's contention

- With reference to the Indian Partnership Act, 1932 (the Partnership Act) and by relying on the decision of the Supreme Court (SC) in the case of Malbar Fisheries Co.[2], the revenue authorities contended that, a partnership firm has no separate legal existence than that of its partners, and a reduction in the share of partners in the firm amounts to the relinquishment of rights over the property of the firm and is to be considered as a taxable transfer as per the Act.

- The withdrawal by the old partners of the full contribution brought in by the new partners within two days and the fact that no business activity was being carried on even after the reconstitution leads to a conclusion that the whole chain of events is a colourable device only to avoid payment of taxes.

- Relying on the decision of SC in the case of Kartikeya V. Sarabhai[3], the revenue authorities claimed that the IT Act provides an inclusive definition of transfer and that the relinquishment or extinguishment of rights in capital assets without sale can also be considered as a transfer.

Assessee's contention

- Share in partnership of the old partners was reduced owing to the admission of new partners in the firm and not because of the sale or transfer of any property of the firm to the new partners.

- The firm's property in the form of land was not held by the partners in their personal capacity but was actually an asset of the firm in its capacity as legal owner of the land.

- The mere withdrawal of the amount by the old partners cannot be considered as a relinquishment of their rights in the property of the firm.

High Court ruling

- The HC concurred with the view of the lower revenue authorities that, none of the provisions of the Act specifically envisages a situation where capital gains would be chargeable on account of reduction in the share of partnership in a firm by way of introduction of new partners.

[2] Malabar Fisheries Co. *v.* CIT [1979] 120 ITR 49 (SC)

[3] Kartikeya V. Sarabhai *v.* CIT [1997] 228 ITR 163 (SC);

- In light of the facts of the case, the HC stated that it cannot be said that the old partners transferred their shares in the property of the firm and the amount of drawings represented the consideration received for such transfer, as for the purpose of the Act, the identity of the firm and its partners were separate and distinct, contrary to the treatment as per the Partnership Act.

- The contention of the revenue authorities that, the above events represent a colourable device adopted by the partners to avoid payment of taxes is not tenable, as tax planning is legitimate, if done within the frame work of law. This is also owing to the fact that the firm was created in 1962, and land was purchased in 1967. The firm carried on business till FY 1992-93, and the old partners continued to be the partners in the firm, even though with a lower share in profits of the firm. Merely because the business was not conducted post reconstitution, one cannot hold that the firm is not genuine.

- The HC observed that, the SC's decision in the case of Kartikeya V. Sarabhai (above) cannot be applied in this case, since the assets are not owned by the partners and, hence, the question of partners relinquishing their right on the assets does not arise.

Conclusion

- The Karnataka HC has held that the reduction in the share of partners after the reconstitution of partnership firms does not amount to a taxable transfer. Further, it reaffirmed that, tax planning within the frame work of law is permitted.

- The principles laid down in this decision can also be applied to the limited liability partnerships, in similar circumstances.

- However, the proposed General Anti Avoidance Rule provisions may impact these conclusions.

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