

(2004) 08 AHC CK 0179
In the Allahabad High Court
Case No : IT Ref. No. 152 of 1984

Commissioner of Income Tax

APPELLANT

Vs

Varanasi Nagar Vikas

RESPONDENT

Date of Decision : 31-08-2004

Acts Referred:

Income Tax Act, 1961 — Section 4
Partnership Act, 1932 — Section 37

Citation : (2004) 192 CTR 323 : (2005) 275 ITR 140

Hon'ble Judges : R.K. Agrawal, J;K.N. Ojha, J

Bench : Division Bench

Advocate : Shambhoo Chopra, for the Appellant; Abhinav Upadhyaya, for the Respondent

Judgement

R.K. Agrawal, J.—The Tribunal, Allahabad, has referred the following question of law u/s 256(1) of the IT Act, 1961 (hereinafter referred to as "the Act"), for opinion to this Court ;

"Whether, on the facts and in the circumstances of the case, the finding of the Tribunal that the assessee is entitled to claim a deduction of Rs. 62,865 is legally correct ?"

2. Briefly stated, the facts giving rise to the present reference are as follows :

The reference relates to the asst. yr. 1977-78. The respondent-assessee is a firm originally consisting of the following partners :

1. Shri Hari Prasad
2. Smt. Uma Devi
3. Shri Jiwat Ram Sharma
4. Shri Jai Kishan Sharma (son of No. 3)
5. Shri Risat Das

6. Smt. Manjoo Jain

7. Shri Shyam Sunder Das

8. Shri Madan Mohan Das

As per the terms of the deed, the heirs of the deceased partner were to step into the shoes of the deceased partner. Shri Jiwat Ram Sharma died on 11th May, 1975, and the firm closed its accounts upto 10th May, 1975. On 29th May, 1975, Smt. Savitri Devi and Shri Jai Kishan Sharma, wife and son of late Shri Jiwat Ram Sharma, gave a notice to retire from the firm, Accounts were again closed on 31st May, 1975. On 1st June, 1975, fresh deed of partnership was executed by the remaining partners along with Shri Jagmohan Das. The period of notice given by Smt. Savitri Devi and her son expired on 1st Sept., 1975. Thereafter, accounts were settled and Rs. 70,000 being the capital plus interest, were paid to Smt. Savitri Devi and her son on 4th Oct., 1975. Further, on 6th Oct., 1975, Smt. Savitri Devi was paid Rs. 41,910 and Shri Jai Kishan Sharma was paid Rs. 20,955 in addition to the capital and interest. The respondent claimed deduction of above amount of Rs. 62,865. The ITO did not accept the claim on the ground that liability should have been claimed in the asst. yr. 1976-77 as the respondent was following mercantile system of accounting.

Against the assessment order, the respondent preferred an appeal before the CIT(A). He did not accept the reasoning of the ITO for disallowing the respondent's claim for deduction of Rs. 62,865. He did not agree with the ITO that the "payment made to a retiring partner over and above his capital is an admissible deduction in the hands of the firm". As such, he was of the opinion that the payment made to Smt. Savitri Devi and Jai Kishan Sharma, was not an allowable deduction either u/s 28 or Section 37 of the Act. Accordingly, he dismissed the appeal.

Being aggrieved by the said order of the CIT(A), the respondent preferred a further appeal to the Tribunal. The Tribunal noticed that there were no sales during the period 1st July, 1974 to 10th May, 1975, and 11th May, 1975 to 31st May, 1975. The Tribunal also observed that there were some sales during the period 1st June, 1975 to 30th June, 1975, but the same belonged to remaining partners as Smt. Savitri Devi and Shri Jai Kishan Sharma had already given a notice that their accounts be settled. The Tribunal further observed that settlement was arrived at on 4th Oct., 1975, in the accounting year relevant to the assessment year under appeal and, therefore, after receiving Rs. 62,865, these two persons executed a release deed. The Tribunal further held that the remaining partners continued to use the capital and stock-in-trade in which these two persons had an interest. The Tribunal, therefore, held that the respondent was entitled to claim deduction of Rs. 62,865. As a result, the Tribunal allowed to that extent appeal and deleted the addition of Rs. 62,865.

3. We have heard Sri Shambhoo Chopra, the learned standing counsel for the Revenue, and Sri Abhinav Upadhyaya, the learned counsel for the Respondent.

4. The learned counsel for the Revenue submitted that Smt. Savitri Devi never opted to become a partner of the firm and Shri Jai Kishan Sharma was held to be a benamidar of late Jiwat Ram Sharma. Since the respondent was following the mercantile system of accounting upto 30th June, 1975, in any case, the respondent was not entitled to claim deduction of the entire amount of Rs. 62,865 in the year under consideration, The payments cannot be said to be for using of the share of partnership asset of Smt. Savitri Devi and Shri Jai Kishan Sharma because after their separation from the firm, the asset ceased to belong to them and they merely wanted proportionate profit being paid to them upto 31st May, 1975.

5. Sri Upadhyaya, the learned counsel for the respondent, has, however, submitted that as the asset of the erstwhile firm was being used, the respondent was liable to make good the proportionate profits to the heirs of the deceased partner, which was an overriding title and, therefore, was allowable as deduction. He referred to Section 37 of the Indian Partnership Act, 1932.

6. Having heard the learned counsel for the parties, we find that after the death of one of the partners, Jiwat Ram Sharma, his heirs, namely, his widow Smt. Savitri Devi and son Shri Jai Kishan Sharma, did not step into the shoes of Jiwat Ram Sharma as they did not choose to become partners. It may be mentioned here that Shri Jai Kishan Sharma had been held to be not a genuine partner. The widow and Jai Kishan gave retirement notice on 29th May, 1975, for settling of accounts from 11th May, 1975 to 31st May, 1975. The notice period expired on 1st Sept., 1975. A settlement was arrived at between Smt. Savitri Devi and Shri Jai Kishan Sharma on one side and the respondent, on the other side, to pay Rs. 70,000 to the widow and the son of late Jiwat Ram Sharma inclusive of their capital plus interest. However, at the time of execution of the release deed on 6th Oct., 1975, which was w.e.f. 1st June, 1975, these two persons were paid a total sum of Rs. 62,865 also. It has also come on record that the respondent had received advances against plots. There was some dispute regarding the valuation of the plots, which were shown as closing stock on 10th May, 1975. The amount in question represents the difference in valuation of these plots. u/s 37 of the Indian Partnership Act, 1932, an outgoing partner has a right to such share of the profits made since he ceased to be a partner, as may be attributable to the use of his share of the property of the firm or to interest @ 6 per cent per annum on the amount of his share in the property of the firm. Thus, after the death of Jiwat Ram Sharma and the retirement notice given by the heirs of Jiwat Ram Sharma, the plots which were already with the existing firm, they had a right to share the profits in respect of the plots which the existing firm had. The profits have been assessed at Rs. 62,865 on the basis of the valuation.

7. The apex Court in the case of The Commissioner of Income Tax, Bombay City II Vs. Shri Sitaldas Tirathdas, has set out the classic statement of the true principle of diversion of income as follows :

"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 by the nature of the obligation 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 (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 (self-imposed and gratuitous) 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 reaches 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."

8. In the case of *Moti Lal Chhadami Lal Jain Vs. Commissioner of Income Tax, Delhi*, , the apex Court has held that the existence of a mere obligation is not sufficient to constitute diversion of income. It has held as follows :

"In the above passage, it is clear that the expressions "reaches the assessee" and "has been received" have been used not in the sense of the income being received in cash by one person or another. What the passage emphasises is the nature of the obligation by reason of which the income becomes payable to a person other than the one entitled to it. Where the obligation flow out of an antecedent and independent title in the former (such as, for example, the rights of dependants to maintenance or of coparceners on partition, or rights under a statutory provision, or an obligation imposed by a third party and the like), it effectively slices away a part of the corpus of the right of the latter to receive the entire income and so it would be a case of diversion. On the other hand, where the obligation is self-imposed or gratuitous (as here), it is only a case of an application of income."

9. In the case of *CIT vs. Sunil J. Kinariwala*, (2003) 259 ITR 10, the apex Court, after referring to the decisions of the Privy Council in the cases of *Raja Bejoy Singh Dudhuria vs. CIT* (1933) 1 ITR 135 and *P.C. Mullick and Anr. (Executors) vs. CIT* (1938) 6 ITR 206 , of the apex Court in the cases of *K.A. Ramachar and Another Vs. Commissioner of Income Tax, Madras*, , *Commissioner of Income Tax, Madras Vs. Bagyalakshmi and Co., Udamalpet*, and *Fatehchand Murlidhar and Another Vs. Commissioner of Income Tax, Calcutta*, , has held that if a third person becomes entitled to receive an amount under an obligation of an assessee even before he could (make) a claim to receive it as his income, there would be a diversion of income by overriding title; but when after receipt of the income by the assessee, the same is passed on to a third person in discharge of the obligation of the assessee, it will be a case of application of income by the assessee and not of diversion of income by overriding title.

10. Applying the principle laid down by the apex Court in the. present case, we find that the respondent had sold the plots worth Rs. 5,69,364.93 during the relevant assessment year and the profit therefrom was distributed amongst the

existing partners, and Smt. Savitri Devi and Shri Jai Kishan Sharma were paid aggregate amount of Rs. 62,865 as per agreement/release deed executed on 6th Oct., 1975. Thus, the sum of Rs. 62,865 representing the interest of the heirs of the erstwhile partner in respect of the share in the firm, which has been utilised by the respondent after their retirement and in view of Section 37 of the Indian Partnership Act, 1932, they were entitled for the said amount. It created an overriding title. Thus, the said amount had rightly been allowed by the Tribunal.

11. In view of the foregoing discussion, we answer the question of law referred to us in the affirmative, i.e., in favour of the assessee and against the Revenue. However, there shall be no order as to costs.