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RBSA Advisors

TT Alert

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No implications under Section 56(2)(viia) of the Income-tax Act on contribution of shares/cash by the Partner to the Partnership Firm

The Hon'ble Hyderabad Income-tax Appellate Tribunal ('ITAT') in its recent ruling[1] has held that provisions of Section 56(2)(viia) of the Income-tax Act ('ITA') shall not be applicable in respect of capital contribution made (whether in cash or kind) by the Partner to the Partnership Firm ('Firm').

The Hon'ble ITAT vide the said ruling has clarified that contribution of assets by the Partner to the Partnership Firm is not without consideration as the respective capital account of the Partner is correspondingly credited with the value at which the contributed assets are recorded in the books of the Firm.

Such credit to the respective Partner's Capital account represents a valuable consideration in the form of the Partner's right such as right to share the profits of the Firm, right to seek settlement at the time of retirement/exit at the time of retirement/dissolution of the firm.

Background[2]

AY 2014-15

Assessee, a Partnership Firm consisted of three partners. During AY14, a new partner (a Private Trust) was admitted into the partnership pursuant to which the Partnership Firm was reconstituted which resulted in change of profit-sharing ratio of each of the partners.

The incoming partner as part of its capital contribution, contributed its ownership of shares in two companies to the Assessee which were recorded in the books of the Assessee at a value in accordance with provisions of Section 45(3) of the ITA.

During the course of tax assessment, the Assessing Officer ('AO') contested that the value at which the shares were recorded in the books of the Assessee does not represent the fair value of shares and accordingly recomputed the value at which such shares should be recorded in the books.

The recomputed value which was substantially higher than the value at which shares were recorded resulted in AO reaching a conclusion that the Assessee has received shares at a consideration which is inadequate or does not represent the fair value of the assets. As a result, the differential (i.e. value of shares recomputed by the AO and the value at which shares were initially recorded) was taxed as income in the hands of the Assessee under Section 56(2)(viia) of the ITA.

[1] *Income-tax Officer Vs Shrilekha Business Consultancy (P) Ltd - 121 Taxmann.com 150 (Hyderabad ITAT)- [2020]*

[2] *The order of the ITAT represents the appeals filed by the Assessing Officer against Assessee for two Assessment years which were clubbed and were herd jointly taking into consideration the specific facts of the case in each of the Assessment Years.*

Aggrieved by the order of the AO, the Assessee contested the additions by filing an appeal before the Commissioner of Income-tax Appeals ('CIT(A)') which deleted the additions and further held that the ITA has prescribed Section 45(3) of the ITA which creates a deeming fiction wherein only the incoming partner is taxed on contribution of assets in the Partnership Firm basis the value recorded in the books of the partnership.

The provisions of the ITA do not provide for adoption of value which is different from the value recorded at the time of admission as the 'fair value' for the purpose of invoking Section 56(2)(viia) in the hands of the recipient.

Further, the CIT(A) held that Section 56(2)(viia) is a general provision and cannot override a specific provision i.e. Section 45(3) of the ITA which provides for taxability on admission of a partner.

AY 2015-16

During AY15, the Assessee was again reconstituted wherein a Company was inducted as a new partner. As a result of the reconstitution, the Assessee as a Partnership Firm had five partners.

The incoming new partner brought in cash as part of its capital contribution out of which certain amount was credited towards the capital account of the incoming partner with remaining amount being credited to the 'Capital Reserve' Account. In addition to the incoming partner, one of the existing partners (Private Trust) also contributed additional capital in the Firm which resulted in the adjustment of the overall profit-sharing ratio.

The proceeds of additional capital received by the Firm were utilized for making fresh investments into a Company (First Investee Company). The said Investee Company in turn invested the funds into shares of another company (Second Investee Company) which allotted shares to the Investee through a private placement process.

Pursuant to the Scheme of Amalgamation, the Investee Company was merged with the Second Investee Company, wherein in consideration of Merger, the Second Investee Company issued shares to the shareholders of the First Investee Company which included the Assessee as well. As a result of the above, the Assessee ended up holding shares in the Second Investee Company.

The above-mentioned series of transactions was minutely reviewed by the AO wherein the AO questioned the commercial rationale of the incoming partner for investing a substantial amount in a small Partnership Firm (i.e. the Assessee).

Basis the information received during the course of the tax assessment, the AO held that the incoming partner wanted to acquire a desired stake in the Second Investee Company for which a substantial amount was infused in the Assessee.

Such funds after being recorded in the books of the Partnership Firm was invested in the First Investee Company which further infused the funds into the Second Investee Company. As the First Investee Company got merged with the Second Investee Company and as on merger shares were issued to the Partnership Firm, the incoming partner effectively ended up holding its desired stake in the Second Investee Company.

The AO held that the entire mechanism was designed to avoid a potential tax liability arising on divestment of identified stake in the Second Investee Company by its shareholders (including the Assessee).

Basis the information collated during the course of tax assessment, the AO concluded that the incoming partner had invested a substantial amount in the Assessee as its capital contribution.

The amount of contribution representing the consideration required for acquiring the desired stake in the Second Investee Company was credited to the Partners Capital account maintained by the Assessee with balance amount i.e. in excess of the amount representing the sale consideration was credited to the 'Capital Reserve' Account. The AO treated the amount credited to the 'Capital Reserve' as a conduit transaction and held that the same should be taxed under Section 56(2)(viia) of the ITA.

Aggrieved by the order passed by CIT(A) for AY 2014-15 and 2015-16, the AO filed an appeal before the Hon'ble ITAT.

What the ITAT Held

With respect to Assessment year 2014-15

- Partner's capital contribution is an event which happens before the Partnerhip comes into existence and thus a Partnerhip Firm cannot come into existence without any capital contribution from the Partners. There cannot be any consideration from the firm to the Partner in respect of capital contribution as long as the firm subsists. Consideration for Partner arises after dissolution of the firm or on retirement or on resignation of Partner.

- Further, placing reliance on the judgement of the Hon'ble Supreme Court in the case of *Kartikeya V Sarabhai* v. CIT 228 ITR 163 (SC) and *Sunil Sidharthbai* v. CIT 156 ITR 509 (SC), it can be inferred that what the partner gets on contribution is share in the profits of the firm during the subsistence of the partnership or on its retirement and no consideration is accrued at the time of contribution of assets to the Partnership Firm.

- Provisions of Section 45(3) of the Act are applicable for levy of capital gains in the hands of the Partner at the time of admission, the consideration fixed thereon cannot be different in the hands of transferee *i.e.* the Assessee.

- Section 45(3) is a special provision and a specific provision, whereas, the provisions of Section 56(2)(viia) is a general provision. It is the accepted rule of construction that special provisions would prevail over general provisions.

- If provisions of Section 56(2)(viia) of the ITA would come into operation for every capital contribution made in kind by a partner into the Partnership Firm, is to be accepted, then the provisions of Section 45(3) would become redundant and operation of that section would be rendered otiose.

- Accordingly, while the transfer of assets by the Partner to the Assessee will constitute a transfer in the hands of the Partner, the value recorded in the books of the Assessee by way of credit to the Partners Capital Account would be conclusive proof of adequate consideration received by the Partner towards transfer of shares.

- Considering the above, provisions of Section 56(2)(viia) of the ITA should not be made applicable on contribution of shares by the Partner.

Cases relied by assessee

- *Addanki Narayanappa v. Bharkara Krishnappa AIR 1966 SC 1300*
- *Estate Duty v. Mrudula Nareshchandra 198b AIR 1821*
- *Vatsala Shenoy v.JCIT, Mysore 2016 389 ITR 519*
- *Sunil Siddharthbhai v. CIT 156 ITR 509*
- *Kartikeya V Sarabhai v. CIT 228 ITR 163 (SC)*
- *DR Yadhav v. R K Singh 2003 7 SCC 110*
- *ACIT v. Dr. D. Ramamurthy 410 ITR 236*

With respect to Assessment year 2015-16

- The entire chain of transaction undertaken does not create any element of income which should be taxed as income under Section 2(24) of the ITA as the entire transaction (i.e. primary infusion of funds in the Investee Company and subsequent Merger of First Investee Company with Second Investee Company) are transactions of capital nature.

- Notwithstanding the fact that a certain amount was credited to the 'Capital Reserve' Account maintained by the Assessee, it cannot be said that the said amount represents a 'gift' by the incoming Partner to the Partnership Firm.

- Also, the event of contribution of capital by the Partner in the Partnerhip which in turn held shares in the Second Investee Company pursuant to merger, giving effective ownership of shares in the said Company to the Partner does not result in an event which triggers a taxable event, additionally the stand of the AO that the capital contribution represents an income under Section 56 of the ITA is devoid of any findings as to in whose hands the income should be taxed and what is the amount which should be liable to tax. Thus, there should be no implications under Section 56 of the ITA as held by the AO.

- With respect to Section 56(2)(viia) of the ITA, the ITAT was of the view that contribution of capital and utilization of the same for subsequent acquisition is not covered within the ambit of Section 56(2)(viia). Additionally, the AO in its findings is silent as to whether such amount was received for a consideration which is inadequate in nature.

- Accordingly, the additions made by the AO in respect of the amount standing to the credit of the Capital Reserve Account under Section 56/56(2)(viia) of the ITA stands deleted.

Cases relied by Revenue

- *Mc Dowell and Co Ltd (154 ITR 148)*
- *CIT vs. Carlton Hotel Pvt. Ltd., reported in 399 ITR 611(All)*
- *CIT v. Wipro Limited reported in 227 Taxman 244 (Kar)*

Cases relied by Assessee

- *ITO v. Ch. Atchaiah 218 ITR 239 (SC)*
- *The Peerless General Finance & Investment Company Ltd., v. CIT - 107 Taxmann.com 228 (SC).*

RBSA Take

The ruling of the Hon'ble ITAT has been pronounced in specific facts of the case and pertains to an era where the tax provisions around Section 56 with respect to transfer of assets without consideration were in very nascent stages and thus the said ruling should be carefully considered in light of the revamped Section 56(2)(x) r.w. Section 50CA of the ITA.

The ruling re-affirms the special nature of Section 45(3) of the ITA by stating that the said Section will overrule other general provisions specially with respect to examining taxability of the transaction involving contribution of assets in cash or in kind at the time of admission.

Also, the ruling of the Hon'ble ITAT is silent on the applicability of the GAAR/Specific Anti Avoidance Rules especially in context of the methodology adopted for undertaking the transaction and to whether such GAAR provisions could apply especially when a new partner is admitted into the Partnership Firm which forms a very small part of an overall transaction resulting in a substantial tax benefit.

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