Progressive Financers

Vs

Commissioner of Income-Tax

Civil Appeal No. 1568 (NT) of 1981 With Civil Appeals Nos. 2439 and 2439-A of 1981, Civil Appeal No. 1568 (NT) of 1981 was From the Judgment and Order Dated January 16, 1978, of the Madras High Court in Tax Case No. 336 of 1974 (Reference No. 149 of 1974). the Judgment of the High Court is Reported as Addl. Cit V. Progressive Financiers [1979] 118 Itr 18 (Mad),

(S. C. Agarwal, G. T. Nanavati JJ)

20.02.1997

JUDGMENT

G.T. NANAVATI J.

1 The appellant in these three appeals is Progressive Financiers, a partnership firm. It came into existence with execution of a partnership deed on July 1, 1967. It consisted of five partners. Out of them Sunitha Pratap was a minor and, therefore, she was admitted to the benefits of partnership. The capital of the partnership was fixed at Rs. 5 lakhs and each partner had to contribute as follows :

> # Rs.1. M.R. Rajakrishna 1,25,0002. Minor Sunitha Pratap 1,87,5003. W.S. Parthasarathy 62,5004. W.S. Sethunarayana Babu 62,5005. M.S. Rajeswari 62,500.##

For the assessment year 1968-69, it applied for registration to the Income-tax Officer under section 184 of the Income-tax Act, 1961 (for short the "Act"), on March 31, 1968. For the assessment years 1969-70 and 1970-71, it applied for renewal of registration. The Income-tax Officer rejected the application for registration on June 30, 1971. On the same day, he passed an assessment order for the assessment year 1968-69 treating the status of the appellant as an association of persons. Applications for renewal of registration for the assessment years 1969-70 and 1970-71 were rejected on March 13, 1972, and the assessment orders for those years were again passed treating the appellant as an association of persons.

The appellant's application for registration was rejected by the Income-tax Officer on the ground that though in the opening paragraph of the partnership deed it was mentioned that Sunitha Pratap, a minor, was admitted to the benefits of partnership, the relevant clauses in the partnership deed indicated that she was taken as a full partner and, therefore, the contract of partnership was void ab initio. The Income-tax Officer arrived at this conclusion as he noticed that the partnership deed was signed by Mrs. Sridevi Pratap, the guardian of minor, Sunitha Pratap; that Sunitha had contributed the maximum capital; that it was not stated in the partnership deed how, i.e., the manner in which, the loss, if any, was to be apportioned; that all partners were entitled to operate bank accounts individually; that all matters of importance were to be decided by a majority of partners holding more than 75 per cent. of capital; and, that on dissolution, all the assets of the firm including good will were to be converted into money and distributed amongst the partners in proportion to their

shares in the capital.

Against this order of the Income-tax Officer, the appellant preferred an appeal to the Appellate Assistant Commissioner. Following the decision of the Andhra Pradesh High Court in Addepally Nageswara Rao and Brothers v. CIT [1971] 79 ITR 306, the Appellate Assistant Commissioner held that the instrument of partnership was required to be construed harmoniously and as the minor was admitted only to the benefits of partnership there was no question of her being made liable for the losses. He, therefore, allowed the appeal holding that the firm was entitled to registration. The Revenue went in appeal to the Income-tax Appellate Tribunal.

Construing the partnership deed in the light of the decisions of this court in CIT v. Shah Mohandas Sadhuram [1965] 57 ITR 415 and CIT v. Shah Jethaji Phulchand [1965] 57 ITR 588 and the decision of the Andhra Pradesh High Court in Addepally Nageswara Rao [1971] 79 ITR 306, the Tribunal held that the minor Sunitha was admitted merely to the benefits of partnership and it was not correct to say that she was made a fullfledged partner. The Tribunal also held that the minor was not to be burdened with losses and they were to be borne by the other partners. It further held that though the instrument of partnership did not specifically provide how the losses were to be borne by the partners the rule that in such cases losses are to be shared in the same proportion as profits became applicable and since the partnership deed was capable of being construed in that manner, the firm was entitled to registration. It, therefore, dismissed the appeal.

The Revenue sought a reference to the High Court and the Tribunal thought it fit to refer the following question to the High Court (see [1979] 118 ITR 18 (Mad)) for its decision (at page 19) :

> "Whether, on the facts and in the circumstances of the case, and on a true construction of the terms of the partnership deed, the assessee is entitled to the benefit of registration under section 185 of the Income-tax Act, 1961, for the assessment year 1968-69 ?"

Against the orders passed by the Income-tax Officer refusing renewal or continuation of registration for the assessment years 1969-70 and 1970-71 the appellant had preferred two separate appeals to the Appellate Assistant Commissioner. They were allowed. The appeals filed by the Revenue against the said appellate orders were dismissed by the Tribunal. At the instance of the Revenue, for the said two assessment years the following question was referred to the High Court :

> "Whether, on the facts and in the circumstances of the case and on a true construction of the terms of the partnership deed the assessee is entitled to the continuation of registration for the assessment year 1969-70 and 1970-71 ?"

The High Court referred to the decision of the Gujarat High Court in Thacker and Co. v. CIT [1966] 61 ITR 540 and the two decisions of the Kerala High Court in CIT v. Ithappiri and George [1973] 88 ITR 332 and United Hardwares v. CIT [1974] 96 ITR 348 wherein it has been held that in view of the clear language of section 184 it is necessary that sharing of the losses also has to be specifically provided in the partnership deed and there is no scope for applying any principle or rule of law for discerning the proportion in which the losses are to be shared. It then held that the decision of this court in Mandyala Govindu and Co. v. CIT [1976] 102 ITR 1 squarely applied to the facts of this case. Following that case it held that it was not possible to determine on any principle of inference, from the document itself, how the remaining four partners were to share the losses and, therefore, the firm was not entitled to registration. The reference was answered

accordingly, in favour of the Revenue and against the assessee.

Following that decision in Tax Case No. 336 of 1974 (Reference No. 149 of 1974), the High Court answered the other two references (Tax Cases Nos. 707 of 1976 and 708 of 1976/References Nos. 575 and 576 of 1976) also in favour of the Revenue and against the assessee. The assessee has, therefore, filed these three appeals against the judgment and orders passed by the High Court in those three cases.

Learned counsel for the appellant submitted that the view taken by the High Court is wrong. The two decisions of the Kerala High Court which are relied upon by the High Court have since been overruled by the Full Bench of the Kerala High Court in Kerala Publicity Bureau v. CIT [1993] 200 ITR 366. He also submitted that the instrument of partnership, if reasonably construed, did indicate the method by which profits and losses were to be shared by the partners. On the other hand, it was contended by learned counsel for the Revenue that as section 184 of the Act confers a benefit which would otherwise be not available it is necessary that the conditions laid down therein are strictly complied with. Therefore, the said benefit can be claimed only if in the instrument of partnership itself shares of the partners in profits and losses are specifically stated.

This court in Rao Bahadur Ravulu Subba Rao v. CIT [1956] 30 ITR 163 and Patel (N.T.) and. Co. v. CIT [1961] 42 ITR 224 (SC), interpreting section 26A of the earlier 1922 Act, held that registration under that section conferred a benefit on the partners which the partners were not entitled to but for that section and, therefore, that right could have been claimed only in accordance with the statute and those who claimed it had to bring their case strictly within the terms of that section. This view was reiterated subsequently by a 5-judge Bench of this court in the case of Kylasa Sarabhaiah v. CIT [1965] 56 ITR 219. At the same time, this court disapproved the mechanical application of that provision and held that "in ascertaining whether the application is in conformity with the Rules, the deed of partnership must be reasonably construed". It was also held that the word "specify" as used in that section and the relevant rule meant "mentioning, describing or defining in detail" and it did not mean "expressly setting out in fractional or other shares". In view of this decision the correct legal position is that the Assessing Officer cannot reject an application for registration merely because in the deed of partnership the shares of the partners are not expressly specified. The Assessing Officer will have to construe the instrument of partnership as a whole and if reasonably the shares of the partners in profits and losses can be ascertained, then to accept it as genuine for the purpose of registration.

We will now refer to the decision of this court in Mandyala Govindu and Co. [1976] 102 ITR 1, which has been relied upon by the High Court and on the basis of which it decided the question referred to it against the appellant. That case arose under section 26A of the 1922 Act. Answering the question whether it was a condition for registration under section 26A that the instrument of partnership ought to have specified the respective shares of partners in losses, it was held that "the Income-tax Officer, before allowing the application for registration, must be in a position to ascertain the shares of the partners in the losses even if section 26A did not require the shares in the losses to be specified in the instrument of partnership". It referred to the conflict of opinion in the High Courts on the point but did not think it necessary to decide which view was correct as the assessee was bound to fail on any view. What is significant to note is that this court referred to rules 2 and 3 of the Rules framed under that Act and also the form of application including the Schedule annexed to rule 3. The form and the Schedule required the partners to state particulars of the apportionment of income and profits or gains (or loss) and also to state if any partner, though entitled to share in profits, was not liable to bear any loss. Thereafter, it was observed that "it does

not appear to have been considered in this case whether the application for registration made by the firm conforms to the prescribed rules". Thus, this court was of the view that even if the shares of the partners were not expressly specified in the instrument of partnership but if that could be ascertained by the Income-tax Officer from the application and the required information supplied therewith then the requirements of section 26A could be said to have been satisfied. It is also significant to note that this court tacitly approved the application of the principle contained in section 13(b) of the Indian Partnership Act that the partners are entitled to share equally in the profits earned and must contribute equally to the losses sustained by the firm and also the rule that "where the shares in the profits are unequal, the losses must be shared in the same proportion as the profits if there is no agreement as to how the losses are to be apportioned". On facts, it was held in that case that even after applying those two principles, it was not possible to ascertain how the losses pertaining to the minor's share were to be apportioned amongst the adult partners.

In an earlier decision in the case of Parekh Wadilal Jivanbhai v. CIT [1967] 63 ITR 485, this court construed the partnership deed by reading it as a whole and "in the context of the relevant circumstances of the case" and held that there was specification of the individual shares of the partners in the profits within the meaning of section 26A of the Act and the assessee-firm was entitled to registration. The relevant circumstances which were taken into account were (1) under clause 3 of the partnership deed the capital allotted to each partner was equal, (2) under clause 10 the net profit or loss was to be divided amongst all partners, (3) in the application the three partners were shown to share the profits equally, and (4) in the books of account the profits were apportioned equally among the three partners. Thus, it was laid down by this court in that case that the instrument of partnership has to be construed reasonably by reading it as a whole and taking into consideration the relevant circumstances disclosed by the instrument of partnership and the account books for the relevant year and the statements made in that behalf in the application.

In this case, it appears that the High Court, without carefully examining the facts and circumstances of the case, applied the decision of this court in Mandyala Govindu and Co. [1976] 102 ITR 1. In the partnership deed the proportion in which the five partners including the minor had to contribute the capital was clearly stated. It was also clearly stated that net profits were to be divided between the partners in proportion to their shares in the capital. The application made by the partners for registration of the firm contained the statements required to be made therein according to the prescribed form. The prescribed Schedule was also attached with that application. The said Schedule read as under :

"SCHEDULE----------Name of Address Date of Interest Salary, Share inpartner admittance on capital commission thebalance to or loans or other of profit partnership if any remuneration or loss; from firm percentage----------(1) (2) (3) (4) (5) (6) (7)----------1. Mr. M.R. Rajakrishna,Vijaya Raghavachari Road, 25% of profitMadras - 17 1-7-67 Nil Nil 40% of loss2. Miss Sunitha Pratap(Minor) Villa Enchantre,Ranjit Road, Kottur, 37.5% ofprofitsAdyar, Madras - 25 1-7-67 Nil Nil No share of loss3. Mr. W.S. Parthasarathy,80, Harris Road, 12.5% of profitMadras - 2 1-7-67 Nil Nil 20% of loss4. Mr. W.S. SethunarayanaBabu, 80, Harris Road, 12.5% of profitMadras - 2 1-7-67 Nil Nil 20% of loss5. W.S. Rajeswari,80, Harris Road, 12.5% of profitMadras - 2. 1-7-67 Nil Nil 20% of loss."----------##

As minor Sunitha was admitted to the benefits of partnership it is obvious that she had not to share any loss. The losses were to be distributed among the major partners only. Since they were to share

the profits in the proportion in which they had contributed the capital it was implied that they were to share the losses in the same ratio. This was the reasonable manner in which the instrument of partnership was required to be construed, applying the second principle referred to above while dealing with the case of Mandyala Govindu and Co. [1976] 102 ITR 1 (SC). Moreover, the application made by the appellant in the prescribed form clearly disclosed as to how the losses of the firm were to be distributed among the major partners. The way they had worked out their share in the loss, if any, in the schedule attached to the application was quite consistent with the provisions made in the instrument of partnership and the legal principles applicable in that behalf. Accordingly, Rajakrishna who was required to contribute 25 per cent. as share capital had to bear 40 per cent. of the loss and the other three major partners who had individually contributed 12.5 per cent. of the capital had to bear the loss in the ratio of 20 per cent. each. The Income-tax Officer had not considered these relevant circumstances as he was of the view that the contract of partnership itself was void. The Appellate Assistant Commissioner and the Tribunal did not refer to the application and, construing the partnership deed alone, held that it was possible to ascertain how the losses of the firm were to be distributed among the major partners.

If the partnership deed is construed reasonably, as indicated above, then it has to be held that it did, by necessary implication, provide for the proportion in which the losses of the firm were to be shared by the major partners. The application for registration made by the appellant fulfilled the conditions laid down by section 184 of the Act and, therefore, the Income-tax Officer ought to have granted registration and made assessment of the appellant for the relevant years on that basis. The High Court was wrong in taking the contrary view. Therefore, we allow these appeals, set aside the judgment and orders passed by the High Court and answer the question referred to the High Court by holding that for the assessment year 1968-69 the appellant was entitled to registration and for the assessment years 1969-70 and 1970-71 it was entitled to renewal/continuation of registration. In view of the facts and circumstances of the case, the parties shall bear their own costs.