

(2010) 09 P&H CK 0349
In the Punjab And Haryana At Chandigarh
Case No : IT Appeal No. 5 of 2001

Commissioner of Income Tax

APPELLANT

Vs

Rita Mechanical Works

RESPONDENT

Date of Decision : 24-09-2010

Acts Referred:

Companies Act, 1956 — Section 575

Income Tax Act, 1961 — Section 143(3), 2(47), 260A, 45, 45(1)

Citation : (2010) 09 P&H CK 0349

Hon'ble Judges : Ajay Kumar Mittal, J; Adarsh Kumar Goel, J

Bench : Division Bench

Final Decision : Dismissed

Judgement

Ajay Kumar Mittal, J.—This appeal u/s 260A of the Income Tax Act, 1961 (hereinafter referred to as "the Act") against the order dated 28-4-2000, Annexure A-3, passed by the Income Tax Appellate Tribunal, Chandigarh Bench, Chandigarh (in short "the Tribunal") in ITA No, 2/Chd/1999 for the assessment year 1995-96, has been filed by the revenue-Appellant.

2. Facts as narrated in the appeal are that M/s Rita Mechanical Works, Ludhiana, the Respondent-firm, which during the relevant year was engaged in the business of manufacturing sewing machines and its spare parts, filed its return for the assessment year 1995-96 declaring income of Rs. 54,31,400, on 31-10-1995. The Respondent re-evaluated its assets on 31-3-1994 and on the basis of the report of valuer enhanced the value of the assets to the tune of Rs. 3,27,38,045, i.e. Rs. 2,51,49,229 in respect of land and building and Rs. 75,88,816 in respect of plant and machinery. The profit accruing on the above amount was credited to the capital accounts of the partners as per their profit sharing ratios. The existence of the Respondent, however, came to an end on 31-3-1995 and the co-partners of the firm made a deed of settlement dated 28-3-1995 whereby they mutually settled their holdings of the subscribed capital amongst themselves as members of the joint stock company and also agreed to

take over certain number of shares of the newly constituted limited company in the name and style of M/s Rita Machines (India) Ltd. as per agreement dated 29-3-1995. No separate dissolution deed was prepared or executed and the Respondent stood dissolved with effect from 31-3-1995. The transfer of capital assets took place by way of distribution within the meaning of Section 45(4) of the Act, and the profit and gain arising therefrom, were liable to be charged as capital gains.

3. The assessing officer after examining the entire situation framed assessment u/s 143(3) of the Act, vide order dated 11-3-1998 (Annexure A-I) at an income of Rs. 3,96,94,499 and while doing so, the assessing officer observed that as the assets and liabilities of the old firm had been taken over by the newly established company, there was relinquishment/extinguishment of right by the firm which is to be treated as transfer in terms of Section 2(47) of the Act. It was further observed that under the circumstances, the transaction of taking over the assets of firm by the company and allotment of shares to the erstwhile partners do constitute "transfer" chargeable to tax u/s 45 of the Act. The assessing officer, after invoking provisions of Section 45(4) read with Section 50 of the Act, charged short-term capital gain on an amount of Rs. 3,27,32,628 and made disallowance on account of depreciation of Rs. 7,38,042 on the ground that the firm ceased to exist on 31-3-1995.

4. This led to filing of appeal before the Commissioner (Appeals) (Central), Ludhiana (in short "The CIT (A)") by the Assessee. In the appeal, the Assessee raised various points, inter alia, that there has been no dissolution of the firm; distribution on dissolution is not transfer; unless there is a transfer, no capital gain arises in view of the decision of Tribunal, Jaipur Bench; for the purpose of transfer, there has to be transferor and a transferee; in the case under consideration there is change in the status only from an unregistered company to a registered company; since an unregistered company succeeded a registered company, there was vesting of assets in favour of successor company and since there was no transfer the provisions of Section 45(4) are not applicable. The Commissioner (Appeals) dismissed the appeal vide order dated 13-11-1998 (Annexure A-2) as none of the above grounds found favour with it. The Commissioner (Appeals), however, differed with the assessing officer who had held that the capital gain was of short-term nature. According to the appellate authority the land was not depreciable asset and as such capital gain chargeable was not short-term but it should be given a long-term treatment and this view of the appellate authority was accepted by the department and long-term capital gain was charged instead of short-term capital gain.

5. The Assessee did not feel satisfied and took the matter in appeal before the Tribunal. The Vice President and the JM constituting the Bench differed from each other on certain points and expressed their individual views. All that is essentially needed to be noticed here is that the Vice President of the Tribunal pronounced that no capital gam arose to the Assessee within the meaning of Section 45(4) of

the Act and deleted the addition made on that account. As regards disallowance of depreciation, it was held that as the firm was in continuation upto 3-4-1995, the Assessee was entitled to depreciation allowance. As per the opinion of the JM of the Tribunal, capital gain u/s 45(4) did arise and was chargeable to tax but the same was chargeable in the assessment year 1996-97 and not in the assessment year 1995-96. He, however, concurred with the Vice President that depreciation was admissible. The Tribunal however, notwithstanding divergent views on certain issues, held vide order under appeal, dated 28-4-2000 (Annexure A-3) that during the assessment year 1995-96, no capital gain chargeable to tax arose and deleted the additions made on account of profits chargeable to tax on capital gain in the assessment year 1995-96. Claim of depreciation was also allowed.

6. It is how the revenue has preferred the present appeal proposing following substantial questions of law for determination by this Court:

1. Whether on the facts and in the circumstances of the case and on proper interpretation of the provisions of Section 45(4) read with Section 2(47) of the Income Tax Act, the Tribunal was right in law in holding that taking over of the assets of the firm by a company and allotting shares to the partners of the firm as per their holding in the firm does not give rise to profit chargeable to capital gain u/s 45(4) of the Act?

2. Whether on the facts and in the circumstances of the case the Tribunal was right in holding that capital gain arisen relates to assessment year 1996-97 instead of assessment year 1995-96 whereas co-partner in the company agreed to receive share allotment in the erstwhile company as per agreement dated 29-3-1995, though the company was incorporated on 3-4-1995 in papers only?

3. Whether on the facts and in the circumstances of the case the Tribunal was right in allowing depreciation to the firm which stood dissolved on 31-3-1995?

7. We have heard learned Counsel for the parties and perused the record.

8. Question Nos. 1 and 2 are inter-related and are being taken up together. In the present case, the partnership firm has been converted into company under the provisions of Part IX of the Companies Act, 1956 (in short "1956 Act"). There is no dissolution of the erstwhile firm and the company has been formed with the same partners as its shareholders. The question for adjudication would be, whether capital gain arises on taking over of business of an erstwhile firm by formation of a limited company in which the partners of the erstwhile firm are the shareholders. The reliance of the revenue is on the judgments, *Artex Manufacturing Co. Vs. Commissioner of Income Tax, Gujarat-II*, ; *Suvaradhan v. CIT ITRC No. 21 of 1999*, decided on 4-8-2006 by Karnataka High Court; *Commissioner of Income Tax Vs. A.N. Naik Associates and Another and Rangavi Realtors and Another*, whereas the reliance by the Assessee has been placed on *Commissioner of Income Tax Vs. Texspin Engg. and Mfg. Works*, ; *Commissioner of Income Tax Vs. Kunnamkulam Mill Board*, and *Commissioner of Income Tax*

Vs. Vijayalakshmi Metal Industries,

9. We have given our thoughtful consideration to the submissions made by the counsel for the parties and find unable to accept the contention of the revenue.

10. The primary thrust of the revenue has been on interpretation and scope of Section 45(4) of the Act.

11. Looking to the legislative history, Sub-section (4) to Section 45 of the Act was inserted whereas Section 47(ii) had been omitted by Finance Act, 1987 with effect from 1-4-1988. Prior thereto, u/s 47(ii) of the Act distribution of capital assets on dissolution of a firm, association etc. was not considered to be transfer and was, thus, exempt from being charged to capital gain tax.

12. Section 45(4) of the Act which is relevant reads thus:

The profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm or other AOP or BOI (not being a company or a co-operative society) or otherwise, shall be chargeable to tax as the income of the firm, AOP or BOI, of the previous year in which the said transfer takes place and, for the purposes of Section 48, the fair market value of the asset on the date of such transfer shall be deemed to be the full value of the consideration received or accruing as a result of the transfer.

13. According to the aforesaid provision, the profits or gains arising from transfer of capital assets by way of distribution of those assets on dissolution of a firm or other AOP or BOI (not being a company or a cooperative society) or otherwise shall be liable to tax as income of the firm etc. of the previous year when such transfer takes place. u/s 48, the fair market value of the asset on the date of transfer shall be deemed to be the full value of the consideration received or accruing as a result of the transfer.

14. For applicability of Section 45(4) of the Act, the following two conditions need to be fulfilled, namely,--

(a) there must be a transfer of capital asset by way of distribution of capital assets, and

(b) there must be a dissolution of a firm, AOP or BOI etc. or otherwise.

15. The Bombay High Court in Texspin Engg. & Mfg. Works case (supra), under similar circumstances interpreting Section 45(4) of the Act recorded thus:

Under Section 45(4), profits arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm are chargeable to tax as the income of the firm in a previous year in which the transfer takes place and for the purposes of Section 48, the fair market value of the asset on the date of such transfer is deemed to be the full value of the consideration received or accruing as a result of the transfer. Section 48 deals with mode of computation. It, inter alia, lays down that the income chargeable under the head Capital gains

shall be computed by deducting from the full value of the consideration, the expenditure incurred in connection with the transfer and the cost of acquisition of the asset. Therefore, u/s 45(4), two conditions are required to be satisfied, viz., transfer by way of distribution of capital assets, and, secondly, such transfer should be on dissolution of the firm or otherwise. Once these two conditions are satisfied then, in that event, for the purposes of computation of capital gains u/s 48, the market value on the date of the transfer shall be deemed to be the full value of consideration received or accruing as a result of the transfer.

16. The court had concluded that Section 45(4) of the Act was not attracted in a situation where the firm was converted into company under Chapter IX of 1956 Act. The relevant observations are as follows:

In this case, the erstwhile firm has been treated as a limited company by virtue of Section 575 of the Companies Act. It is not in dispute that in this case, the erstwhile firm became a limited company under Part IX of the Companies Act. Now, Section 45(4) clearly stipulates that there should be a transfer by way of distribution of capital assets. Under Part IX of the Companies Act, when a partnership firm is treated as a limited company, the properties of the erstwhile firm vests in the limited company. The question is whether such vesting stands covered by the expression transfer by way of distribution in Section 45(4) of the Act. There is a difference between vesting of the property, in this case, in the limited company and distribution of the property. On vesting in the limited company under Part IX of the Companies Act, the properties vest in the company as they exist. On the other hand, distribution on dissolution presupposes division, realisation, encashment of assets and appropriation of the realised amount as per the priority like payment of taxes to the Government, BMC, etc., payment to unsecured creditors, etc. This difference is very important. This difference is amply brought out conceptually in the judgment of the Supreme Court in the case of *Malabar Fisheries Co. Vs. Commissioner of Income Tax, Kerala*, . In the present case, therefore, we are of the view that Section 45(4) is not attracted as the very first condition of transfer by way of distribution of capital assets is not satisfied. In the circumstances, the latter part of Section 45(4), which refers to computation of capital gains u/s 48 by treating the fair market value of the asset on the date of transfer, does not arise.

17. The plea of applicability of Section 45(1) read with Section 2(47)(ii) of the Act was also negated with the following conclusion:

In the present case, we are concerned with a partnership firm being treated as a company under the statutory provisions of Part IX of the Companies Act. In such cases, the company succeeds the firm. Generally, in the case of a transfer of a capital asset, two important ingredients are: existence of a party and a counter-party and, secondly, incoming consideration qua the transferor. In our view, when a firm is treated as a company, the said two conditions are not attracted. There is no conveyance of the property executable in favour of the limited company. It is no doubt true that all properties of the firm vest in the limited

company on the firm being treated as a company under Part IX of the Companies Act, but that vesting is not consequent or incidental to a transfer. It is a statutory vesting of properties in the company as the firm is treated as a limited company. On the vesting of all the properties statutorily in the company, the cloak given to the firm is replaced by a different cloak and the same firm is now treated as a company; after a given date. In the circumstances, in our view, there is no transfer of a capital asset as contemplated by Section 45(1) of the Act. Even assuming for the sake of argument that there is a transfer of a capital asset u/s 45(1) because of the definition of the word transfer in Section 2(47)(ii), even then we are of the view that the liability to pay capital gains tax would not arise because Section 45(1) is required to be read with Section 48, which provides for mode of computation. These two sections are required to be read together as the charging section and the computation section constitute one package. Now, u/s 48 it is laid down, inter alio, that the income chargeable under the head Capital gains shall be computed by deducting from the full value of the consideration received or accrued as a result of the transfer, the cost of acquisition of the asset and the expenditure incurred in connection with the transfer. Section 45(4) is mutually exclusive to Section 45(1). Section 45(4) categorically states that where there is a transfer by way of distribution of capital assets and where such transfer is due to dissolution or otherwise of the firm, the assessing officer was entitled to treat the market value of the asset on the date of the transfer as full value of the consideration received. This latter part of Section 45(4) is not there in Section 45(1). Therefore, one has to read the expression full value of the consideration received/accruing u/s 48 de hors Section 45(4) and if one reads Section 48 with Section 45(1) de hors Section 45(4) then the expression full value of consideration in Section 48 cannot be the market value of the capital asset on the date of transfer.

18. The aforesaid view has the acceptance of the legislative intent as Finance (No. 2) Act, 1998 effective from 1-4-1999 has incorporated Clause (xiii) to Section 47 to the following effect:

Nothing contained in Section 45 shall apply to the following transfers:

(xiii) where a firm is succeeded by a company in the business carried on by it as a result of which the firm sells or otherwise transfers any capital asset or intangible asset to the company.

19. Now stage is set to analyze the case law relied upon by the counsel for the revenue.

20. In Artex Manufacturing Co.'s case (supra), the Gujarat High Court was seized of the matter where the entire assets and liabilities of the partnership were not transferred to the limited company. The business of the firm as a whole was not transferred for a lump sum price to the limited company but only the machinery used in manufacturing of the business of the firm was transferred to the newly formed limited company and the consideration was received by the

partners of the firm in the shape of shares of the company and the shares were allotted to the partners on the same basis as their shares in the profits of the partnership firm. It was in those facts that the provisions of capital gains were held to be exigible.

21. Karnataka High Court in Suvardhans case (supra) was adjudicating the matter where the partners had derived share on the dissolution of the partnership firm.

22. The factual matrix in A.N. Naik Associates case (supra) before the Bombay High Court was that a new partner was inducted before outgoing partners had been relieved and the business also continued. The gain in the hands of the retiring partners was held to be amenable to capital gains tax.

23. These judgments are, thus, not applicable and are clearly distinguishable.

24. In view of the above, the irresistible conclusion is that no capital gain u/s 45(4) of the Act would be attracted in the present case. Accordingly, question Nos. 1 and 2 are answered against the revenue.

25. Adverting to question No. 3 regarding depreciation, the authorities below had concurrently recorded that there was no dissolution which took place as urged by the learned Counsel for the revenue on 31-3-1995, whereas the firm continued upto 3-4-1995, i.e. the date of incorporation of the company. The aforesaid finding has not been shown to be perverse or erroneous in any manner by the learned Counsel. Once that is so, the Assessee-Respondent was entitled to claim depreciation on the assets for the period upto 31-3-1995 relating to the assessment year 1995-96. Accordingly, question No. 3 is also answered against the revenue.

26. As an upshot of the above discussion, finding no merit in the appeal, the same is hereby dismissed.