
(1990) 09 BOM CK 0091

In the Bombay High Court

Case No : Income-tax Reference No. 624 of 1976

Commissioner of Income Tax

APPELLANT

Vs

Dharti Films

RESPONDENT

Date of Decision : 24-09-1990

Acts Referred:

Income Tax Act, 1961 — Section 10(4), 30, 31, 32, 33

Citation : (1990) 90 CTR 10 : (1991) 191 ITR 261

Hon'ble Judges : T.D. Sugla, J; Sujata V. Manohar, J

Bench : Division Bench

Advocate : G.S. Jetley, for the Appellant; I.M. Munim, for the Respondent

Judgement

T.D. Sugla J.

1. The Tribunal has referred to this court u/s 256(1) of the Income Tax Act, 1961, the following two questions as questions of law :

"(i) Whether, on the facts and in the circumstances of the case, the assessee was entitled to claim that the so-called commission paid to Shri N. N. Sippy as proprietor of M/s. Janata Film, Distributors could not be added back in computing the firm's income by relying on the provisions of section 40(b) of the Act ?

(ii) Whether, on the facts and in the circumstances of the case, the assessee was entitled to claim that the payment of Rs. 1,25,000 to Shri N. N. Sippy at the time of his retirement was an expenditure allowable u/s 37(1) of the Act 1961 ?"

2. The reference is at the instance of the Department. The assessee is a partnership firm. The assessment year involved is 1970-71 for which the previous year is from April 1, 1969, to March 31, 1970. There were two changes in the constitution of the assessee-firm during the year. Initially, the firm was constituted under a deed of partnership dated January 14, 1968, with Shri N. N. Sippy, Balbir Kapoor, Roop K. Sakraney and Ramesh G. Sippy as partners. This constitution continued up to November 18 1969, when Shri Balbir Kapoor retired.

With effect from November 19, 1969, Shri Amarnath Kapoor came in as partner in place of Shri Balbir Kapoor. This partnership is evidenced by a deed of partnership dated November 27, 1969. The remaining partners continued as such. Shri N. N. Sippy retired from the firm on December 31, 1969, whereafter, i.e., on and from January 1, 1970, and up to the end of the year i.e., March 31, 1970, the assessee-firm continued with the remaining three partners. As a result of the retirement of Shri N. N. Sippy who had 50 per cent. share, the shares of the remaining partners got increased in proportion to their shares.

3. The firm was constituted primarily with the object of exploiting the distribution of the picture "Dharti Kahe Pukar Ke" which was produced by Vaishali Films. A written agreement dated June 28, 1968, was entered into between Vaishali Films and Shri N. N. Sippy on behalf of the assessee-firm whereby the assessee-firm secured distribution rights over the aforesaid picture on a minimum guarantee commission of Rs. 5,00,000. Overflow beyond Rs. 5,00,000 was to be divided equally between Vaishali Films and the assessee-firm. The assessee-firm was to advance a total sum of Rs. 5,00,000 in instalments and the last instalment was to be paid against the delivery of twelve brand new duly censored quota prints in Eastman colour. Clause 12 of the agreement laid down that the picture was to be distributed, exhibited and exploited through Janata Film Distribution, a proprietary concern of Shri N. N. Sippy.

4. As between the assessee-firm and Janata Film Distributors, there was initially an oral agreement which was subsequently reduced to writing on April 1, 1969. For arranging and looking after distribution and exhibition, etc., Janata Film Distributors was to deduct 5 per cent. of the gross receipts by way of commission. All expenses in connection therewith were to be incurred by Janata Film Distributors. The film was released in July, 1969.

5. Shri N. N. Sippy retired from the partnership-firm on and from December 31, 1969, whereafter the remaining three partners continued the partnership business as partners. A deed of dissolution was drawn up between the parties on February 4, 1970. Shri N. N. Sippy's case share in the profits of the assessee-firm for the period from April 1, 1969, to December 31, 1969 (April 1, 1969, to November 18, 1969, and from November 19, 1969, to December 31, 1968) worked out to Rs. 1,37,073.50. Besides the payment of this amount as his share, Shri N. N. Sippy was paid a further sum of Rs. 1,25,000 in terms of clause 4 of the deed of dissolution. Briefly stated, the payment was in consideration of (i) his assigning unto the continuing partners of the assessee-firm all the benefits available to him as partner, that is, all the right, title and interest of the said firm and all the benefits available to him under the deed of partnership dated November 27, 1969, and (ii) his relinquishing all the benefits available to him as proprietor of Janata Film Distributors under the said agreement of distribution dated April 1, 1968, with the assessee-firm regarding distribution, exhibition and exploitation of the picture "Dharti Kahe Pukar Ke" which, inter alia, included the consideration for handing over all the prints and the publicity material of the said

picture by Shri N. N. Sippy to the assessee-firm.

6. Janata Film Distributors of which Shri N. N. Sippy was the proprietor had deducted from the gross receipts sums of Rs. 59,995 during the first period i.e., up to November 18, 1969, and Rs. 14,386 for the second period i.e., from November 19, 1969, up to December 31, 1969, in all amounting to Rs. 74,381. The Income Tax Officer disallowed the above sum as, in his view, this was the amount paid by the assessee-firm to Janata Film Distributors, a proprietary concern of the partner, Shri N. N. Sippy, and was hit by the provisions of section 40(b) of the Income Tax Act, 1961. He also disallowed the sum of Rs. 1,25,000 paid by the assessee-firm to Shri N. N. Sippy on his retirement in terms of the dissolution agreement dated February 4, 1970. holding the payment to be in the nature of capital expenditure.

7. The Appellate Assistant Commissioner agreed with the Income Tax Officer on both the issues. On further appeal, however, the Tribunal accepted the claim. As regards disallowance of Rs. 74,381 u/s 40(b), the Tribunal observed that the object of disallowance contemplated u/s 40(b) was to tax the firm on its entire income. Merely because the partners had agreed to the payment of interest, salary, bonus or commission, such payments did not cease to be the profits of the firm, being payments out of profits earned by the firm. It was, therefore, necessary to consider the real nature of the payment as distinct from mere nomenclature. The amounts herein were for certain specific services rendered to the assessee-firm by Janata Film Distributors under a separate agreement. The payments herein had to be made even prior to the accrual of income and for the purpose of earning the income. In the present case, the payment was made to Janata Film Distributors, a proprietary concern of Shri N. N. Sippy, not in his capacity as a partner but in some other capacity. According to the Tribunal, it is only the net business income earned by the firm that can be brought to tax. In determining the net income, a sum which in reality represents an expenditure cannot be added back. The payment of 5 per cent. is really in the nature of expenditure which the assessee-firm would have incurred if Janata Film Distributors had not undertaken to incur expenditure in connection with the distribution of the film in lieu of the commission. The payment was determinable with reference to gross receipts in the hands of Janata Film Distributors. It accrued as income to the assessee-firm only after the net amount of collection was transferred by Janata Film Distributors to the assessee-firm. It was a case of diversion of income before accrual.

8. Shri Jetley, learned counsel for the Department, relied on the Madras High Court decision in the case of R. A. GOODSIR AND CO., MADRAS Vs. COMMISSIONER OF EXCESS PROFITS TAX, MADRAS., and the Kerala High Court decision in the case of Commissioner of Income Tax Vs. Veeriah Reddiar, in support of the contention that the prohibition u/s 40(b) is in terms absolute and makes no distinction on the basis of the nature of payment and/or the capacity in which the payment is received by a partner. Counsel for the assessee, on the

other hand, relied on the Madras High Court decision in the case of Commissioner of Income Tax Vs. Gemini Productions, , the Andhra Pradesh High Court decision in the case of Commissioner of Income Tax Vs. Chitra Kalpana, , and the Allahabad High Court decision in the case of The Commissioner of Income Tax Vs. Ram Laxman Sugar Mills, Mohiuddinpur, , in support of the Tribunal's order.

9. Section 40(b) of the Income Tax Act, 1961, reads as under :

"Section 40. - Notwithstanding anything to the contrary in sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head "profits and gains of business or professions", - ...

(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."

10. The Kerala High Court, in Commissioner of Income Tax Vs. Veeriah Reddiar, followed the Madras High Court in Goodsir (R.A. and Co. v. CEPT [1948] 16 ITR 397. The ratio of these two decisions is that the prohibition in section 40(b) is in absolute terms, if payment of salary, interest, bonus or commission is found to be made by a firm to its partners as a matter of fact, the nature of the payment as also the capacity in which the said partner received it is of no consequence and the payment will be hit by section 40(b). However, the Allahabad High Court has drawn a distinction between the payment of remuneration by a firm to a partner as partner and payment in some other capacity. In that case, the payments were made to partners by way of remuneration not in pursuance of the agreement of partnership but under the directions of the Central Government. The board of management was appointed by the Central Government under the provisions of Essential Supplies (Temporary Powers) Act, 1946. The partners themselves constituted the board of management and remuneration was paid to them under the directions of the Central Government in their capacity as members of the board of management. The payments were held to be expenditure incurred for the purpose of business and as such allowable u/s 10(2) (xv) of the old Act. This decision, though makes some distinction depending upon the capacity in which the payments are received by the partners, it appear to us, has no direct bearing on the question involved herein.

11. The Madras High Court decision in Commissioner of Income Tax Vs. Gemini Productions, and the Andhra Pradesh High Court judgment in Commissioner of Income Tax Vs. Chitra Kalpana, . In our judgment, are the cases on point. In the Madras case, under an agreement entered into between the assessee-firm and one of the partners, a limited company, the company had to advance to the firm a sum of Rs. 20,00,000 without interest. In consideration, the company was entitled to the sole and permanent distribution and exploitation rights of the pictures involved in the agreement at their sole discretion. The agreement provided that, out of the realisations of the exhibition and distribution of the pictures, the company may pay themselves their distribution commission in

respect of the said pictures and, thereafter, pay to themselves the available balance until the entire advance of Rs. 20,00,000 was completely discharged and satisfied. After such satisfaction, the company was to pay to the assessee-firm the balance available out of the realisation after adjusting their distribution commission. The question involved was whether the distribution commission which the company paid to itself under an agreement for exhibition and distribution of the pictures was hit by the provisions of section 10(4)(b) of the old Act. It was held, and. In our judgment rightly, that, before the application of section 10(4)(b), two requirements must be satisfied : (i) the income must be the income of the firm; and (ii) out of the said income, the payment must be made to a partner. The very object of the total bar of payment of interest, salary, commission or remuneration to a partner u/s 10(4) (b) was to prevent diversion of the profits of the firm in the hands of its partners. Therefore, it must first be established that the payment were made by the firm to its partners out of its income. Referring to the facts of that case, viz., the company was carrying on an independent business of distribution of films produced by others also and that the payment made by the company to itself was a receipt in the course of its carrying on the business and as such was its income and not the income of the producers whose pictures the company was exhibiting, exploiting and distributing, it was held that the appropriation of the commission by the company never represented the income of the assessee-firm and could not, therefore, be said to constitute "payment of commission" within the meaning of section 10(4) (b) of the Act. A similar view has been taken by the Andhra Pradesh High Court in Commissioner of Income Tax Vs. Chitra Kalpana, . In that case, the assessee-firm was carrying on the business of production, distribution and exploitation of films, it claimed deduction of Rs. 25,000 paid to the managing partner and Rs. 15,000 paid to another partner. It was stated that the managing partner was a reputed story writer for the films and carried it on as a profession individually and the amount had been paid for a story written by him. The amount of Rs. 15,000 had been paid to the other partner in his capacity as director of a film produced by the firm. It was held that section 40(b) was to take care of attempts to avoid tax by making impermissible deductions claimed by the firm as payments to partners on account of salary, bonus, interest, commission or remuneration wherever a partner was under a legal obligation to provide his services or capital and yet charged a quid pro quo for such services or capital. Where, however, a partner was under no legal obligation to provide any particular/special service or involve himself in any particular activity, the payment made to him as a quid pro quo for such services would not fall u/s 40(b) of the Act.

12. We agree with the views expressed by the Madras and the Andhra Pradesh High Courts in that the provisions in section 40(b) are intended to prevent the siphoning off the firm's income to partners in order to reduce the tax liability in the hands of the firm. Income earned by the firm, if diverted into partners' hands by making payment on account of salary, bonus, interest, commission and

other remuneration, is certainly taken care of by the provisions of section 40(b). However, if a payment is made to a partner for something altogether unconnected with the partnership business and has no nexus with the ordinary obligations of the partners inter se, such a payment is not hit by the provisions of section 40(b). Besides, section 40(b) can be applied only if it is established that it is a payment by the firm to a partner out of its income. If the payment is not out of the income of the firm, the question of disallowance cannot arise.

13. Coming then to the facts in the case before us, it is seen that Janata Film Distributors was established in the business of film distribution for more than ten years. It had been undertaking the distribution and exhibition business not only of the assessee-firm but also of other firms and independently. It is evident from the agreement dated June 28, 1968, between the assessee-firm and Vaishali Films that distribution rights over the picture "Dharti Kahe Pukar Ke" were entrusted to the assessee-firm on the express condition that the distribution would be done through Janata Film Distributors. The reason was obvious. While Janata Films had experience in the line of business, the assessee-firm had none. The assessee-firm came in, perhaps, mainly because of its financial involvement. Moreover, Janata Film Distributors had not been paid any amount by the assessee-firm. It paid commission to itself out of gross collections on exhibition and/or distribution of the picture. The net amount of collection was transferred to the assessee-firm. Accordingly, we are in agreement with the Tribunal that the amount retained by Janata Film Distributors by way of commission under the agreement with the assessee-firm. The assessee-firm had not made any payment to Janata Film Distributors and, therefore, the question of any disallowance u/s 40(b) does not arise. The first question is, accordingly, answered in the affirmative and in favour of the assessee.

14. It is pertinent to mention that a number of other decision were cited on behalf of the Department as well as the assessee relating to payment of interest to the karta of a Hindu undivided family in his individual capacity when the Hindu undivided family was a partner or vice versa. The question involved was whether the interest was paid by the firm to a partner. Factually, payment of interest was not to a partner as such. In the present case, there is a dispute that the amount of Rs. 74,381 retained by Janata Film Distributors out of the gross collection on distribution and/or exhibition of the film "Dharti Kahe Pukar Ke" represented the amount retained by the partner, Shri N. N. Sippy, as he was the proprietor of Janata Films. These cases have, thus, no application in the facts of the case.

15. As regards payment of Rs. 1,25,000, the Tribunal found that the payment was for the lost of profits which would have accrued to Shri N. N. Sippy had he continued to be a partner and for loss of income accruing to Janata Film Distributors by way of commission at the rate of 5 per cent. of the gross receipts for distribution rights over the picture. Following the Punjab and Harayana High Court decision in the case of Kartar Singh Duggal v. CIT [1972] Taxation 21, the Tribunal held that payment also represented expenditure of revenue nature. The

appeal was thus allowed.

16. Shri Jetley, learned counsel for the Department, reiterated that the payment of Rs. 1,25,000 was by the continuing partners to the outgoing partner for acquiring his right, title and interest in the partnership firm. He strongly relied on the Madras High Court decision in the case of Rao Bahadur R. Guruswamy Naidu Udumalpet Vs. The Commissioner of Income Tax, Madras, , the Lahore High Court decision in the case of (1945) 13 ITR 430 and the Delhi High Court decision in the case of General Auto Parts Co. Vs. Commissioner of Income Tax, in support of the proposition that such a payment was in the nature of a capital expenditure, counsel for the assessee, on the other hand, referred to and relied upon the Supreme Court decision in the case of Commissioner of Income Tax, Madras Vs. Ashok Leyland Ltd., to show that a payment made to get rid of inconvenient arrangement represents revenue expenditure. Out court, in the case of Commissioner of Income Tax Vs. Natwarlal Mohanlal and Co., and the Punjab and Harayana High Court in the case of Sukhbir Parshad Vs. Commissioner of Income Tax, , he argued, have held that whether a payment is of revenue or capital nature depends upon the nature of the transaction and not on the mere fact that the share of a retiring partner or partners is acquired by the continuing partners.

17. In view of the finding of the Tribunal which is not in dispute, it has to be taken that the sum of Rs. 1,25,000 was paid to Shri N. N. Sippy on two counts, namely, for giving up his interest (i) in the partnership firm as a partner, and (ii) under the sub-distribution agreement dated April 1, 1969, in respect of the picture "Dharti Kahe "Pukar Ke". It has already been held in earlier paragraphs that Janata Film Distributors of which Shri N. N. Sippy was a proprietor was retaining 5 per cent. of the gross collection in respect of the picture as as commission and that the commission never represented the income of the assessee-firm. Consequently, to the extent the payment of Rs. 1,25,000 in the deed of retirement is attributable to the giving up by Shri N. N. Sippy of his right, title and interest under the sub-distribution agreement dated April 1, 1969, it will fall within the ratio of the Supreme Court decision in Commissioner of Income Tax, Madras Vs. Ashok Leyland Ltd., . What was earlier done by the Janata Films, after December 31, 1969, was to be done by the assessee itself. This arrangement was not on capital account and the payment, therefore, will be of revenue nature.

18. However, so far as the payment pertains to his giving up of his right, title and interest in the partnership firm as partner is concerned, it appears to be a settled position that it will be on capital account. In our view, the decision of our court in Commissioner of Income Tax Vs. Natwarlal Mohanlal and Co., and of the Punjab and Harayana High Court decision in Sukhbir Parshad Vs. Commissioner of Income Tax, are not applicable in this case inasmuch as, in those cases, the finding was that the payment in reality was not for acquisition of the rights of a partner as such but for the use of the outgoing partner's share in quota rights,

import licenses/entitlements, etc. Admittedly, in the present case, that situation is not obtaining. In the circumstances, the fact that the only activity of the assessee-firm at the material time was exploitation of rights of distribution over the picture "Dharti Kahe Pukar Ke" is not of much consequence.

19. However, the payment of Rs. 1,25,000 by the assessee-firm to Shri N. N. Sippy, as stated earlier, is a consolidated amount and is on account of the aforesaid two factors. There is no direct evidence to show as to what portion of the payment represents the value of the sub-distribution rights. In our view, the income earned by Shri Sippy from the two sources may provide a reasonable basis. It is on record that Shri Sippy's share of income from the assessee-firm during the period amounted to about Rs. 1,37,073.50 and the amount retained by Janata Films by way of commission under the sub-distribution agreement worked out to Rs. 74,381. Accordingly, it is considered reasonable to apportion Rs. 75,000 towards payment for the relinquishment of the share in the partnership firm and the remaining Rs. 50,000 as consideration for the surrendering of sub-distribution rights.

20. Accordingly, the second question is answered thus :

21. To the extent the payment of Rs. 50,000 which represents, in our view, the consideration for Janata Film Distributors" giving up its sub-distribution rights, the question is answered in the affirmative and in favour of the assessee. The balance payment of Rs. 75,000 represents the consideration for Shri N. N. Sippy relinquishing his right, title and interest as partner in the firm. The question in that regard is answered in the negative and in favour of the Revenue.

22. No order as to costs.