

Supreme Court of India

S.P. Gramophone Company vs C.I.T., Patiala on 29 January, 1986

Equivalent citations: 1986 AIR 1152, 1986 SCR (1) 164

Author: V Tulzapurkar

Bench: Tulzapurkar, V.D.

PETITIONER:

S.P. GRAMOPHONE COMPANY

Vs.

RESPONDENT:

C.I.T., PATIALA

DATE OF JUDGMENT 29/01/1986

BENCH:

TULZAPURKAR, V.D.

BENCH:

TULZAPURKAR, V.D.

MUKHARJI, SABYASACHI (J)

CITATION:

1986 AIR 1152                      1986 SCR (1) 164

1986 SCC (2) 1                    1986 SCALE (1) 137

ACT:

Indian Income Tax Act 1922 & Income Tax Act 1961:

Section 26A/Sections 184 & 185 - Firm - Registration of  
- Refusal by Tax Authorities - When valid - Instrument of  
partnership - Not militating against firm's validity in law  
But pointer against factual genuineness.

HEADNOTE:

Prior to the Assessment Year 1961-62 the appellant-firm was a partnership concern consisting of two partners, each having 50% share in the profits and losses of the firm and it was granted registration. Both the partners met with an accident on 19.10.1958 in which they suffered serious injuries and became invalid. On 1.4.1960 a fresh Deed of Partnership was executed by virtue of which the two original partners retained 25% share each while the four new incoming partners were given 12.1/2% share each. Prior to April 1, 1960 two of the new incoming partners were already working as employees in the original firm. The fresh Partnership Deed, inter alia, provided that the partnership was at will determinable by one month's notice in writing.

For the Assessment Year 1961-62 an application duly signed by all the partners seeking registration of the firm under s. 26A of the Income Tax Act 1922 on the strength of

the fresh Partnership Deed was made on 15th September 1960 annexing therewith the original Partnership Deed. The four new incoming partners were examined by the Income Tax Officer and their statements were recorded, which, the ITO felt, clearly suggested that they were not real partners but dummies brought in to avoid the higher tax incidence. After considering the Partnership Deed, the statement of the four new incoming partners and the fact that profits had not been shown to have been distributed in the books and no entries made in the year of account, the ITO rejected the application and refused registration.

The view taken by the Income Tax Officer was confirmed by the Appellate Assistant Commissioner and by the Tribunal.  
165

The Tribunal, however, was of the view that four new incoming partners were benmidars of the two original partners.

On Reference made to the High Court, the High Court felt that the first question referred to it did not bring into focus the real issue and, therefore, recast the same. The High Court upholding the refusal of registration held: (1) that no genuine partnership had come into existence and that the finding of the lower authorities in that behalf was based on ample material on record; (2) that the assessee is not entitled to the registration under s.26A of the Income Tax Act, 1922 read with Rule 6 of the Income Tax Rules, 1922; and (3) that the mere fact that the four new incoming partners were found to be benamidars of the two original partners could not be a proper ground for refusing registration.

In the appeal to this Court on behalf of the appellant it was contended: (i) that refusal to grant registration to the extent that it was based on the ground that no valid partnership in law had come into existence was unsustainable; (ii) that there was no evidence to justify the finding on the genuineness of the appellant firm, and (iii) that the High Court having held that registration could not be refused merely on the ground that some of the partners were benamidars, registration ought to have been granted.

On behalf of the Revenue it was contended: (1) that even if a valid partnership in law came into existence by executing the Deed registration could be refused on the ground that factually no genuine firm had come into existence; (2) that it is open to the High Court to reframe or recast a question formulated by the Tribunal before answering it so as to bring out a real issue between the parties; (3) that the High Court had rightly affirmed the view of the Tribunal that the appellant-firm had not genuinely come into existence; (4) that though under the 1922 Act no provision similar to the Explanation to Sec.185 of 1961 Act obtained and the fact that some members were benamidars of others in a firm could be no bar to the grant

of registration, if the taxing authorities were to record an adverse finding on the factual genuineness of the firm registration could be refused; and (5) that so far as the actual division or distribution of profits, the lower authorities were justified in not relying on loose sheets indicating the working of the firm and the assessee cannot be allowed to fill the lacuna by producing books for the following year.

Dismissing the Appeal,

166

^

HELD: 1. The concept of a firm being valid in law is distinct from the factual genuineness and for the purpose of granting registration both aspects are relevant and must be present and one without the other will be insufficient. [173 G]

2. Even if a firm brought into existence by executing an instrument of partnership deed is shown to possess all the legal attributes it would be open to the taxing authority to refuse registration if it were satisfied that no genuine firm has been constituted. Moreover, some of the provisions contained in such instrument may not militate against the firm's validity in law but these can be a pointer against its factual genuineness. [173 G-H; 174 A]

3. Clause 5 of the Partnership Deed in the instant case, vests the control and management of the partnership business in the original two partners and denies to the four new incoming partners any right in the management of the affairs or the accounts of the partnership business, may not show lack of the element of mutual agency but has a vital bearing on the factual genuineness of the firm and read along with Clauses 3, 6, 7 and 8 would go to show that the four new incoming partners were no real partners but were dummies thus throwing doubt on the genuineness of the firm. Moreover, the facts that the four new incoming partners were very close relatives of the two original partners and that two of them were working as employees in the erstwhile firm whose service as such were continued in the relevant year on existing remuneration with such increments as the two original partners may agree to give cannot be lost sight of. In addition, the statements of the four new incoming partners that were recorded in November 1965 clearly show that they had signed the instrument mechanically without knowing or reading, much less after understanding the implications thereof. [174 A-D]

4. In the instant case, the profit and loss account statement prepared on loose sheet did not contain any distribution of profits and or allocation thereof to each one of the new partners. [175 E]

5. Production of account books in this Court has deprived the taxing authorities an opportunity to make their comments thereon. Apart from this aspect the question would be whether even such entries were genuine entries intended

to be acted upon or mere paper entries making a show of allocation

167

of the share of profits due to each one of these four new incoming partners and this would require further investigation into relevant facts. This aspect throws considerable doubt on the point whether or not entries were intended to be acted upon. [175 G-H; 176 B]

6. In the instant case, there was sufficient material on record on the basis of which the taxing authorities as well as the Tribunal could record an adverse finding on the genuineness of the firm against the assessee and registration was rightly refused. [176 C]

#### JUDGMENT:

CIVIL APPELLATE JURISDICTION: CIVIL Appeal No. 850 of 1974.

From the Judgment and Order dated 24.9.1973 of the Punjab and Haryana High Court in Income Tax Reference No. 21 of 1972.

S.T. Desai, M/s. J.B. Dadachanji, Harish Salve, P.K. Ram and Mrs. A.K. Verma for the appellant.

V.S. Desai, Gauri Shankar and Miss A. Subhashini for the respondent.

The Judgment of the Court was delivered by TULZAPUKAR, J. This appeal raises the question of granting registration to the appellant-firm (the assessee) under s. 26-A of the Income Tax Act, 1922 for the Assessment Year 1961-62. The taxing authorities, the Tribunal and the High Court have refused registration sought by the appellant-firm and hence this appeal.

Prior to the Assessment Year 1961-62 the appellant-firm was a partnership concern consisting of two partners, Shri Pal Singh and Shri Sadhu Singh, each having 50% share in the profits and losses of the firm and it was being granted registration. It appears that the two partners met with an accident on 19.10.1958 in which Shri Pal Singh suffered a serious head injury and lost his memory for quite some time while Shri Sadhu Singh suffered an injury to the spinal cord which rendered him invalid for quite a long time and the case put forward was that as the business was on extensive scale and the two partners were physically handicapped (they recovered during the meantime) they entered into a fresh Deed of Partnership on 1.4.1960 by virtue of which Pal Singh and Sadhu Singh of the one part and Sarvashri Surjit Singh, Gulzar Singh, Hari Singh and Harbans Singh of the second part became partners with the following share ratio in the profits and losses, namely, Pal Singh and Sadhu Singh the original two partners retained 25% share each while Surjit Singh, Gulzar Singh, Hari Singh and Harbans Singh were given 12-1/2% share each. Admittedly two of the new incoming partners, namely Surjit Singh and Gulzar Singh were relate to Pal Singh being his son and brother respectively who were obviously accommodated within the 50% share originally owned by Shri Pal Singh while the other two incoming partners Hari Singh and Harbans Singh were related to

Shri Sadhu Singh both being his brothers who were accommodated within the 50% share originally owned by Sadhu Singh. Moreover, prior to April 1, 1960 Hari Singh and Harbans Singh were already working as employees in the original firm.

At this stage it will be convenient to indicate some of the salient clauses of the Partnership Deed entered into between the parties on 1.4.1960. Under cl. 1 the partnership was declared to be one at will determinable by one month's notice in writing and under cl. 3 the parties of the second part (i.e. the four new incoming partners) were not required to contribute any capital but the original two partners were to do so in equal shares. Clause 4 provided that Shri Hari Singh and Shri Harbans Singh shall continue to draw their salaries or other remuneration from the firm as was being drawn by them along with any increment as agreed to by the parties of the first part (the original two partners) from time to time. Clause 5 was significant as it provided that the four new incoming partners "shall not interfere in the management or the affairs or the accounts of the partnership business." Under clause 7 it was provided that none of the four new incoming partners shall sell, mortgage, hypothecate, gift or will away or alienate in any way whatsoever his share to any third person and that in case of need they shall alienate their shares in favour of the parties of the first part (the two original partners) only and not even to any one amongst them. It was further provided that in case of a dispute among the partners regarding any of the clauses of the deed the decision of the partners of the first part (two original partners) shall be final and conclusive and binding and shall not be called into question in any court of law.

For the Assessment Year 1961-62 (the relevant accounting year in respect whereof ended on March 31, 1961) an application duly signed by all the partners seeking registration of the firm under sec. 26-A on the strength of the aforesaid Deed of Partnership was made on 15th September, 1960 and the original Partnership Deed was annexed thereto. The four new incoming partners were examined by the I.T.O. and their statements were recorded which, the I.T.O. felt, clearly suggested that they were not real partners but dummies brought in to avoid the higher tax incidence. After considering the several clauses contained in the partnership deed, the statement of the four new incoming partners and the surrounding circumstances including the fact that profits had not been shown to have been distributed in the books and no entries made in the year of account, the I.T.O. rejected the application principally on two grounds: (a) that in law no valid partnership had been created inasmuch as the element of mutual agency was lacking and (b) factually no genuine firm has come into existence inasmuch as the four new incoming partners were y dummies. Registration was also refused on two other grounds, namely, there was a breach of the terms of the Partnership Deed in that, even in the absence of a provision in that ; behalf, salary and remuneration were credited in the personal r accounts of the two original partners Pal Singh and Sadhu Singh and there was non-compliance of income tax rules. In appeal preferred by the assessee the Appellate Assistant Commissioner after discussing the several issues at great length confirmed the I.T.O.'s order refusing registration. In the further appeal preferred by the assessee to the Tribunal the view of the A.A.C. was confirmed by the Tribunal but in doing so the Tribunal expressed the view that four new incoming partners were benamidars of Shri Pal Singh and Shri Sadhu Singh. At the instance of the assessee the following three questions were referred to the High Court for its opinion. (1) Whether on the facts and in the circumstances of the case and on a true construction of the instrument of partnership dated 1st April 1960 a valid partnership came into existence?

(2) Whether on the facts and in the circumstances of the case the assessee is entitled to registration under section 26-A of the Income Tax Act, 1922 read with Rule 6 of the Income Tax Rules, 1922? and (3) Whether on the facts and in the circumstances of the case and in view of the fact that the parties of the second part have been found to be benamidars of the parties of the first part the assessee firm is entitled to the grant of registration?

The High Court felt that the first question referred to it by the Tribunal did not bring into focus the real issue that arose between the parties and therefore the same was required to be recast or reframed and it reframed the question thus:

Whether on the facts and in the circumstances of the case, and on true construction of the instrument of partnership dated 1st April, 1960 there is a genuine partnership, and whether the finding that there is no genuine partnership is based on evidence?"

After considering the entire material on the record as also the rival contentions urged before it by counsel on the either side the High Court answered the first question in favour of the department and against the assessee, that is to say, it held that no genuine partnership had come into existence and that the finding of the lower authorities in that behalf was based on ample material on record. The second question was also answered in the negative in favour of the department and against the assessee. As regards the third question it was answered in favour of the assessee and it was held that the mere fact that the four new incoming partners were found to be benamidars of the two original partners could not be a proper ground for refusing registration. However, in view of its answers to the first two questions particularly the first question as reframed refusal of registration was upheld by the High Court.

This refusal to grant registration for the assessment year 1961-62 has been challenged by the appellant-firm (assessee) in this appeal and counsel for the assessee raised three or four contentions in that behalf. On the aspect of the firm's validity in law counsel contended that the view taken by the taxing authorities as well as the Tribunal that no valid partnership in law had come into existence for lack of mutual agency has proceeded on a misconstruction of s. 4 of the Partnership Act as also clause 5 of the Partnership Deed in question; according to him so far as the element of mutual agency is concerned all that is required to constitute a valid firm under s. 4 is that the business must be carried on by all or any of them acting for all and therefore, if the control and management of the business of the firm was left by agreement between the parties in the hands of even one partner to be exercised by him on behalf of the others the legal requirement could be said to have been satisfied and clause 5 of the Partnership Deed in question vests such control and management with two partners (the two original partners) who would be acting on behalf of all and the mere exclusion of the four new incoming partners from such control and management cannot affect the validity of the firm and in this behalf counsel relied on a decision of this Court in *K.D. Kamath and Co. v. C.I.T. Mysore*, 82 I.T.R.

680. In other words counsel urged that if clause 5 of the Deed is properly read it could not be said that there was any lack of the element of mutual agency. On the aspect whether a genuine firm had come into existence or not counsel urged that the Tribunal had not recorded any clear finding but

had merely proceeded on the basis that no valid firm in law had come into existence but the High Court went out of its way to deal with the question of genuineness of the appellant-firm by recasting or reframing the first question referred to it, and recorded an adverse finding thereon which should not have been done by the High Court. Counsel further pointed out that the Tribunal had erroneously taken the view that because four new incoming partners were benamidars registration could not be granted and he urged that the High Court, having reversed that view, ought to have held that the assessee was entitled to registration under s. 26-A of the 1922 Act; and in this regard counsel pointed out that the position under the 1961 Act is different in view of the Explanation that has been inserted in s. 185 of that Act but in the absence of any similar provision in the 1922 Act the position was well settled that a firm could not be denied registration merely because some of its partners were benamidars of others and in that behalf reliance was placed on a decision of this Court in *C.I.T. Gujarat v. A. Abdul Rahir and Co.* 55 I.T.R.

651. Counsel further urged that undue emphasis was laid on the fact that profits of the previous year ending March 31, 1961 had not been divided or distributed among all the partners by making requisite entries in the books in the year of account and registration was wrongly refused on this basis, though profit and loss account and balance sheet worked out on loose sheets of papers (which were unsigned) had been submitted before the authorities; according to counsel it is not necessary that the requisite entries pertaining to such division or distribution of profits (or losses, if any) should be made in the books in the selfsame year of account and statement prepared by way of profit and loss account and balance sheet for working out such distribution among the partners should have been regarded as sufficient evidence of actual division of profits and in this behalf counsel relied upon a decision of the Orissa High Court in *Rao & Sons v. C.I.T. Bihar and Orissa*, 58 I.T.R. 685. Further counsel pointed out that such division or distribution had been by making the relevant entries in the assessee's books on the first day of the following year and books pertaining to the following year containing such entries were produced before us at the hearing. In substance counsel's contentions were that the refusal to grant registration to the extent that it was based on the ground that no valid partnership in law had come into existence was clearly unsustainable, that there was no evidence to justify the finding on the genuineness of the appellant firm and that the High Court having held that registration could not be refused merely on the ground that some of the partners were benamidars registration ought to have been granted to the assessee.

On the other hand counsel for the revenue supported the refusal of registration by contending that even if a valid partnership in law could be said to have been brought into existence by executing the Deed in question it was open to the taxing authority to refuse registration on the ground that factually no genuine firm had come into existence inasmuch as the two grounds were quite distinct from each other and therefore assuming that some fault could be found with the finding of the lower authorities on the question of validity of the appellant firm in law the refusal to grant registration should not be interfered with as the adverse finding on the genuineness of the appellant firm, for which there was ample evidence on record, was sufficient to justify the order. As regards the reframing of the first question counsel urged that it is well settled that it is open to the High Court to reframe or recast a question formulated by the Tribunal before answering it so as to bring out the real issue between the parties and since in this case the question No. 1 as formulated by the Tribunal presumed or assumed the factual existence of the appellant-firm (which were very much disputed

before the taxing authorities) the High Court reframed it so as to bring into focus the real issue between the parties namely, whether a genuine firm had been constituted or not. Further counsel for the revenue pointed out that the High Court had rightly observed that the Tribunal had, though in a circuitous manner, taken the view that the appellant firm had not genuinely come into existence. Counsel agreed that under the 1922 Act no provision similar to the Explanation to sec. 185 of the 1961 Act obtained and further fairly conceded that the fact that some members were benamidars of others in a firm could be no bar to the grant of registration as held in Abdul Rahim & Co. case (supra) but contended that the said aspect was not decisive of the matter and pointed out, as held that very decision, that notwithstanding the said fact the firm must be found to be otherwise genuine and therefore if the taxing authorities were to record an adverse finding on the factual genuineness of the firm registration could be refused. On the point of actual division or distribution of profits counsel urged that the lower authorities were justified in not relying on loose sheets indicating the working of such distribution especially when the sheets were unsigned and hence unauthentic and the assessee cannot be allowed to fill the lacuna by producing books for the following year in the fifth Court. On the aspect of the genuineness of the firm requisite for the grant of registration counsel relied upon two old decisions in Haji Ghulam Rasul-Khuda Baksh v. C.I.T. Punjab, 5 I.T.R. 506 and Bafi Zabdul Gafoor and others v. C.I.T.C.P. & U.P., 7 I.T.R. 625 which have been subsequently followed in P.A. Raju Chettiar and Brothers v. C.I.T. Madras, 17 I.T.R. 51 and Hiranand Ramsukh v. C.I.T. Hyderabad, 47 I.T.R. 598. Counsel for the revenue therefore, pressed for the dismissal of the appeal.

On a consideration of the entire material on record and on giving our anxious thought to the rival submissions made by counsel on either side we are of the opinion that in the ultimate analysis the real controversy in the appeal centres round the question whether or not factually a genuine firm had come into existence for the Assessment Year 1961-62 as a result of the execution of the instrument of partnership on April 1, 1960 and whether for recording a negative finding thereon against the assessee as done by the lower authorities there was evidence on the record? This being the real issue which was not reflected in the first question formulated by the Tribunal the High Court in our view was justified in reframing that question. It is true that the taxing authorities and the Tribunal did go into the question of the appellant-firm's validity in law but it cannot be disputed that the concept of a firm being valid in law is distinct from its factual genuineness and for the purpose of granting registration both the aspects are relevant and must be present and one without the other will be insufficient. In other words, even if a firm brought into existence by executing an instrument of partnership deed is shown to possess all the legal attributes it would be open to the taxing authority to refuse registration if it were satisfied that no genuine firm has been constituted. Moreover, some of the provisions contained in such instrument may not militate against the firm's validity in law but these can be a pointer against its factual genuineness. The instant case is clearly a case of that type. For instance, Clause 5 of the Partnership Deed in question which vests the control and management of the partnership business in the original two partners and denies to the four new incoming partners any right in the management or the affairs of the accounts of the partnership business may not show lack of the element of mutual agency but surely has a vital bearing on the factual genuineness of the firm and read along with other provisions like Clauses 3, 6, 7 and 8 would go a long way to show that the four new incoming partners were not real partners but were dummies thus throwing doubt on the genuineness of the firm. Moreover, the facts that the four new incoming



partners were very close relatives of the two original partners and that two of them were working as employees in the erstwhile firm whose services as such were continued in the relevant year on existing remuneration with such increments as the two original partners may agree to give cannot be lost sight of. In addition to these aspects the statements of the four new incoming partners that were recorded in November 1965 clearly show that they had signed the instrument mechanically without knowing or reading, much less after understanding the implications thereof as we shall indicate presently.

For instance, Hari Singh in his statement has stated that he was not aware of the profits of the firm in any of the three accounting years 1960-61, 1961-62 and 1962-63; he asserted that for the relevant year 1960-61 the profit and loss account and balance-sheet were prepared in the books and he had inspected these statements which assertions are obviously false because admittedly no such profit and loss account nor balance sheet was drawn up in the books. When asked as to whether Pal Singh and Sadhu Singh had consulted the incoming partners before the Deed was written out and executed he has emphatically given a negative answer and has added that they (original partners) called all four of them and asked them to sign the Deed which they did. Harbans Singh in his statement admitted that he used to do the work of painting but could not say how many factories the firm was running nor did he remember the factory in which he used to do his work; he further asserted that no witnesses were called when the Deed was signed which is obviously a false assertion. Surjit Singh who passed his Intermediate Arts in September 1960, B.A. in 1963 and LL.B. in 1965 has shown utter ignorance of even the share ratio in the profit and loss of the new incoming partners; he stated that he had two annas share in the profits but no share in the losses; when questioned as to how he knew that losses were not to be shared by him he stated that when he was a student of law he was taught that losses should never be shared; he admitted that he had never read the deed which clearly shows that he mechanically signed the document without even attempting to know what he was signing; he was also ignorant of the fact whether he had withdrawn his share of profit in the first year of the partnership, i.e. 1960-61. Gulzar Singh stated that he was called from the village and was asked to sign the document which he did without bothering to know its contents; in fact he admitted that he knew nothing about the matter. These answers given by the four new incoming partners clearly go to show that they were not real partners but mere dummies and the Deed appears to have been executed merely as a cloak to secure registration and thereby reduce the tax incidence.

Counsel for the assessee made much of the fact that profit and loss account and balance sheet prepared on loose sheets of paper had been submitted before the ITO and according to him these were wrongly rejected on the ground that requisite entries in regard to division or distribution of profits had not been made in the books in the self-same year of account, which counsel urged, was not necessary. It must, however, be mentioned that the profit and loss account statement so prepared on a loose sheet did not contain any distribution of profits and or allocation thereof to each one of the new partners but such distribution or allocation was indicated on a loose paper on which the balance sheet was prepared but even that loose sheet was an unsigned piece of paper and therefore, being unauthentic was rightly rejected by the taxing authority. An attempt was made by counsel during the hearing of the appeal to produce before us the books of account pertaining to the following year in which on the opening day entries showing distribution of the earlier years's profit had been made. But the late production of such books has deprived the taxing authorities an

opportunity to make their comments thereon. Apart from this aspect the question would be whether even such entries were genuine entries intended to be acted upon or mere paper entries making a show of allocation of the share of profits due to each one of these four new incoming partners and this would require further investigation into relevant facts. In this context it will not be out of place to mention that from their statements it appears clear that none has made any withdrawal towards his share of profit in any of the three years, 1960-61, 1961-62, 1962-63 and even after the partnership had alleged to have been dissolved after 31.3.1963 and at least one of them Hari Singh stated that a sum of Rs.73,600 became due to him as his share of profits till dissolution and in spite of demand nothing had been paid to him till his statement was recorded in November 1965. Only two of them drew their remuneration as the employees. Considering their economic position it is difficult to appreciate that they would have needed no withdrawal from their share of profits in any year till the alleged dissolution. This aspect throws considerable doubt on the point whether or not entries were intended to be acted upon.

Having regard to the aforesaid discussion it is clear that there was sufficient material on record on the basis of which the taxing authorities as well as the Tribunal could record an adverse finding on the genuineness of the firm against the assessee and registration in our view was rightly refused.

We might observe that there was nothing wrong on the part of the High Court to have confirmed the refusal of registration to the appellant firm even after holding that the fact that some members were benamidars of others was no bar to the grant of registration. In A. Abdul Rahim and Co.'s case (supra) on which counsel for the assessee relied, the Tribunal had held that one of the partners who had been inducted into the erstwhile partnership was a benamidar of one of the three original partners but had otherwise held that the partnership was genuine and valid and therefore, this Court took the view that the mere fact that one member was a benamidar of another as no bar to the grant of registration and directed registration but the ratio would be inapplicable to a case where the firm is otherwise held to be not a genuine one.

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

A.P.J.

Appeal dismissed.