

M/S. BRIJ MOHAN DAS LAXMAN DAS

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v.

COMMISSIONER OF INCOME TAX, ALLAHABAD

DECEMBER 10, 1996

[B.P. JEEVAN REDDY AND K.S. PARIPOORNAN, JJ.]

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Income Tax Act, 1961 : Section 40(b) Explanation 2 (Added by Taxation Laws (Amendment) Act, 1984).

Interest—Paid to partner—On amount deposited by him in his individual capacity—AY 1974-75—Such partner not being a partner in his individual capacity but representing his HUF—Held : such interest paid did not fall within the mischief of S.40(b)—Expln. 2 in the context of S.40(b) was declaratory in nature and, therefore, has retrospective effect.

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The appellant-assessee was a registered partnership firm of three partners. One of the partners was the Karta and represented his H.U.F. The partnership firm maintained capital and deposit accounts in the name of the said partner. The share of profit of the said partner was credited to the capital account while the interest paid to him on the deposits made by him in his individual capacity was credited to his deposit account. The said partner was assessed in the status of individual and also in the status of H.U.F. For the Assessment Year 1974-75, the Income Tax Officer (ITO) sought to include the interest paid to the said partner in the income of the appellant-assessee since it was a payment made to a partner.

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The appellant-assessee contended that since the amount was paid to the said partner in his individual capacity and not in his capacity as a partner, the said payment could not be disallowed under Section 40(b) of the Income Tax Act, 1961. This plea was rejected by the ITO which was upheld by the High Court. Hence this appeal.

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Subsequently, Explanations 1, 2 and 3 to Section 40(b) of the Income Tax Act, 1961 were added by Taxation Laws (Amendment) Act, 1984 with effect from 1.4.1985. Explanation 2 expressly provided that any interest paid by a firm to any individual otherwise than as partner in representative capacity shall not be taken into account for the purpose of Section 40(b) of the Act.

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A The question before this Court was whether the said Explanation 2 was merely declaratory and clarificatory in nature, in which case it would govern the previous assessment years as well or whether it was a substantial provision having effect only prospectively.

B Allowing the appeal, this Court

C HELD : 1. Section 40(b) of the Income Tax Act, 1961 is based upon and is a recognition of the basic nature of relationship between a firm and its partner. Explanation 2 added to Section 40(b) of the Act by Taxation Laws (Amendment) Act, 1984 with effect from 1.4.1985 does not preclude an individual, who is a partner representing a H.U.F., from depositing his personal funds with the partnership and receiving interest thereon. This is the legislative recognition of the theory of different capacities an individual may hold - no doubt confined to Section 40(b) of the Act. Once this is so, there is no reason to hold that this theory of different capacities is not valid or available for the period anterior to 1.4.1985 and any interest paid to a partner, who is a partner representing his H.U.F., on the deposit of his personal/individual funds, does not fall within the mischief of Section 40(b) of the Act. Explanation 2, in the context of clause (b) of Section 40, is declaratory in nature. [781-B-C]

E *Gajanand Poonam Chand v. C.I.T.*, (1984) 174 ITR 346 (Raj.), approved.

CIT v. London Machinery Company, (1979) 117 ITR 111 and *CIT v. Chidambaram Pillai*, (1977) 106 ITR 292, referred to.

F Lindley : "*Law of Partnership*", referred to.

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 2100 of 1979.

G From the Judgment and Order dated 22.12.78 of the Allahabad High Court in I.T.R. No. 66 of 1977.

Jayant Das, M.M. Kshatriya and Ms. Aruna Banerjee for the Appellant.

H T.L. Vishwanath Iyer, S.Rajappa and S.N. Terdol for the Respondent.

The Judgment of the Court was delivered by

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B.P. JEEVAN REDDY, J. Clause (b) of Section 40 of the Income Tax Act specifies one of the amounts which shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession". As it stood at the relevant time, it read thus :

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"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 'Profit and gains of business or profession', -

(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.

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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.

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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 hereinafter referred to as 'partner in a representative capacity' and 'person so represented' respectively),-

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(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;

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(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.

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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

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A or for the benefit, of any other person."

The first and the main question arising herein is whether interest paid to a partner on the amounts deposited by him in his individual capacity is hit by clause (b) where the partner is a partner not in his individual capacity but as representing a Hindu Undivided Family (H.U.F.). The question which was referred by the Tribunal for the opinion of the High Court in this behalf read :

B "Whether the Tribunal was correct in allowing the assessee's claim for interest paid on the credit balance in the individual account of Sri Rajendra Kumar?"

C The assessee, Brij Mohan Das Laxman Das, is a registered partnership firm having three partners. One of them is Rajendra Kumar. He was a partner as the Karta of and representing his H.U.F. The partnership firm maintained two accounts in the name of Rajendra Kumar, a capital account and a deposit account. The share of profit of Rajendra Kumar was credited to the capital account while the interest paid to him on the deposits made by him was credited to his deposit account. In other words, the deposits were said to have been made by Rajendra Kumar in his individual capacity and accordingly interest was paid to him in his individual capacity. Rajendra Kumar was assessed in the status of individual and also in the status of H.U.F. For the Assessment Year 1974-75, the Income Tax Officer called upon the assessee herein to show cause why the interest amount in a sum of Rs. 7, 923 paid to Rajendra Kumar be not added back to the income of the partnership firm since it was a payment made to a partner. The appellant-assessee contended that since the amount was paid to Rajendra Kumar in his individual capacity and not in his capacity as a partner, the said payment cannot be disallowed under clause (b) of Section 40. This plea was rejected by the Income tax Officer and his view was affirmed in appeal by the Appellate Assistant Commissioner. On further appeal, however, the Tribunal agreed with the assessee and deleted the said addition.

G On reference, the High Court held following its earlier decision in *Commissioner of Income Tax v. Landon Machinery Company*, (1979) 117 I.T.R. 111 that the amount was rightly disallowed by the Income Tax Officer and that the Tribunal was not right in allowing the assessee's appeal, The High Court has, however, certified the case under Section 261.

It may be mentioned that Explanations 1, 2 and 3 to the above clause were added by the Taxation Laws (Amendment) Act, 1984 with effect from April 1, 1985. Explanation 2 expressly provides that where an individual is a partner in a firm on behalf of or for the benefit of any other person, any interest paid by the firm to such individual otherwise than as partner in representative capacity, shall not be taken into account for the purpose of clause (b). It is, therefore, clear that with effect from April 1, 1985, the question of the nature involved herein would not arise. Where a person is a partner in a representative capacity, i.e., as representing H.U.F., any interest paid to him in his individual capacity will not be hit by clause (b). The only question is what is the position earlier to April 1, 1985 - which is the case here. Prior to the introduction of the said Explanation, there was a conflict of opinion among the several High Courts in the country, the majority of High Courts taking the view in favour of the assessee and a few High Courts taking the contrary view. There was no decision of the Supreme Court on this question. The Taxation Laws (Amendment) Act which introduced the said Explanation does not say that the said Explanation shall have effect retrospectively. The question is whether the said Explanation is merely declaratory and clarificatory in nature, in which case it will govern the previous assessment years as well or whether it is a substantial provision having effect only prospectively.

In *Gajanand Poonam Chand v. Commissioner of Income Tax*, [1984] 174 I.T.R. 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 the 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 H.U.F. and a firm are distinct persons/entities for the purpose of the Income Tax Act. The High Court, therefore, concluded that since an individual and a H.U.F. are two distinct entities for the purpose of the Act, clause (b) of Section 40 has no application where the interest is paid

- A to the partner on deposits made by him with the firm in his individual capacity where such person is a partner not in his individual capacity but as representing a H.U.F. Sri Jayant Das, learned counsel for the appellant-assessee, strongly relies upon this decision and commends it for our acceptance. Learned counsel points out that even before the enactment of
- B Taxation Laws (Amendment) Act, 1984 (which inserted Explanation 2 aforesaid), a majority of the High Courts in the country had taken the same view though a few High Courts have no doubt taken a contrary view. Looked at from any angle, Sri Das says, the issue must be answered in favour of the assessee.
- C Clause (b) of Section 40 is based upon and is a recognition of the basic nature of relationship between a firm and its partner. In *Commissioner of Income tax v. Chidambaram Pillai*, [1977] 106 I.T.R. 292, this Court observed :
- D "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 agree-
- E ment 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
- F contract of employment requires two distinct persons viz. the employer and the employee, there cannot be a contract of the 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 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."
- G 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
- H 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 H.U.F., 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 capacities an individual may hold - no doubt confined to clause (b) of Section 40. Once this is so, we see no reason to hold that this theory of different capacities is not valid or available for the period anterior to April 1, 1985. Accordingly, we hold that even for the period anterior to April 1, 1985, any interest paid to a partner, who is a partner representing his H.U.F., on the deposit of his personal/individual funds, does not fall within the mischief of clause (b) of Section 40. In this view of the matter, we agree with the view taken by the Rajasthan High Court in *Gajanand Poonam Chand* that Explanation 2, in the context of clause (b) of Section 40, is declaratory in nature. Accordingly, we allow this appeal, set aside the judgment of the High Court and answer the question referred under Section 256 in the affirmative, i.e., in favour of the assessee and against the Revenue.

No costs.

V.S.S.

Appeal allowed.