

(1979) 08 KAR CK 0014

In the Karnataka High Court

Case No : Income-tax Reference Case No. 98 of 1976

Sangam Silks

APPELLANT

Vs

Commissioner of Income Tax, Karnataka

RESPONDENT

Date of Decision : 03-08-1979

Acts Referred:

Income Tax Act, 1961 — Section 143, 144, 187, 256 (2)

Citation : (1980) 14 CTR 202 : (1980) 122 ITR 479

Hon'ble Judges : M. Rama Jois, J;D.M. Chandrashekhar, J

Bench : Division Bench

Advocate : B.P. Gandhi, for the Appellant; S.R. Rajasekhara Murthy, for the Respondent

Judgement

Rama Jois, J.—Whether, on account of any change brought about in the constitution of a partnership firm during an accounting year preceding an assessment year, s. 187 of the I.T. Act, 1961 (hereinafter referred to as "the Act"), requires the Income Tax authorities to make separate assessments, one for the period commencing from the accounting year up to the date of reconstitution of the firm and another for the period commencing from the date of such reconstitution till the end of the accounting year or a single assessment, on the reconstituted firm, is the question of law that arises for consideration in this reference made by the Income Tax Appellate Tribunal, Bangalore Bench, Bangalore (hereinafter referred to as "the Tribunal"), pursuant to an order made by this court under s. 256(2) of the Act.

2. The brief and undisputed facts of the case relevant for answering the reference are these : M/s. Sangam Silks, Bangalore, the assessee, is a partnership firm. The assessment year concerned is 1971-72. During the relevant accounting year ending March 31, 1971, there was a reconstitution of the firm on June 12, 1970. Prior to June 12, 1970, the firm consisted of three partners, namely, V. Pandurangaiah. G. Srinivasulu Shetty and P. R. Sathyanarayana Shetty. On June 12, 1970, P. R. Sathyanarayana Shetty went out

of the firm by executing a release deed. On the same date two other partners entered into the partnership firm. They are P. S. Ramachandra Shetty and K. N. Srinivasa Shetty. Thus, the new firm consisted of four partners out of whom who were partners prior to June 12, 1970. The firm continued its business during the accounting year. For the assessment year 1971-72 the firm filed two separate returns, one for the period commencing from April 1, 1970; to June 12, 1970, and another for the period commencing from June 13, 1970, to March 31, 1971. The ITO made a single assessment on the reconstituted firm clubbing the income for both the periods. Aggrieved by the order, the assessee preferred an appeal before the AAC who affirmed the order of assessment. The further appeal by the assessee to the Income- tax Appellate Tribunal also met with failure. Thereafter, on a petition made to this court under s. 256(2) of the Act, this court directed the Tribunal to refer the following question for the opinion of this court :

"Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that the provisions of section 187 of the Income Tax Act, 1961, apply to the case ?"

3. Accordingly, the Tribunal has drawn up the statement of the case and has referred the above question for the opinion of this court.

4. Sri B. P. Gandhi, learned counsel for the assessee, raised the following contentions :

(i) Section 187 of the Act has no application to this case.

(ii) Even if s. 187 of the Act applies to this case, the said section only authorises the making of two separate assessments, one for the period up to the date of reconstitution of the firm and another for the rest of the period and it does not authorise the clubbing of the income of the firm before its reconstitution with its income after its reconstitution and the making of one assessment.

5. Learned counsel for the assessee submitted that though the question referred covers only the first contention urged for the assessee, the real controversy between the assessee, and the revenue consists of both the contentions urged for the assessee. From the order of the Tribunal, it is clear that the assessee had raised both the contentions before it and in fact the second contention was its main point. Sri. S. R. Rajasekhara Murthy, learned counsel appearing for the revenue, also stated that the question as framed did not cover the second contention urged for the assessee and he did not dispute that it was the main contention urged before the Tribunal. In the circumstances, the learned counsel for the assessee parties for reframing the question so as to include the second contention also. He submitted that in reference made under s. 256 of the Act, it is open to this court to reframe the question so as to bring forth the real issue between the parties. This is also the view taken by the Patna High Court in the case of Ramcharitarram Harihar Prasad Vs. Commissioner of Income Tax, . In the circumstances, learned counsel for both the parties agreed to the reframing of the question as required and accordingly we reframe the question as follows :

"Whether, on the facts and in the circumstances of the case, the Tribunal was justified in upholding the action of the Income Tax Officer in making one assessment for the period from April 1, 1970, to March 31, 1971, on the assessee or whether the Tribunal should have held that the Income Tax Officer should have made two separate assessments, one for the period from April 1, 1970, up to June 12, the date of reconstitution of the firm, and another assessment for the period from June 13, 1970, up to March 31, 1971 ?"

6. In order to appreciate the two contentions raised for the assessee, it is necessary to set out the provisions of ss. 187 and 188 of the Act. They read thus;

"187. (1) Where at the time of making an assessment u/s 143 or section 144 it is found that a change has occurred in the constitution of a firm, the assessment shall be made on the firm as constituted at the time of making the assessment :

Provided that -

(i) the income of the previous year shall, for the purposes of inclusion in the total incomes of the partners, be apportioned between the partners who, in such previous year, were entitled to receive the same; and

(ii) when the tax assessed upon a partner cannot be recovered from him, it shall be recovered from the firm as constituted at the time of making the assessment.

(2) For the purposes of this section, there is a change in the constitution of the firm -

(a) if one or more of the partners cease to be partners or one or more new partners are admitted, in such circumstances that one or more of the persons who were partners of the firm before the change continue as partner or partners after the change; or

(b) where all the partners continue with a change in their respective shares or in the shares of some of them."

"188. Where a firm carrying on a business or profession is succeeded by another firm, and the case is not one covered by section 187, separate assessments shall be made on the predecessor firm and the successor firm in accordance with the provisions of section 170."

7. The aforesaid two sections form part of the special provisions applicable to firms, incorporated in Chap. XVI of the Act. Sub-section (1) of s. 187 provides that in the case of a firm where it is found at the time of making assessment either under s. 143 or under s. 144 of the Act, that a change has occurred in the constitution of the firm, the assessment shall be made on the firm as constituted at the time of making the assessment. There is a proviso to sub-s. (1). It has two clauses. The effect of the first clause is that though the assessment is required to be made on the reconstituted firm, as existing at the time of making the assessment, for purposes of inclusion of total incomes of the partners for the previous year, it should be apportioned between all the partners, who in such

previous year were entitled to receive the same. According to the second clause, when taxes assessed upon any partner could not be recovered from him, it should be recovered from the firm as constituted at the time of making assessment. Sub-section (2) sets out the circumstances which should be regarded as having brought about a change in the constitution of the firm. Clause (a) of sub-s. (2) provides that if one or more of the partners cease to be partners or one or more new partners are admitted, in such circumstances, when one or more partners of the firm before the change continue as partner or partners after the change or where the partners continue after the change with their respective shares or in the shares of some of them, it shall be construed as having brought about a change in the constitution of the firm. Section 188 of the Act provides that in cases where a firm carrying on a business or profession is succeeded by another firm and the case is not one covered by s. 187 of the Act, separate assessment shall be made on the predecessor firm and the successor firm in accordance with the provisions of s. 170 of the Act.

8. In the present case, as can be seen from the facts of the case, only one of the three partners of the firm went out on June 12, 1970. On the same date two other partners got into the partnership. The resultant position was two other partners of the firm before the change continued to be partners of the firm along with two other new partners. Therefore, this is a case of change in the constitution of the firm and it squarely falls under the provisions of s. 187(2) of the Act.

9. In the present case, as can be seen from the facts of the case, only one of the three partners of the firm went out on June 12, 1970. On the same date two other partners got into the partnership. The resultant position was two partners of the firm before the change continued to be partners of the firm along with two other new partners. Therefore, this is a case of change in the constitution of the firm and it squarely falls under the provisions of s. 187(2) of the Act.

10. Learned counsel for the assessee, however, contended that it is only in cases where one or more partners cease to be partners or one or more partners are admitted, the case comes under the description of "change in constitution" given in sub-s. (2) of s. 187, but in a case where both the events, namely, one or more of the partners going out and one or more partners getting into the firm takes place, the case would not be covered by the description of "change in the constitution of the firm" given in sub-s. (2) of s. 187 of the Act. In that view he submitted that in the present case, since one partner went out and two partners got into the firm on June 12, 1970, the case is not governed by sub-s. (2) of s. 187 and consequently sub-s. (1) of s. 187 has no application.

11. In our view the first contention is devoid of any merit. According to sub- s. (2) of s. 187 of the Act, the change in constitution takes place either by one or more partners going out of the firm or by one or more partners entering into the partnership. Both the events have occurred in this case. It is not correct to suggest that only one of the events should happen, and not both, for bringing

the case under sub-s. (2) of s. 187 of the Act. If either of the events is sufficient to bring about a change in the constitution of the firm for the purposes of s. 187, the effect of happening of both the events cannot be different. Hence, we reject the first contention.

12. As regards the second contention raised for the assessee, the question is not *res integra*. A similar question came up for consideration before a Division Bench of this court in *Karupukula Suryanarayana Shetty and Sons Vs. Commissioner of Income Tax, Mysore*, . There, this court held that in cases where the change has occurred in the constitution of the firm, the assessment has to be made on the firm as reconstituted at the time of making the assessment in view of s. 187(1) of the Act. It was also held that to such a case the provisions of s. 188 of the Act are not attracted. The said decision fully covers the second contention urged for the assessee, however, and is against it.

13. Learned counsel for the assessee, however, maintained that certain aspects were not brought to the notice of this court in the aforesaid case and, therefore, the said judgment requires reconsideration. He argued that though s. 187(1) requires the making of an assessment on the reconstituted firm, there is no indication in the said sub-section that the income of the firm before its reconstitution and the income of the firm after its reconstitution, should be clubbed together for the purpose of making an assessment. He further submitted that the sole object of sub-s. (1) of s. 187 was to make the reconstituted firm liable for payment of tax by the firm before its reconstitution and not to include the income of the firm before its reconstitution in the income of the firm after its reconstitution. In support of his submission he relied on the decision of a Division Bench of the Allahabad High Court in *Commissioner of Income Tax Vs. Shiv Shanker Lal Ram Nath*, , wherein the facts were very similar to the facts of this case. There, it was held that s. 187 of the Act, even by implication, did not create a fiction that the income derived by the old firm becomes the income of the reconstituted firm, but the section made the new firm liable to be assessed in respect of the income derived by the old firm. Their Lordships noticed the difference between s. 188, which provided for making separate assessment in the case of succession of one firm by another not covered by s. 187 and also s. 187(1) of the Act which requires the making of an assessment on the reconstituted firm, and held that merely because there is no provision in s. 187 for assessing two different persons as in s. 188, it does not follow that s. 187 contemplates only one assessment being made on the new firm. Learned counsel for the assessee urged that the view of this court in *Karupukula Suryanarayana Shetty and Sons Vs. Commissioner of Income Tax, Mysore*, .

14. In our opinion, the language of ss. 187 and 188 does not give any scope for such interpretation. Section 187 is a special provision incorporated in the Act providing for the making of assessment on the reconstituted firm as existing at the time of making the assessment in cases where there has occurred a change in the constitution of the firm. Sub-section (2) of s. 187 of the Act specifically

defines as to what "the change in the constitution" means for the purpose of s. 187. It may be that under the provisions of the Partnership Act every change of partners brings into existence a new firm. But s. 187 treats the firm before its reconstitution and as reconstituted as one and the same "person" for purposes of making the assessment. Thus, under the provisions of the Act, the firm is treated as a separate and distinct entity and independent from its partners and it continues to exist notwithstanding the change in its composition if such change is one of the types mentioned in s. 187(2). In this behalf, we may refer to the observation of the Supreme Court in *Shivram Poddar Vs. Income Tax Officer, Central Circle II, Calcutta, and Another*, wherein the Supreme Court was interpreting the corresponding provisions in the Indian I.T. Act, 1922. The relevant portion of the judgment reads (pp. 827, 828) :

"Under the ordinary law governing partnerships, modification in the constitution of the firm in the absence of a special agreement to the contrary amounts to dissolution of the firm and reconstitution thereof, a firm at common law being a group of individuals who have agreed to share the profits of a business carried on by all or any or them acting for all, and supersession of the agreement brings about an end of the relation. But the Income Tax Act recognises a firm for purposes of assessment as a unit independent of the partners constituting it; it invests the firm with a personality which survives reconstitution. A firm discontinuing its business may be assessed in the manner provided by section 25(1) in the year of account in which it discontinues its business : it may also be assessed in the year of assessment. In either case it is the assessment of the income of the firm. Where the firm is dissolved, but the business is not discontinued, there being change in the constitution of the firm, assessment has to be made u/s 26(1), and if there be succession to the business, assessment has to be made u/s 26(2). The provisions relating to assessment on reconstituted or newly constituted firms, and on succession to the business are obligatory."

15. The above observations equally apply to the provisions of Chapter XVI of the Act and particularly to ss. 187 and 188 of the Act, which correspond to sub-ss. (1) and (2) of s. 26 of the Indian I.T. Act, 1922. Therefore, the object of s. 187 is to treat the reconstituted firm same as the firm before its reconstitution notwithstanding the change of one or more partners. Obviously, this section is aimed at prevention of evasion of the liability of partnership firms to pay tax on the basis of the total income of a given year by merely substituting one or more partners in the middle of the year and creating two or more taxable entities and filing separate returns in the names of such firms. Section 187, therefore, provides that the reconstituted firm existing at the time of making the assessment alone should be assessed for the relevant assessment year. Therefore, we are unable to agree with the view taken by the Division Bench of the Allahabad High Court in *Commissioner of Income Tax Vs. Shiv Shanker Lal Ram Nath*, on which reliance was placed for the assessee. Further, it should be pointed out that a Full Bench of the same High Court in an earlier case, *Dahi*

Laxmi Dal Factory Vs. Income Tax Officer and Another, , had taken a contrary view which has not even noticed by the Division Bench. In Dahi Laxmi Dal Factory's case, the majority view expressed at page 524 is as follows :

"It is not correct to say that section 187 is merely a machinery section and is not a charging section. It may not be charging section in the sense that it does not by itself authorise the imposition of tax but nevertheless it does affect the liability of a person to pay the tax. By virtue of this section the reconstituted firm which in a sense is a new firm becomes liable to pay the tax for the whole year even though a part of the tax would be payable by the erstwhile firm."

16. The majority also agreed with the view of the Kerala High Court in Excel Productions, Alleppey Vs. The Commissioner of Income Tax, Kerala, Ernakulam, in which a similar contention was negatived by the Kerala High Court and which view has been accepted by this court in Karupukula Suryanarayana Shetty and Sons Vs. Commissioner of Income Tax, Mysore, . A Full Bench of the Punjab and Haryana High Court in Nandlal Sohanlal, Jullundur Vs. The Commissioner of Income Tax, Patiala, has also taken a similar view.

17. Learned counsel for the assessee, however, submitted that every change in the constitution of a firm brings into existence a new firm, and, therefore, separate assessments on the old firm and the new firm must be made. In support of this submission, he relied on a Division Bench decision of this court in Commissioner of Income Tax, Mysore Vs. Bharat Engineering and Construction Co., , which arose under the corresponding provision of the 1922 Act, particularly on the observation made in the judgment to the effect that every change made in the constitution of a partnership brings into existence a new firm. We do not think that the said observation is of any assistance to the assessee. Sub-section (2) of s. 187 specifically states the circumstances which should be treated as bringing about only a change in the constitution of the firm. In view of the provisions of s. 187(2), it cannot be contended that any of the changes in the constitution of a firm of the nature mentioned therein brings into existence a new firm. Further, in the case of Karupukula Suryanarayana Shetty and Sons Vs. Commissioner of Income Tax, Mysore, also, reliance was placed for the assessee therein on the said observation and the Division Bench held that that decision did not lay down that whenever there is a change in the constitution of a firm two separate assessments are to be made.

18. There is no substance in the submission made for the assessee that s. 187(1) only makes the reconstituted firm liable to pay tax of the firm before its reconstitution, but does not authorise the making of one assessment for the whole year on the reconstituted firm. In this behalf it is sufficient to point out that s. 187(1) only speaks of making the assessment on the firm as reconstituted at the time of making the assessment and says nothing about the recovery of the tax due from the firm before its reconstitution. If the intention was that two assessments should be made, the Legislature would have also provided for collecting the tax due from the firm before its constitution from the

firm as reconstituted. In this behalf, it is significant to note that under sub-clause (ii) to the proviso to s. 187(1) specific provisions has been made for the recovery of tax assessed against a partner, from the reconstituted firm, if it cannot be recovered from him. There is no such provision for the recovery of tax assessee against or payable by the firm before its reconstitution at the hands of the reconstituted firm. Absence of such provision is obviously for the reason that s. 187(1) contemplates the making of only one assessment for the entire concerned previous year on the reconstituted firm. Therefore, there is nothing in the wording of s. 187 which persuades us to take the view that two assessments should be made for the two periods, and the total tax assessed for both periods should be collected from the reconstituted firm.

19. Lastly, learned counsel for the assessee argued that unless separate assessments are made on the firm before its reconstitution and after its reconstitution, it would be difficult to work out the apportionment of income between the partners which is required to be made under the proviso to s. 187(1) of the Act and according to him this gives the clearest indication that there should be separate assessments. We are not impressed by this argument either. While sub-s. (1) of s. 187 of the Act provides for making assessment on the reconstituted firm, the proviso there under clearly indicates that the income of the previous year has to be apportioned between all the partners who were entitled to receive the same during such previous year. We do not find that there would be any difficulty in making the apportionment when the entire accounts of the firm before its reconstitution and after its reconstitution is available. Therefore, we see nothing in the proviso which implies that under sub-s. (1) of s. 187 of the Act there should be two separate assessments. In the light of the discussion as above, we hold that in the case of change of constitution of a partnership firm occurring in any accounting year in any of the manners set out in sub-s. (2) of s. 187 of the Act, sub-s. (1) of that section requires that the assessment should be made on the firm as constituted at the time of making the assessment, and not two separate assessments, one on the firm before reconstitution and another on the firm as reconstituted, and we reiterate the view taken by this court in *Karupulula Suryanarayana Shetty's case* [1973] ITR 141.

20. For the reasons aforesaid, we reject the contentions urged for the assessee and answer the reference as follows :

On the facts and in the circumstances of the case, the Tribunal was justified in upholding the action of the ITO in making one assessment for the period from April 1, 1970, to March 31, 1971, on the assessee-firm.

21. The assessee shall pay the costs of the revenue. Advocate's fee Rs. 250.