

(1991) 09 KAR CK 0048

In the Karnataka High Court

Case No : Income-tax Referred Case No. 9 of 1989

Commissioner of Income Tax

APPELLANT

Vs

L.F. D'silva

RESPONDENT

Date of Decision : 27-09-1991

Acts Referred:

Income Tax Act, 1961 — Section 2 (47), 253 (1), 256 (2), 263, 45

Citation : (1992) 101 CTR 152 : (1991) 192 ITR 547

Hon'ble Judges : N. Venkatachala, J;K. Shivashankar Bhat, J

Bench : Division Bench

Advocate : H. Raghavendra Rao, for the Appellant; K.S. Ramabhadran, for the Respondent

Judgement

K. Shivashankar Bhat, J.—The question required to be answered by us as referred u/s 256(2) of the Income Tax Act, 1961 ("the Act" for short), reads :

"Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the assessee was not liable to tax on capital gains without recording a finding about the existence of facts assumed by the Supreme Court in the case reported in Sunil Siddharthbhai Vs. Commissioner of Income Tax, Ahmedabad, Gujarat,

2. We are concerned with the assessment year 1981-82, relating to the accounting period ending on March 31, 1981. The assessee was a co-owner of a property at Bangalore along with two others. His share was one-third in the property. During the relevant accounting year, on July 2, 1980, this property was brought in as an asset of a firm called Messrs. Curzon Project, consisting of six partners, out of whom, three were the co-owners of the property in question. The property was contributed in lieu of the contribution of the three co-owners, each co-owner's contribution being Rs. 9 lakhs. Thus the property was obviously valued at Rs. 27 lakhs. The object of the firm was to engage in the business of developing property. The other three partners had not immediately contributed anything towards the share capital; but it was agreed as per the deed of

partnership, that "further capital of the partnership will be provided by parties of fourth, fifth and sixth parts in such proportions as may be mutually agreed upon. The parties hereto of the first, second and third parts shall not be liable to bring any further capital". The parties of the fourth, fifth and sixth parts were the partners other than the three co-owners, who were parties 1 to 3, referred to in the deed of partnership. The partnership business was to execute building construction contracts, dealing in land, etc., Each partner was to share profits and losses equally, i.e., each had a one-sixth share, and for this purpose the share capital of the firm was taken as Rs. 54 lakhs.

3. On July 30, 1981, one of the partners, Mr. Wilfred D'Souza (who was a co-owner of the property earlier), retired from the firm and he received his share of Rs. 9 lakhs in the capital of the partnership; the firm was reconstituted. Accordingly, the share of the fifth partner (who is the present assessee in this reference) was declared to be one-ninth instead of the earlier one-sixth share. There was also a variation of the share of another partner (which was the sixth party in the first deed of partnership). On April 30, 1985 (nearly 4 years 9 months after the partnership was constituted initially), the assessee retired from the partnership. Along with him another partner, Mr. John D'Souza (who was one of the original co-owners) also retired. It was stated that earlier Wilfred D'souza had retired on health grounds, and the remaining partners found it difficult to carry on the business for the reasons stated in the deed of retirement and, consequently, the retiring partners sought retirement from the partnership.

4. In the meanwhile, on December 30, 1983, the assessee was assessed to Income Tax by the Income Tax Officer for the assessment year 1981-82. This order was proposed to be revised by the Commissioner of Income Tax, u/s 263 of the Act, by issuance of a notice dated August 28, 1985. The said notice stated that, while the share of the assessee was reduced to one-ninth from one-sixth in the share capital of the partnership, he was paid a sum of Rs. 3 lakhs, which was received by the assessee from the firm. Thereafter, the notice stated :

"Where a property or asset belonging to an assessee is brought in or introduced by him into a firm in which he is a partner the property in question would belong to the firm and the assessee would no longer have any power to dispose of the whole or any part of it or any interest therein, as his property. The extinguishment of his title in respect of the said property from the point of time when it was introduced as a capital asset in the firm in which he is a partner, would constitute "transfer" within the meaning of section 2(47) of the Income Tax Act, 1961. Consequently any profits or gains arising from such transfer of a capital asset is chargeable to tax as a capital gain. The Income Tax Officer, however, has omitted to include in your total income, the capital gain arising on the above transfer. This omission on his part is erroneous and has resulted in loss of revenue."

5. Hence, he proposed to make an appropriate order u/s 263 to make good the loss of revenue for the assessment year 1981-82.

6. Thus it is clear that the sole basis of the notice issued u/s 263 was that the contribution of the share in the immovable property as contribution to the share capital of the partnership resulted in a "transfer" of an asset and in the said process whatever gain was earned was liable to capital gains tax u/s 45.

7. After hearing the assessee, the Commissioner made an order on October 28, 1985. He held that the concept of "transfer" u/s 2(47) of the Act was wider (as held by this court in Addl. Commissioner of Income Tax, Mysore Vs. M.A.J. Vasanaik, He held further that :

"In the circumstances, I hold that the Income Tax Officer was clearly in error in not bringing to tax the capital gains on the conversion of the individual property at No. 37, Cubbon Road, Bangalore, which was brought into partnership. I, therefore, direct the Income Tax Officer to recompute the total income and the tax payable by including the capital gains arising on the above transfer in computing the assessee's total income for the year. The assessment is set aside for this limited purpose."

8. The assessee went up in appeal. By the time the Appellate Tribunal took up the appeal for hearing, the decision of the Supreme Court in Sunil Siddharthbhai Vs. Commissioner of Income Tax, Ahmedabad, Gujarat, . Following the said decision, it was held that even though contribution of property towards capital of the firm involved a transfer, there was no provision to apply the capital gains tax.

9. The Revenue contended that the transaction entered into by the assessee was sham and a device to overcome the levy of capital gains and this aspect had to be considered by the Income Tax Officer, for which purpose, the matter should be remanded, specially because, the case of John D'Souza had been remanded by the Commissioner (Appeals) to the Income Tax Officer to examine the genuineness of the transaction. The Appellate Tribunal did not agree with this contention. The Appellate Tribunal clearly negated the basis for this contention by expressing a definite conclusion on facts. It held :

"It is seen that the assessee entered into a partnership with others on July 2, 1980, with one-sixth share. On July 30, 1981, his share was reduced to one-ninth since certain other partners who had brought in larger capital clamoured for a higher share. The assessee retired on April 30, 1985, taking his share, viz., Rs. 9 lakhs. It is not a case where the assessee entered into the partnership on one day and within a few days retired from the partnership taking away the cash equivalent of his share in the firm which was nothing other than the property transferred to the firm. No such inference can be drawn in this case. The genuineness of the partnership is also a different matter. That may disentitle the firm to registration or the entire profit of the so-called firm may have to be considered in the hands of someone else. So far as this particular transaction is concerned, there is no evidence on record to hold that the transaction was sham."

10. It was contended before us by Mr. Raghavendra Rao that the legal position became clear after the Supreme Court rendered its decision in Sunil

Siddharthbhai Vs. Commissioner of Income Tax, Ahmedabad, Gujarat, , in which, in the concluding part of the judgment, certain reservations were made by the Supreme Court as to the possibility of a transaction constituting a firm and contributing a property towards its share capital being sham under certain circumstances and in such a situation, the Income Tax Officer was entitled to scrutinise the entire transaction to unearth the real nature of the transaction. At page 523 (of 156 ITR), the Supreme Court observed :

"If the transfer of the personal asset by the assessee to a partnership in which he is or becomes a partner is merely a device or ruse for converting the asset into money which would substantially remain available for his benefit without liability to Income Tax on a capital gain, it will be open to the Income Tax authorities to go behind the transaction and examine whether the transaction of creating the partnership is a genuine or a sham transaction and, even where the partnership is genuine, the transaction of transferring the personal asset to the partnership firm represents a real attempt to contribute to the share capital of the partnership firm for the purpose of carrying on the partnership business or is nothing but a device or ruse to convert the personal asset into money substantially for the benefit of the assessee while evading tax on a capital gain. The Income Tax Officer will be entitled to consider all the relevant indicia in this regard, whether the partnership is formed between the assessee and his wife and children or substantially limited to them, whether the personal asset is sold by the partnership firm soon after it is transferred by the assessee to it, whether the partnership firm has no substantial or real business or the record shows that there was no real need for the partnership-firm for such capital contribution from the assessee. All these and other pertinent considerations may be taken into regard when the Income Tax Officer enters upon a scrutiny of the transaction, for, in the task of determining whether a transaction is a sham or an illusory transaction or a device or ruse, he is entitled to penetrate the veil covering it and ascertain the truth."

11. In the above case, contribution of the personal asset towards the share capital of the partnership was sought to be valued to levy capital gains. The assessee contended that since a partner was also holding the assets of the partnership along with other partners, the contribution of the personal asset towards the share capital did not involve any transfer. This broad proposition was negated by the Supreme Court, pointing out that the larger interest of the assessee in his personal asset got reduced when he contributed it to the partnership; on such contribution, other partners (who had no interest in this asset) also got some interest in the asset contributed, since the asset became the asset of the firm. At page 518, the Supreme Court observed :

"It is apparent, therefore, that 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 sometimes 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. It is because that interest exists already before dissolution, as was held by this court in *Malabar Fisheries Co. Vs. Commissioner of Income Tax, Kerala*, , that the distribution of the assets on dissolution does not amounts to a transfer to the erstwhile partners. What the partner gets upon dissolution or upon retirement is the realisation of a pre-existing right or interest."

12. However, it is not possible to evaluate the gain, if any, to the partner by the transfer involved while contributing the personal asset to the firm's capital. Hence, the question of levying tax on capital gains would not arise. In this regard, at page 520, it was held :

"The second question is, whether the assessee can be said to have received any consideration as that expression is understood in the scheme of capital gains under the Income Tax Act. In *Commissioner of Income Tax, Bangalore Vs. B.C. Srinivasa Setty*, , this court observed that the charging section and the computation provisions under each head of income constitute an integrated code, and when there is a case to which the computation provisions cannot apply at all, it is evident that such a case was not intended to fall within the charging section. On the basis of that proposition, learned counsel for the assessee has urged that section 45 is not attracted in the present case because to compute the profits or gains u/s 48, the value of the consideration received by the assessee or accruing to him as a result of the transfer of the capital asset must be capable of ascertainment in monetary terms. The consideration for the transfer of the personal assets is the right which arises or accrues to the partner during the subsistence of the partnership to get his share of the profits from time to time and, after the dissolution of the partnership or with his retirement from the partnership, to get the value of a share in the net partnership assets as on the date of the dissolution or retirement after deduction of liabilities and prior charges. The credit entry made in the partner's capital account in the books of the partnership firm does not represent the true value of the consideration. It is notional value only, intended to be taken into account at the time of determining the value of the partner's share in the net partnership asset on the date of dissolution or on his retirement, a share which will depend upon deduction of the liabilities and prior charges existing on the date of dissolution or retirement. It is

not possible to predicate beforehand what will be the position in terms of monetary value of a partner's share on that date. At the time when a partner transfers his personal asset to the partnership firm, there can be no reckoning of the liabilities and the losses which the firm may suffer in the years to come. All that lies within the womb of the future. It is impossible to conceive of evaluating the consideration acquired by the partner when he brings his personal asset into the partnership firm when neither the date of dissolution or retirement can be envisaged nor can there be any ascertainment of liabilities and prior charges which may not have even arisen yet. In the circumstances, we are unable to hold that the consideration which a partner acquires on making over his personal asset to the partnership firm as his contribution to its capital can fall within the terms of section 48. And as that provision is fundamental to the computation machinery incorporated in the scheme relating to the determination of the charge provided in section 45, such a case must be regarded as falling outside the scope of capital gains taxation altogether."

13. Therefore, normally when a person enters into a partnership and contributes his property as part of his share capital, even though there is an element of transfer in it, it is incapable of evaluation and, consequently, this transfer does not attract the levy of capital gains tax.

14. The Revenue contends that if the very constitution of the firm is not a genuine transaction or the apparent contribution of the asset as the share capital is actually a make-believe device, though in reality it is a transfer of the asset capable of being taxed for capital gains, then, the above proposition is not applicable, but the Income Tax Officer has to scrutinise the entire transaction to ascertain the truth; therefore, it is necessary to remand the proceedings to the Income Tax Officer.

15. There are at least two reasons as to why we cannot agree with this contention.

16. This is a proceeding initiated u/s 263 of the Act. The scope of the proceeding has to be ascertained with reference to the purpose and the basis of the initiation of the proceedings. While initiating the proceeding, the Commissioner has nowhere doubted the genuineness of the transaction in question. It was not his case that the contribution towards the share capital made by the assessee was only a ruse or device for converting the asset into money. He sought to revise the assessment order, purely on the basis of the law as he understood it; he proceeded that there was an element of transfer in the transaction of contributing the personal asset as the share capital in the firm. Partially, the Commissioner was justified in this assumption. However, the inapplicability of section 48 of the Act and the impracticability of evaluating the capital gain were not realised by the Commissioner. The notice issued by the Commissioner proceeds as if there was a valid transfer under a genuine situation. The basis of the initiation of the proceedings by the Commissioner cannot be altered by the Appellate Tribunal; the scope of the proceedings has to be seen as the one

envisaged by the Commissioner having regard to the peculiar nature of the revisional jurisdiction u/s 263.

17. Secondly, the Appellate Tribunal has given a definite finding that the transaction in question cannot be suspected to be a sham one. This finding actually wipes out the very question raised by the Revenue as baseless.

18. Mr. Raghavendra Rao argued that the Commissioner had not the benefit of the Supreme Court's decision in *Sunil Siddharthbhai Vs. Commissioner of Income Tax, Ahmedabad, Gujarat*, as otherwise he would have initiated the proceedings in the manner now sought to be done by the Revenue. This cannot be a valid proposition. Nowhere has the Supreme Court stated that in every case of this nature, the reality of the transaction should be scrutinised, irrespective of any suspicious circumstances. Only because the decision clarified the position in law, every assessment proceeding need not be reopened. In fact, when a similar question of taxability to capital gains came up before the Supreme Court again, the assessee's appeal was allowed by the Supreme Court, without remanding the matter for fresh scrutiny by the assessing authority (vide *Dhirajben R. Amin and another Vs. Commissioner of Income Tax and another*,

19. The peculiar nature of the proceedings u/s 263 was brought out in a case decided by the Punjab and Haryana High Court in *Commissioner of Income Tax Vs. Jagadhri Electric Supply and Industrial Co.*, the Bench held :

"The jurisdiction vested in the Commissioner u/s 263(1) of the Act is of a special nature or, in other words, the Commissioner has the exclusive jurisdiction under the Act to revise the order of the Income Tax Officer if he considers that any order passed by him was erroneous in so far as it was prejudicial to the interests of the Revenue. Before doing so, he is also required to give an opportunity of being heard to the assessee. If after hearing the assessee in pursuance of the notice issued by him u/s 263(1) of the Act, he is not satisfied, he may pass the necessary orders. Of course, the order thus passed will contain the grounds for holding the order of the Income Tax Officer to be erroneous, as contemplated u/s 263(1) of the Act. Feeling aggrieved therefrom, the assessee may file an appeal against the same, as provided u/s 253(1)(c) of the Act. In the memorandum of appeal, the assessee is supposed to attack the order of the Commissioner and to challenge the grounds for decision given by him in his order. At the time of the hearing, if the assessee can satisfy the Tribunal that the grounds for decision given in the order by the Commissioner are wrong on facts or are not tenable in law, the Tribunal has no option but to accept the appeal and to set aside the order of the Commissioner. The Tribunal cannot uphold the order of the Commissioner on any other ground which, in its opinion, was available to the Commissioner as well. If the Tribunal is allowed to find out the ground available to the Commissioner to pass an order u/s 263(1) of the Act, then it will amount to a sharing of the exclusive jurisdiction vested in the Commissioner, which is not warranted under the Act. It is all the more so, because the Revenue has not been given any right of appeal under the Act against an order of the Commissioner u/s

263(1) of the Act. In case he proceeds thereunder after hearing the assessee in pursuance of the notice given by him, then the appeal filed by the assessee u/s 253(1)(c) of the Act cannot be treated on the same footing as an appeal against the order of the Appellate Assistant Commissioner passed in assessment proceedings, where both the parties have been given the right of appeal. In this view of the matter, the argument raised on behalf of the Revenue that, in appeal, the Tribunal may uphold the order appealed against on grounds other than those taken by the Commissioner in his order, is not tenable. u/s 263 of the Act it is only the commissioner who has been authorised to proceed in the matter and, therefore, it is his satisfaction according to which he may pass necessary orders thereunder in accordance with law. If the grounds which were available to him at the time of the passing of the order do not find a mention in his order appealed against, then it will be deemed that he rejected those grounds for the purpose of any action u/s 263(1) of the Act."

20. In Commissioner of Income Tax Vs. Harikishan Jethalal Patel, , the Gujarat High Court had occasion to consider the contention of the Revenue to remand the proceedings to the Income Tax Officer to scrutinise the genuineness of a similar transaction and the constitution of the firm. The Revenue relied on the decision of the Supreme Court in Sunil Siddharthbhai Vs. Commissioner of Income Tax, Ahmedabad, Gujarat, . The Revenue's contention was rejected. A.M. Ahmadi J., speaking for the Bench, held, at page 478 :

"In the present case, it must be realised that the Income Tax Officer never doubted the genuineness of the firm or the genuineness of the transaction in question. If he had doubted the genuineness of the firm or the genuineness of the transaction, there would have been no occasion for him to vary the income of the assessee by adding the amount of capital gains for working out the net taxable income for the assessment year 1976-77. If the firm was not genuine or if the transaction was not genuine, there would be no question of the assessee having earned profit which could be brought to tax as capital gains within the meaning of section 45 read with section 48 of the Act. It was only because the Income Tax Officer thought that the transaction in question was a genuine transaction and the agricultural land was transferred to the firm, the genuineness whereof was not in doubt, that the Income Tax Officer, after deducting the cost of acquisition of the land, Computed the capital gain at Rs. 1,32,172 and added the same to the net income of the assessee for the assessment year 1976-77. The genuineness of the firm as well as the transaction was, therefore, never in doubt;....."

21. Further (at page 479) :

"It is true that, in a given case, the genuineness of the firm and/or the transaction may be doubted and may require scrutiny, but, in the present case, there existed no such doubt throughout the proceedings but merely because of the observations of the Supreme Court reproduced earlier, the departmental representative argued before the Appellate Tribunal that the matter should be

remanded for further processing on the basis of fresh facts for finding out the genuineness of the transition and the firm. It is obvious from the demand made before the Appellate Tribunal that the Revenue desires to examine the genuineness of the firm and the transaction on fresh facts, not the existing facts, for the existing facts do not even remotely create any doubt regarding the genuineness of the firm and/or the transaction. The question then is, whether, in these circumstances, it would be permissible to grant a second innings to the Revenue to introduce new facts for the purpose of deciding the genuineness of the firm and/or the transaction. The material on record at present does not create any doubt regarding the genuineness of the firm and/or the transaction. What the Revenue desires is an opportunity for a shot in the dark without there being any foundational facts on record. A mere fishing inquiry is contemplated on remand in the hope of digging out material which would throw a doubt on the genuineness of the firm and/or the transaction. If the demand is acceded to, it would mean that all cases concluded by the decision of the Supreme Court in *Sunil Siddharthbhai Vs. Commissioner of Income Tax, Ahmedabad, Gujarat*, would be reopened in the mere hope that the Revenue may be able to fish out material casting a doubt on the genuineness of the firm and/or the transaction. Hundreds of cases which stand finally settled by the above decision of the Supreme Court and in which no foundational facts exist for doubting the genuineness of the firm and/or the transaction would, on remand, be reopened to enable the Revenue to make a fishing inquiry. The result would be that hundreds of assesses would be unnecessarily vexed and put to avoidable hardship."

22. We are in respectful agreement with the above principle.

23. In these circumstances, we are of the opinion that the Appellate Tribunal was justified in not acceding to the request of the Revenue to remand the proceedings to the Income Tax Officer. Question of assuming any fact asserted by the Revenue does not arise in the circumstances of the case.

24. The question referred to us is answered in the affirmative and against the Revenue.

25. Reference answered accordingly.