
(2002) 08 AHC CK 0085

In the Allahabad High Court

Case No : Income-tax Reference No. 205 of 1983

Additional Commissioner of Income Tax

APPELLANT

Vs

Ram Prasad

RESPONDENT

Date of Decision : 26-08-2002

Acts Referred:

Income Tax Act, 1961 — Section 40

Citation : (2002) 258 ITR 415

Hon'ble Judges : S.K. Sen, C.J;Ashok Bhushan, J

Bench : Division Bench

Advocate : Prakash Krishna, for the Appellant; V.K. Rastogi, for the Respondent

Judgement

S.K. Sen, C.J.—We have heard Sri Prakash Krishna, learned counsel for the Revenue, and Sri V.K. Rastogi, learned counsel for the respondents.

2. The brief facts of the reference which relate to the assessment years 1969-70 and 1970-71, inter alia, are that Bhagwati Prasad Ram Sarup was a Hindu undivided family, which was assessed as such for and up to the assessment year 1952-53. There was a partition in the joint family on November 9, 1950, and a firm was formed with effect from the assessment year 1952-53. The firm has been assessed to tax from the said assessment year up to date. S/Sri Ram Sarup and Ram Prasad, who were real brothers, were the two partners of the firm having equal shares in the firm as constituted on the partition of the family. Both S/Shri Ram Prasad and Ram Sarup were assessed to Income Tax for the assessment year 1956-57. For and up to the assessment year 1968-69, they were assessed as individuals and with effect from the year 1969-70 they were assessed as a Hindu undivided family. However, the income on which they were assessed arose out of the assets, which were received, on the partition of the joint family and the assessments for all the years should have been made in the assessments of the Hindu undivided family. In connection with the assessment year 1964-65, the Income Tax Officer received information that the partners had accounts in banks, which were not incorporated in the books of the firm. So far

as Shri Ram Prasad is concerned he came up with a disclosure petition dated August 9, 1965, disclosing an income of Rs. 76,062, which had escaped assessment and requested that the same be assessed for the assessment years 1956-57 to 1964-65. As per that disclosure he had Rs. 43,919.99 at the end of the financial year 1953-54 which was outside the account books of the firm. Shri Ram Sarup did not make any disclosure petition. In his case, it was found that there were deposits in the bank in 1954 to the extent of Rs. 34,200 as under :

Rs.

14-7-1954

10,200

29-12-1954

12,000

29-12-1954

12,000

34,200

3. Thereafter, he was found to have made further deposits of Rs. 20,000 and Rs. 10,000 in the subsequent years. The assessments of S/Shri Ram Prasad and Ram Sarup were reopened for the assessment years 1956-57 to 1963-64 u/s 147 to assess the undisclosed income represented by the bank deposits and interest thereon. The position of unexplained investments surrendered for assessment in the case of Ram Prasad was that Rs. 31,000 were surrendered in the assessment year 1956-57 and Rs. 8,000 in the assessment year 1960-61 total Rs. 39,000. The position in the case of Ram Sarup was that he surrendered Rs.10,000 in 1963-64 and Rs. 20,000 in the assessment year 1964-65 total Rs.30,000.

4. In the accounts for the previous year relevant to the assessment year 1966-67 and subsequent years they opened another account in the books of the firm, in addition to their original account. They treated their original account as their capital account (in which only the profit was credited) and the accounts subsequently opened were treated as loan accounts (in which interest was charged from the firm). However, the entire income by way of profit and interest from the firm was assessed in the hands of the two partners. Shri Ram Prasad in his disclosure petition dated August 9, 1965, stated that he was a partner in the firm, Bhagwati Prasad Ram Sarup, and that at the time of his marriage he had received substantial amounts from far and near relations in the shape of silver coins, which were kept with his wife and later on sold for Rs. 40,000. He stated that he believed that this Rs. 40,000 was his wife's exclusive property. He further stated that with this amount he purchased and sold bidis and the money earned from bidi business was kept with his wife. He added that although he had a bona fide belief that this money was his wife's exclusive property but since he

had no evidence to prove his claim, he was offering a sum of Rs. 76,062 for assessment. This amount was offered for assessment in his own assessment in which the income from the firm (which was undoubtedly the joint family income) was being assessed. This income was offered for being assessed as joint family income. Similarly, Shri Ram Prasad surrendered the deposits for assessment along with his share income from the firm, which was the income of the joint family. Both the partners also got the interest on these bank deposits assessed along with the income of the joint family. In fact, Shri Ram Swarup in his letter dated January 16, 1965 (filed during the course of the assessment for 1964-65), had stated that the money deposited in the banks represented the savings of his family. Each of the two accounts of both the partners in the books of the firm, Bhagwati Prasad Ram Swarup, were in their own names. For the assessment year 1970-71, it was claimed that they were partners in the firm representing their respective Hindu undivided families. This contention of the assessee was accepted by the Income Tax Officer. The assessee further claimed that the partners had two accounts, one in the name of the Hindu undivided family and the other in the name of the individual, and that the interest paid to the two partners on their individual accounts could not be disallowed while computing the income of the firm. The Income Tax Officer noticed that the assessee paid interest to the two partners for the first time in the assessment year 1970-71 amounting to Rs. 4,567 in the account of the partner, Shri Ram Sarup, and Rs. 8,123 in the account of the partner, Shri Ram Prasad. The Income Tax Officer further noticed that the two partners showed all the assets as usual in their wealth-tax returns for the assessment year 1969-70 and that it was for the first time in the assessment year 1970-71 that an attempt was made to describe a part of the investment in the firm as individual. Considering the past history of the assessee and the fact that the two partners were showing these assets in the wealth-tax returns and also the fact that no distinction was drawn at any time to indicate that one account represented the account of an individual and the other account that of a joint family, the Income Tax Officer rejected the assessee's claim. The Income Tax Officer further held that interest paid to the two partners had to be added back under Clause (b) of Section 40 of the Income Tax Act, 1961, while computing the income of the firm.

5. In appeal before the Appellate Assistant Commissioner, the Appellate Assistant Commissioner rejected the claim on the ground that simply because the assessments of the partners were made for some time in the status of individuals, the assessee could not claim that interest was their individual income. On further appeal before the Appellate Tribunal, the assessee took the stand that these two partners were carrying on some individual business and that they made disclosure petitions, which were not accepted, and the nature and source of the deposits made by them were also not explained. Accepting the above contention of the assessee, the Tribunal observed that this showed that they were having some other undisclosed sources of income, but that certainly it was not from the firm ; that there could be no presumption that in a joint Hindu

family the business carried on by a coparcener belonged to the family and that the coparceners could carry on their individual business as well. The Tribunal further observed that there could be no presumption that the other business, which these persons were carrying on, also belonged to the family. The Tribunal further observed that it was from the assessment year 1966-67 that these two partners opened their individual account in the books of the firm and interest was being paid on that account ; that in the assessment year 1968-69, though interest was not paid, but that it did not mean that interest was not payable on those accounts. Observing that a karta is a separate entity while the individual is distinct from it, the Tribunal held that keeping in view the two capacities the payment of interest on the individual account could not be disallowed. The Tribunal, therefore, held that the amount of interest paid in the individual accounts of the two partners, i.e., Rs. 4,567 to Shri Ram Swarup and Rs. 8,123 to Shri Ram Prasad, were allowable deductions. In the appeals filed by Shri Ram Swarup-Hindu undivided family for the assessment year 1970-71 and by Shri Ram Prasad-Hindu undivided family for the assessment years 1969-70 and 1970-71, the Tribunal held that the interest income could not be included in the assessments of their respective Hindu undivided families.

6. The Revenue, being aggrieved, moved reference application before the Tribunal, which was not allowed. Thereafter, being aggrieved, reference application was moved in this court, whereupon the following questions of law were framed :

"1. Whether, on the facts and in the circumstances of the case, the Tribunal was legally justified in holding that the interest paid to the assessee was not includible in the hands of the firm u/s 40(b) of the Income Tax Act, 1961 ?

2. Whether, on the facts and in the circumstances of the case, there was material before the Tribunal to hold that the two partners were carrying on some individual business and having some other undisclosed sources of income ?"

7. We have considered the submissions of learned counsel for the parties. The amounts of interest were Rs. 4,507 in the account of Shri Ram Swarup and Rs. 8,123 in the account of Sri Ram Prasad. It was noted by the Income Tax Officer that the assessee paid interest to the partners for the first time in the assessment year 1970-71. In the immediate preceding assessment year the status of the partners had been taken as that of Hindu undivided family. For that year both the partners showed all their assets as usual in their wealth-tax returns. An attempt was made by the assessee to describe a part of the investments made in the firm as being on individual account. The Income Tax Officer, relying on Section 40(b) of the Income Tax Act, 1961 (hereinafter referred to as the "Act"), held that the allowance of payment by way of interest, bonus, commission or remuneration made by a firm to any of its partners is not permissible and this is an absolute prohibition. In the result, the same was added back in the income of the assessee. It appears that up to the assessment year 1951-52 it was done in the status of a Hindu undivided family and thereafter a

partition took place in the family and the firm was constituted. In the assessment year 1952-53, the partition was accepted. It was clearly recorded in the findings of the Income Tax Appellate Tribunal referring to the final order of the respective Appellate Assistant Commissioner of Income Tax.

8. It was submitted on behalf of the Revenue that no evidence was adduced at that time that the partner had any individual business. On the basis of this fact, the Tribunal held that no such inference could be drawn that it was Hindu undivided family account as no withdrawals were made except for personal expenses and as such the said view of the Appellate Assistant Commissioner of Income Tax was not accepted. Referring to the Income Tax Officer's order in the assessment year 1968-69 in the case of Shri Ram Prasad, it was stated that no interest was charged on individual accounts, which shows that this account was treated as belonging to the Hindu undivided family. According to the Departmental Representative, it was an important statement and was not rebutted by any concrete evidence and as such this account also belongs to the Hindu undivided family and the interest has been rightly disallowed. In fact, whatever payment was made by way of interest or salary would be a payment made to a partner and cannot be allowed u/s 40(b) of the Act. In this connection, judgment and decisions in the case of A.S.K. Rathnaswamy Nadar Firm Vs. Commissioner of Income Tax, Madras, and GIRIDHARILAL GHASIRAM Vs. COMMISSIONER OF Income Tax, WEST BENGAL., may be taken note of. In the case of A.S.K. Rathnaswamy Nadar Firm Vs. Commissioner of Income Tax, Madras, , the Division Bench of the Madras High Court held that Section 10(4)(b) enacts an absolute prohibition (which corresponds to Section 40(b) of the Income Tax Act, 1961). It does not limit the operation of the Act to a remuneration paid to a partner as such, but includes remuneration or salary paid to a partner in any capacity. The assessee-firm, which paid a salary to one of its partners, claimed that the salary should be deducted in computing its income. It contended that though the recipient of the salary represented a joint family as the manager thereof, in the partnership he worked in his individual capacity for the firm for which remuneration was paid and, therefore, the provisions of Section 10(4)(b) would not apply to the payment. In the aforesaid decision, it was also held that the case was governed by Section 10(4)(b) and the salary paid was rightly added to the profits and gains of the firm.

9. In GIRIDHARILAL GHASIRAM Vs. COMMISSIONER OF Income Tax, WEST BENGAL., , the Division Bench of the Calcutta High Court held that the karta of a Hindu undivided family, receiving a salary for services rendered to a firm, became a partner of the firm and the firm continued to pay a salary to him as before. It was also held in the said decision that in whichever capacity the karta was appointed as a partner of the assessee-firm, the remuneration paid to him could not be claimed as a deduction, as he was serving the firm for remuneration in his capacity as partner.

10. In the aforesaid decision, it was also held thus (page 893) :

"It is now well-settled that a Hindu undivided family cannot, as such, enter into a contract of partnership with another person or persons. The karta of the Hindu undivided family, however, may and frequently does enter into partnership with outsiders on behalf and for the benefit of his joint family. But when he does so, the other members of the family do not, vis-a-vis the outsiders, become partners in the firm. They cannot interfere in the management of the firm or claim any account of the partnership business or exercise any of the rights of partners. So far as outsiders are concerned, it is the karta, who alone is, and is in law recognised, as the partner. Whether in entering into partnership with outsiders the karta acted in his individual capacity and for his own benefit, or he did so as representing his joint family and for its benefit, is a question of fact. In the instant case, there is no dispute that Prahladrai entered into the partnership representing his joint family and for the benefit of that family. But although that is so, the relationship between the partnership and Prahladrai was that of an individual appointed as a partner. The partnership was not in any way concerned with the fiduciary relationship in which Prahladrai stood with the family, which he represented. Thus, the profit earned by Prahladrai as a partner of the assessee-firm may become the income of the family which he represented in the partnership but that would not entitle the partnership to claim remuneration paid to the partner for services rendered as business expenditure u/s 10(2)(xv) of the Indian Income Tax Act. In the view that we take, we find considerable support from the observations of the Supreme Court in *The Commissioner of Income Tax, West Bengal Vs. Kalu Babu Lal Chand*,

Since we are of the opinion that, in whichever capacity appointed as a partner of the assessee-firm, the remuneration paid to Prahladrai could not be claimed as deduction, because he was serving the firm for remuneration in his capacity as partner, we answer the question referred to this court in the affirmative and in favour of the Revenue."

11. On the basis of law, as existed prior to the Explanations added by the Taxation Laws (Amendment) Act, 1984, the settled view was that Section 40(b) of the Act absolutely prohibits the allowances of any payment by way of interest, bonus, commission or remuneration made by a firm to any of its partners. The said view, however, has undergone a sea change in the case of *Brij Mohan Das Laxman Das Vs. Commissioner of Income Tax, Allahabad*, . The Supreme Court upheld the view taken by the Rajasthan High Court in the case of *GAJANAND POONAM CHAND AND BROTHERS Vs. COMMISSIONER OF Income Tax*.,

12. The question that arose before the Supreme Court in the aforesaid decision was as to whether interest paid to a partner on the amounts deposited by him in his individual capacity is hit by Clause (b) where the partner is a partner not in his individual capacity but as representative of a Hindu undivided family. The question, which had been referred by the Tribunal to the High Court for its opinion, reads as follows (page 827) :

"Whether the Tribunal was correct in allowing the assessee's claim for interest

paid on the credit balance in the individual account of Sri Rajendra Kumar ?"

13. Section 40(b) of the Act and the Explanations, which are relevant for the purpose of determination of the present controversy read as under :

"40. Notwithstanding anything to the contrary in Sections 30 to 39, the following amounts shall not be deducted in computing the income chargeable under the head "Profit and gains of business or profession",-- . . .

(b) in the case of any firm, any payment of interest, salary, bonus, commission or remuneration made by the firm to any partner of the firm.

Explanation 1.--Where interest is paid by a firm to any partner of the firm who has also paid interest to the firm, the amount of interest to be disallowed under this clause shall be limited to the amount by which the payment of interest by the firm to the partner exceeds the payment of interest by the partner to the firm.

Explanation 2.--Where an individual is a partner in a firm on behalf, or for the benefit, of any other person (such partner and the other person being hereinafter referred to as "partner in a representative capacity" and "person so represented" respectively),--

(i) interest paid by the firm to such individual or by such individual to the firm otherwise than as partner in a representative capacity, shall not be taken into account for the purposes of this clause ;

(ii) interest paid by the firm to such individual or by such individual to the firm as partner in a representative capacity and interest paid by the firm to the person so represented or by the person so represented to the firm, shall be taken into account for the purposes of this clause.

Explanation 3.--Where an individual is a partner in a firm otherwise than as partner in a representative capacity, interest paid by the firm to such individual shall not be taken into account for the purposes of this clause, if such interest is received by him on behalf, or for the benefit, of any other person."

Explanations 1, 2 and 3 to Section 40(b) of the Act, were added by the Taxation Laws (Amendment) Act, 1984, with effect from April 1, 1985. Explanation 2 expressly provides that where an individual is a partner in a firm on behalf of or for the benefit of any other person, any interest paid by the firm to such individual otherwise than as partner in a representative capacity, shall not be taken into account for the purposes of Clause (b).

14. The question, however, came up before the Supreme Court--if the benefit of the said Explanations could apply retrospectively and if the benefit could be available prior to April 1, 1985. The Supreme Court in this context held that the Taxation Laws (Amendment) Act, which introduced the said Explanation, does not say that the said Explanation shall have effect retrospectively. However, the question is whether the said Explanation is merely declaratory and clarificatory in

nature, in which case it will govern the previous assessment years as well or whether it is a substantive provision, having effect only prospectively. The Supreme Court while dealing with the said basic principle of partnership law in paragraphs 6, 7 and 8 of the said judgment which are set out as under, held thus (page 829) :

"In GAJANAND POONAM CHAND AND BROTHERS Vs. COMMISSIONER OF Income Tax., , the Rajasthan High Court has taken the view that the said Explanation is merely declaratory in nature and that, therefore, even for the assessment years prior to April 1, 1985, the position of law should be understood to be the same. In support of this proposition, the High Court relied upon the fact that ordinarily the purpose of an Explanation is to clarify that which is already enacted and not to introduce something new. The High Court opined that the Explanation was inserted by Parliament with a view to settle the controversy as to the meaning and effect of the said clause among the several High Courts and that the Explanation puts a seal of approval on the view taken by the majority of the High Courts. The High Court also referred to the definition of "person" in Clause (31) of Section 2. It pointed out that the definition shows clearly that an individual, a Hindu undivided family and a firm are distinct persons/entities for the purpose of the Income Tax Act. The High Court, therefore, concluded that since an individual and a Hindu undivided family are two distinct entities for the purpose of the Act, Clause (b) of Section 40 has no application where the interest is paid to the partner on deposits made by him with the firm in his individual capacity where such person is a partner not in his individual capacity but as representing a Hindu undivided family. Sri G. C. Sharma, learned counsel for the appellant-assessee, strongly relies upon this decision and commends it for our acceptance. Learned counsel points out that even before the enactment of the Taxation Laws (Amendment) Act, 1984 (which inserted Explanation 2 aforesaid), a majority of the High Courts in the country had taken the same view though a few High Courts have no doubt taken a contrary view. Looked at from any angle, Sri Sharma says, the issue must be answered in favour of the assessee.

Clause (b) of Section 40 is based upon and is a recognition of the basic nature of the relationship between a firm and its partner. In Commissioner of Income Tax, Madras Vs. R.M. Chidambaram Pillai and Others, , this court observed (page 295) :

"Here the first thing that we must grasp is that a firm is not a legal person even though it has some attributes of personality. Partnership is a certain relation between persons, the product of agreement to share the profits of a business. "Firm" is a collective noun, a compendious expression to designate an entity, not a person. In Income Tax law, a firm is a unit of assessment, by special provisions, but is not a full person which leads to the next step that since a contract of employment requires two distinct persons, viz., the employer and the employee, there cannot be a contract of service, in strict law, between a firm and one of its partners. So that any agreement for remuneration of a partner for

taking part in the conduct of the business must be regarded as a portion of the profits being made over as a reward for the human capital brought in. Section 13 of the Partnership Act brings into focus this basis of partnership business."

This court also quoted with approval the passage from Lindley on the Law of Partnership to the effect: "In point of law, a partner may be the debtor or the creditor of his co-partners, but he cannot be either debtor or creditor of the firm of which he is himself a member, nor can he be employed by his firm, for, a man cannot be his own employer". The provisions in Chapters III and IV of the Partnership Act amply define and delineate the duties, obligations and rights of the partners vis-a-vis the firm. The question yet remains where an individual is a partner in one capacity, e.g., as a representative of another person, can he have no other capacity vis-a-vis the firm. To be more precise, does the above position of law preclude an individual, who is a partner representing a Hindu undivided family, from depositing his personal funds with the partnership and receiving interest thereon ? Explanation 2 says in clear terms that there is no such bar. This is the legislative recognition of the theory of different capacities an individual may hold--no doubt confined to Clause (b) of Section 40. Once this is so, we see no reason to hold that this theory of different capacities is not valid or available for the period anterior to April 1, 1985. Accordingly, we hold that even for the period anterior to April 1, 1985, any interest paid to a partner, who is a partner representing his Hindu undivided family, on the deposit of his personal/individual funds, does not fall within the mischief of Clause (b) of Section 40. In this view of the matter, we agree with the view taken by the Rajasthan High Court in GAJANAND POONAM CHAND AND BROTHERS Vs. COMMISSIONER OF Income Tax., that Explanation 2, in the context of Clause (b) of Section 40, is declaratory in nature. Accordingly, we allow this appeal, set aside the judgment of the High Court and answer the question referred u/s 256 in the affirmative, i.e., in favour of the assessee and against the Revenue."

15. Accordingly, it appears that the Supreme Court in the case of Brij Mohan Das Laxman Das Vs. Commissioner of Income Tax, Allahabad, held that even for the period anterior to April 1, 1985, any interest paid to a partner, who is a partner representing his Hindu undivided family on the deposit of his personal/individual funds, does not fall within the mischief of Clause (b) of Section 40 of the Act and agreed with the view of the Rajasthan High Court that Explanation 2, in the context of Clause (b) of Section 40, is declaratory in nature.

16. In the case of M/s. Suwalal Anadilal Jain Vs. Commissioner of Income Tax, Bihar-II, Ranchi, , the Supreme Court followed the same principle of law laid down earlier in the case of Brij Mohan Das Laxman Das Vs. Commissioner of Income Tax, Allahabad, .

17. In view of the above pronouncements of the Supreme Court, the position of law is well settled and we do not think that this question requires any further elucidation. Accordingly, both the questions are answered in the affirmative, i.e., in favour of the assessee and against the Revenue.

18. The instant reference stands disposed of accordingly.