**INFORMATION MEMORANDUM :**

In a recent ruling, Mumbai ITAT has held that compensation received by the assessee partner for reduction in profit sharing ratio from existing partners will not result in relinquishment of rights and thus, will not tantamount to Capital Gains chargeable to tax u/s 45(1).

# Anik Industries Ltd. v. DCIT

# (2020) 116 taxmann.com 385 (Mum.)

Compensation received by partner from other existing partners for reduction in Profit Sharing Ratio will not attract capital gain tax u/s. 45(1)

## *Facts of the case :*

The assessee is one of the seven partners in a partnership firm having PSR of 30%. During the year under consideration, the firm was reconstituted vide deed of partnership dated 14/12/2004 through which the PSR of the assessee was reduced from 30% to 25% which was distributed amongst the other existing partners. In consideration thereto the other partners compensated the assessee partner by paying a compensation of Rs.4 crores.

The said compensation was not offered to tax by the assessee partner in his return of income on the ground the compensation received from other partner for relinquishing rights in partnership firm is a capital receipt (*A.K. Sharfuddin v. CIT*[1]).

However, the AO did not accept the contention of the assessee and taxed the compensation under the head capital gain chargeable to tax u/s. 45(1) of the Income Tax Act, 1961 ("***the Act***") on the ground that relinquishment of right in the shares to the extent of 5% is a "transfer". The PSR in a firm

[1] (1960) 39 ITR 333 (Mad. HC)

is a "property" and hence is a "capital asset". The CIT(A) upheld the order of AO.

## Question before ITAT :

Whether the compensation received by an assessee partner from other partners for reduction in profit sharing ratio would be chargeable to tax as Capital Gain u/s. 45(1)?

## Rule applied by ITAT :

a) Section 45(1) – capital gain arising on "transfer" of capital asset is chargeable to tax.

b) Section 2(47) defines transfer in relation to capital asset as under :

> *"Transfer includes :*
>
> *(i) the sale, exchange or relinquishment of the asset; or*
>
> *(ii) the extinguishment of any rights therein; or…"*

c) Section 2(31) defines 'person' as :

> *"Person" includes-*
>
> *(iv) a firm…"*

d) Section 45(3) and 45(4) - person who is transferring the capital assets being liable to pay capital gains i.e. the firm or the partner as the case may be.

## ITAT Analysis :

While analysing, the above rules, the ITAT relied upon the decision of Karnataka High Court in the case of *CIT v. Panjawani*[2] and observed that :

(i) Under the provisions of the Indian Partnership Act,1932, the firm is not recognised as a separate legal entity. It is a compendious of the partners who have come together to carry out business. However, the Income Tax Act recognises the firm as a distinct legally assessable entity apart from its partners.

(ii) During the subsistence of a partnership, a partner does not possess any specific and separate interest in specie in any particular asset of the partnership. It just has a right to obtain a share in profits as per the terms of the partnership deed.

(iii) Since the partner is not the owner of asset owned by the firm, the question of relinquishment of interest in that asset or extinguishment of right in their asset upon retirement would not arise.

[2] (2012) 356 ITR 676 (Kar.)

(iv) Accordingly, reconstitution deed does not envisages relinquishment of partner's right in the assets of the firm. There is only a re-adjustment of profit-sharing ratio inter-se between the existing partners.

## ITAT held :

Compensation received by the assessee partner from existing partners for reduction in profit sharing ratio would not tantamount to Capital Gains chargeable to tax u/s 45(1).

### Key Principles :

1. The firm is the owner of the assets as per section 14 of the Partnership Act. The partners do not have any separate right in the assets of the firm.
2. The Partners have a right to obtain profit from the business of the firm in terms of the partnership deed. Such right to share profit is a property and hence capital asset.
3. Reconstitution of terms of deed will not envisage "relinquishment of right" in the assets of the firm and therefore section 45(1) is inapplicable.

## Acelegal Analysis :

Under the Income Tax Act, by virtue of section 45(3) and 45(4), the transfer of capital asset in the case of a partnership firm has been deemed to be a "transfer" and hence taxable as capital gain.

Section 45(3) comes into play when a person transfers a capital assets to a firm as a capital contribution and becomes a partner of a firm. The value recorded for such asset in the balance sheet is deemed as consideration of the partner for transfer of asset to firm. Whereas section 45(4) deals with profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm chargeable to tax as the income of the firm.

Under the Income Tax Act, the partners and the firm are two distinct entities. The property of the firm is owned by the partnership firm and not the member as envisaged from section 45(3) and section 45(4). Therefore, where merely the PSR was varied there was no transfer of any asset of the firm and hence, there would be no incidence of capital gain.

From AY 2019-20, there is an amendment in section 28(ii) wherein clause (e) has been inserted. As per said clause, compensation by whatever named called, received or receivable in connection with termination or modification of terms and contract of a business contract shall be taxable w.e.f. AY 2019-20.Therefore, in future the taxability of said compensation will also be tested under the head "Profits and gains from Business or Profession".

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