IN THE HIGH COURT OF JUDICATURE AT BOMBAY

ORDINARY ORIGINAL CIVIL JURISDICTION

WRIT PETITION NO.2287 OF 2009

Prashant S. Joshi, A-201, Morning Glory Society,
Thakkar Park, Aaram Society Road, Vakola,
Santacruz (East), Mumbai - 400 055. ..Petitioner.

V/s.

1. The Income-tax Officer Ward 19(2)(4),
Room No.310, 3rd Floor, Piramal Chambers,
Lalbaug, Parel, Mumbai-400 012.

2. Union of India, Aaykar Bhavan,
M.K. Road, Mumbai - 400 020. ..Respondents.

WITH

WRIT PETITION NO.59 OF 2010

Dattaram Shridhar Bhosale,
R/at 159/1273, Motilal Nagar No.1,Road No.4,
Goregaon (west), Mumbai - 400 055. ..Petitioner.

V/s.

1. The Income-tax Officer Ward 19(2)(1),
Room No.312, 3rd Floor, Piramal Chambers,
Lalbaug, Parel, Mumbai - 400 012.

2. Union of India, Aaykar Bhavan,
M.K. Road, Churchgage, Mumbai - 400 020. ..Respondents.

Mr. P.J. Pardiwalla, senior advocate with Nishant Thakkar & Rajesh Pujari i/b. Mint & Conferers for petitioner.

Mr. K.R. Chaudhari for respondents.

CORAM : DR. D.Y.CHANDRACHUD AND J.P.DEVADHAR, JJ.

JUDGMENT RESERVED ON : 25TH JANUARY, 2010.

JUDGMENT PRONOUNCED ON : 22ND FEBRUARY, 2010.

JUDGMENT (PER DR. D.Y.CHANDRACHUD, J.)

1. Rule, by consent made returnable forthwith. Counsel for the respondents waive service. With the consent of counsel, both the petitions are taken up for final hearing.

2. The principal challenge in these proceedings is to the notices issued by the first respondent under section 148 of the Income Tax Act, 1961 proposing to assess the income of the petitioner for assessment years 2005-06 and 2006-07 on the ground that there is reason to believe that income chargeable to tax had escaped assessment, within the meaning of section 147. By a deed of Partnership dated 5th May, 2003, the petitioner entered into a partnership with two other persons. The business of the partnership consisted of developing real estate. The petitioner retired from the partnership on 11th March, 2005. Under the Deed of dissolution, the petitioner to the first Writ Petition (W.P. No.2287 of 2009) agreed to receive a sum of Rs.50 lacs, in addition to the balance lying to his credit on the capital and / or current account as reflected in the books of account as on 8th March, 2005 in full and final settlement of his dues on account of retirement.

Out of the amount of Rs.50 lacs, the petitioner received an amount of Rs.17 lacs in financial year 2004-05, relevant to the assessment year 2005-06, and Rs.33 lacs in financial year 2005-06 relevant to assessment year 2006-07. The petitioner filed his return of income for assessment year 2005-06 on 31st August, 2005 and for assessment year 2006-07 on 21st July, 2006. Both the returns disclose the amounts received on account of the retirement of the petitioner from the partnership firm and that the amounts, being capital receipts, were not offered to tax.

3. In the companion Writ Petition (W.P. No.59 of 2010) as well the petitioner received an amount of Rs.50 lacs in financial years 2004-05 and 2005-06. The petitioner filed his return of income disclosing the amount. The amount was not offered for taxation on the ground that it was a capital receipt.

4. The petitioner to the first petition received on 25th November, 2008 two notices under section 148 for assessment years 2005-06 and 2006-07. In response thereto, the petitioner filed his returns for the two assessment years declaring his income as in the original returns. In response to a request by the petitioner, the first respondent communicated the reasons for the assumption of jurisdiction under section 148 by a letter dated 19th January, 2009. The reasons are that the CIT(A), passed an order on 17th September, 2008 in the case of the partnership firm for assessment year 2005-06, by which he allowed its claim for the payment of Rs.1 crore to the retiring partners being treated as revenue expenditure. Since the

assessee had claimed this to be exempted by treating it as capital receipt, the Assessing Officer stated that there was reason to believe that the receipts had escaped assessment within the meaning of section 147. By his letter dated 11th February, 2009, the petitioner filed his objections and requested the first respondent to drop the reassessment proceedings. This request was rejected on the ground that since the petitioner had relinquished his right to be a partner in the partnership firm, any amount received in excess of the capital balance in the partnership was chargeable to tax under the Income Tax Act, 1961.

5. In the companion petition, the reasons furnished on 19th February, 2009 to the petitioner are to the same effect. The objections of the petitioner were rejected on 16th November, 2009. The order disposing of the objection mentions that the assessment of the partners has been validly reopened since in the case of the firm, the payments made to the partners on their retirement has been allowed as revenue expenditure which has become chargeable to tax in the hands of the partners. Reliance has been placed on the provisions of section 28(iv) and section 28(v). The order records that it is settled law that a retirement from the partnership does not result in a transfer under section 2(47).

6. In the first Writ Petition, an order of assessment was passed by the first respondent on 18th November, 2009. In an affidavit filed by the first respondent, it has been stated that the order of assessment has been recalled on 3rd December, 2009 under section 154 of the Income Tax Act,

1961.

7. In assailing the notices issued by the first Respondent under section 148, learned counsel appearing on behalf of the petitioner urged the following submissions:-

(i) The validity of reassessment has to be determined on the basis of reasons recorded. The reasons, as recorded, only refer to the fact that the payment made by the partnership firm to the retiring partners has been treated as revenue expenditure. From this, it does not follow that the amount becomes a revenue receipt in the hands of the assessee; (ii) Assuming that the stand of the department is that the amount is chargeable as capital gains, this would be contrary to the law laid down by the Supreme Court in successive decisions to the effect that an amount paid to a retiring partner in a partnership firm does not amount to a transfer within the meaning of section 2(47). Therefore, the belief that was formed by the first respondent could not be of a reasonable person properly instructed in law; (iii) Even assuming that the stand of the department is that the amount is chargeable as business income, the reliance placed on clauses (iv) & (v) of section 28 to sustain the belief is completely misplaced; and (iv) The basis of the belief, namely that the Commissioner of Income Tax (A) had in his order in the case of the partnership firm allowed the claim of payment of Rs.1 crore to the retiring partners as revenue expenditure, is belied by the circumstance that on the day of formation of the belief the correctness of the order passed by the Appellate authority had been challenged in appeal by the Revenue.

8. On the other hand, it was urged on behalf of the Revenue that (i) In the present case, no assessment having taken place, a petition under Article 226 should not be entertained; (ii) Under Explanation II to section 147, a case where a return of income has been furnished by an assessee but no assessment has been made and it is noticed by the Assessing Officer that the assessee has understated the income or has claimed an excessive loss, deduction, allowance or relief in the returns shall be deemed to be a case where income chargeable to tax has escaped assessment; (iii) the amount received by the assessee was chargeable to tax under section 28(iv) and (v) and consequently, the notice was validly issued under section 147.

9. Section 147 provides that if the Assessing Officer has reason to believe that any income chargeable to tax has escaped assessment for any assessment year, he may subject to the provisions of Sections 148 to 163, assess or reassess such income and also any other income chargeable to tax, which has escaped assessment and which comes to his notice subsequently in the course of the proceedings under the section. The first proviso to section 147 has no application in the facts of this case. The basic postulate which underlines section 147 is the formation of the belief by the Assessing Officer that any income chargeable to tax has escaped assessment for any assessment year. The Assessing Officer must have reason to believe that such is the case before he proceeds to issue a notice under section 147. The reasons which are recorded by the Assessing Officer for reopening an assessment are the only reasons which can be considered when the formation of the belief is impugned. The recording of reasons

distinguishes an objective from a subjective exercise of power. The requirement of recording reasons is a check against arbitrary exercise of power. For it is on the basis of the reasons recorded and on those reasons alone that the validity of the order reopening the assessment is to be decided. The reasons recorded while reopening the assessment cannot be allowed to grow with age and ingenuity, by devising new grounds in replies and affidavits not envisaged when the reasons for reopening an assessment were recorded. The principle of law, therefore, is well settled that the question as to whether there was reason to believe, within the meaning of section 147 that income has escaped assessment, must be determined with reference to the reasons recorded by the Assessing Officer. The reasons which are recorded cannot be supplemented by affidavits. The imposition of that requirement ensures against an arbitrary exercise of powers under section 148.

10. A Division Bench of this Court speaking through Mrs. Justice Sujata Manohar (as the learned Judge then was) held thus in **N.D. Bhatt, Inspecting Assistant Commissioner of Income Tax & Anr. V/s. I.B.M. World Trading Corporation**[1]**:-**

> “ It is also well-settled that the reasons for reopening are required to be recorded by the assessing authority before issuing any notice under section 148 by virtue of the provisions of section 148(2) at the relevant time. Only the reasons so recorded can be looked at for sustaining or setting aside a notice issued under section 148. In the case of Equitable Investment Co. (P.) Ltd. v. ITO [1988] 174 ITR 714, a Division Bench of the Calcutta High Court has held that where a notice issued under section 148 of the Income-tax Act, 1961, after obtaining the sanction of the Commissioner of Income-tax is challenged, the

1 [1995] 216 ITR 811

> only document to be looked into for determining the validity of the notice is the report on the basis of which the sanction of the Commissioner of Income-tax has been obtained. The Income-tax Department cannot rely on any other material apart from the report."

11. The same principle was reiterated in a judgment of the Division Bench of this Court in **<u>Hindustan Lever Ltd. V/s. R,B, Wadkar[2] :-</u>**

> "...the reasons are required to be read as they were recorded by the AO. No substitution or deletion is permissible. No additions can be made to those reasons. No inference can be allowed to be drawn based on reasons not recorded. It is for the AO to disclose an open his mind through reasons recorded by him. He has to speak through his reasons....The reasons recorded should be clear and unambiguous and should not suffer from any vagueness. The reasons recorded must disclose his mind. Reasons are the manifestation of mind of the AO. The reasons recorded should be self-explanatory and should not keep the assessee guessing for the reasons. Reasons provide link between conclusion and evidence. The reasons recorded must be based on evidence. The AO, in the event of challenge to the reasons must be able to justify the same based on material available on record.... That vital link is the safeguard against arbitrary reopening of the concluded assessment. The reasons recorded by the AO cannot be supplemented by filing affidavit of making oral submission, otherwise, the reasons which are lacking in material particulars would get supplemented, by the time the matter reaches to the Court, on the strength of affidavit or oral submissions advanced. "

12. The only reason that has been recorded by the Assessing Officer is that the Commissioner of Income Tax (A) by his order dated 17th September, 2008, in the case of the partnership firm for assessment year 2005-06 allowed a claim for treating the payment of Rs.1 crore to the two retiring partners as revenue expenditure. Since the assessee claimed the payment to be exempt by treating it as a capital receipt, it is stated that there was reason to believe that the receipts under the deed of retirement had escaped assessment within the meaning of section 147.

2 (2004) 268 ITR 332 (Bom)

13. During the subsistence of a partnership, a partner does not possess an interest in specie in any particular asset of the partnership. During the subsistence of a partnership, a partner has a right to obtain a share in profits. On a dissolution of a partnership or upon retirement, a partner is entitled to a valuation of his share in the net assets of the partnership which remain after meeting the debts and liabilities. An amount paid to a partner upon retirement, after taking accounts and upon deduction of liabilities does not involve an element of transfer within the meaning of Section 2(47). Chief Justice P.N. Bhagwati (as the learned Judge then was) speaking for a Division Bench of the Gujarat High Court in **Commissioner of Income Tax, Gujarat V/s. Mohanbhai Pamabhai**[3] dealt with the issue in the following observations :-

> " ...When, therefore, a partner retires from a partnership and the amount of his share in the net partnership assets after deduction of liabilities and prior charges is determined on taking accounts on the footing of notional sale of the partnership assets and given to him, what he receives is his share in the partnership and not any consideration for transfer of his interest in the partnership to the continuing partners. His share in the partnership is worked out by taking accounts in the manner prescribed by the relevant provisions of the partnership law and it is this and this only, namely, his share in the partnership which he receives in terms of money. There is in this transaction no element of transfer of interest in the partnership assets by the retiring partner to the continuing partners : vide also the recent decision of the Supreme Court in *Commissioner of Income-tax v. Bankey Lal Vaidya.* It is true that section 2(47) defines "transfer" in relation to a capital asset and this definition gives an artificially extended meaning to the term "transfer" by including within its scope and ambit two kinds of transactions which would not ordinarily constitute "transfer" in the accepted connotation of that word, namely, relinquishment of the capital asset and extinguishment of any rights in it. But even in this artificially extended sense, there is no transfer of interest in the partnership assets involved when a partner retires from the partnership. "

3 (1973) 91 ITR 393

The Gujarat High Court held that there is, in such a situation, no transfer of interest in the assets of the partnership within the meaning of section 2(47). When a partner retires from a partnership, what the partner receives is his share in the partnership which is worked out by taking accounts and this does not amount to a consideration for the transfer of his interest to the continuing partners. The rationale for this is explained as follows in the judgment of the Gujarat High Court :-

> "... What the retiring partner is entitled to get is not merely a share in the partnership assets; he has also to bear his share of the debts and liabilities and it is only his share in the net partnership assets after satisfying the debts and liabilities that he is entitled to get on retirement. The debts and liabilities have to be deducted from the value of the partnership assets and it is only in the surplus that the retiring partner is entitled to claim a share. It is, therefore, not possible to predicate that a particular amount is received by the retiring partner in respect of his share in a particular partnership asset or that a particular amount represents consideration received by the retiring partner for extinguishment of his interest in a particular asset. "

14. The appeal against the judgment of the Gujarat High Court was dismissed by a Bench of three learned Judges of the Supreme Court in **Addl. Commissioner of Income Tax, Gujarat V/s. Mohanbhai Pamabhai[4].** The Supreme Court relied upon its judgment in *Sunil Siddharthbhai v. Commissioner of Income Tax, (1985) 156 ITR 509 (S.C.)*. The Supreme Court reiterated the same principle by relying upon the judgment in Addanki Narayanappa & Anr. V/s. Bhaskara Krishnappa & Ors. [(1966) SC 1300]. The Supreme Court held that what is envisaged on the retirement of a partner is merely his right to realise his interest and to receive its value. What is realised is the interest which the partner enjoys in the assets during

4 165 ITR 166

the subsistence of the partnership by virtue of his status as a partner and in terms of the partnership agreement. Consequently, what the partner gets upon dissolution or upon retirement is the realisation of a pre-existing right or interest. The Supreme Court held that there was nothing strange in the law that a right or interest should exist in praesenti but its realisation or exercise should be postponed. The Supreme Court inter alia cited with approval the judgment of the Gujarat High Court in Mohanbhai Pamabhai (supra) and held that there is no transfer upon the retirement of a partner upon the distribution of his share in the net assets of the firm. In **Commissioner of Income-Tax V/s. R. Lingmallu Raghukumar**[5], the Supreme Court held, while affirming the principle laid down in Mohanbhai Pamabhai that when a partner retires from a partnership and the amount of his share in the net partnership assets after deduction of liabilities and prior charges is determined on taking accounts, there is no element of transfer of interest in the partnership assets by the retired partner to the continuing partners.

15. At this stage, it may be noted that in **Commissioner of Income Tax V/s. Tribhuvandas G. Patel**[6], which was decided by a Division Bench of this Court, under a deed of partnership, the assessee retired from the partnership firm and was inter alia paid an amount of Rs.4,77,941/- as his share in the remaining assets of the firm. The Division Bench of this Court had held that the transaction would have to be regarded as amounting to a transfer within the meaning of section 2(47) in as much as the assessee had assigned, released and relinquished his share in the partnership and its

5 (2001) 247 ITR 801
6 (1978) 115 ITR 95

assets in favour of the continuing partners. This part of the judgment was reversed in appeal by the Supreme Court in **Tribhuvandas G. Patel V/s. Commissioner of Income Tax[7].** Following the judgment of the Supreme Court in Sunil Siddharhbhai (supra), the Supreme Court held that even when a partner retires and some amount is paid to him towards his share in the assets, it should be treated as falling under clause (ii) of section 47. Therefore, the question was answered in favour of the assessee and against the revenue. Section 47(ii) which held the field at the material time provided that nothing contained in section 45 was applicable to certain transactions specified therein and one of the transactions specified in clause (ii) was distribution of the capital assets on a dissolution of a firm. Section 47(ii) was subsequently omitted by the Finance Act of 1987 with effect from 1st April, 1988. Simultaneously, sub-section (4) of section 45 came to be inserted by the same Finance Act. Sub-section (4) of section 45 provides that profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm or other association of persons or body of individuals (not being a company or a co-operative society) or otherwise, shall be chargeable to tax as the income of the firm, association or body, of the previous year in which the said transfer takes place. The fair market value of the assets on the date of such transfer shall be deemed to be the full value of the consideration received or accruing as a result of the transfer for the purpose of section 48. Ex-facie sub-section (4) of section 45 deals with a situation where there is a transfer of a capital asset by way of a distribution of capital assets on the dissolution of a firm or otherwise. Evidently, on the admitted position before the Court, there is no transfer of a

7 (1999) 236 ITR 515 (SC)

capital asset by way of a distribution of the capital assets, on a dissolution of the firm or otherwise in the facts of this case. What is to be noted is that even in a situation where sub-section (4) of section 45 applies, profits or gains arising from the transfer are chargeable to tax as income of the firm.

16. Counsel for the revenue submitted before the Court that in the present case, no assessment has taken place and at the stage of section 143(1), there is only an intimation. Reliance is sought to be placed on the judgment of the Supreme Court in **Assistant Commissioner of Income Tax V/s. Rajesh Jhaveri Stock Brokers P. Ltd.**[8] The judgment of the Supreme Court in Rajesh Jhaveri has noticed the difference between the expression `intimation' and `assessment' and the Supreme Court held that in the scheme of things an intimation under section 143(1)(a) cannot be treated as an order of assessment. The Supreme Court held that there being no assessment under section 143(1)(a), the question of a change of opinion, as contended did not arise. The judgment of the Supreme also emphasises what is meant by the expression "reason to believe" and the nature of the belief that is to be formed by the Assessing Officer that the income for any assessment year has escaped assessment. The Supreme Court held that at the stage of the issuance of a notice under section 148, the Assessing Officer must have reason to believe that income has escaped assessment and at that stage an established fact that income has escaped assessment is not required. The Supreme Court held thus :-

> " Section 147 authorises and permits the Assessing Officer to assess or reassess income chargeable to tax if he has reason to believe that income for any assessment year has escaped assessment. The word

8 (2007) 291 ITR 500 (S.C.)

> "reason" in the phrase "reason to believe" would mean cause or justification. If the Assessing Officer has cause or justification to know or suppose that income had escaped assessment, it can be said to have reason to believe that an income had escaped assessment. The expression cannot be read to mean that the Assessing Officer should have finally ascertained the fact by legal evidence or conclusion....... At that stage, the final outcome of the proceeding is not relevant. In other words, at the initiation stage, what is required is "reason to believe", but not established fact of escapement of income. At the stage of issue of notice, the only question is whether there was relevant material on which a reasonable person could have formed a requisite belief. Whether the materials would conclusively prove the escapement is not the concern at that stage. This is so because the formation of belief by the Assessing Officer is within the realm of subjective satisfaction."

The Supreme Court held that so long as the ingredients of section 147 are fulfilled, the Assessing Officer is free to initiate proceedings under section 147 and failure to take steps under section 143(3) will not render him powerless to initiate reassessment proceedings even when an intimation under section 143(1) had been issued. In other words, when an intimation has been issued under section 143(1), the Assessing Officer is competent to initiate reassessment proceedings provided that the requirements of section 147 are fulfilled. In such a case as well, the touchstone to be applied is as to whether there was reason to believe that income had escaped assessment.

17. Learned counsel appearing on behalf of the revenue has sought to urge that the amount received by the assessee is chargeable to tax under clauses (iv) and (\v) of section 28. As already noted earlier, reliance on the provisions of section 28(iv) & (v) has been placed in the order passed by the Assessing Officer on 16th November, 2009 in the companion petition, while disposing of the objections of the assessee. Section 28 provides certain categories of income which shall be chargeable to income-tax under the

head "profits and gains of business of profession". Clause (iv) of section 28 specifies the value of any benefit or prequisite, whether convertible into money or not, arising from business or the exercise of profession. Ex-facie, section 28(iv) does not apply to benefits which are paid in cash or money. This is concluded by the judgment of Hon'ble Mr. Justice S.H. Kapadia (as the learned Judge then was) speaking for a Division Bench of this Court in **Mahindra & Mahindra Ltd. V/s. Commissioner of Income Tax.**[9] Similarly, clause (v) of section 28 refers to any interest, salary, bonus, commission or remuneration, by whatever name called, due to, or received by, a partner of a firm from such firm. A payment made to a partner in realisation of his share in the net value of the assets upon his retirement from a firm, does not fall under clause (v) of section 28. In the companion petition, the attention of the Court is also drawn to the circumstances that on the date on which reasons were recorded by the Assessing Officer, the revenue had challenged the order of the CIT(A) before the Tribunal. One of the grounds of appeal is that the assessee had claimed in the Income tax returns that his share of Rs.50 lacs received from the firm as a capital asset was not exigible to tax. The revenue, therefore, submitted that when the recipient claimed the receipt as capital expenditure, in the hands of the firm, the payment is also to be treated as capital expenditure.

18. For all these reasons, it is evident that there was absolutely no basis for the first respondent to form a belief that any income chargeable to tax has escaped assessment within the meaning of the substantive provisions of section 147. Explanation (2) to section 147 creates a deeming

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9 (2003) 261 ITR 501 (Bom)

fiction of cases where income chargeable to tax has escaped assessment. Clause (b) deals with a situation "where a return of income has been furnished by the assessee but no assessment has been made and it is noticed by the Assessing Officer that the assessee has understated the income or has claimed excessive loss, deduction, allowance or relief in the return." For the purpose of clause (b) to explanation (2), the Assessing Officer must notice that the assessee has understated his income or has claimed excessive loss, deduction, allowance or relief in the return. The taking of such notice must be consistent with the provisions of the applicable law. The act of taking notice cannot be at the arbitrary whim or caprice of the Assessing Officer and must be based on a reasonable foundation. The sufficiency of the evidence or material is not open to scrutiny by the Court but the existence of the belief is the sine qua non for a valid exercise of power. In the present case, having regard to the law laid down by the Supreme Court it was impossible for any prudent person to form a reasonable belief that the income had escaped assessment. The reasons which have been recorded could never have led a prudent person to form an opinion that income had escaped assessment within the meaning of section 147. In these circumstances, the petition shall have to be allowed by setting aside the notice under section 148.

19. Writ Petition No.2287 of 2009 is allowed by quashing and setting aside the notice dated 19th January, 2009. Writ Petition No.59 of 2010 is allowed by quashing and setting aside the notices dated 23rd January, 2009 and 9th February, 2009.

20. Rule is made absolute accordingly. There shall be no order as to costs.

(J.P.DEVADHAR, J.) (DR. D.Y.CHANDRACHUD, J.)