



ERGO

Analysing developments impacting business

TAXATION OF PARTNERS' COMPENSATION ON RECONSTITUTION OF PARTNERSHIP

27 April 2020

Introduction

The Mumbai Bench of the Income Tax Appellate Tribunal (Tribunal) in the case of M/s Anik Industries Limited (Tax Payer) vs DCIT (ITA No. 7189/Mum/2014 & ITA No. 5234/Mum/2016) allowed the appeal by the Tax Payer that the compensation received by the Tax Payer for reduction in profit sharing ratio would not tantamount to capital gains chargeable to tax under Section 45(1) of the Income-tax Act, 1961 (IT Act).

Background

The Tax Payer who was engaged in the business of manufacturing and processing of milk products, wind power generation and mining and trading in commodities, was also a 30% partner in the partnership firm, M/s Mahakosh Property Developers (Firm). During FY 2009-10, there was a reconstitution of the Firm, wherein one of the partners retired and the partnership interest of the Tax Payer was reduced to from 30% to 25%. In lieu of its reduction in the share of partnership, the other partners of the Firm compensated the Tax Payer INR 40 million. The entries for the aforesaid adjustments and payments were made in the Firm's books of accounts by crediting the current account of the Tax Payer by INR 40 million and corresponding debits to the other partners' current account. The Tax Payer treated the aforesaid compensation as capital receipt not liable to tax. However, during the assessment proceedings the Assessing Officer sought to tax the aforesaid compensation on the ground that the aforesaid compensation was for consideration towards transfer of an intangible asset i.e. share of goodwill of the Firm.

The first appellate authority confirmed the decision of the Assessing Officer and held that relinquishment of the asset and the extinguishment of any rights therein are included as "transfer" under the provisions of Section 2(47) of the IT Act. Therefore, relinquishment or the extinguishment of the appellant's right over the share of profit in the Firm from 30% to 25% and the consideration of a sum of INR 40 million received on account of same have to be necessarily treated as consideration received for transfer of capital asset.

Aggrieved by the order of the first appellate authority, the Tax Payer preferred an appeal before the Tribunal.

Tribunal's Ruling

The Tribunal held that since it was not a case of distribution of capital assets on the dissolution of firm and it was only a case of reduction in share of one partner which was taken over by existing partners, Section 45(4) of the IT Act should not be applicable.

The Tribunal also noted that the case entails adjustment of profit sharing ratio *inter se* amongst the existing partners of the Firm which was routed through the respective partner's current account and that even after the reconstitution the Tax Payer continues to remain a partner of the Firm. Relying on the Karnataka High Court judgment in CIT vs P.N. Panjawani (356 ITR 676), the Tribunal ruled that the compensation received by the Tax Payer from existing partners for reduction in profit sharing ratio would not tantamount to capital gains chargeable to tax under Section 45(1) of the IT Act.

The Tribunal also distinguished a ruling of the Ahmedabad Bench in another case, as the facts in that case involved consideration for transfer of profit share in favour of a third party (incoming partner), whereas the current facts only related to re-constitution amongst existing partners of the Firm.

Comments:

Reconstitution in partnership firms on account of change in profit-sharing ratio between existing partners is a common event. As per this ruling, inter-se adjustment of partner's capital on account of such event should not be taxable in the hands of the partner whose account is credited by reason of such reconstitution. Notably, the cases distinguished by the Tribunal also involved payment of consideration directly by an incoming partner to existing partners, without involvement of the firm. Therefore, a case by case examination of the purpose as well as the manner of carrying out such one-time transactions/adjustments, should be undertaken to determine any income-tax consequences.

- *Vinita Krishnan (Director), Sanket Shah (Principal Associate) & Jimmy Bhatt (Principal Associate)*

For any queries please contact: editors@khaitanco.com

We have updated our [Privacy Policy](#), which provides details of how we process your personal data and apply security measures. We will continue to communicate with you based on the information available with us. You may choose to unsubscribe from our communications at any time by clicking [here](#).

For private circulation only

The contents of this email are for informational purposes only and for the reader's personal non-commercial use. The views expressed are not the professional views of Khaitan & Co and do not constitute legal advice. The contents are intended, but not guaranteed, to be correct, complete, or up to date. Khaitan & Co disclaims all liability to any person for any loss or damage caused by errors or omissions, whether arising from negligence, accident or any other cause.

© 2020 Khaitan & Co. All rights reserved.

Mumbai

One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi

Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru

Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata

Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com