BOMBAY HIGH COURT

Shantikumar Narottam Morarji

Vs.

Commissioner of Income Tax

I.T. Ref. No. 21/X of 1954

(Chagla, C.J. and Tendolkar, J.)

23.09.1954

JUDGMENT

Chagla, C.J.

1. The following questions of law were referred to the High Court:

> "(i) Whether any deduction is permissible from the share of profits which a partner of a registered firm gets, in view of the provisions contained in Section 23(5)(a), Income-tax Act?
> (ii) If the answer to question No. (i) is in the affirmative, whether the interest paid to the assessee's grand-mother and the assessee's sister is admissible as a deduction in view of the fact that the managing agency rights of the assessee in the Scindia Managing Agency were pledged with them?
> (iii) If the answer to question No.(i) is in the affirmative, whether the interest disallowed is admissible for the reason that the creditors threatened to attach the managing agency?"

Chagla, C.J.

1A. The assessee is a partner in the firm of Messrs. Narottam Morarji and Co. The firm is a registered firm and his share of the profits in this firm for the assessment year 1942-43, which corresponds with the year of account Samvat Year 1997, amounted to Rs. 2,28,706. This share was shown by the assessee in his return of total income. The assessee claimed that he had paid a certain amount as interest on moneys borrowed and he claimed that amount of interest as a permissible deduction against the profits shown by him in respect of his share in the firm of Messrs. Narottam Morarji and Co., and the question that arises is, first, whether it is open to a partner in a registered firm to claim any deduction whatsoever against the amount of profit determined by the Income-tax Authorities as the profits of the firm, and the other question that

arises is whether, if it is so permissible to the assessee to claim those deductions, whether the deductions claimed in this case are permissible deductions.

2. Now, in the year of account Samvat Year 1997 the assessee paid interest amounting to Rs. 31,382. The loans on which this interest was paid amounted to Rs. 6,19,478. The Income-tax Officer allowed interest at 6 per cent. on Rs. 2,77,000. This interest came to Rs. 16,620. The balance of the claim with regard to interest which came to Rs. 14,762 was disallowed by the Income-tax Officer. It is in respect of this amount that this reference has been made.

3. Now, this interest was paid on loans which may be divided into two categories. One was loans aggregating to Rs. 1,54,097 and the other loans aggregating to Rs. 1,88,361. With regard to the first category, these were loans taken by the assessee from his relations and the important fact with regard to these loans was that he had pledged his interest in the managing agency commission with his relations to secure these loans. With regard to the other category, those loans were taken by the assessee for the purpose of paying off some of the creditors of his father Narottam Morarji. Now, the reason for paying off the creditors of Narottam Morarji was that before the death of Narottam Morarji in 1929 the firm of Messrs. Narottam Morarji and Co. consisted of the assessee and his father Narottam. It appears that when Narottam died in 1929 he left a large number of debts and as the creditors of Narottam Morarji threatened to attach the share of Narottam Morarji in their Scindia managing agency commission, according to the assessee he paid off these creditors by raising loans and these loans amounted to Rs. 1,88,381.

4. Before we deal with the merits of the matter, we must consider the very important question of law that has been raised in this reference. The question is, what exactly are the rights of a partner in a registered firm with regard to deductions which he claims in respect of the share of profit earned by him? Now, there is a vital and important distinction between a registered and an unregistered firm under the Income-tax Act. When a firm is unregistered, the unregistered firm is the assessee and the firm itself is liable to pay tax. The profits of the unregistered firm are ascertained as an assessee, the various deductions claimed by it are considered under Section 10(2), and the amount of profit is determined and the tax payable on that amount is also determined, and it is the unregistered firm as such which is liable to pay the tax. With regard to the registered firm, the position is entirely different. It is true that up to a point the procedure followed by the Income-tax Department with regard to the registered and unregistered firm is identical. In order to assess the profits, assessment is carried on in the same way with regard to an unregistered firm and also a registered firm. But when the profits of the registered firm are ascertained, the assessee for the purpose of paying the tax is not the registered firm but each partner of the registered firm. The share of the profits coming to a partner on the basis of the assessment made against the firm is to be included by the partner in his total income, and then the assessment of the partner proceeds because he is the assessee and he is liable to pay tax. Now, his total income may consist of various sources. Here also the assessee had various sources of income. He had property, he had dividends, he had director's fees, and so on. But to the extent

that his source of income is the share of profits in the partnership firm, that income is to be shown by him in his total income as already ascertained and computed by the Income-tax Authorities. The importance of doing this lies in this, fact that whereas the total profits of an unregistered firm are to be paid by the unregistered firm and the rate that would apply would be the rate applicable to the total profits, in the case of a registered firm the profits are divided between the various partners and the rate which would apply would depend upon the total income of each partner as consisting of his share in the profits and any other income that he might have. If his income is only the share of the profits, then as against the unregistered firm he would pay tax at the rate applicable to only the share of the profits and not the total profits.
This special provision with regard to the registered firm and the partner of the registered firm is to be found in Section 23(5) and the provision is to the following effect:

> "Notwithstanding anything contained in the foregoing sub-sections, when the assessee is a firm and the total income of the firm has been assessed under Sub-Section (1), Sub-Section (3) or Sub-Section (4), as the case may be,-
> (a) In the case of a registered firm, the sum payable by the firm itself shall not be determined but the total income of each partner of the firm, including therein his share of its income, profits and gains of the previous year, shall be assessed and the sum payable by him on the basis of such assessment shall be determined."

5. Now, Mr. Joshi's contention is that the only right that a partner in a registered firm gets is that he pays tax on his share of the profits and the firm is not made to pay tax on the total profits earned by the firm. Mr. Joshi says that the scheme of the Act is that the partner is substituted for the firm as assessee only for the purpose of paying the tax, and apart from that the partner has no other rights. Now, that would not be quite correct because as pointed out by Mr. Palkhivala, certain exemptions are given under the Act which could only be taken advantage of by a partner in a registered firm and which are not open to a partner of an unregistered firm. Attention is drawn to Section 15 where tax is not payable in respect of any sum paid by an assessee to effect an insurance on the persons mentioned in that section, and Mr. Palkhivala says that a partner in a registered firm would be able to claim this exemption even though the only income he had was his share in the partnership. The position would be different with regard to a partner in an unregistered firm if his income was also confined to the share in the unregistered firm, because if he paid any insurance, no question of exemption would arise because he would have no income to show as a taxable income. The income would be taxed in the hands of the unregistered firm. It is also pointed out that an assessee would be entitled to exemption in respect of earned income, and whereas in the case of a registered firm each partner may become entitled to exemption to the extent of Rs. 4,000, in the case of an unregistered firm the exemption would be confined to the firm as a whole and which could not exceed Rs. 4,000. It is pointed out that in the definition of "earned income" in Section 2(6AA), whereas earned income may include the income of an unregistered firm, it does not include the income of a registered firm because the earned income is claimed by the assessee, the partner of a registered firm in his own right. But it may be pointed

out that the Income-tax Act makes a clear distinction between exemptions and deductions. Whereas the question of exemption can only arise after the income of the assessee is ascertained, deductions are to be made before the income is ascertained and the deductions do not form part of the income at all. Therefore, even though we may agree with Mr. Palkhivala that the assessee who is the partner of a registered firm is entitled to certain exemptions in his own right, it does not necessarily follow that therefore he is also entitled to the deductions permissible under the Income-tax Act. The question of deductions must be approached from a different point of view.

6. The deduction in this case is claimed under Section 10(2), and the first question that we have to consider is whether Section 10 has any application to the case of an assessee who is a partner of a registered firm. Mr. Joshi's contention is that Section 10 has no application at all because Section 10 deals with the profits of a business carried on by the assessee, and according to Mr. Joshi the business in this case is not carried on by the assessee but is carried on by the assessee along with a partner or partners. Mr. Joshi says that a firm, under the Income-tax Act is an assessable entity and therefore a distinction must be made between a business carried on by a firm and a business carried on by an individual. Although a firm is an assessable entity under the Income-tax Act, a firm is not a legal entity. In the eye of the law a firm is a compendious expression used to indicate that several persons constituting that firm are carrying on a business. But that compendious expression cannot give to the firm a legal entity or a legal existence. In law it is only the partners who exist and who carry on the business. It is equally true that looking to the definition of "partnership" in Section 4 of the Partnership Act, when you have a partnership business, the business is carried on by each of the partners, and the definition of a partnership in the Partnership Act has been incorporated in the Income-tax Act in Section 2(6B). Therefore, the contention that Section 10(1) cannot apply to a partner in aregistered firm is untenable, because he does carry on the business although that business happens to be a partnership business, and therefore if any profits and gains are derived by the assessee from the business carried on by him, those profits and gains |must be brought to tax only under this head, viz. the head falling under Section 10(1) which is the head of business.

7. It is pointed out by Mr. Palkhivala that when you turn to the provisions of super tax, super tax is not payable by a registered firm under Section 55 and therefore with regard to profits from a business super tax would be payable by the assessee himself in the case of a registered firm, and this super tax would only be payable provided the income falls under one of the provisions of the Income-tax Act, and it is clear that the assessee would be liable to pay super tax because income which he has derived is an income from business which is not only liable to pay income-tax but by reason of Section 55 also liable to pay super tax. It is also pointed out that in the definition of "earned income", earned income can only be claimed in respect of income which is chargeable under the head "salaries" or which is chargeable under the head "profits and gains of business, profession or vocation" where the business, profession or vocation is carried on by the assessee or, in the case of a firm, where the assessee is a partner actively engaged in the conduct of the business, profession or vocation. Therefore, in order to claim exemption in respect of earned

income the assessee has got to satisfy the taxing authorities that his income is chargeable under the head of "business" and he himself is actively engaged in the conduct of the business.

8. It is further pointed out that the first proviso to Section 23(5) permits, the setting off of any loss sustained by a partner and also the carrying forward in accordance with the provisions of Section 24, and when we turn to the provisions of Section 24(2) it is clear that a carry forward would only be permissible provided the loss has been sustained in a business and it can be set off against the profits and gains of the same business in a year other than the year of assessment. In the case of the year of assessment it could be set off undoubtedly against any other head. Therefore, this section clearly shows that the Legislature looked upon the income earned by the assessee by reason of his partnership as an income derived from business. Indeed it is difficult to understand how that income could be anything else than income derived from business. It is by reason of his partnership, it is by reason of the fact that he carried on his business along with his partners, that profits are earned and he gets a share of those profits, and we cannot possibly accept Mr. Joshi's contention that the income of the partner may conceivably fall under Section 12. Section 12, as has often been pointed out, is a residuary section and we can only resort to that section provided we are satisfied that the income of the partner does not fall under any other head enumerated in Section 6.

9. But even assuming that the income earned by the partner falls under Section 10(1), the question still remains as to whether any deduction is permissible to him which is set out in Sub-Section (2). Now, two views are possible on the construction of Sub-Section (2). One is that it refers to the computation of profits and gains of the business which is carried on and in which the assessee is a partner, and the allowance which can be made is only in respect of that business and the computation contemplated by Sub-Section (2) is also the computation of the profits of that business. It may be suggested that Sub-Section (2) can have no reference to the share of the profits earned by the assessee. Mr. Joshi says that the amount which is arrived at on the assessment of the firm after taking into consideration all the allowances claimed is a sacrosanct figure which cannot be under any circumstance varied in the assessment of the assessee. The other point of view is that it is perfectly true that it is not open to the assessee to challenge the figure of profits arrived at on the assessment of the firm, nor is it open to him to claim any deductions which could have been claimed by the firm. But there may be deductions which the partner alone can claim as referable to his own share of profits, and to the extent that such deductions could be claimed by the partner there is no reason why those deductions cannot be allowed under Sub-Section (2) of Section 10. Another difficulty which may be noticed in accepting the latter view is that the various clauses of Sub-Section (2) refer to "deductions in respect of such business" and it may be said that the business contemplated in these clauses is the business of the firm and not the business in the sense of the profits derived by the assessee from his share in the business.

10. In our opinion, it is unnecessary in this reference to decide the larger and perhaps the more

important question as to whether a partner in a registered firm who is being assessed under Section 10(1) in respect of a share of profits is entitled to claim any deduction under Sub-Section (2) of Section 10. When we turn to Section 24(5) the provision made in that sub-section by the Legislature is that the share of the income, profits and gains of the registered firm must be included in the total income of the partner who is being assessed to tax. It is well settled that the profits and gains contemplated by the Legislature under Section 10 are the true profits and gains and ordinarily the true profits and gains must be ascertained from the point of view of commercial accounting. In a well known case the Privy Council in - *'Income Tax Commr., C.P. and Berar v. S.M. Chitnavis*[1]*',* considered whether a bad debt was an admissible deduction at a time when there was no provision in Section 10(2) with regard to bad debts, and the Privy Council stated that (pp.180-181) :

> "Although the Act nowhere in terms authorizes the deduction of bad debts of a business, such a deduction is necessarily allowable. What are chargeable to income-tax in respect of a business are the profits and gains of a year; and in assessing the amount of the profits and gains of a year account must necessarily be taken of all losses incurred, otherwise you would not arrive at the true profits and

[1] AIR 1932 PC 178

> gains."

These observations would equally apply to the share of a partner in a registered firm which is being assessed to tax. It is not the share as ascertained on the assessment of the firm that is liable to tax, but the share as representing the true profit of the partner. It is true that if there is a specific prohibition in the Act, the Court will not permit an allowance in face of that prohibition. It is equally true that if there is an allowance permissible under the Act and the allowance deals with the whole subject-matter, the Court will not permit that subject-matter to be expanded. But where there is no prohibition and where no allowance deals with a particular subject-matter, it is open to the Court to permit an allowance in order to arrive at the true profits or gains of an assessee, and therefore if an assessee claims a deduction against the share which is included in his total income contending that without that deduction the share will not represent his true profits and gains, in our opinion the assessee will be entitled to such a deduction. The deduction which would ordinarily be allowed to him would be a deduction which was necessary in order that the assessee was enabled to earn the income which represented the share in the profits. If it was incumbent upon the assessee to spend an amount in order that he should be in a position to remain a partner and to earn the profit, it may be argued that that was a permissible deduction because without allowing that deduction the share of the profits would not represent the true income of the assessee. Therefore, as far as this reference is concerned, the view we take is that it is not correct as a general legal proposition that a partner in a registered firm is not entitled to claim any deduction against the share of the profits included in his total income, the share having been arrived at on the assessment of the firm with regard to its profits. It would be open to the assessee to claim a deduction, provided he satisfies the taxing authority that such deduction represents a

necessary expenditure, the extenditure being incurred in order to enable him to earn the profits which were being subjected to tax.

11. We must next proceed to apply this principle to the facts of this case. It would be for the assessee to satisfy us that both the sums of Rs. 1,54,097 and Rs. 1,88,381 were borrowed in order to enable the assessee to earn the profits in the firm of Narottam Morarji and Co. There is a finding given by the Accountant Member in the following words: "We understand that no part of the borrowings were utilised in the agency firm business and therefore the interest paid was not incurred for the purposes of the business."
Mr. Palkhivala has rightly quarrelled with the nature of this finding. With respect to the learned Accountant Member, it is difficult to understand how a judicial tribunal can record a finding in the language in which this so-called finding has been recorded. The duty of a fact finding tribunal is to find facts, and not to understand that certain facts may exist or may have been established. Therefore, as far as the assessee is concerned, we must discard that finding. But there are sufficient findings on record which clearly go to show that the assessee has not succeeded in discharging the burden which was upon him to prove that these two amounts were borrowed in order to enable him to earn the profits in the managing agency firm.

12. Now, what is urged by Mr. Palkhivala is that with regard to the sum of Rs. 1,54,097 he had to pay interest on this amount, because if he had not done so, the pledgees would have put to sale the managing agency, and therefore according to Mr. Ralkhivala he paid this interest in order to preserve and maintain an asset belonging to the business. In our opinion that is not the correct approach to the subject. It is impossible to contend that whatever the purpose for which the moneys were borrowed, merely because the assessee pledges a capital asset of a business the interest paid on those moneys would be a revenue expenditure deductible from the profits of the business. It is only if moneys were borrowed either for the purpose of the business or in order to enable the business to earn profits that interest paid on the moneys would be a permissible deduction. The assessee has failed to establish that the moneys were borrowed for any such purpose. It seems that these moneys were borrowed by the father of the assessee and the borrowings were continued subsequently by the assessee himself and it may be that the assessee is unfortunate in not having the necessary materials to prove for what purpose his father originally borrowed these moneys. With regard to the sum of Rs. 1,88,381, the only finding recorded is that this amount, as already pointed out, was borrowed in order to pay off some of the creditors of Narottam Morarji. Mr. Palkhivala contends that here again is a case where what the assessee was doing was to preserve and maintain a capital asset. If he had not paid off his father's creditors, the creditors would have attached his father's share and brought the managing agency to a standstill. But the same considerations apply to these loans as apply to the loans we have already discussed. We must know for what purpose these moneys were borrowed by Narottam Morarji, and in the absence of any evidence led by the assessee, the mere fact that the creditors of Narottam Morarji were paid off would not constitute that payment a payment for the purpose of the business.

13. It is then urged by Mr. Palkhivala that Narottam Morarji left large debts and he had to discharge the debts in order to safeguard Narottam Morarji's share in the managing agency firm. Now, in putting forward this argument Mr. Palkhivala overlooks the important fact that on the death of Narottam Morarji the original partnership was dissolved in law and Narottam Morarji's share no longer remained in the new partnership which then started doing the business of the managing agency. It may be that the creditors of Narottam Morarji might have got a decree for taking accounts of the partnership before its dissolution by the death of Narottam Morarji and for being paid out of the assets in the partnership coming to the share of Narottam Morarji. But we do not know whether at the death of Narottam Morarji there were any assets at all which would have gone to the share of Narottam Morarji, and even assuming that there were any assets, it is difficult to understand how it would affect the new partnership which had come into existence on the death of Narottam Morarji. There is nothing on the record to show that that new partnership could not have subsisted and could not have done the work of managing agents without the aid of the assets, if any, left by Narottam Morarji. These are all speculations which have no basis or substance on the facts actually found by the fact finding authorities. All that is clear and patent on the record is that there is absolutely no evidence to justify us in taking the view that the loans on which the interest was paid by the assessee were loans to enable the assessee to earn the profits in the managing agency agreement. In the absence of any such evidence or materials, we must hold that the interest paid by the assessee on these loans was not a justifiable deduction.

14. We must, therefore, answer the first question in the affirmative to the extent indicated in the judgment, and questions Nos.2 and 3 in the negative. No order as to costs of this reference. No order as to costs of the notice of motion.
Answer accordingly.