The Mansukh Dyeing Case - A Critique

Feb 14, 2023

Anand Laxmeshwar

Partner, Bobby Parikh Associates

Dhruv Mehta

Director, Bobby Parikh Associates

Jaya Lalwani

Associate, Bobby Parikh Associates

The only constant in life is change, whether such change is welcome or otherwise!

In keeping with this spirit, the Supreme Court ('**SC**') delivered a somewhat bewildering verdict in the case of **CIT v. Mansukh Dyeing and Printing Mills** [1] changing a critical element of how partnership firms ('**PF**') are taxed. The case was fairly simple:

1. there was a PF with eight partners;
2. the PF revalued some of its assets, and the revaluation surplus of ~Rs 17 crores was credited to the partners accounts in their profit sharing ratio;
3. two of the partners thereafter withdrew part of their capital amounting to Rs 25 lacs.

The Revenue treated this act of revaluation and its credit to the partners capital account as a taxable event, and levied tax in the hands of the PF on the entire revaluation gains. For doing so, the Revenue invoked the provisions of section 45(4) of the Income Tax Act, 1961 ('**Act**'). These actions were reversed by the Tribunal, whose decision was upheld by the High Court ('**HC**').

Undeterred by these reversals and unwearied by the 20 years that it took for the matter to be decided by the HC, the Revenue doggedly carried their battle to the SC, which surprisingly upheld the Revenue's action, undertaken three decades earlier. Well, the Revenue must be saying *'Bhagwan ke ghar der hai, par andher nahi!'.*

So why, you may ask, is this judgment interesting? Well, for one, it appears to be a classic case of reference to the wrong context, and in doing so, the judgment has turned tax fundamentals on their head. There are follow-on consequences as well, which we shall discuss a little later.

To understand this, a little peek into history is warranted. Indulge us.

The early years

The scheme of the Act requires for there to be a transfer of a capital asset, before any charge of capital gains tax can enjoin. Prior to the introduction of Section 45(4) the SC had observed in the case of ***Malabar Fisheries Co. v. CIT***[2] that a PF is not a distinct legal entity. Equally in law, the firm has no separate rights of its own in the partnership assets; therefore, when one talks of the PF's property or assets, what it means is the property or assets in which all the partners have a joint or common interest through the PF. With this observation, the SC held that any distribution of assets on the dissolution of PF is nothing but a mutual adjustment of rights between partners; that this did not tantamount to a transfer of assets even in the sense of any extinguishment of the PF's rights in the partnership assets; that therefore, any such distribution did not give rise to any tax in the hands of the PF or the receiving partner.

Stung by this, the Revenue introduced Section 45(4), which read as follows:

"The 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 and, for the purposes of section 48, the fair market value of the asset 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."

Through Circular No 495 (1987) the rationale for this introduction was explained as follows:

*"24.3 **Conversion of partnership assets into individual assets** on dissolution or otherwise also forms part of the same scheme of tax avoidance. Accordingly, the Finance Act, 1987 has inserted new sub-section (4) in section 45 of the Income-tax Act, 1961. The effect is that profits and gains arising from the **transfer of a capital asset by a firm to a partner on dissolution or otherwise** shall be chargeable as the firms income in the previous year in which the transfer took place and for the purposes of computation of capital gains the fair market value of the asset on the date of transfer shall be deemed to be the full value of the consideration received or accrued as a result of the transfer."*

You'll agree that even Lestrade, the bumbling inspector from Sherlock Holmes, would be able to deduce that the above provision is to apply where an asset, which originally belonged to a PF, became the asset of an individual partner.

Into the millennium: The A N Naik case

A question came up before the Bombay HC in the case of ***CIT v A N Naik Associates***[3], as to whether section 45(4) takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of a retiring partner. Mind you, this was a case where an asset was in fact transferred to a retiring partner. Answering in the affirmative, the HC held that even when a firm is in existence and there is a transfer of capital assets it comes within the expression "otherwise".

Seen in the context of the case, therefore, the HC interpreted that the expression "otherwise" appearing in section 45(4) referred to events other than dissolution of the firm, which might have occasioned the transfer of an asset, and held that any such transfer was liable to tax under section 45(4). This was in line with a simpliciter reading of Circular 495 (see above). Let's put a pin on this.

The lead-up to 2021

Emboldened by its success in the A N Naik case, an intrepid Revenue tried to expand the coverage of section 45(4) even to cases where partners had not got any assets, but had, like the Mansukh Dyeing case, revalued assets, credited the revaluation gains to their capital accounts and thereafter withdrawn the whole or part of their capital in the form of cash. This approach had not met with any success[4], till now at least. The logic for this lack of success was fairly simple – that section 45(4), which came under the chapter 'Capital Gains' could only apply where there was a ***transfer of a capital asset*** and not when a partner withdraws cash against the balance in her capital account that the PF transfers. The courts logically inferred that what needs to be transferred is a capital asset held by the PF and not fungible cash.

So what do you do when you cannot win at the game? If you're a sportsperson, you've no option but to try harder. But what if the game is cricket, and you're ICC – well, you can simply change the rules of the game! That's exactly what the Revenue did.

Come 2021, the Revenue substituted section 45(4), and also introduced section 9B in the Act to provide that any cash, capital asset or stock-in-trade distributed by a PF to its partner either on dissolution or reconstitution of the firm shall be taxable in the hands of the firm, to the extent that the amount or value of asset distributed exceeds the amount standing to the credit of the partners' capital account. Learning from experience, the Revenue also provided that the amount standing to the credit of the partners' capital account would not include any revaluation credits.

Back to the future

With this crash course in history, let's get back to Mansukh Dyeing. If you recollect the facts, there was revaluation of the PF assets, followed by partial capital withdrawal by some of the partners. On these facts, the Revenue levied tax on the entire revaluation gains. This action has now received the SC's imprimatur. Does this sound right?

For the reasons discussed below, we argue that it doesn't (and no, we are not suicidal. We checked. Arguing against a SC judgment doesn't tantamount to contempt of the Court).

1. *Where was the transfer?* Clearly, there was none! As we discussed above, for erstwhile section 45(4) to apply, there had to be a 'transfer' of a capital asset. 'Transfer' is defined by section 2(47) to include sale, exchange, relinquishment, exchange, etc. Was either of these elements involved in the Mansukh Dyeing case? The answer has to be a resounding NO, as the PF continued to own all its assets before and after the revaluation, and also after the partial withdrawal of capital.

2. *Was a capital asset distributed, like in the Naik case?* Explaining the concept of 'distribution', the authors of Kanga & Palkhiwala[5] have this to say: "Distribution of assets contemplated under this sub-section must be either the tangible act of physical transfer of properties or the intangible act of conferring exclusive rights on certain identified property on the retiring partner".

This analysis is in line with the Revenue's averment in Circular 495 (*see above*) discussing the intent for introduction of section 45(4) – being to curb tax avoidance through conversion of partnership assets into individual assets.

One may ask, where in the Mansukh Dyeing case was there any 'distribution' of capital assets? The assets that were revalued belonged to the PF both before and after the revaluation. The only thing that was done was that from an accounting perspective, their value was recognized at the prevailing fair value, and such amounts were credited to the partners' capital accounts. As a consequence, what the partners could withdraw was an enhanced amount standing to their respective credits. But by no means could they claim to have any individual or exclusive rights in relation to any of the revalued assets. There was, in short, no "distribution".

3. *Was there any real or even notional income which can be taxed as income under the Act?* One of the basic precepts underpinning the Act is that a person can only be taxed in respect of his real income; notional may be taxed only if specifically so provided for. Examples of such provisions include section 50C, section 50D and section 56.

What this means is that a person cannot be taxed on unrealized gains, unless specifically provided for. Revaluation represents unrealized gains, and cannot be taxed at all, till the asset is actually transferred. And yet, this is exactly what the SC judgment has done.

Worse still, the judgment, read along with the 2021 amendment, will likely result in double taxation on multiple counts. The PF will not get a cost step-up on the capital gains that have already been paid on revaluation. Which means that when the PF actually sells the asset or if the partners withdraw further capital, the PF will once again need to pay tax on the revaluation gains. With respect, this is neither the intent nor the scheme of the Act.

In conclusion

The evolution of partnership taxation is a story that could easily put Darwin to shame. Much of this evolution reflects a scholarly discourse on the reading, interpretation and interplay of the Act with the general law relating to partnerships. The Mansukh Dyeing case is another page in this never-ending book.

Having studied the case, one would be tempted to ask the question that if taxing revaluation and cash withdrawal was always the intent of Parliament, why was the 2021 amendment to section 45 required at all?

Several judgments have observed that subsequent legislation may be looked into to fix the proper interpretation to be put on the statutory provisions as they stood earlier. The SC, whilst adjudicating in the Mansukh Dyeing case should have had the benefit of looking at the 2021 amendments. It would have been clear that these amendments had to be brought in because the previous law had a vacuum. If the judgment of the SC reflects the true intent of the lawmakers, then it would mean that the 2021 amendments were simply not required. Unfortunately, it appears from a reading of the case that the 2021 amendments were not brought to the SC's notice at all.

On a slightly different note, this is also a judgment where there are no winners. From the taxpayers' perspective, of course there is no gain in saying that this is adverse. But even from the Revenue's perspective, this is a ruling that has come a little too late. The 2021 amendments sought to achieve the same objective that the SC ruling has delivered. However, the SC ruling is more beneficial from the Revenue's perspective, as it provides for taxation on the entire revaluation gains. The 2021 amendments, wisely, restrict taxation only to the extent of the amounts that are actually withdrawn by the partners. To that extent, the Revenue might be ruing the fact that it introduced the 2021 amendments too soon!

---

[1] CIT v. Mansukh Dyeing and Printing Mills [TS-904-SC-2022]

[2] Malabar Fisheries Co. v. CIT [TS-5023-SC-1979-O]. Also confirmed by SC in CIT v. Mohanbhai Pamabhai [TS-5006-SC-1987-O] and Sunil Siddharthbhai v. CIT [TS-4-SC-1985-O]

[3] CIT v. A.N. Naik Associates [TS-29-HC-2003(BOM)-O]

[4] CIT v. Dynamic Enterprises [TS-556-HC-2013(KAR)-O], CIT v. Kunnamkulam Mill Board [TS-17-HC-2002(KER)-O]

[5] Kanga and Palkhivala's the Law and Practice of Income Tax edited by Arvind P Datar