

(1972) 03 MAD CK 0014

In the Madras High Court

Case No : Tax Case No. 296 of 1966 (Reference No. 66 of 1966)

Commissioner of Gift-tax

APPELLANT

Vs

A.M. Abdul Rahman Rowther

RESPONDENT

Date of Decision : 22-03-1972

Acts Referred:

Gift Tax Act, 1958 — Section 2, 4
Partnership Act, 1932 — Section 48

Citation : (1973) 89 ITR 219

Hon'ble Judges : V. Ramaswami, J;G. Ramanujam, J

Bench : Division Bench

Advocate : V. Balasubrahmanyam and J. Jayaraman, for the Appellant; K. Srinivasan, D.S. Meenakshisundaram and K.C. Rajappa, for the Respondent

Judgement

Ramaswami, J.—The following two questions have been referred u/s 26(1) of the Gift-tax Act (hereinafter referred to as "" the Act "") on

application by the Commissioner of Gift-tax, Madras:

1. Whether, on the facts and in the ciicumstances of the case, the Appellate Tribunal was right in law in holding that the redistribution of the profit

sharing ratio on the admission of the two partners did not amount to a gift by the assessee of a portion of his share in the goodwill of the firm ?

2. Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in holding that the surrender or abandonment

by the assessee of a share in the goodwill of the business in favour of his two children was bona fide and, therefore, did not amount to a gift within

the meaning of Section 4(c) of the Gift-tax Act ?

2. The assessee was carrying on a business in tobacco as sole proprietor. On June 9, 1954, he converted his business into a partnership business

consisting of himself and his two daughters, Rookia Bibi and Rahma Bibi. He had a 60% share in the assets and the profit and loss and his two

daughters had 20% share each in the partnership. This firm was recognised by this court as being genuine and entitled to registration u/s 26A of the

Indian Income Tax Act, 1922. Subsequently, on November 2, 1960, the assessee transferred a sum of Rs. 25,000 each to his daughter, Rabiath

Bibi, and son, Noor Mohamed, from his share capital account.

3. On November 3, 1960, a partnership deed was executed with Rabiath Bibi and Noor Mohamed as partners. The deed provided that the gross

assets and liabilities of the predecessor-firm shall form the assets and liabilities of the partnership business, that the capital of the firm shall be Rs.

1,25,000 and it shall belong to the five partners (the assessee, his three daughters and a son) in equal shares and that the profits and losses of the

partnership shall be divided between and borne by the parties in equal proportions.

4. The assessee filed a gift-tax return for the assessment year 1961-62 admitting a gift of Rs. 50,000 which he had transferred to the accounts of

his daughter, Rabiath Bibi, and son, Noor Mohamed. The Gift-tax Officer was of the view that by gifting Rs. 50,000 share capital in favour of his

son and daughter and making them as partners he transferred a part of his 60% share in the partnership and his daughter and son became entitled

to one-fifth share each in the partnership. He also held that by this process, in addition to gifting a share in the partnership, he had also made a gift

of 40% of the goodwill out of the 60% to which he was entitled. He valued the 40% goodwill at Rs. 60,000 and adding this amount to Rs. 50,000,

the gift returned by the assessee, he determined the total value of the gift at Rs. 1,10,000.

5. On appeal by the assessee, the Appellate Assistant Commissioner held that the business had gained goodwill but the computation of the

goodwill by the Gift-tax Officer was not correct and directed the Gift-tax Officer to recompute the value of the goodwill gifted on the basis

suggested in his order. However, on the main question he confirmed the order of the Gift-tax Officer that the assessee had not only gifted a sum of

Rs. 50,000 but also 40% of the share in the firm's goodwill.

6. The assessee preferred a further appeal to the Income Tax Appellate Tribunal.

The Tribunal held that since on the date of admission of the new partners the assessee was not the proprietary owner of the business but was only a partner in the firm, it was the firm that entered into the new arrangement and any benefit that was conferred on the new partners was due to the act of the firm and not that of the assessee and the fact that under the new arrangement it was the share of the assessee himself that had been redistributed between him and the two new partners was immaterial. The Tribunal also held that when the new partners entered the business with their contribution of capital, they were entitled to a share in the business and that though such share might be to the detriment of the single partner or of all the existing partners, there was no element of gift in such redistribution of shares on the admission of new partners. The Tribunal was of the view that even assuming that there was a surrender or abandonment of a portion of the assessee's share in the goodwill in favour of his two children, since the surrender or abandonment was bona fide it did not amount to a gift within the meaning of Section 4(c) of the Act. In that view, the Tribunal held that, the assessee was liable to pay gift-tax only on the sum of Rs. 50,000, which was returned by him.

7. It is necessary to notice certain relevant clauses in the deed of partnership dated November 3, 1960, in order to answer the reference. After setting out in the preamble the gift of share capital of Rs. 25,000 each to his son and daughter, the deed further stated that the gross assets and liabilities of the predecessor-firm shall form the assets and liabilities of the partnership business newly constituted and that the value of the same to be as found in the books of the predecessor firm. The capital of the firm shall be Rs. 1,25,000 and it shall belong to the five partners of the partnership in equal shares; the profits and losses of the partnership shall be divided between and borne by the partners in equal proportions ; any amount standing to the credit of any of the partners in excess of their share capital and any further advance made by the partners shall carry interest at 6 per cent. per annum. It is seen from these clauses of the partnership deed and the order of the Appellate Tribunal that the partnership deed did not deal with the goodwill specifically as an asset. In fact, it was contended on behalf of the assessee before the Appellate Assistant Commissioner that there was no goodwill at all attached to the business. The value of the net

assets excluding the goodwill was determined, by the parties at, Rs.

1,25,000, on the basis of the value of the assets as found in the books of the predecessor-firm. Therefore, the total capital of Rs. 1,25,000

represented the value of the assets excluding the liabilities. As already noticed, the gross assets and liabilities of the predecessor firm was

transferred to the new partnership and the share capital belonged to the partners in equal shares. The profits and losses also have to be shared by

the parties in equal proportion. Thus, the gift of the share capital of Rs. 25,000, each to the daughter and son of the assessee, represented only the

share value of the net assets excluding the goodwill. The other two partners had already a one-fifth share each in the partnership. By this process of

gifting a two-fifth share in the share capital and admitting them as two new partners, the assessee has transferred a 2/5th share out of his 3/5th

share in the partnership to his daughter and son.

8. Goodwill is a heritable and transferable asset of the partnership admits of no doubt. Since the 2/5th share in the partnership gifted by the

assessee was valued at Rs. 50,000, only, taking the value of the net assets as found in the books in the predecessor-firm without taking the value

of the goodwill, and since the gift of the 2/5th share in the partnership and their admission as partners also entitled the donees to a 2/5th share in the

goodwill as an asset of the partnership, the Gift-tax Officer took the view that there was a gift of the proportionate share of the goodwill in addition

to the share capital of Rs. 50,000.

9. Section 2(xii) of the Gift-tax Act defines "" gift"" as meaning "" the transfer by one person to another of any existing movable or immovable

property made voluntarily and without consideration in money or money's worth """. Section 2(xxiv) defines "" transfer of property "" as "" including the

grant of partnership or interest in property """. In Commissioner of Gift-tax v. V.A.M. Ayya Nadar, [1969] 73 ITR 761 763 a Division Bench of

this court considered the scope and meaning of the phrase "" grant of partnership or interest in property "" in the definition of "" transfer of property "".

That was a case in which the assessee who had a 1/3rd share in the assets and a 1/3rd share in the profits and losses of the partnership business

transferred a 2/9th share in the profits and losses alone to two of the partners without transferring any portion of his share in the assets of the

partnership. In other words, the assessee's share capital remained as it was prior to the transfer and the transfer was in effect a redistribution of the profit sharing ratio among the parties. The Gift-tax Officer treated the distribution of the 2/9th share in the profits and losses as a gift and value of the distribution of the 2/9th share as if it was a part of the goodwill. The Appellate Assistant Commissioner and the Tribunal held that the reallocation of shares in the profit and loss did not involve any transfer or surrender of the 2/9th share in favour of the other two partners on the ground that the redistribution of shares was the result of mutual consent and that the goodwill could be valued only at the dissolution of the partnership firm. The question for consideration in the High Court was whether, on the facts and circumstances of that case, the assessee was not liable to pay gift-tax. In dealing with the definition of "transfer of property" in Section 2(xxiv) of the Act, this court held:

If grant of partnership amounts to transfer of property, logically we do not see why the distribution of two-ninths share out of the one-third share of the assessee is any the less transfer of property. A grant of partnership may mean an individual getting into a partnership agreement with another, implying by that process the creation of new rights or distribution of rights between him and his partner. The term may also include an existing firm of partnership taking one or more partners and realigning the basis of sharing. What we have before us may be yet another instance of none being newly taken into the partnership but the sharing basis being realigned or redistributed among the partners.

10. Ultimately, the Division Bench held that the distribution by way of realignment of the One-third share of the assessee did involve transfer of property amounting to a gift chargeable to tax but the learned judges did not agree with the contention of the department that that gift was a gift of share in the goodwill of the firm and directed the revenue to revalue the gift in accordance with law.

11. An unreported judgment of the Kerala High Court in *N.K. Krishna Iyer, Sreeman Motors Vs. Commissioner of Gift Tax*, (Appendix)--See

infra was also brought to our notice. In that case the assessee who was the proprietor of a business, converted it into a partnership business by

taking his four sons as partners. The capital of the partnership was Rs. 1,10,500, the share of each partner being Rs. 22,100. The whole

arrangement was effected by necessary adjustments in the books of the business. The department valued the assets of the business at Rs. 1,76,630

and claimed that the value of the gift of the 4/5th share of the business on the basis of this valuation was at Rs. 1,41,304 as against the market value

of the total assets shown by the assessee at Rs. 1,10,500. The difference in valuation came in because the partners did not value the goodwill when

the value of the assets were determined at Rs. 1,10,500. But, the department took the view that the donor had impliedly transferred the goodwill

attached to the business also while transferring the 4/5th share in the business. Three questions were referred for decision u/s 26(1) of the Gift-tax

Act, of which two are relevant here and they are :--"" (1) Whether a specific transfer of goodwill is necessary to invoke the provisions of the Gift-

tax Act ? and (2) Whether by the transfer of the business, the father had impliedly transferred the goodwill that is attached to that business ?"" These

questions were answered in favour of the department holding that the gift also included the goodwill and was liable to tax.

12. There could, therefore, be no doubt, in the instant case, that there was a transfer of interest in property when the assessee took his daughter

and son into the partnership, assigned them a portion of the share capital and realigned the shares in the partnership and the profit sharing ratio,

which amounted to a gift chargeable to tax.

13. The learned counsel for the assessee contended that since goodwill is an asset of the firm it is not open to the Gift-tax Officer to pick and

choose one item of the assets of the partnership and treat it as a subject-matter of the gift and add it on to the sum of Rs. 50,000 which was

returned by the assessee. He further contended that it might or might not be open to the Gift-tax Officer to value the entire assets of the partnership

as a whole and treat the shares that were allotted to the donees as a gift, but definitely the Gift-tax Officer was not entitled to pick up one item

alone as being the subject-matter of the gift. In support of his argument, the learned counsel placed strong reliance on the decision of the Supreme

Court in Commissioner of Gift-Tax, Kerala Vs. P. Gheevarghese, Travancore Timbers and Products, . The facts of the case were these: The

assessee, who was the sole proprietor of a business, converted it into a partnership consisting of himself and his two daughters. The capital of the

partnership was Rs. 4 lakhs, of which his contribution was Rs. 3,50,000 and the contribution of the capital of Rs. 25,000 each by the daughters

was effected by transfer of Rs. 25,000 from the assessee's account to the account of each of the daughters. All the assets of the proprietary

business were transferred to the partnership and in these assets the assessee and his daughters were entitled to shares in proportion to their share

capital. The profits and losses of the partnership were, however, to be divided in equal shares between all the three partners. The assessee

returned a sum of Rs. 50,000 as the taxable gift but the Gift-tax Officer held that in addition to the sum of Rs. 50,000 the assessee had gifted one-

third share each in the goodwill of the business to his daughters. On appeal by the assessee the Appellate Tribunal held that the gift was exempt u/s

5(1)(xiv) of the Act on the ground that the assessee was actually carrying on business when he admitted his two daughters into the partnership. At

the instance of the revenue, the following question, among others, was referred u/s 26(1) of the Act: "" Whether, on the facts and in the

circumstances of the case, the assessee gifted only 1/8th share in the goodwill of the business ?"" While disposing of this reference, the Supreme

Court held that since the departmental authorities never treated all the assets and property of the assessee which were transferred to the

partnership as the subject-matter of the gift, it was not open to the department to pick out only one of the assets of the assessee's proprietary

business, namely, the goodwill, and regard that as the subject of the gift and that no gift-tax was payable on the goodwill of the assessee's

business.

14. Though, at first blush, the decision of the Supreme Court appeared to be in point, on further scrutiny it is quite clear that the decision is not

applicable to the facts of the present case. In the present case, as already stated, the value of the net assets excluding the goodwill was determined

by the parties at Rs. 1,25,000 on the basis of the value of the assets as found in the books of the predecessor firm ; whereas in the case before the

Supreme Court the value of the goodwill was also included in the ascertainment of the total value of the capital at Rs. 4 lakhs. This is clear from the

following passage in the said judgment :

Now it is quite clear that according to the deed of partnership and even

otherwise on admitted facts goodwill was a part of the properties and assets of the business which the assessee was running under the style of Travancore Timber and Products at Kottayam. All these were valued at Rs. 4,00,000. The entire property of the assessee's proprietary business was transferred to the new partnership. According to clause 7 in the schedule to the partnership deed the parties were to be entitled to the capital and property of the partnership in the following shares :

Assessee 7/8th share

Each daughter 1/16th share

These shares were proportionate to the capital with which the partnership was stated to have been started. Out of Rs. 4 lakhs the assessee was deemed to have contributed Rs. 3,50,000 and each of the daughters Rs. 25,000. The goodwill, as stated earlier, was a part of the assets which had been transferred to the partnership,

15. It is in those circumstances, their Lordships of the Supreme Court went on to state as follows ;

The departmental authorities, in the present case, never treated all the assets and property of the assessee which were transferred to the partnership pertaining to his proprietary business as a gift nor has any suggestion been made before us on behalf of the revenue that the property and assets valued at Rs. 4,00,000 were the subject-matter of gift. All that the departmental authorities did and that position continued throughout was that they picked up one of the assets of the assessee's proprietary business, namely, its goodwill, and regarded that as the subject of gift having been made to the daughters who were the other partners of the firm which came into existence by virtue of the deed of partnership. This approach is wholly incomprehensible and no attempt has been made before us to justify it.

16. Therefore, the Supreme Court reframed the question as : "" Whether, on the facts and in the circumstances, any gift-tax was payable on the goodwill of the assessee's business.....?"" and answered the question in the negative.

17. In this connection, it is very relevant to note the provisions of Section 48 of the Partnership Act. Section 48(h)(iv) provides that, in settling the accounts of a firm after dissolution, subject to the agreement between the

partners, the residue of the assets of the firm shall be divided among the partners in the proportions in which they were entitled to share profits. Therefore, the donees would be entitled to a share in the goodwill of the business.

18. The learned counsel for the assessee then contended that the gift of the share capital was on November 2, 1960, and the partnership deed was executed on November 3, 1960, and that, therefore, the donees became entitled to a share in the goodwill not by virtue of the gift of the share capital but by virtue of the mutual agreement or contract entered into by the partners as evidenced by the partnership deed dated November 3, 1960. This argument which found favour with the Appellate Tribunal is really not understandable. The whole thing was one transaction amounting to admission of two new partners and reconstituting the old partnership, The gift of the share capital and the transfer of the assets and liabilities and also the whole arrangement were effected by necessary adjustments in the books of the business. In fact, such an argument was advanced in the case in Commissioner of Gift-tax v. V. A. M. Ayya Nadar also which was repelled by the Division Bench and it was held therein that distribution by way of realignment of the profit sharing ratio did involve transfer of property amounting to "" gift "" chargeable to tax.

19. On the facts and circumstances of this case, we are of the view that the redistribution of the profit sharing ratio on the admission of the two new partners did amount to a "" gift "" by the assessee of a portion of his share in the goodwill of the firm.

20. In view of our finding that there was a gift of a share of the goodwill chargeable under the charging section itself, the consideration as to whether it will fall u/s 4(c) of the Act as a "" deemed gift "" does not arise, and, therefore, we need not answer the second question. We answer the first question in favour of the revenue and against the assessee with costs. Counsel's fee Rs. 250.