

Rashiklal & Co.

Vs

Commissioner of Income Tax, Orissa

Civil Appeals Nos. 4589-90 of 1992

(S. C. Sen, S. Saghir Ahmed JJ)

09.12.1997

JUDGMENT

SEN, J. –

1. The following question of law was referred by the Tribunal to the Orissa High Court under Section 256(1) of the Income Tax Act, 1961 :

"Whether on the facts and in the circumstances of the case, the commission paid by the assessee-firm to Shri Rashiklal P. Rathor (individual) is allowable under Section 40(b) of the Income Tax Act, 1961 as a deduction while computing the business income of the assessee.

2. The assessee is a partnership firm carrying on a number of businesses including sale and purchase of various commodities as well as mining. The partners of the firm were :

(1) Popatlal Devram

(2) Jayantilal Jagmal

(3) Pragji Devram

(4) Ratilal Odhavji

(5) Rashiklal P. Rathor

3. Popatlal is Rashiklal's father. On 1-4-1967, there was an oral partition of the share of Popatlal in the firm amongst Popatlal, his wife and his two sons including Rashiklal. The assets of Rashiklal continued to be invested in the partnership firm. Rashiklal was the Karta of a smaller HUF. On 17-10-1978, there was an agreement between Rashiklal and the firm Rashiklal and Company that Rashiklal will receive 37 paise per tonne of mineral sold by the firm. In the Assessment Year 1980-81 Rashiklal received a sum of Rs. 28,579 as commission. The firm claimed deduction of this amount from its income. The claim was negated by the Income Tax Officer. The Appellate Assistant Commissioner allowed the appeal holding that the commission was paid to Rashiklal in his individual capacity and not as Karta of the smaller HUF which is the partner of the firm. Since the payment was not made to the partner, Section 40(b) of the Income Tax Act was not attracted. The amount of commission paid to Rashiklal could not be included in the income of the firm. On further appeal by the Revenue, the Tribunal held that Section 40(b) of the Income Tax Act clearly applied in this case. Payment to a partner. The partnership firm could not claim any deduction for

this payment from its income. The High Court on reference held that there was clear material that Rashiklal had invested his joint family funds to enter into the partnership. Payment was made to Rashiklal who was a partner. Accordingly, the Tribunal was correct in coming to the conclusion that Section 40(b) will be applicable in this case. The firm was not entitled to claim any deduction on account of payment of commission to one of its partners.

4. The firm has come up in appeal against the judgment of the High Court. Section 40(b) of the Income Tax Act, at the material time, stood as under :

"40. Notwithstanding anything to the contrary in Sections 30 to 39, the following amounts shall not be deducted in computing the income chargeable under the head 'profits and gains of business or 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."

5. In our view the answer to the question raised in this case is self-evident. There is no dispute that Rashiklal was a partner of the assessee-firm. For assessment of the firm under the head profits and gains of business and profession any payment of commission by the firm to any partner of the firm will not be allowed as deduction. The firm has paid a commission of Rs. 28,579 to Rashiklal and has claimed that amount as deduction. Such deduction is not permissible in clear terms of Section 40(b).

6. The language of the section is simple and clear. But to complicate the matter an argument was sought to be made that Rashiklal had not joined the firm as an individual but was really representing an HUF. The real partner of the firm was the HUF. The payment of Rashiklal did not amount to payment of commission to the HUF which was the real partner. Therefore, the amount of commission paid by the firm to a non-partner or a partner who had joined the firm in a representative capacity, will not fall within the mischief of Section 40(b).

7. We are unable to uphold this contention for a number of reasons. A firm is a compendious way of describing the individuals constituting the firm. An HUF directly or indirectly cannot become a partner of a firm because the firm is an association of individuals.

8. In the case of *Dulichand Laxminarayan v. CIT* ((1956) 29 ITR 535 : AIR 1956 SC 354) it was held by a Bench of three Judges of this Court that a firm is not a "person" and as such was not entitled to enter into a partnership with another firm or an HUF or an individual. In that case, an individual, a joint family and three firms purported to enter into a partnership. The agreement of partnership was signed by the individual partner, the Karta of the joint family and one partner each of the three firms. The firm applied for registration under Section 26-A of the Income Tax Act. The application was signed by the aforesaid five individuals. This Court held that there could be no question of granting registration to a partnership purporting to be one between three firms, an HUF and an individual. In coming to this conclusion, this Court relied on the provisions of the Indian Partnership Act wherein, "partnership", "partner", "firm" and "firm name" were defined in the following manner :

"4. Definition of 'partnership', 'partner', 'firm' and 'firm name'. - 'Partnership' is the relation between persons who have agreed to share the profits of a business carried

on by all or any of them acting for all.

Persons who have entered into partnership with one another are called individually 'partners' and collectively 'a firm', and the name under which their business is carried on is called the 'firm name'."

S. R. Das, C.J. speaking for the Court observed :

"This section clearly requires the presence of three elements, namely, (1) that there must be an agreement entered into by two or more persons; (2) that the agreement must be to share the profits of a business; and (3) that the business must be carried on by all or any of those persons acting for all. According to this definition 'persons' who have entered into partnership with one another are collectively called a 'firm' and the name under which their business is carried on is called the 'firm name'. The first question that arises is as to whether a firm as such can enter into an agreement with another firm or individual. The answer to the question would depend on whether a firm can be called a 'person'."

9. Das, C.J., therefore, went on to examine the meaning of the word "person" in the Partnership Act. It noted that "person" had not been defined in the Partnership Act. However, the General Clauses Act, 1897, had defined 'person' in Section 3(42) as under :

"'person' shall include any company or association or body of individuals, whether incorporated or not;"

After referring to the definition of 'person' in the General Clauses Act, Das, C.J. observed that the firm was not a company but was certainly an association or body of individuals.

10. The Court, however, after examining the scheme of the Partnership Act and the corresponding provisions of the English law on the subject, held that the definition given to "person" by the General Clauses Act could not be extended to the Partnership Act having regard to the various provisions of that Act. The Court concluded :

"It is clear from the foregoing discussion that the law, English as well as Indian, has, for some specific purposes, some of which are referred to above, relaxed its rigid notions and extended a limited personality to a firm. Nevertheless, the general concept of partnership, firmly established in both systems of law, still is that a firm is not an entity or 'person' in law but is merely an association of individuals and a firm name is only a collective name of those individuals who constitute the firm."

11. The view of this Court was that when Section 4 of the Partnership Act spoke of "persons" who had entered into partnership with one another it could only be individuals and not a body of persons. A body of persons like a firm could not enter into partnership with other individuals.

12. An HUF cannot be in a better position than a firm in the scheme of the Partnership Act. The reasons that led this Court to hold that a firm cannot join a partnership with another "individual" will apply with equal force to an HUF. In law, an HUF can never be a partner of a partnership firm. Even if a person nominated by the HUF joins a partnership, the partnership will be between the nominated person and the other partners of the firm. Having regard to the definition of "partnership" and "partners" and in view of the principle laid down in Dulichand case ((1956) 29 ITR 535 : AIR

1956 SC 354) it is not possible to hold that an HUF being a fluctuating body of individuals, can enter into a partnership with other individual partners. It cannot do indirectly what it cannot do directly. If a Karta or any other member of the HUF joins a partnership, he can do so only as an individual. His rights and obligations vis-a-vis other partners are determined by the Partnership Act and not by Hindu law. Whatever may be the relationship between an HUF and its nominee partner, in a partnership, neither the HUF nor any member of the HUF can claim to be a partner or connected with the partnership through a nominee. Where the Karta of an HUF enters into a partnership agreement with a stranger, the Karta alone in the eye of law is the partner. If any payment by the firm to a partner is prohibited by law, the Karta cannot be heard to say that the payment was received by him not as a partner but in some other capacity. Within the partnership, the Karta is a partner like any other partner with whom he has entered into a partnership agreement individually. It is essential to have an agreement between the partners to form a partnership. An HUF not being a "person" cannot enter into an agreement of partnership. If the Karta of an HUF enters into partnership with a stranger, upon the death of the Karta, the partnership will stand dissolved. In the absence of a contract to the contrary, another member of the family cannot step into the shoes of the Karta claiming that the Karta was merely representing the HUF and the real partner was the HUF. A Karta who enters into a contract of partnership with a stranger may be accountable to the other members of the HUF for the profits received from the partnership business. But that is something between the Karta and the HUF. But so far as the partnership firm is concerned, the Karta is a partner like any other partner. If a commission is paid to a partner who happens to be a nominee of an HUF, the commission is not paid to the HUF. It is paid by the firm to one of its individual partners. The partner may have to account for the monies received from the firm to another person or another firm or an association of persons or an HUF. But that will not alter the fact that commission was paid by the firm to one of its partners.

13. The Partnership Act contains various provisions regulating the relationship between partners. The partners are bound to carry on the business of the firm to the greatest common advantage, to be just and faithful to each other and to render true account and true information of all things affecting the firm to any partner or his legal representative. Every partner has a right to take part in the conduct of the business. Every partner is bound to attend diligently to his duties in the conduct of the business. Any differences arising as to ordinary matters connected with the business may be decided by majority of the partners and every partner shall have the right to express his opinion before the matter is decided. No change can be made in the nature of the business without the consent of all the partners. Every partner has a right to have access to and to inspect and copy any of the books of the firm. All these provisions will apply to a partner who represents another body. The HUF who has a nominee partner in a firm has neither any right nor any obligation under the provisions of the Partnership Act. Section 13 provides that a partner is not entitled to receive remuneration for taking part in the conduct of the business. The partners are entitled to share equally in the profits earned and shall contribute equally to the losses sustained by the firm. Where a partner is entitled to interest on the capital subscribed by him, such interest shall be payable only out of profits. A firm has to indemnify a partner in respect of payments made and liabilities incurred by him in the ordinary and proper conduct of business and in doing such act, in an emergency for the purpose of protecting the firm from any loss as would be done by a person of ordinary prudence under similar circumstances. The partner has also a duty to indemnify for any loss caused to the firm by his wilful neglect in the conduct of the business of the firm.

14. All these provisions relating to mutual rights and liabilities are only applicable to the individual partners who are members of the firm. There is no way that an HUF can intrude into the relationship created by a contract between certain individuals. The only right of the HUF is possibly to call upon

its nominee partner to render accounts for the profits that he has made from the partnership business. But that is something between the nominee and the HUF with which the partnership is not concerned.

15. The specific provision in Section 13 of the Partnership Act that a partner is not entitled to receive any remuneration for taking part in the conduct of the business has been interpreted to mean that every partner is bound to attend diligently to the business of the firm. For doing his duties he cannot charge his co-partners any sum or remuneration whether in the shape of salary, commission or otherwise on account of the trouble taken by him in conducting the partnership business. There, however, can be a special contract to the contrary in which case, the provisions of that contract will prevail.

16. Section 40(b) of the Income Tax Act will apply even when there is such a special contract. Any commission paid by a firm to its partner will not be permitted as deduction from the business income of the firm. If a claim is made by a partner that he is representing an HUF or any other body of persons then the position in law will not be any different. The HUF is not and cannot be a partner in a partnership firm. The remuneration or the commission that is paid to the partner cannot be claimed to be a remuneration or commission paid to the HUF. The partner may be accountable to the family for the monies received by him from the partnership. But in the assessment of the firm, the partner cannot be heard to say that he has not received the commission as a partner of the firm but in a different capacity.

17. We were referred to two decisions of this Court on this point, *Brij Mohan Das Laxman Das v. CIT* ((1997) 1 SCC 352 : (1997) 223 ITR 825) and *Suwalal Anandilal Jain v. CIT* ((1997) 4 SCC 89 : (1997) 224 ITR 753). Both the cases dealt with payment of interest to a partner who had joined the firm in a representative capacity. Section 40(b) prohibits deduction on account of payment of interest, salary, bonus or remuneration by a firm to any partner of the firm. Explanation II was added to Section 40(b) specifically providing that where an individual was a partner in a firm in a representative capacity for and on behalf of any other person, the interest paid by the firm to such individual shall not be taken into account for the purpose of clause (b) of Section 40.

18. This Court held that in view of this Explanation, when a Karta of an HUF had joined a firm representing his HUF and had made deposits in the firm in his individual capacity, the interest paid to him could not be disallowed by reason of Explanation II added to Section 40(b) of the Income Tax Act, 1961. It was further held that the Explanation was only clarificatory. It is difficult to agree with that proposition because the Explanation was added by the Taxation Laws (Amendment) Act, 1984 with effect from 1-4-1985, i.e., from the Assessment Year 1985-86. By adding the Explanation, the legislature altered the law prospectively on and from 1-4-1985. If what was contained in the Explanation was already the law in force, then giving effect to the Explanation from 1-4-1985 does not make any sense.

19. However, in the case before us, no question of payment of any interest is involved. A commission was paid by the firm for the services rendered by the partner. Such commission cannot be paid because of the provisions of Section 13 of the Partnership Act in the absence of a special contract. Even if a special contract exists, Section 40(b) of the Income Tax Act prohibits allowance of such commission as deduction from the business income of the firm.

20. The argument that Rashiklal had joined the firm Rashiklal & Company not as an individual but in a representative capacity overlooks the fact that the partnership Rashiklal & Company is a

compendious way to describe the individuals who are partners of the firm. The other partners of the firm have a contractual relationship with Rashiklal only. Section 40(b) categorically disallows any deduction of payment of commission to a partner.

21. The position of a person belonging to an HUF who has joined a firm on behalf of the family has been explained in Mulla's Hindu Law, 16 Edn., p. 265 :

"Not all members of the joint family, but only such of its members as have, in fact, entered into partnership with the stranger, become partners. The manager, no doubt, is accountable to the family, but the partnership is exclusively one between the contracting members including the manager and the stranger. Such a partnership would be governed by the provisions of the Indian Partnership Act, 1932, with the result that if the manager died, the partnership would be dissolved on his death."

22. Under the Income Tax Act, 1961, "firm", "partner" and "partnership" have been given the same meaning as assigned to them in the Partnership Act. But the expression "partner" has been extended to include any person who, being a minor, has been admitted to the benefits of a partnership. Therefore, there is no scope for any argument that even though under the Indian Partnership Act, an HUF not being a "person" cannot be a partner, but the payment of commission to the nominee partner will tantamount to payment to the HUF and therefore, such payment will not come within the mischief of Section 13 of the Partnership Act or Section 40(b) of the Income Tax Act. To repeat what has been stated in Mulla's Hindu Law, only the members who have entered into partnership are to be regarded as partners. The position of the other members is no higher than sub-partnership.

23. The application for registration of a firm has to be made under Section 184 of the Income Tax Act. It is specifically provided that :

- (1) the partnership must be evidenced by an instrument in writing;
- (2) the individual shares of partners must be specified in that instrument;
- (3) the application for registration shall be signed by all the partners.

24. The very fact that individual shares of the partners have to be specified and that such partners must personally sign the partnership deed and also the application for registration go to show that even if a person joins a firm as a representative of an HUF or any other body or association, within the firm his position is that of an individual. He may have an agreement with a third party to divide the profits received from the firm, but that agreement does not bind the firm nor does it alter the position of the partners under the Partnership Act or the Income Tax Act. This aspect of the matter was explained by Subba Rao, J. (as his Lordship, then was) in the case of CIT v. Bagyalakshmi & Co. ((1965) 55 ITR 660 : AIR 1965 SC 1708) in the following words :

"A partnership is a creature of contract. Under Hindu law a joint family is one of status and right to partition is one of its incidents. The income tax law gives the Income Tax Officer a power to assess the income of a person in the manner provided by the Act. Except where there is a specific provision of the Income Tax Act which derogates from any other statutory law or personal law, the provision will have to be considered in the light of the relevant branches of law. A contract of partnership has no concern with the obligation of the partners to others in respect of their shares of profit in the partnership. It only regulates the rights and liabilities of the partners. A

partner may be the Karta of a joint Hindu family; he may be a trustee; he may enter into a sub-partnership with others; he may, under an agreement, express or implied, be the representative of a group of persons; he may be a benamidar for another. In all such cases he occupies a dual position. Qua the partnership, he functions in his personal capacity; qua the third parties, in his representative capacity. The third parties, whom one of the partners represents, cannot enforce their rights against the other partners nor the other partners can do so against the said third parties."

25. This judgment given by a Bench of three Judges of this Court is a complete answer to the argument advanced on behalf of the assessee. A partner does not act in a representative capacity in the partnership. He functions in his personal capacity like any other partner. The provision of the Partnership Act and the Income Tax Act relating to partners and partnership firms will apply in full force in respect of such a partner. If any remuneration is paid or a commission is given to a partner by a partnership firm, Section 40(b) will apply even if the partner has joined the firm as a nominee of an HUF. The Hindu undivided family or its representative does not have any special status in the Partnership Act. Although the partnership firm is not a legal entity, it has been treated as an independent unit of assessment under the Income Tax Act. The assessment of a firm will have to be made strictly in accordance with the provisions of the Income Tax Act. The law has to be taken as it is. Section 40(b) applies to certain payments made by a firm to its partners. Neither the firm nor its partners can evade the tax law on the pretext that although in law he is a partner but in reality he is not so. He may have to hand over the money to somebody else. That may be his position qua a third party. But the firm has nothing to do with it. It has paid the commission to one of its partners. It cannot get any deduction in its assessment for that payment because Section 40(b) of the Act expressly prohibits such deduction.

26. The basic principle that a firm is a compendious mode of describing the persons constituting the firm must not be overlooked. It is the individuals constituting the firm who are its partners. The partner may be under an obligation to hand over the monies received by him to somebody else by virtue of a sub-contract or any other arrangement. That will not change the character of the payment by the firm to its partner or the status of the partner in the firm. The firm is not entitled to get any deduction on account of payment of commission to a partner merely because the partner has an obligation to share the money with somebody else. So far as the firm was concerned, the commission was paid to one of the partners in his personal capacity.

27. The provisions relating to assessment of the firm should not be construed in a way to defeat its object. Section 40(b) forbids deduction of any amount paid by way of commission to a partner. In the instant case, Rashiklal is a partner of the firm Rashiklal and Company. The commission received by him from the partnership firm cannot be allowed as a deduction from the business income of the partnership.

28. The appeals, therefore, fail and are dismissed with no order as to costs.