Khanjan Lal Sewak Ram vs Commissioner Of Income Tax, U.P on 31 August, 1971

Equivalent citations: 1972 AIR 61, 1972 SCR (1) 502, AIR 1972 SUPREME COURT 61, 1972 TAX. L. R. 26

Author: K.S. Hegde

Bench: K.S. Hegde, A.N. Grover

PETITIONER:
KHANJAN LAL SEWAK RAM

Vs.

RESPONDENT:
COMMISSIONER OF INCOME TAX, U.P.

DATE OF JUDGMENT31/08/1971

BENCH:
HEGDE, K.S.
BENCH:
HEGDE, K.S.
GROVER, A.N.

CITATION:
1972 AIR 61 1972 SCR (1) 502
1971 SCC (3) 662
CITATOR INFO :
F 1973 SC1445 (15)
R 1973 SC2401 (4)

ACT:
Income Tax Act (11 of 1922), s. 26A and rr. 6(3) and 6A of the Rules-Application for renewal of registration-Book Profits distributed but black market profits not distributed-If firm entitled to renewal of registration.

HEADNOTE:
The assessee was a registered firm. The partners applied to the Income-tax Officer for renewal of registration. To that application they appended a certificate that the profits of the previous year were divided or credited as shown. While the application was pending, the partners fell out and the Income-tax Officer found, that the firm had earned

considerable black market profits which had not been credited in the account books and had not been distributed among the partners in accordance with the instrument of partnership. The Department, Tribunal and the High Court, on reference, held that the firm was not entitled to renewal.

Dismissing the appeal to this Court,

HELD : Under s. 26A of the Income-tax Act, 1922, one of the conditions for registration and renewal is that the application should contain such particulars as are prescribed in the Rules under the Act.. Rule 6(3) provides that the partners should append a certificate to the application for renewal that the profits (or loss if any) of the previous year or period up to the date of dissolution were divided or credited as shown. So long as the divisible profits had in fact been divided or had been credited to the accounts of the partners, the requirements of the provision must be held to have been complied with. But the certificate is not a mere formality because, a registered firm is not taxable, but only the partner and, if a portion of the profits earned by the firm was not actually divided amongst the partners or credited to their accounts, to that extent the assessee firm had evaded tax. In such a case the only course open to the Income-tax Officer is not to register the firm but to tax the partners of the firm as an association of persons. [506 B, G; 507 C-G]

Since, in the present case, the application for renewal of registration did not comply with the prescribed conditions, under r. 6A, the Income-tax Officer was justified in refusing renewal of registration. [507 F-G]

Agarwal & Co. v. C. 1. T., U. P., 77 I. T. R. 110 (S.C.), followed.

JUDGMENT:

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1947 of 1968.

Appeal from the judgment and decree dated January 21, 1964 of the Allahabad High Court in Misc. Income-tax Reference No. 383 of 1958.

T. A. Ramachandran and A. G. Ratnaparkhi, for the appellant.

B. Sen, J. Ramamurthy, R. N. Sachthey and B. D. Sharma, for the respondent.

The Judgment of the Court was delivered by Hegde, J. This is an appeal by certificate. It arises from. a decision of the Allahabad High Court. The appellant is the assessee and the concerned assessment year is 1948-49. The assessee is a firm constituted under an Instrument, of partnership dated April 30, 1947. The shares of the partners in, the profit and loss' of the firm as mentioned in that deed are

as follows :

1. L. Khanjan Lal--/4/-

2. L. Lalloo Ram- -/2/

3. L. Dwarka Prasad- -/2/-

4. L. Ram Lal- -/2/-

5. L. Sewak Ram- -/4/-

6. Smt. Jagrani Devi- -/2/-

Lallu Ram, Dwarka Prasad and Ram Lal are the children of- Khanjan Lad. Sewak Ram is the son of Jagrani Devi. The first group has -/ 10/- share in the profit and loss of the firm and the second group has -/6/- share.

The assesesee firm was registered for the assessment year 1947-48. On July 12, 1949, the partners of the firm applied to the Income-tax Officer for renewal of the registration for the assessment year 1948-49. That application was signed by all the partners. To that application they appended a certificate to the. effect that "profits of the previous year were divided or credited as shown below. . . "

> On November 5, 1949, the partner-ship was dissolved under a deed of distribution dated November 9, 1949 One of the clauses in that deed provides :
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> "But if an amount which was not entered in the books at the time of settlement is found then only that person will be accountable for it through whom the money was received or paid. None of the parties will have any objection to it."

On October 5, 1950, the first four partners made a disclosure statement to the Income-tax Officer to the effect that the firm had' earned Rs. 15,000/- by way of profits outside the books. In that disclosure statement, they further stated that those profits had been divided between the partners. On December 9, 1950, Sewak Ram, one of the partners stated on oath before the Income-tax Officer that he and his mother Jagrani Devi were not given full' share of the profits of the business earned by the firm in Sam v. year 2005. He further stated that the entire profits earned in that business carried on in the previous year were not recorded in the books and the first four partners had given to him and his mother only their shares of those profits which were recorded in the books. Therein he sought to withdraw the application for registration because all the profits earned had not been divided according to the shares. According to Sewak Ram, the profits ,earned and not entered in the accounts amounted to Rs. 1,13,571/-. From the aforementioned statements, it s clear that the firm was trying to evade tax on a portion of the profits .earned by it by not bringing the same into their books. On March 31, 1951, Sewak Ram sued the first four partners for rendition of accounts. In that

suit he estimated his share of profits in the amount that had not been entered in the account books at Rs. 50,0001. Ultimately the suit was compromised and Sewak Ram withdrew his suit. In his application to withdraw the suit, he stated that he wanted to withdraw the suit "in view of the circumstances of the above case", an expression of utmost ambiguity. Therein he stated that he is not entitled to get any more amount from the defendants.

On March 15, 1952, Sewak Ram and his mother Jagrani Devi gave an application to the Income-tax Officer stating that they are withdrawing their signatures on the application for renewal of registration as the profits of the previous year were not distributed according to the deed of partnership and the certificate of registration required under rule 4(1) of the Income-tax Rules, 1922 (to be hereinafter referred to as "the Rules") framed under the Indian Income-tax Act, 1922 (in brief 'the Act') had never been granted as required by law on the back of the partnership deed. Therein they further stated that as the certificate under rule 6 had not been granted by the assessee in accordance with law, the firm was not entitled for registration under rule 6 of the Rules.

On the basis of the material before him, the Income-tax Officer came to the conclusion that the firm had earned considerable black market profits, and the same had not been distributed amongst the partners according to the partnership deed and therefore the firm was not entitled for renewal of the registration. He further opined that the application for registration had stood withdrawn. On the basis of those conclusions, he refused to renew the registration of the firm and taxed the firm in the status of association of persons. In appeal the Appellate Assistant Commissioner, upheld the decision of the Income-tax Officer. The assessee took the matter in appeal to the Income-tax Appellate Tribunal. The two members who heard the appeal ,concurred with the Income-tax Officer and the Appellate Assistant Commissioner that a substantial portion of the profits earned by the firm had not been entered in the books. They also held that those profits were not distributed amongst the partners according to the Instrument of partnership. On the basis of those findings the Judicial member held that the firm was not entitled to the renewal of registration asked for but the Accountant member opined that inasmuch as the profits that had been entered in the books had been distributed, there was compliance with the provisions of the "Act" as well as the, "Rules". In view of this difference of opinion between the two members, the matter was referred to the President of the Tribunal under s. 5A(7) of the Act. The President agreed with the Judicial Member that firm was not entitled to have the renewal of the registration asked for. There- after at the instance of the assessee, the Tribual submitted the following question to the High Court under s. 66(1) of the Act.

> "Whether the assessee firm which had distributed its book profits amongst the partners according to the Instrument of Partnership but which had not distributed the profits earned by it in the black market amongst the six partners in accordance with the Instrument of Partnership was entitled for renewal of registration for the assessment year 1948-49 ?"

The High Court answered that question in favour of the Department. Hence this appeal by the assessee firm. Before examining the scope of the question submitted to the High Court under s. 66(1) of the Act, we may mention that the question whether the application for renewal of

registration stood withdrawn or not is not before us. On that question, the Judicial member of the Tribunal took the view that the said application stood withdrawn but the Accountant member did not agree with that view. The President of the Tribunal did not express any opinion on that point.

Now turning to the question referred to the High Court, that question is based on two findings of fact which are no more open to question. Those findings are : (1) that the firm had distributed its book profits amongst the partners according to the Instrument of partnership, (2) but it had not distributed the profits earned by it in the black market amongst the six partners in accordance with the Instrument of partnership.

Mr. Ramachandran, the learned Counsel for the assessee sought to assail the correctness of those findings on the ground that those findings are not supported by evidence, but we did not permit him to go into the same as that question is not before us. We are bound by those findings. Having said that much, we shall now turn to the relevant provisions in the Act and the Rules. Section 26 (A) of the Act reads :

> " 1. Application may be made to the Income-tax Officer on behalf of any firm, constituted under an ins-
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> trument of partnership specifying the individual shares of the partners, for registration for the purposes of this Act and of any other enactment for the time being in force relating to income-,tax or super-tax.
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> 2. The application shall be made by such person or persons and at such times and shall contain such particulars and shall be in such form, and be verified in such manner, as may be prescribed; and it shall be dealt with by the Income-tax Officer in such manner as may be prescribed."

This Court has ruled in Agarwal & Co. v. Commissioner of .Income-tax, U.P.(1) that the conditions of registration prescribed by s. 26-A and the relevant Rules are :

> 1. On behalf of the firm, an application should be made to the Income-tax Officer by such person and at such times and containing such particulars, being in such form and verified in such manner as are prescribed by the rules;
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> 2. The firm should be constituted under an instrument of partnership;
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> 3. The instrument must specify the individual shares of the partners and
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> 4. The partnership must be valid and must actually exist in the terms specified in the instrument.

Therein it was further laid down that if those conditions are fulfilled, the Income-tax Officer is bound to register the firm. The same rule will apply in the case of renewal of registration. In this

case we are primarily concerned with the question whether the application made by the firm is in accordance with the rules prescribed. The rules with which we are concerned in this appeal is paragraph 3 of rule 6 and rule 6-A. Paragraph 3 of rule 6 provides that the partners should append the following certificate to their application for renewal of registration.

> "We do hereby further certify that the profits (or loss, if any) of the previous year or period upto the date of dissolution were divided 'or credited as shown below..... Rule 6-A provides that " on receipt of an application under rule 6, the Income-tax Officer may if he is satisfied that the application is in order and that there is or was a firm in existence (1) 77 I.T.R,10.

constituted as shown in the instrument of partnership, grant to the assessee a certificate signed and dated by him in the following form. . . . . It further provides :

> "If the Income-tax Officer is not satisfied he shall pass an order in writing refusing to renew the registration of the firm."

Now the sole question for decision is whether the application made in this case complied with the requirements of paragraph 3 of rule 6. If it did not comply with the requirements of rule 6, the Income-tax Officer was within his powers in rejecting it. As seen earlier, the finding of the Tribunal is that though the profits of the firm entered in its account books had been distributed, the profits earned but not entered into the account books have not been divided or credit in the account books. From that it follows that the certificate given in the application for renewal of registration is not a true certificate and further that a substantial portion of the profits earned had not been divided.

The reason behind rule 6 was that at the relevant time, the registered firm as such was not taxable. Only the partners of a firm could be taxed. That being so, if 'a portion of the profits earned by the firm was not divided amongst the partners or credited to their accounts, to that extent, the profits earned by the firm escaped assessment. Therefore the certificate contemplated by rule 6 is not a mere formality. It has a definite purpose. If a portion of the profits earned by the firm was not actually divided amongst the partners or credited to their accounts, then the only course open to the Income-tax Officer was not to register that firm and to tax the partners of the firm as an association of persons. By giving a false certificate that the profits earned by the firm had been divided or credited in the manner shown in the application, the assessee firm was trying to evade tax. Hence we must hold that the application for renewal of registration made by the assessee did not comply with conditions prescribed in paragraph 3 of rule 6. Hence the Income-tax Officer was justified to refuse to renew the registration.

In resisting the above conclusion, Mr. Ramachandran Counsel for the assessee relied on certain decisions of the High Courts. The first decision relied on by him is that of the Bombay High Court in Commissioner of Income-Tax, M. P. Nagpur and Bhandaru v. D Costa Brothers(1). Therein the Court held that the Income-tax Officer was not entitled to reject the application for registration of the deed of partnership of the assessee firm on the ground that the house-hold expenses of the partners were debited to the profit and loss account of the firm. Therein there was no (1) 49, I.T.R.

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contention that all the profits earned were not distributed. The only question was whether the household expenses could have been deducted before dividing the profits. In other words the question was whether the household expenses was a proper deduction to be made in the circumstances of that case before dividing the profits. Hence that decision has no bearing on the question under consideration. He next placed reliance on the decision of the Punjab High Court in Commissioner of Income-tax, Simla v. Sat Ram Gian Chand(1). Therein the partners first estimated the divisible profit and divided the same. The Court held that the division of profit was a matter relating to the internal affairs of the partnership and had no bearing on the genuineness of the firm and that no question of law arose from the order of the Appellate Tribunal. The ratio of that decision has no relevance for our present purpose. Counsel for the assessee next relied on the decision of the Madras High Court in N. S. S. Chokkalingam Chettiar- and Co. v. C.I.T. Madras (2). In that case though there was no provision in the deed of partnership for payment of salary to any of the partners, some of the partners were paid a salary in addition to the shares to which they were entitled under the terms of the partnership and the Income-tax Officer refused to register the firm on the ground that the profits were not divided in accordance with the partnership deed as some of the partners took an additional amount out of the profits in the shape of salary. The court held that, as the partnership was found to be a genuine one and the application for registration was also in due form, the mere fact that some partners took some portion of the profits as salary was not a ground for refusing registration. The question whether a partner should be paid salary for the services rendered by him is a matter to be decided by the partners of the firm : so long as their payment is bona fide one, the same has to be deducted before the divisible profits are computed. Hence the ratio of that decision also does not bear on the facts of the present case. Reliance was next placed on the decision of the Madhya Pradesh High Court in C.I.T., M.P. v. Mandanlal Chhagan Lal(3). In that case the partnership deed provided that each partner will be entitled to interest at 6 per cent per annum on his capita investment and that the profit and loss will be divided equally among the partners after deducting the interest payable on the capital advances made by the partners. When the partners made an application for registration under s. 26A of the Act, the Income-tax Officer refused to register it but the Court held that the application was a valid one and the provision for payment of inte-

(1) 42, ITR, 543. (2) 60, ITR, 671.

(3) 50, I.T.R. 477.

rest did not in any manner conflict with the relevant provision. Here again there is no question of not dividing any portion of, profits earned. That being so, that decision is irrelevant for our present purpose. Lastly reliance was placed on the decision of the Kerala High Court in St. Joseph's Provisions Store v. C.I.T., Kerala(1). Therein the partners of the assessee firm resolved that the profits of the firm as disclosed in the profit and loss account need not be divided and credited in the profit and loss accounts of the partners, but should be credited to a reserve account but each of the partners to have an equal share in that amount. An application for registration of the firm was rejected on the ground that the firm had not complied with the requirements of rule 6 of the Rules.

The court held that the absence of entries in the separate accounts of each partner was not fatal; the requirement of rule 6 was met when the profit was taken into a reserve fund showing the partners' shares therein and indicating what was the contribution of each partner to the reserve fund. Therefore the application for registration was not liable to be rejected on the ground that rule 6 had not been complied with. Here again the profits earned had beep divided and they were credited to the accounts of the partners though the same were credited to a reserve fund. Hence the rule laid down in that case is inapplicable to the facts of the present case. As the above referred decisions do not bear on the point in issue we have not gone into the question whether all or any of them were correctly decided or not.

The apprehension of Mr. Ramachandra that our decision might be taken advantage of by the Department for refusing registration of firms whose return of income or claim for some allowance has not been accepted by the Income-tax Officer for one reason or the other, appears to us to have no basis. Herein we are merely considering the scope of paragraph 3 of rule 6. So long as the divisible profits had been divided or had been credited to the accounts of the partners, the requirement of that provision was complied with.

In the result this appeal fails and the same is dismissed with costs.

V.P.S. Appeal dismissed.
(1) 45, I.T.R. 380.
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