

Suwalal Anandilal Jain

Vs

Commissioner of Income-Tax.

Tax Reference Case No. 1 of 1993

(CJI A. M. Ahmadi, K. Venkataswami, Sujata V. Manohar JJ)

10.03.1997

JUDGMENT

K. VENKATASWAMI J. –

1. 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 ?"

The assessment year in question is 1976-77. The case of the assessee- firm was that Shanti Kumar Jain, Ashok Kumar Jain, Raj Kumar Jain and Niranjan were partners in the firm in their capacity as karta of the respective Hindu undivided family. They have advanced monies to the assessee-firm in their individual capacity. The assessee-firm paid interest to them on the investments 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 Hindu undivided family as partners in the firm. The sources of the money, according to the assessee, are quite separate. The assessee-firm claimed that the interest paid 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 date

On appeal to the Appellate Assistant Commissioner, the assessment was confirmed by an appellate order dated August 27, 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 Makhan Lal Harnarayan v. CIT, 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 Brij Mohan Das Laxman Das v. CIT [1997] 223 ITR 825, had occasion to consider an identical issue. Jeevan Reddy J., speaking for the Bench, after noticing the subsequent amendment to section 40 by the Taxation Laws (Amendment) Act, 1984, under which Explanation 2, inter alia, has been added, has observed as follows (at page 829) :

"In *Gajanand Poonam Chand and Bros. v. CIT* [1988] 174 ITR 346, the Rajasthan High Court has taken the view that the said Explanation is merely declaratory in nature and that, therefore, even for the assessment years 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 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 the definition shows clearly that an individual, a Hindu undivided family and a firm are distinct persons/entities for the purpose of t

Clause (b) of section 40 is based upon and is a recognition of the basic nature of the relationship between a firm and its partner. In *CIT v. R.M. Chidambaram Pillai* [1977] 106 ITR 292, this court observed (at page 295) :

'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 a 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.'

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 Hindu undivided family, 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

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.