Supreme Court of India
Commissioner Of Income-Tax, ... vs Ashokbhai Chimanbhai on 20 October, 1964
Equivalent citations: 1965 AIR 1343, 1965 SCR (1) 758
Author: S C.
Bench: Shah, J.C.

PETITIONER:
COMMISSIONER OF INCOME-TAX, GUJARAT

Vs.

RESPONDENT:
ASHOKBHAI CHIMANBHAI

DATE OF JUDGMENT:
20/10/1964

BENCH:
SHAH, J.C.
BENCH:
SHAH, J.C.
SUBBARAO, K.
SIKRI, S.M.

CITATION:
1965 AIR 1343 1965 SCR (1) 758
CITATOR INFO :
D 1968 SC 75 (8)

ACT:
Income-tax Act, (11 of 1922), ss. 3 and 4-Trading firm-Profits of individual partners-Time of accrual.

HEADNOTE:
The assessee was a Hindu undivided family. Its manager was a partner in a firm and the family was entitled to his share of the profits. The partnership agreement provided that the accounts of the firm should be adjusted every calendar year, that is, on the 31st December of each year. On November 12, 1955, by a deed of partition, the family and its property were divided and it was declared that the manager became exclusively entitled to the profits in the partnership from 1st January 1955. In proceedings for assessment for 1955-56, the corresponding previous year for the assessee being 27th October 1954 to 14th November 1955, the assessees contended that the share in the profits of the partnership should not be included in its taxable income because (i) under the partition deed the profits belonged to the quondam manager exclusively from 1st January 1955 and, (ii) since the partnership made up its accounts at the end of the

calendar year, the assessee had no interest in the share of the profits which accrued exclusively to its quondam manager at the end of the year. The Income-tax Officer rejected the contentions. The Appellate Assistant Commissioner and the Appellate Tribunal held that since there was a disruption in the family only on 12th November 1955, the profits had to be apportioned between the assessee and its manager. The High Court on a reference, held in favour of the assessee accepting the second contention. The Commissioner appealed to the Supreme Court.

HELD : The profits accrued to the quondam manager only on 31st December 1955, though they were the result of transactions spread over the entire period of the calendar year 1955. Since on that date the assessee had, because of the partition deed, no interest in the profits or any part thereof, the assessee was not liable to pay any tax on those profits. 1766 C-D; 769 D-E]

In the gross receipts of a business day after day or from transaction to transaction lie embedded or dormant profit or loss. On such dormant profits or loss, undoubtedly, taxable profits, if any, of the business Will be computed. But dormant profits cannot be equated with accrued profits charged to tax under ss. 3 and 4 of the Income-tax Act, 1922. The concept of accrual of profits of a business involves the determination by the method of accounting at the end of the accounting year or any shorter period determined by law; and unless a right to the profits comes into existence, there is no accrual of profits. In the case of a partnership, where, by a covenant binding between the parties, the accounts are to be made at stated intervals, the right of a partner to demand his share of the profits does not arise until the contingency under the covenant which gives rise to that right, has arisen. [762 E-F; 765 H, 766 A]

E. D. Sassoon & Co. Ltd., v. Commissioner of Income-tax, Bombay City, [1955], 1 S.C.R. 313, followed.

In re : The Spanish Prospecting Co. Ltd. [1911] 1 Ch. 92 and Bhogilal Laherchand v. Commissioner of Income-tax, Bombay City, 28 I.T.R. 919, referred to.

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Turner Morrison & Co. Ltd. v. Commissioner of Income-tax, West Bengal [1953] S.C.R. 520 and Dulichand Laxminarayan v. Commissioner of Income-tax, Nagpur, [1956] S.C.R. 154, explained.

JUDGMENT:

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 817 of 1963.

Appeal from the judgment and order dated April 17, 1961 of the Gujarat High Court in I.T.R. 21 of 1960. K. N. Rajagopal Sastri, R. H. Dhebar and R. N. Sachthey for the appellant.

The respondent did not appear.

The Judgment of the Court was delivered by Shah J. The respondent was a Hindu undivided family con- sisting of Ashokbhai-the manager-his wife Shobhana and his minor son Chirag. Ashokbhai was a partner in a firm styled Messrs Amrit Chemicals with a share of five annas in every rupee in the profit and loss. It is common ground that the beneficial interest in the profits of the firm falling to the share of Ashokbhai belonged to the undivided family. The year of account of the Hindu undivided family was the Samvat year-1st of Kartika to 30th Ashwin. The year of account of Messrs Amrit Chemicals was the calendar year according to the Gregorian calendar.

By deed dated November 12, 1955, the Hindu undivided family was disrupted, and the property of the family was divided. The following are the material clauses of the deed of partition:-

> "4. There is joint family property of the joint family of Seth Ashokbhai Chimanbhai of the First Part. Out of that we are making a partial partition of the property as hereinafter stated, particulars whereof are as follows:-
>
> (a) in the Partnership Firm in the name of the Amrit Chemicals five annas share out of sixteen annas in the rupee including goodwill together with the benefit and liability in respect of the profit and loss relating to five annas share in a rupee of sixteen annas made by the said firm from 1-1-1955 of the value of about Rs. 70,001.
>
> 8. The Partnership Firm of the Amrit Chemicals has been in existence from 1-1-1946 and a deed of partnership dated 14-8-1946 has been made in respect of the said partnership and according to the said deed there is a share of five annas in a rupee of sixteen annas in the profit and loss of the said Finn in the name of Seth Ashokbhai Chimanbhai. Seth Ashokbhai Chimanbhai has become the full owner of the said share henceforth and all the rights under the said deed of partnership are to be enjoyed by Seth Ashokbhai Chimanbhai party of the First Part himself. Similarly, any liability under the said deed is to be borne and discharged by Seth Ashokbhai Chiman- bhai party of the First Part.
>
> The account of the profit and loss of the said partnership Firm from 1-1-1955 remains to be made up and on the making of such accounts whatever profit or loss the partnership Firm may have made thereout Seth Ashokbhai Chimanbhai shall be the full owner and res- ponsible for a five annas share out of the rupee of sixteen annas."

In proceedings for assessment for 1955-56-the corresponding previous year being October 27, 1954 to November 14, 1955the Hindu undivided family-hereinafter called "the assessee"- contended that the share in the profits of Messrs. Amrit Chemicals for the calendar year which accrued on or after December 31, 1955 belonged to Ashokbhai in his individual capacity and was not liable to be

included in the taxable income of the assessee, because it had been declared under the partition deed to belong exclusively to Ashokbhai as from January 1, 1955, and that in any event since the firm made up its accounts at the end of the calendar year, the assessee had no interest in the share of profits for the calendar year 1955 which accrued at the end of that year to Ashokbhai in his individual capacity. The Income-tax Officer ordered that Rs. 21,051 received by Ashokbhai as five annas share in the profits of the firm be included in the computation of the total income of the assessee. In appeal the Appellate Assistant Commissioner held that on November 12, 1955 Ashokbhai ceased to represent the Hindu undivided family and the share of profits received from the firm had to be apportioned between the assessee and Ashokbhai. This order was confirmed by the Income-tax Appellate Tribunal.

The Tribunal submitted a statement of case on the following question to the High Court of Gujarat:

> "Whether on the facts and circumstances of this case the 5 annas share of the income of Amrit Chemicals or any part thereof for the year 1-1-1955 to 31-12-1955 accrued to the assessee and whether it could be charged in its hands?"

The High Court agreed with the Revenue authorities that Ashokbhai had become full owner of the five annas share in Messrs Amrit Chemicals with effect from November 12, 1955 and not before, but upheld the alternative contention that no part of the share of profits which accrued to Ashokbhai on December 31, 1955 was liable to be included in the income of the assessee, because on the date of accrual the assessee had no interest in those profits, and recorded a negative answer to the question referred.

Ashokbhai represented the assessee in the firm Messrs. Amrit Chemicals tiff November 12, 1955, and thereafter he became by virtue of the deed of partition the sole owner of the five annas share in the firm. The beneficial interest of the assessee in the profits of Messrs. Amrit Chemicals therefore ceased only on the execution of the deed of partition and not before. The Appellate Assistant Commissioner and the Tribunal held that the share in the profits of the firm for the year 1955 was liable to be apportioned between the assessee and Ashokbhai as an individual the assessee being entitled to a fraction of the profits equal to the fraction which the period January 1, 1955 to November 12, 1955 bears to the calendar year 1955. It was also held by the Revenue authorities that the settlement of accounts of Messrs. Amrit Chemicals did not give rise to a debt due by a third person to Ashokbhai. The argument assumes that in the gross receipts. in respect of any trading transaction carried on by an individual or a firm lies dormant some element of profit, and to that element of profit attaches immediately the charge to tax and it is not deferred till the date on which profits as a result of the transactions of the accounting year are ascertained after taking into consideration the business outgoings at the end of the year on making up accounts. This argument raises an important question about the time of accrual of profits to individual partners in a trading firm. Do the profits in a trading venture carried on by a firm accrue to the partners of the firm from day to day or from transaction to transaction, or when the accounts are made, and a right to receive the profits arises under the covenants of the deed of partnership?

Under the Income-tax Act, income is taxable when it accrues, arises or is received, or when it is by fiction deemed to accrue, arise or is deemed to be received. Receipt is not the only test of chargeability to tax; if income accrues or arises it may become liable to tax. For the purpose of this case it is unnecessary to dilate upon the distinction between income "accruing" and "arising". But there is no doubt that the two words are used to contradistinguish the word "receive". Income is said to be received when it reaches the assessee: when the right to receive the income becomes vested in the assessee, it is said to accrue or arise. Fletcher Moulton L.J., in In re The Spanish Prospecting Co. Ltd. (1) observed at p. 98:

> "The word 'profit' has . . . . a well-defined legal meaning and this meaning coincides with the fundamental conception of profits in general parlance; although in mercantile phraseology the word may at times bear meanings indicated by the special context which deviate in some respects from this fundamental signification. Profit implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a companion of the assets at the two dates."

In the gross receipts of a business day after day or from transaction to transaction he embedded or dormant profit or loss: on such dormant profit or loss undoubtedly taxable profits, if any, of the business will be computed. But dormant profits cannot be equated with profits charged to tax under ss. 3 and 4 of the Income-tax Act. The concept of accrual of profits of a business involved the determination by the method of accounting at the end of the accounting year or any shorter period determined by law. If profits accrue to the assessee directly from the business the question whether they accrue de die, in die in or at the close of the year of account has at best an academic significance, but when upon ascertainment of profits the right of a person to a share therein is determined, the question assumes practical importance, for it is only on the right to receive profits or income, profits accrue to that person. If there is no right, no profits will be deemed to have accrued. This principle was applied by this Court in E.D. Sassoon & Co. Ltd. V. The Commissioner of Income-tax Bombay-City (2). The material facts bearing on that principle were these: E.D. Sassoon & Co. Ltd.--called 'Sassoons' -were the managing agents of a Company which may be called (1) [1911) 1 Ch. 92.

(2) [1955] 1 S.C.R. 313.

"the United Mills" and were entitled to receive a percentage, of annual net profits of the Company as their remuneration. On December 1, 1943 Sassoons assigned to Messrs. Agarwal & Co. their office as managing agents and all their rights and benefits under the managing agency agreement. Accounts of the managing agency commission payable to the managing agents for the calendar year 1943 were made up in 1944 and commission for the whole year was paid to Messrs. Agarwal & Co., thereafter. In the course of assessment proceedings of Sassoons it was debated whether in respect of commission earned by the managing agency, tax was payable on the entirety of the commission by Messrs. Agarwal & Co. or by Sassoons or it 'was liable to be apportioned between Messrs. Agarwal & Co. and Sassoons. This Court held (Jagannadhadas J. dissenting) that Messrs. Agarwal & Co. alone

were liable to pay tax on the whole of the remuneration received under the contract of service between the United Mills, because the managing agency was entire and indivisible, and the remuneration or commission fell due to the managing agents, only on completion of a definite period of service and at stated periods it being a condition of recovery of wages or salary that the service or duty should be completely performed. Remuneration as managing agents constituted according to the Court "a debt" only at the end of each such period of service and no remuneration or commission was payable to the managing agents for broken periods. After referring to the observations of Fletcher Moulton L.J., in the Spanish Prospecting Co. Ltd.'s case(1) Bhagwati J., observed that "it would be absurd to suggest that the profits of the company could accrue from day to day or even from month to month". The working of the company from day to day could certainly not indicate any profit or loss, even the working of the company from month to month could not be taken as a reliable guide for this purpose. If the profit or loss has to be ascertained by a comparison of the assets at two stated points, the most businesslike way would be to do so at stated intervals of one year and that would be a reasonable period to be adopted for the purpose. In the case of large business concerns the working of the company during a particular month may show profits and the working in another month may show loss. The business during the earlier part of the year may show profit or loss and in the later part of the year may show loss or profit which would go to counterbalance the profit or loss as the case may be in the earlier part (1) [1911] 1 Ch. 92.

of the year. It would therefore be reasonable to determine the profit or loss as the case may be at the end of every year so that on such calculation of net profits the managing agents may be paid their remuneration or commission at the percentage stipulated in the managing agency agreement and the shareholders also be paid dividends out of the net profits of the company.

Counsel for the Commissioner submitted that the judgment in E.D. Sassoon Co. Ltd.'s case(1) proceeded upon the special character of a managing agency agreement and did not purport to lay down a general rule that accrual of income depends on quantification, or that right to payment of an ascertainable amount does not arise till accounts are made. Counsel also submitted that in sale transactions of a trading venture profits accrue to the trader from transaction to transaction and are embedded in each transaction carried on by the trader, and the charge imposed by S. 4 (1) (a) is not deferred till settlement of accounts. On that premise, counsel said, that profits dormant or embedded in the transactions carried on by Messrs. Amrit Chemicals accrued from transaction to transaction till November 12, 1955 and properly belonged to the assessee and were liable to be taxed in the hands of the assessee notwithstanding any subsequent disposition of those profits by the assessee. In support of his contention counsel relied upon Turner Morrison & Co. Ltd. v. Commissioner of Income-tax, West Bengal(1)-a case decided by 'this Court. In that case an Indian company received commission on sales effected in India of goods received from a foreign company. The Indian Company handled the cargo arriving at Calcutta and made disbursements in connection therewith. collected and after deducting expenses including their commission remitted the balance to the foreign principal. It was held by this Court that the income, profits and gains derived from sale of goods by the Indian Company in British India were assessable to tax under S. 4(1) (a) as income, profits and gains received in the taxable territories by the company on behalf of the foreign principal. The Court in that case observed at pp. 529-530 :

"There can, therefore, be no question that when the gross sale proceeds were received by the agents in India they necessarily received whatever income, profits and gains were lying dormant or hidden or otherwise embedded in them. Of course, if on the taking of accounts it be found that there was no profit during the year (1) [1955] 1 S.C.R. 313.

(2) [1953]S.C.R. 520.

then the question of receipt of income, profits and gains would not arise but if there were income, profits and gains, then the proportionate part thereof attributable to the sale proceeds received by the agents in India were income, profits and gains received by them at the moment the gross sale proceeds were received by them in India and that being the position the provisions of section 4 (1)

(a) were immediately attracted and the income profits and gains so received became chargeable to tax under section 3 of the Act."

These observations were, it may be noticed, made in rejecting the contention raised by Counsel for the tax-payer that in the gross sale proceeds received by him in India, there was no income at all. Counsel for the Indian company said that the gross sale proceeds were merely credit items in the account and that several amounts were to be debited in the same account and if there remained any credit balance, such balance alone could be regarded an stamped with the formal impress of income capable of being dealt with as such: income could therefore be said to have been received only at that stage. The Court did propound that when gross sale proceeds are received in which is embedded income, that income will enter the ultimate computation of the total profits assessable to tax. But that is not to say that the profits accrue or arise to a trader from day to day or from transaction to transaction. The observation that to the income, profits and gains embedded in the gross receipts s. 4(1) was immediately attracted also does not warrant the inference that the Court intended to lay down that profits accrue to a tax-payer before the right thereto has come into existence. "Profits" as pointed out in E. D. Sassoon Co. Ltd.'s case(1) do not accrue from day to day or even from month to month and have to be ascertained by a comparison of assets at two stated points. The Court also pointed out in that case that the test for ascertaining whether profits have accrued or arisen is whether the person who is entitled thereto has a right to claim the profits.

It is true that E. D. Sassoon Co. Ltd.'s case(1) related to a managing agency transaction and the Court said that the managing agency being "a service contract one and indivisible" until the entire contract is performed, no right to remuneration arises. But the principle of the case is that unless a right to profits comes into existence, there is no accrual of profits. In the case of a partner- ship, where by a covenant binding between the partners the (1) 11955] 1 S.C.R. 313.

accounts are to be made at stated intervals, the right of a partner to demand his share of the profits does not arise until the contingency which by operation of law or under a covenant of the partnership deed gives rise to that right has arisen. In the present case by cl. 11 of the partnership agreement the accounts of the firm had to be adjusted every year, and accounts for the calendar year

1955 were not and could not be adjusted before December 31, 1955. By the covenant in the deed of partnership Ashokbhai was entitled to receive the share of profits at the time when the accounts were adjusted. Before the agreed date, he had, under the deed of partnership, no right, unless the other partners agreed, to claim that the accounts be adjusted. If the profits arose on the settlement of accounts on December 31, 1955, Ashokbhai alone was the owner of those profits and the assessee had no right therein. Those profits were undoubtedly the result of transactions spread over the entire period of the calendar year 1955, but if the profits did not arise from day to day or from transaction to transaction, destination of the profits must be determined by the title thereto on the day on which they arose. If the assessee acquired no right in the share of profits received by Ashokbhai, the taxing authorities could not claim that the profits should still be apportioned between the assessee and Ashokbhai and tax should be levied on the apportioned income. In our judgment, income becomes taxable on the footing of accrual only after the right of the tax-payer to the income accrues or arises, and in the case of an agreement which makes profits receivable at or on the happening of a contingency, the fact that the profits are the result of transactions spread over a period which covers a period preceding the happening of that contingency would not make the receipt liable to be paid to persons other than those who are entitled to receive it on the date on which it is actually received or became receivable. Counsel for the Commissioner contend that under the Indian system of law a partnership is not a body distinct from the members composing it and that whatever may be the outlook of laymen concerning partnership, except for certain specific purposes it is established that a firm is not an entity or person in law but is merely an association of individuals, a firm name being only a collective name of those individuals who have agreed to carry on business in partnership; and therefore when income accrued to, the firm in respect of each transaction it must be deemed to accrue to the individual partners of the firm as well, and accrual is not postponed till the making up of accounts. Counsel relied upon the observations made by this Court in Dulichand Laxminarayan v. Commissioner of Income-tax, Nagpur(1). In Dulichand's case(2) it was held that deed evidencing a partnership of which the partners were an individual, a joint Hindu family and three firms could not be registered under s. 26-A of the Income-tax Act. But it cannot be inferred therefrom that whenever the partnership receives gross receipts in respect of its business transaction in which is embedded some profit or loss of the partnership, that profit or loss results immediately on the gross receipts reaching the partnership to the individual partners in their aliquot shares. Normally for profit to accrue or arise, there should be a right either under the statute or under contract between the tax-payer and others which entitles the former to make a demand for those profits. Bhogilal Laherchand v. Commissioner of Income-tax Bombay City(2) on which the High Court relied may be referred to. In Bhogilal's case (2) under a deed of partnership a father carried on a business in partnership with his sons. Two of his minor sons were admitted to the benefits of the partnership. One of the minor sons named Arvind attained majority on August 22, 1950, and a fresh partnership deed was executed on August 28, 1950. Under the partnership de Id as well as new-accounts were to be taken and the profit or loss was to be ascertained on the Divali day of each Samvat year. Arvind died on August 31, 1950, and his share in the profits as ascertained on August 31, 1950 was sought to be added under s. 16 (3) of the Income-tax Act, 1922, to the income of his father on the footing that the amount constituted income of a minor child of the assessee which arose from the admission of that minor child to the benefits of the partnership. The Court held that as Arvind had agreed to remain a partner after attaining majority and under the terms of the partnership profit or loss was to be ascertained only on the Divali day of each year, it

was impossible to predicate whether the partnership had made any profit or loss, on any date prior to the date of Divali in any year and as the right to receive a share of the profits arose on the death of Arvind the share of profit could not be treated as income which arose directly or indirectly to Arvind during his minority so as to make it liable to be included under s. 16(3) in the assessment of the father. Chagla C.J., in delivering the judgment of the Court referred to E. D. Sassoon Co. Ltd.'s case(3) and observed that though income may accrue or arise to an (1) [1956] S.C.R. 154.

(2) (1955) 28 I.T.R. 919.

(3) [1955] 1 S.C.R. 313.

assessee before he actually receives it, income cannot accrue or arise to him until he acquires a right to receive it; and unless and until there is created in favour of the assessee a debt due by somebody, it cannot be said that he has acquired a right to receive the income. In so holding, the learned Chief Justice quoted a passage from the judgment of Bhagwati J., in E. D. Sassoon Co. Ltd.'s case(1) to the effect that "income may accrue to an assessee without the actual receipt of the same. If the assessee acquires a right to receive the income, the income can be said to have accrued to him though it may be received later on its being ascertained. The basic conception is that he must have acquired a right to receive the income. There must be a debt owed to him by somebody. There must be as is otherwise expressed debitum in praesenti, solvendum in futuro..... Unless and until there is created in favour of the assessee a debt due by somebody it cannot be said that he has acquired a right to receive the income or that income has accrued to him".

It was urged by Counsel for the Commissioner that between the partners collectively and individual partner there can be no relation of a debtor and creditor and therefore the principle enunciated by this Court in E. D. Sassoon Co. Ltd.'s case(1) has no application to cases where a partner receives his share of the profits of the firm on making up the account of the partnership. But the principle of E. D. Sassoon Co. Ltd.'s case 11 is that income accrues or arises when a right thereto comes into existence and not before. If that be the correct ratio, and we think it is, the argument that a partnership is nothing but a compendious name for partners involving the corollary that a partner cannot be a creditor of the partnership will have no practical impact.

In Bhogilal's case(2) the position was substantially the same as in the present case. On Arvind attaining the age of majority and electing to continue as a partner he became entitled to all the rights and obligations of a partner since he was admitted to the benefits of the partnership and also to receive his share of profits computed at the end of the year as regulated by the partnership deed. On the death of Arvind the partnership stood dissolved and accounts had to be made up on August 31, 1950. But the earliest date on which Arvind's estate became entitled to a share in the profits was after he attained the age of majority: it was therefore not income which arose directly or indirectly in favour of a minor child so as to attract the application of S. 16(3) of the (1) [1955] 1 S.C.R. 313.

(2) (1955) 281.T.R. 919.

Income-tax Act. It must be noticed that in Bhogilal's case(1), income was earned by the firm in Samvat year 2006, and Arvind attained the age of majority before the end of that year. The Revenue authorities sought to apportion the share of Arvind in the income, and sought to render the father liable for that part of the income which it was claimed was properly attributable to the part of the year during which Arvind was a minor, but that claim was rejected and the entire share of Arvind in the profits was held not taxable under s. 16(3) as part of the income of his father. In the present case at the date when Ashokbhai acquired the right to receive a share of profits, there was no subsisting joint family and his share of the profits was not received by him on behalf of the assessee.

There was in this case no assignment of the profits which had already accrued to the assessee. Profits accrued to Ashokbhai and on the date on which they accrued the assessee had because of the deed of partition no interest in the profits. The Revenue authorities could not claim that profits which under the instrument of partition did not accrue or arise to Ashokbhai as representing the Hindu undivided family must for purposes of taxation be so deemed. The High Court was, therefore, right in answering the question in the negative.

The appeal fails and is dismissed.

Appeal dismissed.

(1) (1955) 28 I.T.R. 919.