Keshavji Ravji and Co. and Others

Vs

Commissioner of Income Tax

Civil Appeals Nos. 1177 to 1184 (NT) of 1990

(M.N. Venkatachaliah, N.D. Ojha, J.S. Verma JJ)

05.02.1990

JUDGMENT

VENKATACHALIAH, J. -

1. These special leave petitions arise out of and are directed against the orders of the High Court of Judicature at Madras disposing of references made under section 256(1) of the Income Tax Act, 1961 ('the Act' for short), in Tax Case Nos. 694 of 1982, 565 of 1980, 1404 of 1980, 637 and 638 of 1981, 521 of 1981, 429 of 1983 and 572 of 1983. The High Court, following it earlier pronouncement in CIT v. O. M. S. S. Sankaralinga Nadar and Co. ((1984) 147 ITR 332 : 1984 Tax LR 89 (Mad) answered the question of law, similar in all the cases, in favour of the Revenue. The question was whether, in making a disallowance of the interest paid by a in turn, paid by the partner on his borrowing from the firm should be taken account of and deducted and only the balance disallowed under section 40(b).

2. On this question, there is a sharp divergence of judicial opinion in the High Courts. In Sri. Ram Mahadeo Prasad v. CIT ((1953) 24 ITR 176 (All)); CIT v. Kailash Motors ((1982) 134 ITR 312 : (1979) 11 CTR 239 (All)); CIT v. T. V. Ramanaiah and Sons ((1986) 157 ITR 300 : 1985 Tax LR 748 (AP)); CIT v. Kothari and Co. ((1987) 165 ITR 594 (Kar)) CIT v. Balaji Commercial Syndicate ((1987) 165 ITR 596 (Kar)); CIT v. Motilal Ramjiwan and Co.((1988) 171 ITR 294 (Raj)); CIT v. Precision Steel and Engg. Works ((1989) 179 ITR 283 (P&H)), the High Courts have taken the view that, where a firm pays interest to its partner and the partner also pays interest to the firm, only the net amount of interest paid by the firm to the partner is liable to disallowance under section 40(b) of the Act. However, in CIT v. O. M. S. S. Sankaralinga Nadar and Co.((1984) 147 ITR 332 : 1984 Tax LR 89 (Mad)), the High Court of Madras has taken a contrary view.

3. We have heard Sri Ramachandran, learned senior counsel for the appellants and Sri Manchanda, learned senior counsel and Sri B. B. Ahuja for the Revenue. Special leave is granted. The appeals are taken up for final hearing, heard and are disposed of by this common judgment.

4. We may refer to the facts in S.L.P. (C) No. 14291 of 1985 which is representative of and typifies the context in which the question arises. The appellant, Messers Keshavji Ravji and Co., is registered firm consisting of six partners and carries on a business in the manufacture and export of stainless steel articles. In the accounting year ended November 13, 1974, corresponding to the assessment year 1975-76, the firm paid interest to its partners on the amounts standing to their respective credits in the firm. The firm also received from the partners interest on their borrowing from the firm. For the relevant assessment year, the appellant filed a return disclosing a total income of Rs. 2,55,225. The Income Tax Officer, while disallowing the amount of interest paid to the

partners, did not set off the interest received from the partners of their own borrowings. With this disallowance, the income of the firm was assessed Assistant Commissioner of Income Tax, by his order dated October 18, 1977, allowed the claim of the appellant that only the net interest paid to the partners, after setting off the interest received from them, was to be disallowed. The Revenue took up the matter is further appeal before the Income Tax Appellate Tribunal which, by its order dated January 6, 1979, dismissed the appeal and affirmed the order of the Assistant Commissioner. The Tribunal, as did the Appellate Assistant Commissioner, placed reliance on the decision of the Allahabad High Court in Sri. Ram Mahadeo Prasad v. CIT ((1953) 24 ITR 176 (All)).

5. At the instance of the revenue, the Tribunal stated a case and referred the following question of law for the opinion of the High Court :

> "Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was correct in holding that the net interest should be disallowed under section 40(b) of the Income Tax Act, 1961 ?"

6. This reference under Section 256(1) of the Act was registered in the High Court as Tax Case No. 694 of 1982 and the High Court, by its order dated March 5, 1985, answered the question in the negative and against the appellant relying, as stated earlier, on its earlier pronouncement in Sankaralinga Nadar case. ((1984) 147 ITR 332 : 1984 Tax LR 89 (Mad)) Broadly similar are the circumstances under which the other appeals arise.

7. Before we advert to and evaluate the merits of contentions, it is appropriate to refer to the statutory provision as it then stood. Section 40 of the Act provided :

> "40. Notwithstanding anything to the controversy in section 30 to 39 the following amounts shall not be deducted in computing the income chargeable under the head "Profits and gains of business of profession."
>
> #(a) * * * *##
>
> (b) in the case of any firm, any payment of interest, salary, bonus, commission or remuneration made by the firm to any partner of the firm.
>
> #(c) and (d) * * * *"##

By the Taxation Laws (Amendment) Act, 1984, several amendments were introduced in the body of Section 40. One of them was the introduction of Explanation I in clause (b) of Section 40. That Explanation reads :

> "Explanation I. - Where interest is paid by a firm to any partner of the firm who has also paid interest to the firm, the amount of interest to be disallowed under this clause shall be limited to the amount by which the payment of interest by the firm to the partner exceeds the payment of interest by the partner to the firm."

Referring to the new Explanation inserted in clause (b) of Section 40 by the amendment, the "Notes on Clauses" say :

> "This clause seeks to insert three new Explanations to Section 40(b) of the Act. Explanation I seeks to provide that where interest is paid by a firm to a partner who

has also paid interest to the firm, the amount of interest to be disallowed under Section 40(b) of the Act shall be limited to the net amount of interest paid by the firm to the partner, that is, the amount by which the payment of interest by the firm to the partner exceeds the payment of interest by the partner to the firm."

"The proposed amendments will take effect from April 1, 1985, and will, accordingly, apply in relation to the assessment year 1985-86 and subsequent years."

The Explanation I, which was introduced in 1984, proprio vigore, does not apply to the assessment relating, as here, to an earlier year. Whether the Explanation brings about a change in, or admits of being understood as an exposition of, the law, is, however, a different matter. It is, perhaps, also appropriate here to refer to the Circular No. 33-D (XXV-24) of 1965 of the Central Board of Direct Taxes, the operative part of which provides :

"However where a firm pays interest to as well as receives interest from the same partner, only the net interest can be stated to have been received or paid by the firm, as the case may be, and only the net interest should be taken into consideration. This view also finds support in the decision of the Allahabad High Court in the case of Sri. Ram Mahadeo Prasad ((1953) 24 ITR 176 (All)). In view of the above, the instructions contained in Board's Circular No. 55 of 1941 may be treated as modified accordingly ...."

8. Section 40 imposes a restriction on the deductibility of certain outgoings and expenses which are, otherwise, enabled under Sections 30-39 of the Act and constitutes an exception to these sections. Clause (b) of Section 40 is analogous, with some enlargement, to Section 10(4)(b) of the predecessor Act of 1922. The prohibition in Section 40 against the deductibility of certain outgoings is in mandatory terms. It is this aspect that has loomed large in the reasoning supporting the view accepted by the Madras High Court in Sankaralinga Nadar case ((1984) 147 ITR 332 : 1984 Tax LR 89 (Mad)) and emphasised by the learned counsel for the revenue. The reasoning of the Madras High Court in that case and of the Andhra Pradesh High Court in CIT v. T. V. Ramanaiah & Sons ((1986) 157 ITR 300 : 1985 Tax LR 748 (AP)) illustrate the rival points of view. The Madras High Court held : (ITR p. 336)

"..... The collocation of the words shows that what is disallowed in the matter of payment of interest cannot be the net interest, but can only be interest paid with reference to a given account relating to payment of interest by the firm to the partner. This is because the subject of disallowance in the matter of payment of interest appears in Section 40(b) cheek by jowl with salary, bonus, commission or remuneration made by the firm to the partner. There cannot be any net salary or net bonus or net remuneration as matters of disallowance. They can only be salary, as such, or bonus, as such, or commission, as such, or remuneration as such which are the subject of disallowance. In like manner, when the section speaks of payment of interest by the firm to a partner as the subject of disallowance, it can only be payment of 'gross' interest in the particular account in which interest is payable. Salary, bonus, commission or remuneration do not have what may be charactersed as a two-way traffic ....."

"..... In the earliest of the cases, the Allahabad High Court endorsed the Tribunal's decision to disallow only the net interest. The court did so, not on a construction of

> the words of the section, but on equitable grounds of "fairness"."

9. The Andhra Pradesh High Court, however, taking the contrary view relied on, what it considered, the revenue's own understanding of the legal position as made manifest in the Board's circular that the "real purpose of Section 40(b) of the Act was to add back only the net amount of interest and not the gross amount." On the interpretation of Section 40(b), the Andhra Pradesh High Court in Ramanaiah case ((1986) 157 ITR 300 : 1985 Tax LR 748 (AP)) said : (ITR p. 304)

> "..... As a matter of interpretation of Section 40(b) of the Act, we find that here is nothing in the provision which expressly sates that the amount to be added back is either gross or net. The provision requires that "any payment of interest" by a partnership firm to a partner shall not be deducted in computing the income of the partnership firm. For the purpose of finding out the amount paid by way of interest, it is necessary for the Income Tax Officer to find out the amount of interest paid by the partnership firm to the partner and also see if the same partner paid any interest to the partnership firm and ascertain the amount of interest effectively paid by the partnership firm to the partner."

10. The arguments of learned counsel on both sides covered a wide range of contentions. The submissions of Sri. Ramachandran in support of the appeals admit of being formulated thus :

> (a) The scheme of Section 40 of the Act does not evince any intention to penalise a firm for the outgoings which are rendered nondeductible; but the sole object of section 40(b) is, having regard to the special features and legal incidents of a partnership, to enable the assessment of the 'real income' of the firm. The outgoings disallowed by section 40(b) are not really outgoings at all, but constitute what are, otherwise ingredients or components of the real income of the firm. Therefore, the ascertainment of the real income or the real commercial profits does not require or compel the exclusion of the cross-interest paid by a partner in determining the quantum to be disallowed under Section 40(b).
>
> (b) The extent of the embargo under section 10(4)(b) of the 1922 Act on the disallowance of 'interest' paid to a partner was judicially interpreted as ascertained in Sri. Ram Mahadeo Prasad v. CIT ((1953) 24 ITR 176 (All)) and when the Legislature re-enacted those provisions in section 40(b) of the 1961 Act in substantially the same terms, the Legislature must be held to have used that expression with the same implications attributed it by the earlier judicial expositions.
>
> (c) Interest payable by the partners to the firm pursuant to an agreement between the partners is of the same nature as that payable by the firm to the partners on the capital brought in by them. Interest paid to and received from a partner are both integral parts of a method adopted by the partners for adjusting the division of profits and, in that sense, both payments partake of the same character.

In identifying and quantifying the 'interest' for purposes of section 40(b), it would be permissible to take both the payments into consideration and treat only such excess, if any, paid by the firm as susceptible to the exclusionary rule in Section 40(b).

> (d) The Circular No. 33-D(XXV 24) of 1965 of the Central, Board of Direct Taxes,

which is statutory in character, is binding on the authorities. The High Court was in error in taking a view of the legal position difference from the one indicated in it.

(e) The amendment of 1984 inserting Explanation I in section 40(b), though later in point of time, constitutes a legislative exposition of the correct import of the provision and, so construed, it offers a guide to the correct understanding of the provisions in section 40(b) in its application to the earlier years as well.

Re Contention (a)

11. The primes of the argument is good in parts; but the inference does not logically follow. Section 40(b), it is true, seeks to prevent evasion of tax by diversion of the profits of a firm; but the legislative expedience adopted to achieve that objective requires to be given effect on its own language. Section 40 opens with the non-obstante clause and directs that certain outgoings specifically enumerated in it "shall not be deducted" in computing the income chargeable under the head "Profits and gains of business or profession". As long as there is no ambiguity in the statutory language, resort to any interpretative process to unfold the legislative intent becomes impermissible. The supposed intention go the Legislature cannot then be appealed to whittle down the statutory language which is otherwise unambiguous. If the intendment is not in the words used it is nowhere else. The need for interpretation arises when the words used in the statute of the are, on their own terms, ambivalent and do not manifest the intention of the legislature. In Doypack Systems Pvt. Ltd. v. Union of India ((1988) 2 SCC 299 : (1988) 2 SCR 962) it was observed : (SCC pp. 331-32, paras 58 and 59)

> "The words in the statute must, prima facie, be given their ordinary meanings. Where the grammatical construction is clear, manifest and without doubt, that construction ought to prevail unless there are some strong and obvious reasons to the contrary ....."
>
> "It has to be reiterated that the object of interpretation of a statue is to discover the intention of Parliament as expressed in the Act. The dominant purpose in construing a statue is to ascertain the intention of the Legislature expressed in the statute, considering it as a whole and in its context. The intention, and therefore, the meaning of the statute is primarily to be sought in the words used in the statute itself, which must, if they are plain and unambiguous, be applied as they stand ......"

12. Artificial and unduly latitudinarian rules of construction, which with their general tendency to "give the tax payer the breaks", are out of place where the legislation has a fiscal mission. Indeed, taxation has ceased to be regarded as an "impertinent intrusion into the sacred rights of private property" and it is now increasingly regarded as a potent fiscal tool of State policy to strike the required balance - required in the context of the felt needs of the times - between the citizens' claim to enjoyment of his property the one hand and the need for an equitable distribution of the burdens of the community to sustain social services and purpose on the other. These words of Thomas M. Cooley in 'Law of Taxation', Volume 2 are worth mentioning :

> "Artificial rules of construction have probably found more favour with courts than they have ever deserved. Their application is legal controversies has often times been pushed to an extreme which has defeated the plain and manifest purpose in enacting the laws. Penal laws have sometimes had all their meaning construed away and in

> remedial laws, remedies have been found which the legislature never intended to give. Something akin to this has befallen the revenue laws ...."

13. There are, indeed, strong and compelling considerations against the adoption of the test suggested by Sri. Ramachandran. Limiting of the ambit of section 40(b) on the supposed "real income" test would, perhaps, lead to positions and results, whose dimensions and implications of which are not to say the least, fully exploded. The test suggested by Sri. Ramachandran might, on its own extended logic, validate a set off of the interest paid to one partner against interest received from another and, likewise, "interest" received from one partner on some other dealing between him and the firm against interest paid to another partner on his or her capital contribution. The test of "real income" as one on which the operation of section 40(b) could be sought to be limited is not a reliable one. Indeed, the following observations of this court on the concept of "real income" in State Bank of Travancore v. CIT ((1986) 2 SCC 11 : 1986 SCC (Tax) 289 : (1986) 158 ITR 102, 155), though made in a different context, are apposite : (SCC p. 67, paras 69 and 70)

> "..... The concept of real income is certainly applicable in judging whether there has been income or not but, in every case, it must be applied with care and within well - recognized limits.
>
> We were invited to abandon legal fundamentalism. With a problem like the present one, it is better to adhere to the basic fundamentals of the law with clarity and consistency than to be carried away by common cliches. The concept of real income certainly is a well accepted one and must be applied in appropriate cases but with circumspection and must not be called in aid to defeat the fundamental principles of the law of income-tax as developed."

This contention of Sri. Ramachandran rests on generalisations which incur the criticism of being too board and have certain limitations of their own.

14. Contention (a) does not advance the appellants' case.

Re Contention (b)

15. The submissions of Sri. Ramachandran on the point are that where the meaning of a word used in a statue had been judicially ascertained by a court and where the Legislature, while re-enacting the law on the subject, uses the same word, it must be taken to have been aware of the meaning so judicially ascertained earlier and not to have used the word with a different content. This is no doubt, a well recognized guide to construction. When words acquire a particular meaning or sense because of their authoritative construction by superior courts, they are presumed to have been used in the same sense when used in a subsequent legislation in the same or similar context. This principle was stated by the Judicial Committee in H. H. Ruckmaboye v. Lulloobhoy Mottichund (5 Moo IA 234, 250 : 8 Moo PC 4) thus :

> ".... it is, therefore, of considerable importance to ascertain what has been deemed to be the legal import and meaning of them, because, if it shall appear that they have long been used, in a sense which may not improperly be called technical, and have been judicially constructed to have a certain meaning, and have been adopted by the legislature in that sense, long prior to the statute, 21 James I.C. 16, the rule of construction of statutes will require, that the words in the statute should be construed

> according to the sense in which they had been so previously used, although that sense may vary from the strict literal meaning of them."

This principle has been reiterated by this court in several pronouncements. But the limitations of its applications in the present case arise out of the circumstance that the decision of the Allahabad High Court in Sri. Ram Mahadeo Prasad v. CIT ((1953) 24 ITR 176 (All)) did not proceed or rest on any special or technical connotation of the word "interest" nor any special legal sense which that word could be said to have acquired by the earlier judicial ascertainment of its amplitude. The decision proceeded on a construction of the relevant provision i.e. Section 10(4)(b) of the 1922 Act, and on what the High Court considered as affording to the assessed a fair treatment. Nothing particular stemmed from the interpretation of the expression "interest". The appeal to this principal of construction is, in our opinion, somewhat out of place in this case. The rules of interpretation are not rules of law; they are mere aids to construction and constitute some broad pointers. The interpretative criteria opposite in a given situation may, by themselves, be mutually irreconcilable. It is task of the court to decided which one, in the light of all relevant circumstances, ought to prevail. The rules of interpretation are useful servants but quite often tend to become difficult masters. It is appropriate to recall the words of Lord Reid in Maunsell v. Olins ((1975) 1 All ER 16).

> "Then rules of construction are relied on. They are not rules in the ordinary sense of having some binding force. They are our servants not our masters. They are aids to construction, presumptions or pointers. Not infrequently one 'rule' points in one direction, another in a different direction. In each case we must look at all relevant circumstances and decide as a matter of judgment what weight to attach to any particular 'rule'."

This passage was referred to with approval by this court in Utkal Contractors and Joinery (P) Ltd. v. State of Orissa ((1987) 3 SCC 279, 290 (para 13) : (1987) 3 SCR 317, 330).

16. Contention (b) is, therefore, not of any assistance to the appellants.

Re Contention (c)

17. There are certain aspects of the legal relationship amongst partners which do impart a special complexion to the question under consideration. The point raised in these appeals is confined to a situation where a partner receives interest on the capital subscribed by him and the same partner pays interest on the drawings made by him.

18. A firm under the general law is not a distinct legal entity and has no legal existence of its own. The partnership property vests in all the partners and in that sense every partner has an interests in the assets of the partnership. However, during the subsistence of the partnership, no partner can deal with any portion of the property as his own. In Addanki Narayanappa v. B. Krishtappa ((1966) 3 SCR 400 : AIR 1966 SC 1300), this court referred to the nature of the interest of a partner in the firm and observed :

> ". . . The whole concept of partnership is to embark upon a joint venture and for that purpose to bring in as capital money or even property including immovable property. Once that is done whatever is brought in would cease to be the exclusive property of the person who brought it in. It would be the trading asset of the partnership in which all the partners would have interest in proportion to their share in the joint venture of

> the business of partnership. The person who brought it in would, therefore, not be able to claim or exercise any exclusive right over any property which he has brought in, much less over any other partnership property. He would not be also to exercise his right even to the extent of his share in the business of the partnership."

19. In CIT v. R. M. Chidambaram Pillai ((1977) 1 SCC 431, 433-34 : 1977 SCC (Tax) 188, 190-91 : (1977) 106 ITR 292, 295-96) this court observed : (SCC pp. 433-34, paras 5 and 8)

> "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 persons, 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 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."
>
> ". . . It is implicit that the share income of the partner takes in his salary. This telling test is that where a firm suffers loss, that salaried partner's share in it goes to depress his share of income. Surely, therefore, salary is a different label for profits, in the context of a partner's remuneration."

20. In Lindley on Partnership (14th Edn.), we find this statement of the law : (p. 30)

> ". . . In point of law, a partner may be the debtor or 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 position, as stated above, was approved by this court in R. M. Chidambaram case ((1977) 1 SCC 431, 433-34 : 1977 SCC (Tax).

21. In Regional Director, Employees' State Insurance Corporation v. Ramanuja Match Industries ((1985) 1 SCC 218 : 1985 SCC (L&S) 213 : (1985) 2 SCR 119) this court, dealing with the question whether there could be a relationship of master and servant between a firm on the one hand and its partners on the other, indicated that under the law of partnership there can be no such relationship as it would lead to the anomalous position of the same person being both the master and the servant. The following observations of Lord Justice Mathew in Ellis v. Joseph Ellis and Co. ((1905) 1 KB 324 : 21 TLR 182 (CA)) were referred to with approval : (SCC p. 224, para 7 : SCR p. 126)

> "The argument on behalf of the applicant in this appeal appears to involve a legal impossibility, namely, that the same person can occupy the position of being both master and servant, employer and employed."

22. And observed : (SCC p. 221, para 4 : SCR p. 123)

> ".... A partnership firm is not a legal entity. This court is Champaran Cane Concern v.

> State of Bihar (AIR 1963 SC 1737 : (1964) 2 SCR 921 : (1963) 49 ITR 152), pointed out that in a partnership each partner acts as an agent of the other. The position of a partner qua the firm is thus not that of a master and a servant or employee which concept involves an element of subordination but that of equality. The partnership business belongs to the partners and each one of them is an owner thereof ...." (SCC p. 224, para 9 : SCR p. 127)

And concluded :

> "It is thus clear that in the United States, Great Britain and Australia, a partner is not treated as an employee of his firm merely because he receives a wage or remuneration for work done for the firm. This view is in complete accord with the jurisprudential approach. In the absence of any statutory mandate, we do not think there is any scope for accepting the view of the Rajasthan High Court."

23. Sri Ramachandran's contention is that both the capital brought in by the partners to the firm and the amounts that may be drawn by them from the partnership firm partake of the same nature and character as the funds of the partnership. This may be so. But, in effectuating the consequences of the recognition of this position, it is necessary to ensure that express provisions of the statute departing from the general law are not whittled down. To the extent that the statute expressly, or by necessary implication, departs from the general law, the latter cannot be invoked to displace the effect of the statute.

24. But, if there is no such statutory departure, the general principles operating on that branch of the law determine the nature of the legal relationship. Sri Francis Bennion, in his Statutory Interpretation observes : (at pp. 350 and 354) :

> "Unless the contrary intention appears, an enactment by implication imports any principle or rule of law (whether statutory or non-statutory) which prevails in the territory to which the enactment extends and is relevant to its operation in that territory."
>
> "Unless the contrary intention appears, an enactment by implication imports the principle of any legal maxim which prevails in the territory to which the enactment extends and is relevant to the operation of the enactment in that territory."

What follows is that, to the extent not prohibited by the statute, the incidents of the general law of partners are attracted to ascertain the legal nature and character of a transaction. This is quite apart from distinguishing the "substance" of the transaction from its 'form'. In Sargaison v. Roberts ((1969) 45 Tax Cas 612, 617-18 : (1969) 3 All ER 1072) Megarry, J. observed :

> "I appreciate that what I have to do is to construe the words used, and not to insert words which are not there, or to resort to a so-called "equitable construction" of a taxing statute. But even when I have given full weight to this consideration, I think that I am entitled to distinguish between the substance of a transaction and the machinery used to carry it through ..." "Substance" and "form" are words which must no doubt be applied with caution in the field of statutory construction. Nevertheless, where the technicalities of English conveyancing and land law are brought into juxtaposition with a United Kingdom taxing statute, I am encouraged to look at the

> realities at the expense of the technicalities."

In CIT v. Gillanders Arbuthnot and Co. ((1973) 3 SCC 845 : 1973 SCC (Tax) 359 : (1973) 87 ITR 407, 418) this court said : (SCC p. 854, para 25)

> "..... The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have authority to unravel the device and to determine the true character of the relationship. But the legal effect of a transaction cannot be displaced by probing into the "substance of the transaction"...."

25. The court is not precluded from treating what the transaction is in point of fact as one in point of law also.

26. How do these principles operate on the present controversy ? It appears to us that, if, in substance, the interest paid by the firm to a partner and the interest, in turn, received from the partner are mere expressions of the applications of the funds or profits of the partnership and which having regard to the community of interest of the partners, are mere variations of the method of adjustment of the profits, there should be no impediment in treating them as part of the same transaction if, otherwise, in general law, they admit of being so treated. The provisions of section 40(b) do not exclude or prohibit such an approach. If, instead of the transactions being reflected in two separate or distinct accounts in the books of the partnership, they were in one account, the quantum of interest paid by the firm to the partner would, to the extent of the drawings of the partner, stand attenuated. The mere fact that the transaction are split into or spread over two or more accounts should not, by itself, make any difference if, otherwise, the substance of the transaction is the same. One of the relevant test would be to see whether the funds on which interest is paid received partake of the same character.

27. A broad analogy, though in itself may not be conclusive, is furnished by the idea of "mutual dealings" and the principle of set-off statutorily recognized in bankruptcy proceedings under section 46 of the Provincial Insolvency Act and attracted also to proceedings for winding up of companies by virtue of section 529 of the Companies Act, 1956, where the 'mutual credit' clause steps in to avoid the injustice, which would otherwise arise, of compelling a creditor to pay the official assignee the full amount of the debt due from him to the insolvent, while the creditor would, perhaps, only receive a small dividend on the debt due from the insolvent to him under a pari passu payment. This principle was recognized by this court in Official Liquidator v. Lakshmikutty ((1981) 3 SCC 32 : (1981) 2 SCR 349). The set-off in this case is, no doubt, the result of a statutory provision. In the case of partners, the special legal incidents of their relationship would substitute for the statutory provision and given the situation. Indeed, even the idea of a set-off itself, which presupposes a duality of entities, may be out of place in the very nature of the relationship between a firm and its partners where the former is mere compendious reference to the latter. But even to the extent the income-tax law which identifies the firm as a distinct entity and unit of assessment goes, the idea of set-off may be invoked in view of the mutuality implicit in the putative duality inherent in deeming the firm as a distinct entity under the Act for certain purposes. The fiction may have to be pushed to its logical conclusions.

28. The decision of the Madras High Court in Sankaralinga Nadar case ((1984) 147 ITR 332 : 1984 Tax LR 89 (Mad)) speaks of income-tax and equity being strangers. To say that a court could not resort to the so-called "equitable construction" of a taxing statute is not to say that, where a strict literal construction leads to a result not intended to subserve the object of the legislation another

construction, permissible in the context, should not be adopted. In CIT v. J. H. Gotla ((1985) 4 SCC 343 : 1985 SCC (Tax) 670 : (1985) 156 ITR 323), this court said : (SCC p. 360, para 47 : ITR pp. 399-40) :

> ".... we should find out the intention from the language used by the legislature and if strict literal construction leads to an absurd result i.e., a result not intended to be subserved by the object of the legislation found in the manner indicated before, then if another construction is possible apart from the strict literal construction then that construction should be preferred to the strict literal construction. Though equity and taxation are often strangers, attempts should be made that these do not remain always so and if a construction results in equity rather than in injustice, then such construction should be preferred to the literal construction. Furthermore, in the instant case, were dealing with an artificial liability created for counteracting the effect only by the assessee to reduce tax liability by transfer ....."

In this respect, taxing are not different from other statues. In Attorney-General v. Carlton Bank ((1899) 2 QB 158 : 15 TLR 380) Lord Russel of Killowen C.J. said : (QBD p. 164)

> "I see no reason why special cannons of construction should be applied to any Act of Parliament, and I know of no authority for saying that a taxing Act is to be constructed differently from any other Act. The duty of the court is, in my opinion, in all cases the same, whether the Act to be constructed relates to taxation or to any other subject, viz. to give effect to the intention of the Legislature ..."

29. We, accordingly, accept the submission of Sri. Ramachandran on this point. In our opinion, where two or more transactions on which interest is paid to or received from the partner by the firm are shown to have the element of mutuality and are referable to the funds of the partnership as such, there is no reason why section 40(b) should be so construed as to exclude in quantifying the interest on the basis of such mutuality. In such circumstances, the interest, if any, paid to a partner by the firm in excess of what is received from the partner could alone be excluded from deduction under Section 40(b).

30. Contention (c) is held and answered accordingly.

Re Contention (d)

31. Sri. Ramachandran contended that the circular of 1965 of the Central Board of Direct Taxes was binding on the authorities under the Act and should have been relied upon by the High Court in support of the court's construction of section 40(b) to accord with the understanding of the provision made manifest in the circular.

32. This contention and the proposition on which it rests, namely, that all circulars issued by the Board have a binding legal quality incurs, quite obviously, the criticism of being too broadly stated. The Board cannot pre-empt a judicial interpretation of the scope and ambit of a provision of the 'Act' by issuing circulars on the subject. This is too obvious a proposition to require any argument for it. A circular cannot even impose on the tax payer a burden higher than what the Act itself, on the true interpretation, envisages. The task of interpretation of the laws is the exclusive domain of the courts. However, - this is what Sri Ramachandran really has in mind - circulars beneficial to the assessees and which tone down the rigour of the law issued in exercise of the statutory power under

section 119 of the Act or under corresponding provisions of the predecessor Act are binding on the authorities in the administration of the Act. The Tribunal, much less the High Court, is an authority under the Act. The circulars do not bind them. But the benefits of such circulars might have departed from the strict tenor of the statutory provision and mitigated the rigour of the law. But that is not the same thing as saying that such circulars would either have a binding effect in the interpretation of the provision itself or that the Tribunal and the High Court are supposed to interpret the law in the light of the circular. There is, however, the support of certain judicial observations for the view that such circulars constitute external aids to construction.

33. In State Bank of Travancore v. CIT ((1986) 2 SCC 11 : 1986 SCC (Tax) 289 : (1986) 158 ITR 102, 155), however this court, referring to certain circulars of the Board, said : (SCC p. 51, para 43 : ITR p. 139)

> "... The earlier circulars being executive in character cannot alter the provisions of the Act. These were in the nature of concessions and could always be prospectively withdrawn. However, on what lines the rights of the parties should be adjusted in consonance with justice in view of these circulars is not a subject matter to be adjudicated by us and, as rightly contended by counsel for the Revenue, the circulars cannot detract from the Act."

34. The expression 'executive in character' is, presumably, used to distinguish them from judicial pronouncements. The circulars referred to in that case were also of the Central Board of Direct Taxes and were, presumably also, statutory in character.

35. However, this contention need not detain us, as it is unnecessary to examine whether or not such circulars are recognized as legitimate aids to statutory construction. In the present case, the circular of 1985 broadly accords with the view taken by us on the true scope and interpretation of Section 40(b) in so far as the quantification of the interest for purposes of Section 40(b).

36. Contention (d) is disposed of accordingly.

Re Contention (e)

37. Sri. Ramachandran urged that the introduction, in the year 1984, of Explanation I to section 40(b) was not to effect or bring about any change in the law, but was intended to be a mere legislative exposition of what the law has always been. An 'Explanation', generally speaking is intended to explain the meaning of certain phrases and expressions contained in a statutory provision. There is no general theory as to the effect and intendment of an Explanation except that the purpose and intendment of the 'Explanation' are determined by its own words. An Explanation, depending on its language, might supply or take away something from the contents of a provision. It is also true that an Explanation may - this is what Sri. Ramachandran suggests in this case - be introduced by way of abundant caution in order to clear any mental cobwebs surrounding the meaning of a statutory provision spun by interpretative errors and to place what the Legislature considers to be the true meaning beyond any controversy or doubt. Hypothetically, that can be the possible purpose of an 'Explanation' cannot be doubted. But the question is whether, in the present case, Explanation 1 inserted into section 40(b) in the year 1984 has had that effect.

38. The notes on clauses appended to the Taxation Laws (Amendment) Bill, 1984, say that clause 10 which seeks to amend section 40 will take effect from 1st April, 1985, and will accordingly, apply

in relation to the assessment year 1985-86 and subsequent years. The express prospective operation and effectuation of the 'Explanation' might, perhaps, be a factor necessarily that the Explanation was intended more as a legislative exposition or clarification of the existing law than as a change in the law as it then obtained. In view of what we have said on point (C), it appears unnecessary to examine this contention any further.

39. Contention (e) is disposed of accordingly.

40. In the result, for the foregoing reasons, these appeals are allowed; the orders of the High Court under appeal are set aside and the question of law referred for opinion is answered in the affirmative in terms of paras 29-30 [supra]. In the circumstances, there will be no orders as to the costs in these appeals.

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