Compensation received by an existing partner from other partners for reduction in profit sharing ratio is or isn't taxable as capital gains under Income Tax Act, 1961 ("Act")?

Anik Industries Limited (**'Partner of Firm' or 'Partner'**)	M/s Mahakosh Property Developers (**'Firm'**)	Assessing Officer (**'AO'**)

Grounds of Appeal against AO's Order:-

1. The confirmation of long-term capital gain taxable Rs. 4 Crores for reduction of share ratio in the Firm is quite illegal, arbitrary, unwarranted, unjustified and bad in law;
2. The confirmation of long-term capital gain taxable is without considering the proper facts of the case;
3. Thus, the order so passed is quite illegal, arbitrary, unwarranted, unjustified and bad in law.

FACTS OF THE CASE
o The Partner held 30% share in profit of the Firm. The Partner received a sum of Rs. 4 Crores on account of surrender of 5% share of profit from 30% to 25% and reduced the said income from its computation of income by submitting that the Firm was reconstituted and right was created in favour of existing partners.
o In Financial Year 2010-11, it further received Rs. 8 Crores as compensation for surrendering of further 4% of its shareholding i.e. reduction of share from existing 25% to 21%.
o The AO brought to tax Rs. 4 Crore and Rs. 8 Crores as capital gain u/s 45(1) of the Act holding that the sum was received by the Partner on account of relinquishment of its right in the shares on the ground that Section 45(1) of the Act provides that any profits or gains arising from the transfer of capital assets shall be chargeable to income-tax under the head Capital Gains in the year in which the transfer took place.
o The Partner preferred an Appeal wherein it contended that the compensation received by a partner from another partner for ***relinquishing rights*** in the Firm is **neither** revenue receipt nor taxable under the head capital gains and there would be no transfer of asset as per section 45(4)of the Act.
o AO contended that the compensation received by the Partner on the premise that it was nothing but consideration for ***intangible asset*** i.e. the loss of share of partner in the goodwill of the Firm would be taxable under the head Capital Gains
o Appeals preferred by the Partner before the First Appellate Authority was rejected.
o Aggrieved by the order of First Appellate authority the Partner preferred an appeal to Income Tax Appellate Tribunal ("**AT**");

Appeals were admitted to consider the following substantial question of law

Whether the AT was right in holding that the admission of the new partners and assignment of right in the Firm to the new partners out of the rights of the Partner for consideration does not amount to transfer in the hands of Partner under Sec. 2(47) of the Act and consequently not liable to tax under Sec.45 of the Act?

JUDGEMENT`
The AT by referring the decision of Karnataka High Court in the case of P.N. Panjwani observed the following: o *The above case was about adjustment of profit sharing ratio inter-se between the existing partners. Also, the Partner is still holding the share in the Firm;* o *It was further held that the Firm and its partners are separate legal entities and the income of the Firm cannot be taxed in the hands of the partners and vice versa;* o *As the property of the Firm was owned by the Firm and not by the partners, it cannot be said that they transferred the property in favour of the other partners. Since the asset belonged to the Firm and not the partners, the question of relinquishment of interest in the asset or extinguishment of their right in the asset does not arise.* o *There is no provision for levying capital gains on consideration received for reduction in the share in the partnership firm in the Act.*

AT held that the compensation received by the Partner from existing partners for reduction in profit sharing ratio would not tantamount to capital gains chargeable to tax u/s. 45(1) of the Act. The Appeal was allowed by ITAT

Our Team's Observation: -

1. *Partner could have argued on one more (**Basic Important point**) i.e. Share of profit received from the Firm is not taxable in the hands of Partners, as in the said case amount received by Partner from other Partners to reduce (relinquish) the share in the profit of the Firm is nothing but the profit Partner would have received in future years. Therefore, the same (lumsum profit against 5% share) should not be taxed in his hand as income*.

2. *Said judgment is of Income Tax Appellate Tribunal, there are no judgments available on the same grounds given by upper courts (High Court or Apex Court). Upper courts view might be different in this case which may prevail the above judgment of Income Tax Appellate Tribunal.*

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Thanks and Regards
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