KPMG

TAX FLASH NEWS

21 October 2016

Sale of a partnership firm, where values are assigned to individual assets, is taxable as capital gains – Supreme Court

Background

Recently, the Supreme Court in the case of Vatsala Shenoy[1] (the taxpayer) observed that sale of a partnership firm on a going concern basis could be treated as slump sale only if there was no value assigned to the individual assets and liabilities. However, in the taxpayer's case, not only value was assigned to individual assets, even the liabilities were taken care of when the amount of sale was apportioned among the outgoing partners. There was a specific and separate valuation for land as well as building and also machinery.

Accordingly, the Supreme Court held that the taxpayer, a partner, is liable to pay capital gains tax on such sale, since assets of the firm were 'capital asset' within the meaning of Section 2(14) of the Income-tax Act, 1961 (the Act).

Facts of the case

- The taxpayer was a partner in the partnership firm. There were thirteen partners in the said partnership firm, which was sold to three partners, as a going concern after the dissolution of the partnership firm on 6 December 1987.
- However, because of the difference of opinion among the erstwhile partners, the affairs of the firm could not be wound up. Therefore, two of the partners of the firm filed a petition before the High Court under the provisions of Part X of the Companies Act, 1956 for winding up of the affairs of the firm.
- The business of the partnership was continued because of the interim order passed by the High Court. On 5 November 1988, the High Court passed an order permitting the seven partners to continue the business as an interim arrangement till the completion of winding up proceedings.
- Ultimately, on 14 June 1991, the High Court passed an order for winding up the affairs of the firm by selling its assets as an 'ongoing concern'. The High Court permitted the sale of a firm, as a going concern to such of its partner(s), who makes an offer of highest price.
- On the aforesaid terms, a bid of Association of Persons comprising three partners (AOP-3), turned out to be the highest and the same was accepted by the High Court vide order dated 21 September 1994. AOP-3 deposited the amount of INR 92 crores with the official liquidator on 17 November 1994 and with the occurrence of this event, assets of the firm were treated as having been sold to AOP-3 on 20 November 1994.
- The Assessing Officer (AO) included the proportionate share from the amount of INR 92 crores as a capital gain at the hands of a partner and divided the same into long term and short term gain.
- The Commissioner of Income-tax (Appeals) [CIT(A)], Income-tax Appellate Tribunal (the Tribunal) and the High Court upheld the order of the AO.

[1] Vatsala Shenoy v. JCIT (Civil Appeal No. 1234 of 2012) – Taxsutra.com

Taxpayer's contentions

- As per the definition of the capital asset provided in Section 2(14)(a) of the Act, the undertaking that was transferred as a going concern was a capital asset. However, at that time, there was no provision as to how the asset of the firm when sold is to be computed as a capital gain. Such a provision was introduced for the first time (vide the Finance Act, 1999) by inserting Section 50B to the Act with effect from 1 April 2000, laying down the mechanism for computation of capital gains in case of slump sale. Therefore, slump sale prior to 1 April 2000 was not taxable. The taxpayer relied on the decision of PNB Finance Limited[2].

- Since it was a sale of an ongoing concern, it had to be treated as a slump sale within the meaning of Section 2(42C) of the Act and, therefore, it was not permissible for the AO to assign the lump sum amount into different heads of land, building and machinery and treating balance amount as goodwill.

- It was a capital asset as an ongoing concern, which was sold and in the absence of provisions relating to the mode of computation and deductions at the relevant time, which were inserted subsequently only with effect from 1 April 2000, the consideration was to be treated as capital receipt and no capital gain was payable thereon.

Supreme Court ruling

- In the orders passed by the High Court from time to time, insofar as the firm is concerned, it has always been described as '*the dissolved partnership firm*'. Thus, the assets, which were sold ultimately on 20 November 1994 were of a dissolved partnership firm, though as a going concern.

- During the pendency of the winding up petition before the High Court, the High Court had passed various orders, which included an order for valuation of the assets of the firm. This valuation was done to enable the Court to fix the reserve price for the purpose of *inter se* bidding between the erstwhile partners and/or association of erstwhile partners.

- It has been observed that the asset of the firm that was sold was the capital asset within the meaning of Section 2(14) of the Act. Once it is held to be the 'capital asset', gain therefrom is to be treated as a capital gain within the meaning of Section 45 of the Act.

- The taxpayer argument that payment of capital gain tax is not taxable on the ground that it was a 'slump sale'[3] and there was no mechanism at that time as to how the capital gain is to be computed in such circumstances is not acceptable since the assets were put to sale after their valuation. There was a specific and separate valuation for land as well as building and also machinery. Such valuation has to be treated as that of a partnership firm, which had already stood dissolved.

- As per the definition of slump sale provided in Section 2(42C) of the Act, sale in question could be treated as slump sale only if there was no value assigned to the individual assets and liabilities in such sale. In the present case, not only value was assigned to individual assets, even the liabilities were taken care of when the amount of sale was apportioned among the outgoing partners.

- Once it is held that the sale in question was not a slump sale, obviously Section 50B also does not get attracted as this section contains special provision for computation of capital gains in case of slump sale. The decision in the case of PNB Finance Limited also would not apply to the facts of the present case.

- The amount distributed by the official liquidator among the nine partners, including the taxpayers, after deducting the liability of each of the partners, is the value of the net asset of the firm which would attract capital gain. The High Court has rightly held that the amount received by them is the value of the net asset of the firm, which would attract capital gain.

- We find that the partnership firm had dissolved and thereafter winding up proceedings were taken up in the High Court. The result of those proceedings was to sell the assets of the firm and distribute the share thereof to the erstwhile partners. Thus, the 'transfer' of the assets triggered the provisions of Section 45 of the Act and making the capital gain subject to the payment of tax under the Act.

[2] PNB Finance Limited v. CIT [1980] 122 ITR 594 (Bom)

[3] Within the meaning of Section 2(42C) of the Act

- Accordingly, the Supreme Court upheld the order of the AO in respect of payment of capital gain tax by the taxpayer.

Our comments

The taxability of the slump sale transactions prior to the introduction of Section 50B read with Section 2(42C) in the Act has been the subject matter of debate before the Courts.

Prior to amendment in the Act, Courts have held that slump sale is a sale of a business on a going concern basis where the lump sum price cannot be attributed to individual assets or liabilities. In Artex Manufacturing Co.[4], the Supreme Court treated the sale of the business on a going concern for a lumpsum consideration as an itemised sale on the ground that the price was determined by the valuer on the basis of itemised assets. In Electric Control Gear Mfg. Co.[5] the Supreme Court observed that the sale of the business on a going concern basis was a lump sum sale since there was nothing to indicate that the price is attributable to any asset.

The Supreme Court in the present case has held that sale of a partnership firm where values are assigned to individual assets, is taxable as capital gains.

Section 50B[6] read with Section 2(42C) of the Act provides that slump sale means the transfer of one or more undertaking as a result of the sale for a lump sum consideration without values being assigned to individual assets and liabilities. It provides that any profits or gains arising from slump sale effected shall be chargeable to tax as capital gains arising from the transfer of long-term capital assets and shall be deemed to be the income of the previous year in which the transfer took place.

Post amendment to Section 50B of the Act, the Mumbai Tribunal in the case of Mahindra Engineering & Chemical Products Ltd[7] held that transfer of significant tangible and intangible assets of a business was in the nature of the transfer of single undertaking. In substance, the transfer was a slump sale of a business undertaking on a going concern basis rather than an itemised sale of assets individually and was taxable under Section 50B of the Act.

[4] CIT v. Artex Mfg. Co. [1997] 227 ITR 260 (SC)
[5] CIT v. Electric Control Gear Mfg. [1997] 93 Taxman 384 (SC)
[6] Inserted by the Finance Act, 1999 with effect from 1 April 2000
[7] Mahindra Engineering & Chemical Products Ltd v. ITO [2012] 51 SOT 496 (Mum)

www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.