

(1988) 08 KAR CK 0025

In the Karnataka High Court

Case No : Income-tax Referred Case No. 128 of 1983

Commissioner of Income Tax

APPELLANT

Vs

Pompei Tile Works

RESPONDENT

Date of Decision : 12-08-1988

Acts Referred:

Income Tax Act, 1961 — Section 256 (1)

Citation : (1988) 73 CTR 54 : (1989) 175 ITR 1 : (1988) 3 KarLJ 404 : (1988) 41 TAXMAN 181

Hon'ble Judges : S.A. Hakeem, J;S. Rajendra Babu, J

Bench : Division Bench

Advocate : K. Srinivasan, for the Appellant; G. Sarangan, for the Respondent

Judgement

Rajendra Babu, J.—Under a deed November 1, 1961, (i) Mr. Francis Xavier Pinto; (ii) Mr. Harold Charles Pinto; (iii) Mr. Guthbert Joseph Pinto; (iv) Mrs. Margaret Pinto and (v) Mrs. Deanna Lobo formed a partnership which provided for a share of 25% of profit of loss to Mrs. Margaret Pinto. The deed also provided that an outgoing partner had to give three months' notice of intention in writing to sever his/her connection with the partnership and the continuing partners had an option to purchase his/her share at a price as provided in clause 10 of the said deed. The purchaser price was to be calculated in the manner provided in clause 10 of the deed. There is a provision in the deed for settlement of disputes amongst the partners by arbitration.

2. For some time prior to April 1, 1975, serious misunderstandings and disputes having arisen between Mrs. Margaret Pinto and other partners, Mrs. Deanna Lobo having expressed her desire for retirement from the partnership and Mr. Francis Xavier Pinto having died, a new partnership was entered into among :

1. Mr. Harold Charles Pinto,
2. Mr. Guthbert Joseph Pinto,
3. David J. Pinto, sons of the deceased, Francis Xavier Pinto

4. Paul J. C. Pinto, and

5. Mrs. Beatrice Pinto (who replaced na Lobo by a deed dated April 1, 1975).

3. The said partnership deed provided, inter alia, in clause 5, the following :

"The profits or loss to be divided and distributed among the partners as referred to above shall be ascertained in the manner prescribed hereinafter. The profit or loss for the working of the firm shall be first ascertained by charging all the expenses incurred for the purpose of the business of the firm and also after charging the interest paid or payable to the partners on their deposits and also any salary payable to the working and managing partners. In case such annual working after charging interest and salary results in a profit, a sum representing 25% of such profits arrived at shall be charged to the profit and loss account towards the rights of Mrs. Margaret Pinto, who, by her actions, allowed herself to keep out of the partnership having certain rights conferred under law for the user of the partnership assets and her partnership interest. The amount ascertained as payable to Mrs. Margaret Pinto under law as also under the covenants of this partnership deed shall be a charge on the income of the firm. Such income as is ascertained after making due provision towards the rights of Mrs. Margaret Pinto under law and by means of this agreement of the firm shall alone be the income of the firm which is to be divided and distributed among the partners. In case of loss, Mrs. Margaret Pinto is entitled to 6% (six) per cent. interest per annum on the amount outstanding to her credit and the loss so arrived at after providing for the interest on the amounts standing to her credit towards the user of the assets of the firm and her partnership interest shall be the loss of the firm to be divided and distributed among the partners, in accordance with the terms as set out above."

4. In the circumstances set forth above, the said Mrs. Margaret Pinto ceased to be a partner of the firm and other partners with certain changes either on account of death or on account of retirement, as stated above, continued to carry on the business of the old firm without any settlement of accounts as between them and Mrs. Margaret Pinto who ceased to be a partner for whose benefit the aforesaid provision was made. Mrs. Margaret Pinto died on June 14, 1975, issueless and there were disputes pending regarding the question of succession to her estate.

5. The new firm that came into existence by said deed dated April 1, 1975, is the assessee in this case and for the assessment year 1976-77, it claimed that an amount of Rs. 35,594 calculated at 25% of the profits credited to the account of Mrs. Margaret Pinto did not constitute a part of the assessee's income at all, but was diverted by an overriding title or charge. The assessing authority rejected the said claim. On appeal to the Commissioner of Income Tax he accepted the contention of the assessee that there was an overriding charge on the assets of the firm as well as the shares of the partners and hence the claim was admissible. The Revenue carried the matter further to the Tribunal which held

that an effective and valid charge was created in favour of Mrs. Pinto; this charge was enforceable in a court of law; an overriding title was created in her favour; and the income of the firm to that extent was diverted by overriding title" the overriding charge was on the profits of the firm and to that extent the income of the firm was diverted by an overriding title; and the amount paid to and credited to Mrs. Pinto's account was, therefore, not taxable in the hands of the firm.

6. At the instance of the Revenue, the following question has been referred to this court u/s 256(1) of the Income Tax Act, 1961 ("the Act" for short) :

"Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in upholding the Commissioner of Income Tax (Appeals)"s order who held that 25% of the share of profit paid to the ex-partner and to her estate has to be deducted in computing the total income of the assessee ?"

7. Sri K. Srinivasan, learned counsel for the Revenue, contended that :

(1) A close reading of clause 5 of the deed extracted above discloses that there is no diversion of income by an overriding title resulting either from the statute or contract and the payment is only a voluntary payment of income and hence not deductible;

(2) Mrs. Margaret Pinto having died on June 14, 1975, there was no legal claim in the absence of issues :

(3) Mrs. Margaret Pinto has not issued notice to sever her connection with the firm nor have the other partners exercised their option as provided under clause 10 of the deed of the year 1961 and, hence, there is no liability on the part of the assessee-firm to pay any amount to Mrs. Margaret Pinto;

(4) The arrangements made by the partners amongst themselves on the one hand is unilateral and Mrs. Pinto not being a party to the same on the other, there is no enforceable obligation on the assessee to pay the said amount under the said clause; and

(5) The business would not have come to a standstill unless the payments in question were made and, therefore, the deduction claimed is not for the purpose of the business.

8. There have been a number of decisions of the Supreme Court and High Courts which set out what are the two tests for determining whether there is diversion by overriding charge on the income. The leading case on the point is the decision of the Supreme Court in *The Commissioner of Income Tax, Bombay City II Vs. Shri Sitaldas Tirathdas*, wherein it is observed (p. 374) :

"... the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligation, no doubt, there are in every case, but it is the nature of the obligation which is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his

income and an amount which by the nature of the obligation cannot be said to be a part of the income of the assessee. Where by the obligation, income is diverted before it reached the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow. It is the first kind of payment which can truly be excused and not the second. The second payment is merely an obligation to pay another a portion of one's own income, which has been received and is since applied. The first is a case in which the income never reached the assessee, who even if he were to collect it, does so, not as part of his income, but for and on behalf of the person to whom it is payable..."

9. Every income must have a source either from a property or a business or a contract. There is a definite distinction between an obligation to spend money in a particular manner attached to the income and a similar obligation attaching to the source of income. If the obligation is on the receipt of the income and not on the source of it, the legal effect is different. In the one case, income is diverted at source and hence cannot be deemed to have accrued or arisen therefrom. In the other case, the income has accrued and, therefore, it has to be applied in a particular manner. In the former case, the income is not included at all. In the latter case it is. where a person is obliged to spend something out of certain income on a specified object, income himself and spending it on the object; there are two ways in which the object, can be achieved. His receiving the income himself and spending it himself on the object. The payer's retaining the amount of income and spending it himself on the object In one case, there is actual receipt, but not in the other. The liability to pay tax does not depend on actual receipt. Even if it is actually received, it may not be liable, just as even though it is not actually received it can be liable, if the doctrine of diversion applies.

10. There is ample authority as to the concept of income which is diverted by an overriding title or charge before it reached the hands of the assessee, but all of them have followed the decision in *The Commissioner of Income Tax, Bombay City II Vs. Shri Sitaldas Tirathdas*, and *Senairam Doongarmall Vs. Commissioner of Income Tax, Assam*, and there is no divergence of views, but only an elaboration with different hues and overtones. Therefore, in each case, what we must look at is the obligation imposed by the contract or statute and the purpose for which it was entered into and it is not necessary to examine all the cases which have been cited at the Bar.

11. Now, we may take up the first contention. In the existing partnership Mrs. Pinto had an interest to the extent of 25% as indicated in clause 4 and in the event of her retirement or severance from the firm, she was entitled to the purchase price as indicated in clause 10 at the option of the continuing partners. Thus, on the date when the partnership was entered into (April 1, 1975), Mrs. Pinto had pre-existing rights in the partnership and its assets. Therefore, without settling her rights, the other partners could not have excluded her from the partnership. To meet that liability of the pre-existing rights of Mrs. Pinto, the

partners of the assessee had adopted a standard, that is, that she should be compensated by giving her 25% of the profits or if not profits are earned, a minimum of 6% on the amount standing to her credit. The agreement amongst the partners and the assessee at clause 5 of the 1975 deed is, therefore, to meet the pre-existing liability towards Mrs. Pinto in the circumstances stated above.

12. However, Sri Srinivasan contended that, inasmuch as she is paid 25% of the profits, the payment is only after the income has reached the assessee and, hence, there is no diversion at source. As pointed out above, when on the date the new partnership came into existence, Mrs. Pinto was entitled to claim certain benefits as provided in clause 10 of the old deed dated November 1, 1961. The new firm came into existence only by creating a pre-existing charge at source resulting in the diversion at source. Further, even in the absence of profits, she becomes entitled to 6% of the amount standing to her credit. This fact also lends credence to the contention of the assessee that irrespective of profit or loss, Mrs. Pinto had to be compensated. The deed makes it clear that the payment is for the user of the assets of the firm to the exclusion of Mrs. Pinto's interest, in the same which is compensatory in nature. The compensation paid to her is measured in terms of profit and in the event of loss at 6% interest. When compensation is measured with reference to or in terms of profit, that does not become profits, but is an amount computed by reference to profits with an obligation to pay the same even when there is a loss. It has been held by the Supreme Court in *Senairam Doongarmall Vs. Commissioner of Income Tax, Assam*, thus :

"The compensation which was paid in the two years was no doubt paid as an equivalent of the likely profits in those years; but, as pointed out by Lord Buckmaster in *Glenboig Union Fircelay Co. Ltd. v. Commissioners of Inland Revenue* [1922] 12 Tax Case 427 and affirmed by Lord Macmillan in *Van den Berghs Ltd. v. Clark* [1935] 3 ITR 17, " there is no relation between the measures that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test... It is the quality of the payment that is decisive of the character of the payment and not the method of the payment or its measure, and makes it fall within capital or revenue."

13. It is the quality of the payment that is decisive of the character of the payment and not the method or measure of the results to be treated as a diversion at source. It is clear in the present case that the obligation for diversion of income to Mrs. Pinto came into existence even at the time when the assessee firm came into existence, that is, at source and, hence, the first contention of the Revenue has got to be rejected.

14. The second contention raised on behalf of the Revenue is wholly devoid of merit on the face of it. Even when the partnership deed dated April 1, 1975, was entered into, there was an obligation on the assessee to compensate Mrs. Pinto and that was recognised and provided for under clause 10. Such a right certainly

devolves on her death on her estate and is claimable by her heirs even in the absence of her own progeny. The law is too well settled and needs no discussion to reject this contention of Sri Srinivasan. We agree with the conclusion of the Tribunal in this regard.

15. Next, the Revenue contended that Mrs. Pinto had not issued any notice to the other partners indicating her severance from the firm and they had not exercised their option exercised their option as provided in clause 5 of the partnership deed of 1961, and, hence, she is not entitled to the purchase price mentioned in the said clause and thus there was no obligation on the part of the assessee to make payment as provided in clause 7 of the 1975 deed. Mrs. Pinto did not express her desire to retire nor did she sever her connection with the firm and hence issue of notice or exercise of option as provided in clause 5 does not arise at all. The partners, other than Mrs. Pinto, decided to exclude her and provide her compensation for the user in the new partnership of the assets of the firm to the extent of her share in the old partnership. Such a position does not result from her retirement nor severance from the partnership but from her exclusion by other partner. There is no voluntary act on the part of Mrs. Pinto to attract the conditions prescribed in clause 5 of the 1961 deed. Hence, invoking the conditions of clause 10 of the 1961 deed does not arise at all. This contention of the Revenue is also devoid of merit.

16. Now, we may turn to contention No. 4 Elaborating on the same. Sri Srinivasan contended that a contract requires two parties between whom rights and obligation are created and privity of contract is absolutely essential for a right of action. Mrs. Pinto, not being a party to the deed dated April 1, 1975, is a stranger to the said contract and, hence, she cannot enforce her right, if any under the said deed. Undoubtedly, though a transfer to a contract cannot, as a general rule, sue upon the contract, except in certain circumstances, in the present case, though Mrs. Pinto is not eo nomine a party to the deed dated April 1, 1975, the assesses-partners are entitled to confer a benefit on Mrs. Pinto as cestui que trust in such a way that the latter may sue in her own right to enforce her contract. She has an interest in the assets of the firm the user of which is compensated by an interest in the assets of the firm the user of which is compensated by the clause in question which also sets out the measure of the same. It is, therefore, difficult to accept that she had no enforceable right to recover such compensation. Apart from any other aspect, the right to the user of the firm's assets, to the extent of her share, will definitely constitute consideration for the payment provided in the contract and although she may be stranger to the contract, she is not a stranger to such consideration. Looked at from any angle, the contention of the Revenue that she had no legal or enforceable right holds no water and has got to be rejected.

17. Lastly, it was contended that such payment as in clause 5 of the 1975 deed was not necessary at all for the purpose of carrying on the business and is not incurred for the purpose of this deed. Inasmuch as the firm took over the

partnership interest of Mrs. Pinto in the assets of the firm, the business could not have been carried on is obvious and too manifest to need any elaboration. The firm was carrying on the business of manufacture and sale of tiles; the factory was not easily divisible and the new partnership had to utilise the assets of the firm as the firm as a whole including the interest of Mrs. Pinto in the same. Therefore, it cannot be said that without providing for such utilisation, the business could have been carried on.

18. The Revenue, has lost on all the points raised by it and we have to answer the questions referred to us in the affirmative and against the Revenue. Answered accordingly.