

# RAJASTHAN HIGH COURT

Gajanand Poonam Chand

Vs.

Commissioner of Income Tax

D.B.I.T. Reference Nos. 1 and 2 of 1982  
(Jagdish Sharan Verma, C.J. and Milap Chandra Jain, J.)

06.05.1988

## JUDGMENT

### **Jagdish Sharan Verma, C.J.**

1. This common order shall dispose of both the above references, which relate to the same assessee. Reference No. 1/82 relates to assessment years 1974-75 and 1978-79, while reference No. 2/82 relates to assessment years 1979-80.

2. At the instance of the assessee the Tribunal has referred under Section 256(1) of the income-tax act, 1961 a common question of law arising out of the tribunal's order in respect of the above assessment years, for the decision of this court.

3 The question of law as framed in Reference No. 1/82 is as under:

"Whether, on the facts and in the circumstances of the case, the Tribunal was right in sustaining the disallowance of ₹ 8,506/- and ₹ 10,720/- pertaining to the assessment years 1974-75 and 1978-79 respectively under Section 40(b) of the Income Tax Act, 1961?"

The question of law as framed in Reference No. 2/82 is as following :-

"Whether, on the facts and in the circumstances of the case the Tribunal was right in law in holding that interest paid to Shri Poonam Chand, who was a partner as karta of his HUF in the a assessee firm, on his individual account by the assessee was hit by the provisions of Section 40(b) of the Act, 1961?"

In the substance the question of law referred in both the reference is the same and is based on the same set of facts.

4. One of the partners of the assessee firm M/s Gajanand Poonam Chand and Brothers is Poonam Chand in his representative capacity as Karta of his HUF. Apart from this capacity of Poonam Chand in his representing the HUF as its karta for the purpose of partnership of the firm the said Poonam Chand in his individual capacity had a separate account with the firm. for the assessment years 1974-75, 1978-79 and 1979-80 the assessee firm paid interest to Poonam Chand on his individual account distinct from his account as partner in his capacity as Karta of HUF. The question arose whether Section 40(b) of the Income Tax Act, 1961 applied to the interest so paid by the assessee firm in the distinct individual account of Poonam Chand, due to the fact that Poonam Chand in a separate representative capacity as Karta of the HUF is a partner of that firm. The ITO took the view that Section 40(b) of the Act is attracted. The assessee's appeal to the CIT (Appeals) was dismissed. The Tribunal has affirmed that view on further appeal by the assessee. Hence these references at the instance of the assessee in respect of the aforesaid assessment years.

5. It is admitted that the interest paid to Poonam Chand by the assessee firm is in respect of his distinct account as an 'individual' separate from the account of Poonam Chand as Karta of HUF, in which capacity alone he is a partner of the assessee firm. The question, therefore, is whether in spite of this distinct and separate personality as an 'individual' in which capacity alone the interest has been paid by the assessee firm, is the interest to be disallowed merely because in a separate representative capacity the said Poonam Chand represents the HUF as a partner in the firm? There are conflicting decisions of several High Courts and there is no decision on the point either of this Court or of the Supreme Court. It is, therefore, necessary for us to consider this question at some length.

6. The relevant part of Section 40 of the Income-tax Act, 1961 is as under:-  
Section 40-Not with standing any thing 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 of profession".

(a) xx xx xx xx

(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.

Explanation-1: 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.

Explanation-2: Where an individual is a partner in a firm on behalf, or for the benefit, of any other person (such partner and the other person being herein after referred to as "partner in a representative capacity" and "person so represented" respectively):

- (i) interest paid by the firm to such individual or by such individual to the firm otherwise than as partner in a representative capacity, shall not be taken into account for the purposes of this clause;
- (ii) interest paid by the firm to such individual or by such individual to the firm as partner in a representative capacity and interest paid by the firm to the person so represented or by the person so represented to the firm, shall be taken into account for the purposes of this clause.

Explanation-3: Where an individual is a partner in a firm otherwise than as partner in a representative capacity, interest paid by the firm to such individual shall not be taken into account for the purposes of this clause, if such interest is received by him on behalf, or for the benefit of any other person.

The three Explanations in Clause (b) of Section 40 have been inserted by the Taxation Laws (Amendment) Act, 1984 w.e.f. 1-4-1985. We are here concerned with Section 40(b) as it stood without these Explanations during the relevant assessment years.

7. A mere perusal of Explanation-2 inserted in Section 40(b) w.e. from 1-4-1985 clearly indicates that for the period subsequent to the insertion of the Explanation there can be no ambiguity and interest paid by the firm to an individual otherwise than as a partner in a representative capacity does not attract the prohibition contained in Section 40(b) of the Act. The real question, therefore, is whether the main enacting part in Clause (b) as it stood prior to insertion of this Explanation is required to be construed differently. In other words, is this Explanation merely clarificatory of the existing law contained in Clause (b) prior to its insertion or it is by itself a distinct

enacting provision in the nature of a proviso carving out an exception from the general rule enacted in Clause (b)? We shall first consider without reference to this Explanation whether Clause (b) should be construed as depriving the individual of the benefit merely because in a distinct representative capacity he is a partner in the firm.

8. It would be useful to refer to the definition of "person" given in Section 2(31) of the Act. This is an inclusive definition and it clearly shows that an 'individual' a Hindu undivided family' and a 'firm' are to be treated as distinct persons or entities for the purposes of the Income-tax Act. In this Scheme of things it is obvious that under the provisions of the Income-tax Act there is no inconsistency in treating an individual as a distinct person from the same individual representing the HUF as its Karta for the purposes of partnership in a firm. The question, therefore, is whether in such a situation for the purpose of Section 40(b) the distinction between the two personalities of an individual, which is clearly recognized by the provisions of the Income-Tax Act is to be treated as obliterated? We do not find anything in Section 40(b) to require obliteration of the distinction between these two personalities of an individual in order to hold that merely because an individual is also in his representative capacity as Karta of HUF, a partner of the assessee firm, the interest paid to him in his distinct individual account must be disallowed under Section 40(b).

9. It appears to us that the Legislature inserted Explanation-2 in Section 40(b) w.e. f 1-4-1985 to settle the controversy on account of divergence of opinion between the High courts on point, there being no authoritative pronouncement of the Supreme Court. In this view of the matter we are inclined to hold that Explanation-2 is merely declaratory of the existing law as contained in Clause (b) of Section 40 intended to remove the doubt raised on account of conflicting High Court decisions; and it is not a new enacting provision carving out an exception from the general rule contained in Clause (b). The ordinary purpose of an explanation is to clarify that which is already enacted and not to enact some thing new. No doubt, the Explanation some time may be a distinct enacting provision itself. However, it would then not be performing its ordinary or normal function of an Explanation. We are of the view that the function of Explanation-2 inserted in Clause (b) w.e.f 1-4-1985 is its normal function of explaining that which is already contained in Clause (b).

10. Incidentally, we may mention that we had an occasion to consider the nature of Explanation-1 inserted in Clause (b) of Section 40 at the same time with effect from 1-

4-1985 in *Commissioner of Income Tax v. M/S Motilal Ramjiwan & Company D.B.I.T.*<sup>1</sup> and the view taken by us is that Explanation-1 was merely clarificatory or declaratory of the existing law already contained in Clause (b) to remove ambiguity, if any, in its construction. We are inclined to take the same view also with regard to Explanation-2, as already stated.

11. Insertion of Explanation-2 along with Explanation-3 without any amendment being made simultaneously in Clause (b), of Section 40 or the definition of 'person' in Section 2(31) of the Act reinforces our conclusion that under the IT Act an individual representing the HUF has a personality distinct from his capacity as a mere individual. It is with the different facts of personality of an individual under the IT Act with which we are concerned.

12. We shall now refer to the decision of several High Courts, which were cited at the Bar. The decisions of Andhra Pradesh High Court are-*Commissioner of Income Tax v. T. Veeraiath*<sup>2</sup> & *K. Narasimhulu* ; *Additional Commissioner of Income Tax v. K.G. Narayanaiah Chetty*<sup>3</sup> *Commissioner of Income Tax v. Chinna Balaiah Chetty & Company*,<sup>4</sup> *Terla Veeraiah v. Commissioner of Income Tax*,<sup>5</sup> *N.T.R. Estate v. Commissioner of Income Tax*<sup>6</sup> And 6 and *CIT v. Chitra Kalpana*<sup>7</sup> It has been expressly held in a similar situation in (1988) 169 ITR 678 that the character in which the partner received the amount from the firm is relevant and significant for the purposes of determining whether the provisions of Section 40(b) are applicable; and that interest paid to a partner in a character other than a partner could not be disallowed under Section 40(b) of the Act. In both these decisions, the Andhra Pradesh High Court also referred to the newly added Explanation-2 in Section 40(b) and expressed the view that the Explanation was merely clarificatory of the existing law and not a new enacting provision. The earlier decisions of the Andhra Pradesh High Court need no separate consideration The same view has been taken by the Bombay High Court in *Commissioner of Income Tax v. Pannalal Hiralal*<sup>8</sup> & by a Full Bench of the Gujarat High Court in *Chhotaylal & Company v. Commissioner of Income Tax, Gujarat*,<sup>9</sup> which has been referred by the Andhra Pradesh High Court in its later decisions. The Madras High Court also has taken the same view in *Venkaatesh Emporium v. Commissioner of Income Tax*<sup>10</sup> on the basis of the principle that an individual has a distinct legal personality as an 'individual' from that of his personality as Karta of the HUF and, therefore, unless interest is paid by the assessee firm to him as a partner of the firm, the same cannot be disallowed under Section 40(b) of the Act. It is also significant that while taking this view a strong dissent was expressed with the

contrary view taken by the Allahabad High Court, to which we shall refer later. This decision was followed by another Division Bench of Madras High Court in *Commissioner of Income Tax v. Colombo Stores* <sup>11</sup> We may here mention that some earlier decisions of the Andhra Pradesh, Madras & Gujarat High Courts purporting to take a different view are now no longer relevant in view of the latest consistent view of these High Courts already indicated by us. We are, therefore, not making any reference to these earlier decisions. A Full Bench of Madhya Pradesh High Court in *Commissioner of Income Tax v. Narbharam Popatbhai & Sons* <sup>12</sup> has also taken the same view following the decisions we have already cited. There is thus strong opinion of these several High Courts consistent with the view we have taken on the meaning of Section 40(b) of the Act even without the aid of Explanation-2 inserted therein w.e.f. 1-4-1985.

13. We shall now refer to the decisions, which have been cited in support of the contrary view. The Patna High Court in *Chandmal Rajgarhia v. Commissioner of Income Tax* <sup>13</sup> has taken the contrary view and dissented from the above quoted Full Bench decision of the Gujarat High Court and some other High Courts taking that view. The basis of this decision appears to be the non-existence of two distinct personalities, one as an individual and the other as Karta of the HUF, on the ground that Section 40(b) does not contemplate this dichotomy.

14. The view of the Allahabad High Court in *Commissioner of Income Tax v. London Machinery*, <sup>14</sup> has been followed to which reference will be made by us later. The two decisions of the Karnataka High Court, which have been cited to support the contrary view are- *Commissioner of Income Tax v. Khoday Eswarsa & Sons* <sup>15</sup> and *Shri Ramajnaeya Textiles v. Commissioner of Income Tax J.* <sup>16</sup> The basis of this view is that the prohibition contained in Section 40(b) is absolute and makes no distinction between the payments made by way of interest etc. to a partner as a partner and such payments made to him in a different character. In other words, it has been assumed that no dichotomy in the personality of an individual is permissible under the IT Act. We may also mention that in the Karnataka cases, there is no consideration of the earlier decisions of several High Courts taking the opposite view.

15. Now the main cases which remain to be referred are of Allahabad High Court, which have also been relied on in some decisions of High Court taking the contrary view. The Allahabad decisions are-*Commissioner of Income Tax v. London Machinery*

(supra), *Commissioner of Income Tax v. Brijmohandas Laxmandas*,<sup>17</sup> *Commissioner of Income Tax v. Chandulal Surajpal*,<sup>18</sup> and *Commissioner of Income Tax v. Harinath*,<sup>19</sup> The decision in *Commissioner of Income Tax v. London Machinery*, (supra) is the one, which has been followed in the later decisions. The basis of this decision taking contrary view is that the capacity in which a person receives the payment whether on behalf of the family or for his own individual benefit is immaterial. In other words, this view proceeds on assumption that for the purpose of Section 40(b) there can be no dichotomy in the personality of an individual. On this assumption naturally the conclusion is that payment is to be treated as that made to the partner even when it is not to him in his representative capacity as a partner but in a distinct individual capacity. With respect, we are unable to subscribe to either the basis on which the contrary view proceeds or the ultimate conclusion reached on that basis.

16. The reason for our inability to concur with this contrary view has already been indicated by us. We also find that the decisions of other High Courts taking the other view are not considered and their reasoning has not been noticed in the Allahabad decisions. The divergence of judicial opinion on the point was noticed in *Commissioner of Income Tax v. Harinath & Company* (supra), but the Division Bench preferred to follow the view taken by that Court in the earlier decisions declining to make a reference to a Larger Bench as suggested and without considering the reasons on which the other view is based. It does not appear from this decision that both the learned Judges constituting the Division Bench had reservations about the correctness of the earlier view, which they were merely following as a binding precedent. In our opinion the weight of the Allahabad view is considerably reduced by these factors also. However, with respect, we find ourselves unable to concur with the view also because the view we have taken is in consonance with the view taken by majority of the High Courts. More over, if both views were possible then the view in assessee's favour must be preferred while construing such an enactment.

17. As a result of the above discussion, we have come to the conclusion that the Tribunal was not justified in holding that the interest paid to Poonam Chand in his individual account distinct from the account of HUF, which he represented as Karta and in which capacity alone, he was partner of the assessee firm, is hit by the prohibition contained in Section 40(b) of the Income-tax Act, 1961. We answer the questions referred in both these references accordingly in favour of the assessee and against the revenue.

No costs.

Reference answered in favor of assessee.

Cases Referred.

1. Ref. No. 31/81 (Jodhpur), decided on 2-9-1987
2. (1977) 106 ITR 283 (A.P)
3. (1977) 106; Addl
4. (1977) 106 ITR 420 (AP)
5. (1979) 120 ITR 502 (AP)
6. (1986) 157 ITR 285 (AP)
7. (1988) 169 ITR 678 (AP).
8. (1984) 146 ITR 549 (Bom)
9. (1984) 150 ITR 276 (Guj)
10. (1982) 137 ITR (593 (Mad)
11. (1984) 149 ITR 105 (Mad)
12. (1987) 166 ITR 534 (MP)
13. (1987) 164 ITR 486(Pat)
14. (1979) 117 ITR 111 (All)
15. (1985) 152 ITR 423 (KAR)
16. (1986) 159 ITR 509 (Kar)
17. (1979) 117 ITR (All)
18. (1986) 157 ITR 346 (All)
19. (1987) 168 ITR 440 (All)