Commissioner Of Income Tax vs Sunil J. Kinariwala on 10 December, 2002

Equivalent citations: AIR 2003 SUPREME COURT 668, 2003 (1) SCC 660, 2002 AIR SCW 5340, 2003 TAX. L. R. 104, 2003 (2) SRJ 77, 2002 (9) SCALE 217, 2002 (7) SLT 270, 2003 (1) UJ (SC) 543, 2003 UJ(SC) 1 543, (2003) 126 TAXMAN 161, (2002) 9 SCALE 217, (2003) 1 SUPREME 241, (2003) 3 JLJR 62, (2003) 259 ITR 10, (2003) 2 PAT LJR 143, (2003) 172 TAXATION 389, (2003) 2 GCD 1522 (SC), (2003) 179 CURTAXREP 15

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Bench: Syed Shah Mohammed Quadri, K.G. Balakrishnan

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           CASE NO.:
Appeal (civil)  1899 of 2002

PETITIONER:
COMMISSIONER OF INCOME TAX

RESPONDENT:
SUNIL J. KINARIWALA

DATE OF JUDGMENT: 10/12/2002

BENCH:
SYED SHAH MOHAMMED QUADRI & K.G. BALAKRISHNAN

JUDGMENT:
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JUDGMENT 2002 Supp(4) SCR 650 The Judgment of the Court was delivered by SYED SHAH MOHAMMED QUADRI, J.

Civil Appeal No. 1899 of 2002:

> This appeal, by the Revenue, is directed against the judgment of the Division Bench of the High Court of Gujarat in Income Tax Reference No. 191 of 1980 dated 29th October, 1993 [Sunil J. Kinariwala v. Commissioner of Income Tax, reported in (1995) 211 I.T.R. 127.] At the instance of the Revenue, the Income Tax Appellate Tribunal (for short, 'the Tribunal') referred the following questions, under Section 256(1) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act'), for the opinion of the High Court:

"(1) Whether, on the facts and in the circumstances of the case, 50 per cent out of the assessee 's ten per cent, right, title and interest in the partnership firm of Messrs. Kinariwala R.J.K. Industries belongs to Sunil Jivanlal Kinariwala Trust and the income arising therefrom belongs to the said trust by overriding title?

(2) Whether, on the facts and in the circumstances of the case, the sum of Rs. 20, 141 being the profits referable to 50 per cent, out of the assessee 's right, title and interest often per cent, in the partnership firm of Messrs. Kinariwala R.J.K. Industries is not the real income of the assessee, but of Sunil Jivanlal Kinariwala Trust and as such assessable only in the hands of the trust?

(3) Whether, on the facts and in the circumstances of the case, fifty per cent, out of the assesseee 's ten per cent, share in the firm of Messrs.

Kinariwala R.J.K. Industries has been validly assigned to Sunil Jivanlal Kinariwala Trust under the deed of trust dated December, 27, 1973, and whether the income arising therefrom belongs to the said trust by way of overriding title?"

The fact which gave rise to these questions may be noticed here.

The assessee, a partner in the partnership firm, known as 'M/s. Kinariwala R.J.K. Industries', Ahmedabad, (for short, 'the firm') was having ten per cent share therein. On December 27, 1973, he created a Trust named "Sunil Jivanlal Kinariwala Trust" by a deed of settlement assigning fifty percent out of his ten per cent right, title and interest (excluding capital), as a partner in the firm, and a sum of Rupees five thousand out of his capital in the firm in favour of the said Trust. There are three beneficiaries of the Trust-the assessee's brother's wife, assessee's niece and the assessee's mother. In the Assessment Year 1974-75, he claimed that as fifty per cent of the income attributable to his share from the firm, stood transferred to the Trust resulting in diversion of income at source, the same could not be included in his total income for the purpose of his assessment. The Income Tax Officer rejected the claim on the view that it was a case of application of income and not diversion of income at source; he also found that Section 60 of the Act was attracted as only income without transfer of asset was settled. Against the order of assessment, the assessee appealed before the Appellate Assistant Commissioner of Income Tax who allowed the appeal directing that a sum of Rs. 20, 141/ which stood transferred to the trust under the settlement, be excluded from the total income of the assessee. However, on appeal by the Revenue, the Tribunal reversed the order of the Appellate Assistant Commissioner. Thus the afore- mentioned questions of law came to be referred to the High Court by the Tribunal.

The High Court, relying on the judgements of this Court in Commissioner of Income tax, Madras v. Bhagyalakshmi and Co. (1965) 55 I.T.R. 660 and Murlidhar Himatsingka and Anr. v. Commissioner of Income tax, Calcutta, (1966) 62 I.T.R. 323,

> held inter alia, that on assignment of fifty per cent share of the assessee in the firm, it became the income of the Trust by over riding title and it could not be added in the total income of the assessee. In that view of the matter, the afore-mentioned Question Nos. (1) to (3) were answered in the affirmative, in favour of the assessee and against the Revenue.

It appears that for a considerable time no steps to file an appeal were taken against the impugned judgement of the High Court. On the assumption that it was accepted by the Revenue, various matters were disposed of by the High Court, following the said judgement. In some of those cases, special leave petitions were filed but they were dismissed on the ground that the main judgement of the High Court was allowed to become final. Thereafter, the Revenue woke up and challenged the said judgement by filing the present appeal. That is how, the appeal came to be filed and is before us.

Mr. Preetesh Kapur, learned counsel appearing for the Revenue, contended that having regard to the terms of the settlement, what was assigned was the right to receive profits to the extent of fifty per cent of the share of the assessee; there was, therefore, no over riding title in the Trust so as to divert the income at source and the High Court erred in treating the assignment as resulting in diversion of the income. The question of application of Section 60 of the Act was urged as an alternative contention and was not seriously pursued. Mr. U.U. Lalit, learned counsel appearing for the respondent assessee, on the other hand, argued that under Section 29 (1) of the Indian Partnership Act., 1932, the Trust became entitled to receive fifty per cent share of the assessee's income from the firm by assignment under the settlement deed and, therefore, the Trust was getting the income by virtue of the over-riding title and the High Court had correctly answered the questions. Further, it was conceded by the learned counsel for the parties that question Nos. 1 and 3 overlap and they need to be re-framed. By order of this Court dated December 3, 2002, they were re-framed as Question No.1. Now, we have to advert to the following two questions:

> "(1). Whether, on the facts and in the circumstances of the case, assignment of 50 per cent out of the assessee's ten per cent share in right, title and interest (excluding capital) in M/s. Kinariwala R.J.K. Industries in favour of Sunil Jivanlal Kinariwala Trust under deed of trust dated December 27, 1973 creates over riding title in favour of the Trust and whether the income accruing to the Trust can be treated as the income of the assessee?
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> (2). Whether, on the facts and in the circumstances of the case, the sum of Rs. 20, 141 being the profits referable to 50 per cent, out of the assessee's right, title and interest often per cent in the partnership firm of Messrs. Kinariwala R.J.K. Industries is not the real income of the assessee, but of Sunil Jivanlal Kinariwala Trust and as such assessable only in the hands of the trust?"

It may be pointed out that under the scheme of the Act, it is the total income of an assessee, computed under the provisions of the Act, that is assessable to income tax. So much of the income which an assessee is not entitled to receive by virtue of an over-riding title created in favour of a third party would get diverted at source and the same cannot be added in computing the total income of the assessee. The principle is simple enough but more often than not, as in the instant case, the question arises as to what is the criteria to determine, when does the income attributable to an assessee get diverted by over riding title? The determinative factor, in our view, is the nature and effect of the assessee's obligation in regard to the amount in question. When a third person becomes entitled to receive the amount under an obligation of an assessee even before he could lay a claim to receive it as his income, there would be diversion of income by over riding title; but when after receipt of the income by the assessee, the same is passed on to a third person in discharge of the obligation of the assessee, it will be a case of application of income by the assessee and not of diversion of income by over-riding title. The decisions of the Privy Council in Bejoy Singh Dudhuria v. Commissioner of Income tax, (1933) 1 I.T.R. 135 and P.'C. Mullick v. Commissioner of Income tax, (1938) 6 I.T.R. 206 together are illustrative of the principle of diversion of income by over-riding title. In Bejoy Singh Dudhuria (supra), under a compromise decree of maintenance obtained by the step-mother of the assessee, a charge was created on the properties in his hand. The Law Lords of the Privy Council, reversing the judgement of the Calcutta High Court, held that the amount of maintenance recovered by the step-mother was not a case of application of the income of the assessee. In contrast, in P.C. Mullick (supra) under a Will, certain payments had to be made to the beneficiaries by the executors and the trustees (assessees) from the property of the testator. It was held by the Privy Council that such payments could only be out of the income received by the assessees from the property, therefore, such payments were assessable 'o income tax in the hands of the assessees and there was no diversion of income at source. Whereas in the former case, the step-mother of the assessee acquired the right to get the maintenance by virtue of charge created by the decree of the court on the properties of the assessee even before he could lay his hands on the income from the properties, but in the latter case, the obligation of the assessee to pay amounts to the beneficiaries was required to be discharged after receipt of the income from the properties.

In Commissioner of Income Tax, Bombay City-II v. Sitaldas Tirathdas (1961) 41 I.T.R. 367, speaking for a Bench of three learned Judges of this Court, Hidayatullah, J. (as he then was) having considered, among others, the aforesaid two judgements of the Privy Council laid down the test as follows:

> "In our opinion, the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligation, 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 obligation 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 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, but for and on behalf of the

person to whom it is payable."

In that case, the respondent-assessee derived his income from many sources. He sought to deduct certain sums of money on the ground that, under a consent decree, he was required to pay those sums as maintenance to his wife and children. Though no charge was created on the properties of the assessee by the compromise decree, the decreed sums were, in fact, paid by the assessee to his wife and children. The High Court took the view that notwithstanding absence of specific charge upon the properties of the assessee, the assessee was under an obligation to pay maintenance under the decree which could be enforced by a court of law and purporting to apply the principle of Bejoy Singh Dudhuria (supra), held that in view of the decree of the court, the sums must be taken to have been diverted to the wife and children and never became income in the hands of the assessee. Setting aside the judgement of the High Court, this Court held, "In our opinion, the present case is one in which the wife and children of the assessee who continued to be members of the family received the income as his own. The case is one of application of a portion of the income to discharge an obligation and not a case in which by an overriding charge the assessee became only a collector of another's income. The matter in the present case would have been different if such an overriding charge had existed either upon the property or upon its income, which is not the case. In our opinion, the case falls outside the rule in Bejoy Singh Dudhuria s case and rather falls with in the rule stated by the judicial Committee in P.C. Mullick's case."

We may notice a few decisions as instances of application of the principle of diversion of income by over-riding title.

In K.A. Ramachar and Anr. v. Commissioner of Income Tax, Madras (1961) 42 I.T.R. 25, the assessee was a partner in a firm. He executed three deeds of settlement in favour of his wife, married daughter and a minor daughter, assigning to each of them one-fourth of his share of the profits in the firm. They were entitled to receive and collect their share from the firm under the settlement. The assessee contended that the amounts covered by the settlements could not be included in his total income for the purpose of assessment to income tax. Applying the principle laid down in Sitaldas Tirathdas (supra), it was held that under the law of partnership, it was the partner and the partner alone who was entitled to profits and that a stranger, even if he were an assignee, did not have and could not have any direct claim to the profits. The claim of the assessee was negatived on the ground that what was paid was in law a portion of his income, as such the amounts have to be included in his total income. The ratio of this case squarely applies to the facts of the case on hand.

In Moti Lal Chhadami Lal Jain v. Commissioner of Income Tax (1991) 190 I.T.R. I, a company took over the business of the Hindu Undivided Family (referred to as 'the landlord'). Under the agreement of lease with the landlord, the company was required to pay Rupees ten thousand to a college, run by a Trust out of the annual rent of Rupees twenty one thousand. In a subsequent agreement entered into between the landlord the company, the Trust and the college, it was stipulated, inter alia, that in the event of failure to pay the amount to the college, it would have full right to recover the said amount by recourse to the court and that the college shall have the first charge on the property. The landlord claimed that the amount paid to the college was the income of the college as it got diverted by over-riding title and ceased to be the income of the landlord. That contention was rejected by the Tribunal as well as the High Court. On appeal to this Court, applying the principle in Sitaldas Tirathdas (supra), it was held by a Bench of three learned Judges that the stipulation in the agreement to pay Rupees ten thousand out of the annual rent directly to the college was only a mode of application of the income of the landlord, which made no difference to its liability to pay tax on the entire rent of Rupees twenty one thousand which had accrued to the landlord. The fact that the college was given the right to sue and recover Rupees ten thousand directly from the company in case of default, it was observed, did not alter the position, nor would creation of charge in favour of the college make any difference.

Now, we shall advert to the cases relied upon by the High Court.

In Bhagyalakshmi (supra), two members of the Hindu Undivided Family together held ten annas share in a firm. On partition in the family, the share of the said members was divided among various members of the family. Thereafter, a fresh partnership deed was executed in which the said two persons were, however, shown as having the same proportion of share in the firm. They claimed that they were liable to pay tax only on the respective shares shown in the partnership deed. That contention was upheld by the Tribunal. Thereafter, the Commissioner cancelled the registration of the partnership firm under the Act on the ground that it did not specify the correct shares of the said two persons in the partnership. It was held by this Court that the firm was entitled to be registered and that the shares given to the said two persons in the partnership deed were correct according to the terms of the deed, although they would be answerable to the divided members of the family in respect of profits certaining to their shares. This case does not deal with the principle of diversion of income by over-riding title and is of no help to the respondent-assessee to support his contention that there was diversion of income by over-riding title in his case.

In Murlidhar Himatsingka (supra), one of the partners of the firm constituted a sub-partnership firm with his two sons and a grandson. The deed of sub-partnership provided that the profits and losses of the partner in the main firm shall belong to the sub-partnership and shall be borne and divided in accordance with the shares specified therein. The question in that case was: whether the share of the partner in the main firm, who had become a partner in the sub-partnership, could be assessed in his individual assessment. It was held that there was over-riding obligation which converted the income of the partner in the main firm into the income of the sub-partnership and, therefore, the income attributable to the share of the partner had to be included in the assessment of the sub-partnership. That was on the principle that a partner in the sub-partnership had a definite enforceable right to claim a share in the profits accrued to or received by the other partner in the main partnership, as on entering into a sub-partnership, such a partner changes his character vis-a-vis the sub- partners and the Income Tax authorities. Further, a sub-partnership creates a superior title and results in diversion of the income from the main firm to the sub-partnership before the same becomes the income of the concerned partner. In such a case, even if the partner receives the income from the main partnership, he does so not on his behalf but on behalf of the sub- partnership. Distinguishing K.A. Ramachar (supra), it was observed, "In that case it was neither urged nor found that 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."

It is apt to notice that there is a clear distinction between a case where a partner of a firm assigns his share in favour of a third person and a case where a partner constitutes a sub-partnership with his share in the main partnership. Whereas in the former case, in view of section 29(1) of the Indian Partnership Act, the assignee gets no right or interest in the main partnership except of course, to receive that part of the profits of the firm referable to the assignment and to the assets in the event of dissolution of the firm, but in the latter case, the sub-partnership acquires a special interest in the main partnership. The case on hand cannot be treated as one of a sub-partnership, though in view of Section 29(1) of the Indian Partnership Act. The Trust, as an assignee, becomes entitled to receive the assigned share in the profits from the firm not as a sub-partner because no sub-partnership came into existence but as an assignee of the share of income of the assigner-partner.

In this view of the matter, it is unnecessary to consider the alternative contention based on Section 60 of the Act.

For the aforementioned reasons, we are of the view that the order under challenge cannot be sustained. It is, accordingly, set aside. Consequently, the share of the income of the assessee assigned in favour of the Trust has to be included in the total income of the assessee. The questions are, accordingly, answered in favour of the Revenue and against the assessee.

The civil appeal is, accordingly, allowed but in view of the peculiar facts in which the appeal came to be filed, we make no order as to costs.

Civil Appeal Nos. 6148-57/1998, 6375-6412/1998, 5020/2000, 3792/ 1999, 3830/1999, 3829/1999, 3827/1999, 3373/2000 and 5720/1998.

These appeals have been disposed of by the impugned orders of the High Court following the decision in Sunil J. Kinariwala v. Commissioner of Income Tax, (1995) 211 I.T.R. 127, which has since been reversed in Civil Appeal No. 1899 of 2002 today.

In view of the aforesaid judgement, the orders under appeal are set aside. The applications under Section 256(2) of the Income Tax Act, 1961 are allowed and the questions mentioned therein are ordered to be referred. They are, accordingly, answered in terms of the said judgement.

The civil appeals are allowed in the above terms. No costs.