

(1997) 02 MAD CK 0189
In the Madras High Court
Case No : TC No. 86 of 1984

Commissioner of Income Tax

APPELLANT

Vs

Subramaniam Bros.

RESPONDENT

Date of Decision : 11-02-1997

Acts Referred:

Income Tax Act, 1961 — Section 256(2), 4

Citation : (1999) 236 ITR 148

Hon'ble Judges : N.V. Balasubramanian, J; Abdul Hadi, J

Bench : Division Bench

Advocate : S.V. Subramanian, for C.V. Rajan, for the Appellant; P.P.S. Janarthana Raja, for the Respondent

Judgement

N.V. Balasubramanian, J.—Pursuant to the direction given by this Court in T. C. P. No. 5 of 1982, dt. 26th April, 1982, the Tribunal, Madras, has stated a case and referred the following questions of law for the opinion of this Court under s. 256(2) of the IT Act, 1961 :

"1. Whether, on the facts and in the circumstances of the case, the Tribunal was justified in holding that the ITO was not justified in disallowing a sum of Rs. 23,293 being the commission paid to the retired partners while computing the income of the assessee-firm ?

2. Whether, on the facts and in the circumstances of the case, the Tribunal's view that the commission of Rs. 23,293 received by the firm was not the income of the assessee-firm as there was overriding title in respect of such commission is sustainable in law ?"

2. The facts relating to the case are as under : The assessee is a registered firm carrying on wholesale business in paper. During the previous year relevant to the asst. yr. 1974-75, the assessee consisted of four partners including one minor, who were admitted to the benefits of the partnership. Before the firm came into existence, there was another firm of different constitution and the said firm was

dissolved w.e.f. 31st March, 1973, and the business of the said firm was taken over by the continuing partners w.e.f. 1st April, 1973. The deed of dissolution provided that the outgoing partners were enabled to share the profit of the firm upto the end of 31st March, 1973, and to the amounts standing to their credit in their capital accounts inclusive of their share of profits as at the end of 31st March, 1973. The outgoing partners were also entitled to the commission income of the firm relating to the period prior to their retirement, but not received by the said firm up to the end of 31st March, 1973. There is no dispute about the fact that there were certain transactions in respect of which the old firm earned certain commission but it was not received by the old firm and hence not brought to the books of the old firm. It is also an undisputed fact that in respect of such commission, the continuing partners were authorised to collect and pay the same to the outgoing partners. The authorisation was provided in the deed of dissolution and there is also no dispute that the firm was maintaining its accounts on mercantile basis. The assessee-firm collected during the previous year relevant to the asst. yr. 1974-75 a sum of Rs. 23,293 and credited the same in the P&L a/c and paid to the retired partners the share of Rs. 23,293. The amount paid to the retiring partners was debited in the P&L a/c and it was claimed before the ITO that it represented the expenditure incurred by the assessee-firm for the purpose of its business. The ITO, naturally, disallowed the claim holding that it is not an admissible item of expenditure. The assessee preferred an appeal before the CIT (A) against the order of assessment and the claim for deduction of the amount was altered to a case of diversion of income by overriding title. The CIT (A) held that under the terms of the deed of retirement dt. 31st March, 1973, the right to receive the commission is vested with the retired partners and the deed of retirement created an overriding title in respect of commission to the retiring partners on 31st March, 1973. The CIT (A) placed reliance on the decision of this Court in *V.N.V. Devarajulu Chetty and Co. Vs. The Commissioner of Income Tax*, and the decision of the Bombay High Court in *Commissioner of Income Tax, Bombay City-I Vs. Crawford Bayley and Co.*, , to hold that the sum of Rs. 23,293 cannot be included in the assessment of the firm.

3. Aggrieved by the order of the CIT (A), the Department preferred an appeal before the Tribunal. After considering the facts of the case, the Tribunal came to the conclusion that the continuing partners have no right to retain the commission as the commission was earned during the period prior to the retirement of the partners and the payment made by the assessee-firm came out of obligation imposed by the deed of retirement. The Tribunal, therefore, held that by virtue of obligation created by the deed of retirement, the amount never became part of the assessee's income and that the order of the CIT holding that the said income received by the retiring partners, never belonged to the continuing partners at any point of time and it is not a case of application of income was correct in law. The order of the Income Tax Tribunal is the subject-matter of the present tax case.

4. Mr. S. V. Subramanian, learned senior counsel appearing for the Department,

submitted that the same firm continued and when some of the partners retired, there was only reconstitution of the members of the firm. According to learned senior counsel, the firm earned the income and the other considerations are not quite relevant in taxing the income earned by the firm. According to learned senior standing counsel, when the firm paid the money to the retired partners, it was only an application of its income to its partners. According to learned senior standing counsel that the clause provided in the retirement deed for payment to the retired partners does not divert the income by an overriding title and it is open to the firm to set off its normal expenses against the commission income earned and if a loss has occurred by setting off of the expenses, there would not be any payment to the retired partners. He also placed reliance on a decision of the Supreme Court in *The Commissioner of Income Tax, Bombay City II Vs. Shri Sitaldas Tirathdas*, , and a decision of the Bombay High Court in *The Commissioner of Income Tax Vs. Makanji Lalji*, , and another decision of the Calcutta High Court in *K.C. Bose and Co. Vs. Commissioner of Income Tax*, , and submitted that it was the personal obligation of the continuing partners to pay the money and there is no diversion of income by overriding title.

5. Mr. Janarthana Raja, learned counsel appearing for the assessee, submitted that the commission income was earned by the firm for the period prior to the retirement of the partners on 31st March, 1973, and when the retirement deed was drawn up it was specifically agreed by the retired partners and the continuing partners, that the retired partners would be entitled to the commission income of the firm relating to the period prior to 31st March, 1973. It is submitted that the payment of commission is a part and parcel of the retirement of some of the partners and by virtue of the deed dt. 31st March, 1973, the income was diverted, even before the income was received by the new firm. According to learned counsel for the respondent, the new firm acted merely as a trustee and if the money is not paid, the retired partners have the right to claim the amount and the firm collected the commission income and paid the same to the retired partners. He also submitted that it is not possible to set off the loss or expenditure of the firm against the commission income earned. He placed reliance on a decision of this Court in *V. N. V. Devarajulu Chetty & Co. vs. CIT* (supra), and another decision of the Supreme Court in *CIT vs. Sitaldas Tirathdas* (supra), and submitted that it is a case of diversion of income by overriding title and the commission paid to the retired partners was diverted by overriding title.

6. We have carefully considered the contentions raised by learned senior standing counsel for the Department and learned counsel appearing for the assessee-firm. The clause in the retirement deed provides in no unmistakable terms, that insofar as the commission income of the firm relating to the period prior to the retirement of the partners, but not received by the said firm upto the end of 31st March, 1973, is concerned, the retired partners are alone entitled to the same. In other words, the right to the money or the title to the money vested with the retired partners. Therefore, when the firm received the

commission payment subsequent to 31st March, 1973, for the work done prior to 31st March, 1973, the firm has received it as a trustee for the benefit of the retired partners. The money was received by the firm because there was no privity of contract between the retired partners and the third parties as regards the payment of the commission. The relevant clauses in the deed make it clear that the firm undertook the responsibility of collecting the commission for and on behalf of the retired partners. Therefore, when the firm received the commission income, it has to hand over the entire commission income earned to the retired partners. In that sense, the firm acted merely as an agent or a trustee for the retired partners in the matter of the receipt of the commission for the work done prior to the date of their retirement. In other words the amount sought to be taxed, never reached the assessee as a part of its income and it cannot also be said that the continuing partners received the money in their own right. They have no right over the income and, therefore, it is incorrect to say that the firm earned income or that there was only an application of the income. The true test whether there was an application of income or diversion of income has been laid down by several decisions of the Supreme Court as well as this Court and other Courts. The leading authority on this point is the decision of the Supreme Court in CIT vs. Sitaldas Tirathdas (supra), wherein the Supreme Court laid down the proposition of law on the subject as under :

" . . . the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligations, 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 reaches 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."

7. Applying the tests laid down by the Supreme Court, it is clear that the assessee acted as a collector of others' income, because by virtue of an overriding title the income was diverted even before it was received by the assessee.

Let us now consider the cases relied upon by learned senior counsel for the Department. The decision of the Calcutta High Court in K. C. Bose & Co. vs. CIT (supra), turns upon the facts of the case. On the facts of the case it was found that a personal obligation was imposed on the continuing partners to pay a stipulated sum to the widow of a deceased partner (erstwhile partner) and a charge was also created for fulfilling the personal obligation of the surviving partners. In that factual situation, the Calcutta High Court held that there was no

overriding title, and it was a case of an application of income. The Calcutta High Court noticed a decision of the Bombay High Court in CIT vs. Crawford Bayley & Co. (supra), wherein by the deed of partnership by which the assessee was constituted, it was provided that on the death of any of the partners, his widow would be entitled to a monthly payment, subject to a maximum amount from the continuing acting partners. Two of the partners of the firm died and certain payments were made to the widows of the deceased partners and the Bombay High Court noted that the partnership was to continue indefinitely and that on the death of a partner, the surviving partners would succeed to the share of the deceased in the firm. It was also noticed that the payments made to the widows were not dependent upon the profit or loss of the firm, but there was an absolute obligation in the nature of the trust created which the widows could enforce. It was, therefore, held that such payments were made under an overriding obligation and not includible in the assessable income of the firm. We are of the opinion that the decision of the Bombay High Court is applicable to the facts of the case rather than the decision of the Calcutta High Court in K. C. Bose & Co.'s case (supra). In the decision before the Calcutta High Court, a personal obligation was imposed on the surviving partners and only in discharge of the personal obligation of the surviving partners, certain payments were made. However, on the facts of this case, it is seen that by virtue of the deed of retirement, the title to the money, that is commission earned by the firm prior to 31st March, 1973, vested with the retired partners and the firm paid the money to the retired partners as a trustee. It is not a case of a firm, which received money and then paid certain sum in discharging some personal obligation of the continuing partners. On the other hand, the situation herein is that the retired partners had a vested title to the commission money and the assessee-firm collected the money on their behalf and paid the same to the retired partners. Hence, the decision of the Calcutta High Court on which heavy reliance was placed by learned standing counsel has no application to the facts of the case.

8. Similarly, the decision of the Bombay High Court in the case of Commissioner of Income Tax Vs. V.G. Bhuta, , is also not helpful to the Revenue. The Bombay High Court was dealing with a case of payment by the surviving partners to the widow of the deceased partner and the payments consisted of the three kinds of payments, (i) share of profit of the deceased accrued up to his death; (ii) an amount equal to the share of profit which would have accrued to him for a period of one year from the date of his death; and (iii) payment of amount towards the price of the share of the deceased partner of the partnership business. The Bombay High Court in the factual situation held that if the surviving partners wanted to take the share of the deceased partner and continue the partnership business, the relevant clause imposed an obligation on the surviving partners to pay the said amount. The Bombay High Court, therefore, held that it was a case of application of income that accrued to the surviving partner. The Bombay High Court, in the case, cited supra, distinguished the earlier decision in the case of CIT vs. Crawford Bayley & Co. (supra), on the ground that an absolute obligation

was imposed on the surviving partners to pay to the widow of the deceased partner under the partnership deed even if there was no profit in a particular year. The decision of the Bombay High Court in the case of V. G. Bhuta (supra), is clearly distinguishable, because in that case there was no absolute obligation on the part of the surviving partners to pay money, but, on the other hand, the deed of partnership in the instant case clearly imposed an absolute obligation on the surviving partners to realise the commission that accrued up to the date of retirement and pay the same to the retired partners. This obligation has to be discharged irrespective of the fact whether the assessee-firm had made a profit or not and, equally the retired partners have an enforceable right to receive the said commission. The obligation, on the part of the assessee to pay to the retired partners would arise upon the receipt of the commission and it must also be remembered that the commission was earned for the work done prior to their retirement. The substance of the entire transaction is that the assessee-firm was collecting money as a trustee for and on behalf of the retired partners. The finding of the Tribunal on the facts clearly establishes that when the assessee collected the money, there was an existing liability to pay commission to the retired partner and the important feature is that it is not possible or permissible for the assessee to set off its expenditure against the commission amount collected by the assessee. Though the conduct of the assessee in taking the said receipt to its P&L a/c may not be correct and not in accordance with the stand of the assessee, once it is held that the amount received is not the profit or the loss of the assessee, the consequence would be that the assessee has collected the money, not as its business income, and it cannot be treated as revenue receipt as well. The assessee, as already seen, as soon as the amount is collected, has to hand over the money without anything further to be done to the retired partners. In the instant case, there is a clause in the deed of retirement which provides that the assessee collected the money on behalf of the retired partners and the money belonged to the retired partners. The disbursement made by the assessee can only be regarded as an incident of diversion by overriding title. Therefore, we have no hesitation in holding that there is an absolute obligation imposed on the continuing partners to hand over the commission to the retired partners and the income was diverted by overriding title. In a similar situation, in V. N. V. Devarajulu Chetty & Co. vs. CIT (supra), this Court has held that where a new firm which merely collected the money on behalf of the old firm and bank the same to the new firm (sic), the new firm cannot be assessed. According to us, the Tribunal has correctly come to the conclusion that the commission paid to the retired partners was not includible in the total income of the assessee. Accordingly, we answer both the questions in the affirmative and against the Department. The assessee will have the cost of the reference which is fixed at Rs. 500.