

SUWALAL ANANDILAL JAIN

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v.

COMMISSIONER OF INCOME TAX, BIHAR, RANCHI

MARCH 10, 1997

[A.M. AHMADI, CJ., SUJATA V. MANOHAR AND
K. VENKATASWAMI, JJ.]

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Income Tax Act, 1961 : Section 40(b) Explanation 2 (added in 1984).

Income Tax—Deductions—AY 1976-77—Assessee-firm comprised of partners in their capacity as Kartas of their respective HUFs—Such partners invested their personal funds in the assessee-firm—Held : Interest paid by the firm to such partners on deposits made by them in their individual capacity even prior to 1.4.1978 was an allowable deduction by virtue of Expln. 2 to S. 40(b).

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The assessee-firm comprised of partners in their capacity as Kartas of their respective HUFs. The said partners had advanced monies to the assessee-firm in their individual capacity. The assessee-firm paid interest to them on the interests made in their respective individual capacity. For the assessment year 1976-77 the assessee-firm claimed that the interest paid to such partners was an allowable deduction by virtue of Explanation 2 to Section 40(b) of the Income Tax Act, 1961. The Income Tax Officer (ITO) disallowed the claim. The Income Tax Appellate Tribunal confirmed the view taken by the ITO. In view of the divergence of views among the High Courts on the application of S. 40(b) of the Act, issue has been referred to this Court, under S. 257 of the Act.

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Answering the reference in favour of the assessee, this Court

HELD : 1. Section 40(b) of the Income Tax Act, 1961 is based upon, and is a recognition of, the basic nature of relationship between a firm and its partners. Explanation 2 to Section 40(b) of the Act is merely declaratory in nature. Accordingly even for the period anterior to 1.4.1985, any interest paid to a partner, who is a partner representing his HUF on the deposit of his personal/individual funds, does not fall within the mischief of Section 40(b) of the Act. [796-D, 797-D]

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A *Brij Mohan Das laxman Das v CIT, JT (1997) 1 SC 155, relied on.*

Gajanand Poonam Chand & Bros. v. CIT, (1984) 174 ITR 346 (Raj.), approved.

CIT v. Chidambaram Pillai, (1977) 106 ITR 292, referred to.

B *Makhan Lal Hamarayan v. CIT, Tax Case No. 83- 84 of 1971 (Pat.), overruled.*

CIVIL APPELLATE JURISDICTION : Tax Reference Case No. 1 of 1993.

C From the Order dated 22.9.81 of the Income Tax Appellate Tribunal, Patna in I.T.A. No. 871 (Pat.) of 1980.

A. Subba Rao for the Applicant.

D A. Raghuvir, Ms. Lakshmi Iyengar and B.K. Prasad for the Respondent.

The Judgment of the Court was delivered by

E **K. VENKATASWAMI, J.** The question that has been referred to this Court under Section 257 of the Income Tax Act, 1961 (hereinafter called "the Act") reads as follows :

"Whether on the facts and circumstances of the case, the assessee's claim to the benefit of clause (b) of Section 40 of the Income Tax Act, 1961 has been rightly disallowed?"

F The assessment year in question is 1976-77. The case of the assessee firm was that M/s. Shanti Kumar Jain, Asok Kumar Jain, Raj Kumar Jain and Niranjana were partners in the firm in their capacity as Karta of respective HUF. They have advanced monies to the assessee firm in their individual capacity. The assessee firm paid interest to them on the investment made in their respective individual capacity. It is the further case of the assessee firm that it has maintained two separate ledger accounts of the partners : one of individual as loan creditor and another of Karta of HUF as partner in the firm. The sources of the money, according to the assess, are quite separate. The assessee firm claimed that the interest paid
H to them shall not be included while computing the income chargeable

under the head "profits and gains of business or profession". Notwithstanding such claim, the Income Tax Officer applied Section 40((b) of the Act and completed the assessment by Order dated 29.1.1978. The result was that the interest paid to the partners in the circumstances stated above was included under the head "profits and gains of business or profession".

On appeal to the Appellate Assistant Commissioner, the assessment was confirmed by an Appellate Order dated 27.8.1980. Still aggrieved, the assessee firm preferred further appeal to the Income Tax Appellate Tribunal. The Tribunal relying upon an unreported decision of the Patna High Court in Tax Case No. 83-84 of 1971 in the case of *M/s. Makhan Lal Harnarayan v. Commissioner of Income Tax, Bihar*, confirmed the view taken by the Income Tax Officer and Upheld by the Appellate Assistant Commissioner. In view of the Divergence of views among the High Courts on the application of Section 40(b) of the Act, the issue has been referred to this Court.

We have heard counsel on both sides.

Under identical circumstances, this Court in *M/s. Brij Mohan Das Laxman Das v. Commissioner of Income Tax, Amritsar*, JT (1997) 1 SC 155, had occasion to consider an identical issue. Jeevan Reddy, J. speaking for the Bench after noticing the subsequent amendment to Section 40 by Taxation Law (Amendment) Act, 1984, Under which Explanation (2) *inter alia* has been added, has observed as follows :

"In *Gajanand Poonam Chand v. Commissioner of Income Tax*, (1984) 174 I.T.R. 346, the Rajasthan High Court has taken a view that the said Explanation is merely declaratory in nature and that, therefore, even for the assessment prior to April 1, 1985, the position of law should be understood to be the same. In support of this proposition, the High Court relied upon the fact that ordinarily the purpose of an Explanation is to clarify that which is already enacted and not to introduce something new. The High Court opined that the Explanation was inserted by the Parliament with a view to settle the controversy as to the meaning and effect of the said clause among the several High Courts and that the Explanation puts a seal of approval on the view taken by the majority of the High Courts. The High Court also referred to the definition of "person" in clause (31) of Section 2. It pointed out that

A the definition shows clearly that an individual, a H.U.F. and a firm are distinct persons/entities for the purpose of the Income Tax Act. The High Court, therefore, concluded that since an individual and a H.U.F. are two distinct entities for the purpose of the Act, clause (b) of Section 40 has no application where the interest is paid to the partner on deposits made by him with the firm in his individual capacity where such person is a partner not in his individual capacity but as representing a H.U.F. Sri G.C. Sharma, learned counsel for the appellant-assessee, strongly relies upon this decision and commends it for our acceptance. Learned counsel points out that even before the enactment of Taxation Law (Amendment) Act, 1984 (which inserted Explanation 2 aforesaid), a majority of the High Courts in the country had taken the same view though a few High Courts have no doubt taken a contrary view. Looked at from any angle, Sri Sharma says, the issue must be answered in favour of the assessee.

D Clause (b) of Section 40 is based upon and is a recognition of the basic nature of relationship between a firm and its partner. In *Commissioner of Income Tax v. Chidambaram Pillai*, (1977) 106 I.T.R. 292, this Court observed :

E "Here the first thing that we must grasp is that a firm is not a legal person even though it has some attributes of personality. Partnership is a certain relation between person, the product of agreement to share the profits of a business. 'Firm' is a collective noun, a compendious expression to designate an entity, not a person. In Income-Tax law, a firm is a unit of assessment, by special provisions, but is not a full person which leads to the next step that since a contract of employment requires two distinct persons viz, the employer and the employee, there cannot be a contract of the service, in strict law, between a firm and one of its partners. So that any agreement for remuneration of a partner for taking part in the conduct of the business must be regarded as portion of the profits being made over as a reward for the human capital brought in. Section 13 of the Partnership Act brings into focus this basis of partnership business.

H This Court also quoted with approval the passage from Lindley on

the law of Partnership to the effect : In point of law, a partner may be the debtor or the creditor of his co- partners, but he cannot be either debtor or creditor of the firm of which he is himself a member, nor can he be employed by his firm, for a man cannot be his own employer". The provisions in Chapters III and IV of the Partnership Act amply define and delineate the duties. Obligations and rights of the partners vis-a-vis the firm. The question yet remains where an individual is a partner in one capacity, e.g. as a representative of another person, can he have no other capacity vis-a-vis the firm. To be more precise, does the above position of law preclude an individual, who is a partner representing a H.U.F. from depositing his personal funds with the partnership and receiving interest thereon? Explanation 2 says in clear terms that there is no such bar. This is the legislative recognition of the theory of different capacities an individual may hold - no doubt confined to clause (b) of Section 40. Once this is so, we see no reason to hold that this theory of different capacities is not valid or available for the period anterior to April 1, 1985. Accordingly, we hold that even for the period anterior to April 1, 1985, any interest paid to a partner, who is a partner representing his H.U.F. on the deposit of his personal/individual funds, does not fall within the mischief of clause (b) of Section 40. In this view of the matter we agree with the view taken by the Rajasthan High Court in Gajanand Poonam Chand that Explanation 2 in the context of clause (b) of Section 40 is declaratory in nature. Accordingly, we allow this appeal, set aside the judgment of the High Court and answer the question referred under Section 256 in the affirmative, i.e. in favour of the assessee and against the Revenue."

In view of the above pronouncement of this Court, we do not think that this question requires any further elucidation. Accordingly the question is answered in favour of the assessee and against the Revenue. There will be no order as to costs.

V.S.S.

Answering the reference in favour of the assessee.