A

FATEHCHAND MURLIDHAR AND ANR.

v.

COMMISSIONER OF INCOME-TAX, CALCUTTA

July 19, 1966

B

[K. N. WANCHOO AND S. M. SIKRI, JJ.]

Income-tax Act (11 of 1922), *s.* 23(5)(*a*)—*Scope of—Partnership—Sub-partnership between a partner and strangers—Agreement to share profits and losses of partner in the Partnership—Income from the Partnership—Whether belongs to partner or sub-partnership.*

C The assessee was a partner in a registered firm. In 1949, he entered into a partnership with persons who were strangers to the registered firm and a deed of partnership was executed between them. It recited that the profits and losses for the share of the assessee in the registered firm should belong to the new firm and be divided and borne by the partners of the new firm in accordance with the shares specified in the deed.

On the question whether the income of the assessee from the registered firm for the years 1952-53, 1953-54 and 1955-56, should be D included in his individual assessment,

HELD: The income should be included in the assessment of the new firm and not in the personal assessment of the assessee.

(i) The new partnership constituted a sub-partnership in respect of the assessee's share in the registered firm. In the case of a sub-partnership, it creates a superior title and diverts the income before it becomes the income of the partner, that is, the partner in the main E firm receives the income not only on his own behalf but on behalf of the partners in the sub-partnership. The fact that a sub-partner can have no direct claim to the profits *vis-a-vis* the other partners of the main firm and that it is the partner alone who is entitled to the profits *vis-a-vis* the other partners in the main firm, does not show that the changed character of the partner should not be taken into consideration for income-tax purposes. [461E-F; 462C]

F (ii) The object of s. 23(5)(a) is not to assess the firm itself but to apportion the income among the various partners. After the income has been apportioned, the Income-tax Officer has to find whether it is the partner who is assessable or whether the income should be taken to be the real income of some other person. If it is the real income of another firm, it is that firm which is liable to be assessed under the section. There is nothing in the section that prevents the income of the assessee from the registered firm being treated as the income of the sub-partnership and the section being applied again. G [463C, F]

Charandas Haridas v. *Commissioner of Income Tax*, [1960] 3 S.C.R. 296, and *Commissioner of Income Tax, Bombay* v. *Sitaldas Tirathdas* [1961] 3 S.C.R. 634, followed.

Commissioner of Income Tax, Punjab v. *Laxmi Trading Co.* 24 I.T.R. 173 and *Ratilal B. Daftari* v. *Commissioner of Income Tax, Bombay*, 36 I.T.R. 18, referred to. H

Mahaliram Santhalia v. *Commissioner of Income Tax* 33 I.T.R. 261, overruled.

CIVIL APPELLATE JURISDICTION: Civil Appeal Nos. 1108 to 1110 of 1964. A

Appeals by special leave from the judgment and order dated August 1, 1962 of the Calcutta High Court in Income-tax Reference Nos. 20 and 21 of 1959.

A. K. Sen, S. C. Mazumdar and *J. Datta Gupta, for the* appellants. B

R. M. Hazarnavis, R. Ganapathy Iyer and *R. N. Sachthey,* for the respondent.

The Judgment of the Court was delivered by

Sikri, J. These appeals by special leave are directed against the judgment of the High Court of Calcutta in two cases referred to it by the Income Tax Appellate Tribunal, Calcutta Bench, under s. 66(1) of the Indian Income-tax Act (XI of 1922) hereinafter called the Act). One of the references (Income Tax Reference No. 20 of 1959) was made at the instance of M/s Fatehchand Murlidhar, and the other (Income Tax Reference No. 21 of 1959) was made at the instance of Shri Murlidhar Himatsingka. In the former reference the question referred was "whether on the facts and in the circumstances of the case, the income of Murlidhar Himatsingka for his share in the firm of Messrs. Basantlal Ghanshyamdas for the assessment years 1952-53 and 1953-54 was rightly excluded from the income of the applicant firm". In the latter reference the question referred was "whether on the facts and circumstances of the case the income of Murlidhar Himatsingka for his share in the firm of Messrs. Basantlal Ghanshyamdas for the assessment year 1955-56 was rightly included in his personal assessment for that year". C D E

The facts and circumstances out of which these references were made are common because the real question raised by these references is whether the income of Murlidhar Himatsingka, from the firm of M/s Basantlal Ghanshyamdas, in which he was a partner, should be included in his personal assessment or in the assessment of the firm of Fatehchand Murlidhar, to which Murlidhar Himatsingka had purported to assign the profits and losses from M/s Basantlal Ghanshyamdas. It is sufficient to take the facts from the statement of the case in Income Tax Reference No. 21 of 1959, made at the instance of Murlidhar Himatsingka. Murlidhar Himatsingka was carrying on business in shellac, jute, hessian etc. under the name and style of "Fatehchand Murlidhar" at 14/1, Clive Row and 71, Burtolla Street, Calcutta. He was also a partner in the registered firm, Messrs Basantlal Ghanshyamdas having -/2/8 share. On December 21, 1949, a deed of partnership was executed by the said Murlidhar Himatsingka and his two sons, Madanlal Himatsingka and Radhaballav Himatsingka and a grandson named Mahabir Prasad Himatsingka. The deed recited that Murlidhar Himatsingka had become too old and infirm F G H

A to look after the various businesses and that Madanlal and Radha Ballav were already practically managing the business and that they had signified their intention to become the partners of the said firm "Fatehchand Murlidhar" and had agreed to contribute capital, Rupees ten thousand, Rupees five thousand and Rupees five thousand respectively. The parties further agreed to become
B and be partners in the business mentioned in the deed. Clause 5 of this deed is important for our purpose and reads as follows:—

> "The profits and losses for the share of the said Murlidhar Himatsingka as partner in the said partnership firm of Basantlal Ghanshyamdas shall belong to the present partnership and shall be divided and borne by the parties
C hereto in accordance with the shares as specified hereafter, but the capital with its assets and liabilities will belong exclusively to Murlidhar Himatsingka the party hereto of the First Part and the Parties hereto of the Second, Third and Fourth parts shall have no lien or claim upon the said share capital or assets of the party hereto of the first part in the business of the said Messrs
D Basantlal Ghanshyamdas".

Clause 10 provides:

> "The Profits and losses (if any) of the partnership including the shares of the profits and losses of the said partnership firm of Basantlal Ghanshyamdas aforesaid shall be divided and borne by and between the parties in the following manner:—
>
> E Party hereto of the First Part—Six annas (Murlidhar Himatsingka).
>
> Party hereto of the Second Part—Four annas (Madanlal Himatsingka).
>
> Party hereto of the Third Part—Three annas (Radhaballav Himatsingka).
>
> F Party hereto of the Fourth Part—Three annas (Mahabirprasad Himatsingka).

Clause 11 provides that "all partnership moneys and securities for money shall as and when received be paid into and deposited to the credit of the partnership account". In clause 13 it is provided that "the party hereto of the First Part shall have the sole control and direction of the partnership business and his opinion
G shall prevail if there be any dispute between the parties hereto". Clause 16 provides that "the net profits of the partnership after payment of all outgoings interest on capital or loans and subject to the creation and maintenance of any reserve or other fund shall belong to the parties and the losses, if any, shall also be borne and paid by the parties in proportion to their shares as
H stated in Clause 10 hereof".

For the assessment year 1955-56 the Income Tax Officer included the income from the share in the registered firm of

Basantlal Ghanshyamdas in the individual assessment of Murlidhar Himatsingka, Murlidhar Himatsingka appealed to the Appellate Assistant Commissioner. Referring to s. 23(5)(a) of the Act, he held that as Murlidhar Himatsingka was a partner in the registered firm of Basantlal Ghanshyamdas, his share had to be assessed in his hands. He further held that the agreement was merely an arrangement which came into force after the profits were earned and not before they were earned. He held that this agreement being a subsequent disposition of profits, after they had been earned, had to be disregarded.

Murlidhar Himatsingka appealed to the Income Tax Appellate Tribunal. The Appellate Tribunal heard this appeal together with the two appeals filed by M/s Fatehchand Murlidhar. The Appellate Tribunal, agreeing with the views of the Appellate Assistant Commissioner, dismissed the appeal.

The High Court held that it was a case of diversion of income by Murlidhar Himatsingka after it had accrued to him and it was not a diversion at the source by any overriding interest. In the result, the High Court answered the questions in the affirmative in both the references. Murlidhar Himatsingka and M/s Fatehchand Murlidhar having obtained special leave, the appeals are now before us.

The learned counsel for the appellants, Mr. A. K. Sen, contends that a partner's share is property capable of being assigned, mortgaged, charged and dealt with as any other property, and where a partner sells his share to a stranger, though that stranger does not become a partner yet the vendor partner holds the property as trustee for the purchaser and consequently the income received by the partner is not his income but the income of the purchaser. He says that similarly if a partner assigns part of his share the same result follows. He further contends that in this case, by the agreement dated December 21, 1949, Murlidhar Himatsingka had entered into a sub-partnership with his two sons and a grandson in respect of his share in the firm Basantlal Ghanshyamdas, and it is the sub-partnership that is entitled to the income from the firm Basantlal Ghanshyamdas and not Murlidhar Himatsingka who must be taken to be acting on behalf of the firm Fatehchand Murlidhar. Mr. Sen further urges that the Indian Income Tax Act taxes real income and not notional income and the real income in this case belonged not to Murlidhar but to M/s Fatehchand Murlidhar.

Mr. Hazarnavis, on the other hand, contends that this agreement is a mere device for dividing income which had accrued to Murlidhar Himatsingka among his sons and grandson. In the alternative he contends that the Indian Income Tax Act does not contemplate the application of s. 23(5)(a) twice. He says that the firm of Basantlal Ghanshyamdas was a registered firm and the

A Income Tax Officer was bound, under s. 23(5)(a), to assess Murlidhar in respect of the income received from this firm; he could not carry this income to the assessment of another registered firm, namely, Fatehchand Murlidhar, and then apply s. 23(5)(a).

The first point that arises is whether the agreement dated
B December 21, 1949, has succeeded in diverting the income from Murlidhar's share in M/s Basantlal Ghanshyamdas to M/s Fatehchand Murlidhar before it reached Murlidhar. What is the effect of the agreement? In our opinion the agreement dated December 21, 1949, constituted a sub-partnership in respect of Murlidhar's share in M/s Basantlal Ghanshyamdas. The High Court in this connection observed:—

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> "At best it could be called a sub-partnership entered into by Murlidhar with strangers in respect of his share of the partnership".

In arriving at this conclusion we attach importance to the fact that losses were also to be shared and the right to receive profits
D and pay losses became an asset of the firm, Fatehchand Murlidhar.

In Commissioner of Income-tax, Bombay v. *Sitaldas Tirathdas*,(1) Hidayatullah, J., speaking for the Court, laid down the following test for determining questions like the one posed above. After reviewing a number of authorities, he observed:—

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> "In our opinion, the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligations, no doubt, there are in every case, but it is the nature of the obligation which is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obli-
F gation cannot be said to be a part of the income of the assessee. Where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow. It is the first kind of payment which can truly be excused and not the
G second. The second payment is merely an obligation to pay another a portion of one's own income, which has been received and is since applied. The first is a case in which the income never reaches the assessee, who even if he were to collect it, does so, not as part of his income
H but for and on behalf of the person to whom it is payable".

(1) [1961] 3 S.C.R. 634, 642.

This test clearly shows that it is not every obligation to apply income in a particular way that results in the diversion of income before it reaches the assessee. In its judgment in the above case (*Sitaldas Tirathdas* v. *Commissioner of Income-tax, Bombay*(1) the High Court of Bombay had observed:—

> "It is not essential that there should be a charge, it is quite sufficient if there is a legally enforceable claim".

These observations must be treated as unsound. The test laid down by this Court is quite clear, though like some other tests it is not easy of application in all cases.

The other cases cited before us, namely, *K. A. Ramachar* v. *Commissioner of Income-tax, Madras*(2) and *Provat Kumar Mitter* v. *Commissioner of Income-tax, West Bengal*(3) do not assist us in disposing of this case because the facts are not similar. Only two cases, one of the Bombay High Court and the other of the Calcutta High Court, have close resemblance to the facts of this case and we may now consider them. In *Ratilal B. Daftri* v. *Commissioner of Income-tax, Bombay*(4) the assessee who was one of the sixteen partners in a registered partnership had contributed Rs. 25,000/- out of the capital of the partnership, Rs. 3,45,000/-. In order to contribute this capital of Rs. 25,000/- he had entered into an agreement with four others on the same date on which the registered partnership deed was executed, which provided for contribution of diverse sums by the four others and it was further provided in this agreement that the five parties would share the profits and losses in proportion to their individual contribution. It was also mentioned that the terms and conditions mentioned in the registered partnership were to be applicable and binding on them. The Bombay High Court held that the assessee was liable to be assessed only in respect of his share of the profits of the registered partnership. In coming to this conclusion, the High Court relied on two other decisions of the same Court, namely, *Motilal Manekchand* v. *Commissioner of Income-tax*(5) and *Sitaldas Tirathdas* v. *Commissioner of Income-tax*(1) As pointed out by the learned counsel for the respondent, Mr. Hazarnavis, *Sitaldas Tirathdas* v. *Commissioner of Income-tax*(1) was reversed by this Court in *Commissioner of Income-tax* v. *Sitaldas Tirathdas*(6) Hidayatullah, J., at p. 374 of his judgment reversing the judgment of the Bombay High Court, had also referred to *Motilal Manekchand* v. *Commissioner of Income-tax* (5) but did not expressly dissent from this case. In our opinion the case of *Ratilal B. Daftari* v. *Commissioner of Income-tax, Bombay*(4) was rightly decided, although the reasoning given by the learned Judges of the High Court has to some extent not been accepted by Hidayatullah, J., in *Commissioner of Income-tax* v. *Sitaldas Tirathdas*(6). We say so far the follow-

(1) 33 I.T.R. 390,394. (2) 42 I.T.R. 25. (3) 41 I.T.R. 624.
(4) 36 I.T.R. 18. (5) 31 I.T.R. 737. (6) 41 I.T.R. 367, [1961] 3 S.C.R. 634.

ing reasons. Lindley on Partnership, 12th Edition, page 99, deals with sub-partnerships as follows:—

> "A sub-partnership is, as it were, a partnership within a partnership; it presupposes the existence of a partnership to which it is itself subordinate. An agreement to share profits only constitutes a partnership between the parties to the agreement. If, therefore, several persons are partners and one of them agrees to share the profits derived by him with a stranger, this agreement does not make the stranger a partner in the original firm. The result of such an agreement is to constitute what is called a sub-partnership, that is to say, it makes the parties to it partners *inter se;* but it in no way affects the other members of the principal firm".

He further states:—

> "Since the decision of the House of Lords in Cox v. Hickman (1860) 8 H. L. Cas. 268, a sub-partner could not before the Partnership Act, 1890, be held liable to the creditors of the principal firm by reason only of his participation in the profits thereof, and there is nothing in that Act to alter the law in this respect".

Sub-partnerships have been recognised in India and registration accorded to them under the Indian Income Tax Act. (See *Commissioner of Income-tax, Punjab* v. *Laxmi Trading Company*)(1)

The question then arises is whether the interest of the sub-partnership in the profits received from the main partnernship is of such a nature as diverts the income from the original partner to the sub-partnership. Suppose that A is carrying on a business as a sole proprietor and he takes another person B as a partner. There is no doubt that the income derived by A after the date of the partnership cannot be treated as his income; it must be treated as the income of the partnership consisting of A and B. What difference does it make in principle where A is not carrying on a business as a sole proprietor but as one of the partners in a firm? There is no doubt that there is this difference that the partners of the sub-partnership do not become partners of the original partnership. This is because the Law of Partnership does not permit a partner, unless there is an agreement to the contrary, to bring strangers into the firm as partners. But as far as the partner himself is concerned, after the deed of agreement of sub-partnership, he cannot treat the income as his own. Prior to the case of *Cox* v. *Hickman*(2), sub-partners were even liable to the creditors of the original partnership. Be that as it may, and whether he is treated as an assignee within s. 29 of the Indian Partnership Act, as some cases do, a sub-partner has definite enforceable rights to claim a share in the profits accrued to or received by the partner.

(1) 24 I.T.R. 173. (2) [1860] 8 H.L. Cas. 268.

The decision of this Court in *Charandas Haridas* v. *Commissioner of Income-tax* (1) seems to support, at least by inference, this conclusion. In that case the facts were as follows. Charandas Haridas was the *karta* of a Hindu undivided family consisting of his wife, his three minor sons and himself. He was a partner in six managing agency firms and the share of the managing agency commission received by him as such partner was being assessed as the income of the family. By a memorandum executed by the co-parceners of the family a partial portion of the income from the managing agency was brought about.

The memorandum stated:—

> "We have decided that.....in respect of the commission which accrues from 1st January, 1946 and received after that date each of us becomes absolute owner of his one-fifth share and therefore from that date..... these commissions cease to be the joint property of our family".

This Court held that the document effectively divided the income and the income could no longer be treated as that of the Hindu undivided family. This case shows that although the *karta* continued to be a partner in the managing agency firm, yet the character in which he received the income *vis-a-vis* the Hindu undivided family had changed and the Court gave effect to the change of his position. Previously he was acting as a *karta* on behalf of the Hindu undivided family in the managing agency firm; later he became a partner on behalf of the members of the family. It seems to us that when a sub-partnership is entered into the partner changes his character *vis-a-vis* the sub-partners and the Income Tax authorities, although other partners in the original partnership are not affected by the changes that may have taken place.

In our view the Calcutta High Court decision relied on by the High Court and the learned counsel for the respondent (*Mahaliram Santhalia* v. *Commissioner of Income-tax*(2) was wrongly decided. The facts in that case were these. Mahaliram Santhalia was a partner in the firm M/s Benares Steel Rolling Mills. He was also a partner in another firm named M/s Radhakissen Santhalia. By agreement dated April 3, 1944, between the partners of M/s Radhakissen Santhalia, it was provided that the partnership income from M/s Benares Steel Rolling Mills would belong not to Mahaliram Santhalia individually but to the firm of M/s Radhakissen Santhalia. The High Court of Calcutta held that the agreement amounted only to voluntary disposition by Mahaliram Santhalia of his income and there was no diversion of income to the firm M/s Radhakissen Santhalia before it became

(1) [1960] 3 S.C.R. 296. (2) 33 I.T.R. 261.

A Mahaliram Santhalia's income. The High Court observed at p. 272:—

> "If, as Mr. Mitra conceded, Mahaliram was rightly taken as a partner of the Benares Steel Rolling Mills in personal capacity and if a one-fourth share of the income was rightly allocated to him, any agreement between him and his three partners of the firm of Radhakissen Santhalia, under which the income was to be treated as the income of the whole firm, could only be an agreement by which Mahaliram Santhalia was allowing what was really his income to be treated as the income of the firm or, in other words, as agreement by which he was applying or distributing an income which he had already himself earned and received. Such application or distribution would be a voluntary act of Mahaliram Santhalia in respect of a sum which it was conceded, had rightly been included in his own total, income and, therefore was his own income. If the moment the share of the income from the Benares Steel Rolling Mills was allocated to Mahaliram Santhalia, it became his income and liable to be included in his own total income for the purpose of his personal assessment, an agreement by him with other persons regarding the rights to that income could only be a voluntary disposition of his income by him. No question of a diversion by superior title could possibly arise."

With respect, we are unable to agree with most of this reasoning. In our view, in the case of a sub-partnership the sub-partnership creates a superior title and diverts the income before it becomes the income of the partner. In other words, the partner in the main firm receives the income not only on his behalf but on behalf of the partners in the sub-partnership. The Calcutta High Court also seems to be, in our opinion, erroneously impressed by the argument that "It is impossible to see how, after a proportionate share of the income had thus been included in the total income of a partner for the purposes of his personal assessment, it could then go anywhere else or could be further divided between such partners and other parties." We will deal with this aspect while dealing with the second point raised by the learned counsel for the revenue.

Mr. Hazarnavis, in this connection, drew our attention to the following passage in *K. A. Ramachar* v. *Commissioner of Income-tax, Madras*(1):—

> "This, in our opinion, is neither in accordance with the law of partnership nor with the facts as we have found on the record. Under the law of partnership, it is the partner and the partner alone who is entitled to

(1) 42 I.T.R. 25, 29.

> the profits. A stranger, even if he were an assignee, has and can have no direct claim to the profits. By the deeds in question, the assessee merely allowed a payment to his wife and daughters to constitute a valid discharge in favour of the firm; but what was paid was, in law, a portion of his profits, or, in other words, his income".

This passage was also relied on by the High Court. In our opinion, these observations have to be read in the context of the facts found in that case. In that case it was neither urged nor found that a sub-partnership came into existence between the assessee who was a partner in a firm and his wife, married daughter and minor daughter. It was a pure case of assignment of profits (and not losses) by the partner during the period of eight years. Further the fact that a sub-partner can have no direct claim to the profits *vis-a-vis* the other partners of the firm and that it is the partner alone who is entitled to profits *vis-a-vis* the other partners does not show that the changed character of the partner should not be taken into consideration for income tax purposes. This Court held in *Commissioner of Income-tax, Gujarat* v. *Abdul Rahim*(1) that registration of the firm could not be refused on the ground that a partner was a *benamidar* and that a *benamidar* is a mere trustee of the real owner and he has no beneficial interest in the profits of the business of the real owner. Under the law of partnership it is the *benamidar* who would be entitled to receive the profits from the other partners but for income tax purposes it does not mean that it is the *benamidar* who alone can be assessed in respect of the income received by him.

In conclusion we hold that the High Court was in error in holding that there was no question of an overriding ogligation in this case and that the income remained the income of Murlidhar Himatsingka in spite of the sub-partnership created by him under the agreement dated December 21, 1949.

The second contention raised by Mr. Hazarnavis was not debated in the High Court, but in our opinion, there is no substance in this contention. We have already mentioned that a *benamidar* can be a partner in a firm. Now if Mr. Hazarnavis's contention is right, under s. 25(5)(a) of the Act it is only he who could be assessed, but there is no warrant for this proposition. In *Commissioner of Income-tax, West Bengal* v. *Kalu Babu Lal Chand*(2) this Court mentioned with approval *Kaniram Hazarimull* v. *Commissioner of Income-tax*(3) where income from a partnership received by a *karta* was held to be assessable in the hands of Hindu Undivided family.

This Court observed at p. 12 as follows:—

> "If for the purpose of contribution of his share of the capital in the firm the *karta* brought in monies out

(1) 56 I.T.R 651. (2) 37 I.T.R. 123. (3) 27 I.T.R. 294.

A of the till of the Hindu undivided family, then he must be regarded as having entered into the partnernship for the benefit of the Hindu undivided family and as between him and the other members of his family he would be accountable for all profits received by him as his share out of the partnership profits and such profits would be
B assesseable as income in the hands of the Hindu undivided family. Reference may be made to the cases of *Kaniram Hazarimull* v. *Commissioner of Income-tax*(1) and *Dhanwatav* v. *Commissioner of Income-tax*(2) in support of this view".

The object of s. 23(5)(a) is not to assess the firm itself but to
C apportion the income among the various partners. After the income has been apportioned, the Income Tax Officer has to find whether it is the partner who is assessable or whether the income should be taken to be the real income of some other person. If it is the real income of another firm, it is that firm which is liable to be assessed under s. 23(5)(a) of the Act.

D This view was taken by the Bombay High Court in *Ratilal B. Daftri* v. *Commissioner of Income-tax*(3). The Bombay High Court observed at p. 24 as follows:—

> "The principle asserted in that case is that even in the case of a partner in a registered firm, when the question arises as to his individual assessment, what is to be considered is not the income allocated to his
E share by employing the machinery of section 23(5)(a), but his real income, and that real income is what remains after deducting the amounts which may be said to have been diverted and never constituted his real income and such amounts will have to be excluded before his real income is reached".

F In conclusion we hold that there is nothing in s. 23(5)(a) that prevents the income from the firm Basantlal Ghanshyamdas being treated as the income of M/s Fatehchand Murlidhar and s. 23(5)(a) being applied again.

In the result we accept the appeals, set aside the judgment of the High Court and answer the questions in the negative. The appellants will be entitled to costs here and in the High Court. One
G hearing fee.

Appeals allowed.

(1) 27 I.T.R. 294. (2) 32 I.T.R. 682. (3) 36 I.T.R. 18.