Privy Council Appeal No. 29 of 1935.

Rm. Ar. Ar. Rm. Arunachalam Chettiar - - - - *Appellant*

v.

The Commissioner of Income Tax, Madras - - - *Respondent*

FROM

THE HIGH COURT OF JUDICATURE AT MADRAS.

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 27TH FEBRUARY 1936.

Present at the Hearing:

LORD BLANESBURGH.

SIR SHAH LAL.

SIR GEORGE RANKIN.

[*Delivered by* SIR GEORGE RANKIN]

This is an appeal by the assessee from the decision of the High Court at Madras on a reference made by the Commissioner of Income-tax, Madras, under section 66 (2) of the Indian Income-tax Act (Act XI of 1922). The appellant is the manager of a Hindu undivided family and the order of assessment dated 11th March, 1932, was in form an assessment to income tax of the Hindu undivided family. The year of assessment is the year 1931-32 and the year of account is the previous year, viz.: 1930-31. The appellant took exception to the assessment made by the Income-tax Officer on the 11th March, 1932, as aforesaid, but his appeal to the Assistant Commissioner of Income-tax was on the 10th December, 1932, dismissed and the High Court of Madras has in effect upheld the orders of the Income-tax authorities.

The facts of the case as stated by the Commissioner and as appearing by the orders of the Assistant Commissioner and Income-tax Officer [extracts from these orders being exhibited to the letter of reference] are as follows. The appellant [for this purpose he will be referred to as an individual] carries on a money-lending business in various places and in addition is possessed of property at various places and of dividends, all of which are subject to Indian income-tax. At a place called Perambalur, he carries on two businesses, one of which is a business of money-lending, and prior to the 31st March, 1930, he had also carried on, but in partnership with one A. Soma-Sundaram Pillai, a third business in the purchase and sale of cotton. This

business had been started in 1926, the respective shares of the appellant and Pillai in both profit and loss being $\frac{5}{8}$ths and $\frac{3}{8}$ths. It appears that Pillai was a working partner, a man of little or no means; there does not appear to have been any written agreement of partnership; and neither partner undertook to bring any capital into the partnership in the strict sense of this expression—that is in the sense in which the word is used in clauses (*c*) and (*d*) of section 13 of the Indian Partnership Act (IX of 1932). The money necessary for purchasing cotton and carrying on the business was provided by the appellant on the terms that interest was to be paid upon his advances. In the books of his money-lending business at Perambalur these advances were debited to the cotton partnership. It is not clear how far interest was actually paid in any particular year, but interest was charged and was entered in the books of both businesses. The cotton business was started in the year 1926, but there is not in evidence any statement of the profits or losses of each year, nor of the details of the interest account in the books of the money-lending business. It is clear, however, that the accounts of the cotton partnership were made up on the footing that it was liable to pay interest in respect of the advances. The business was a losing one. Accounts were first settled between the partners on the 31st March, 1928, with the result that Pillai's share of the loss up to that date was found to be Rs.9,396 and the appellant's Rs.15,660. Thereafter the business incurred further losses and when it was discontinued as at the 31st March, 1930, Pillai's share of the further losses was Rs.20,268 and the appellant's Rs.33,780. Pillai's shares of loss debited to his account in the partnership books on the 31st March, 1930, was with interest Rs.34,069.

The appellant in his assessment for the year 1928-29 was allowed to deduct his share of the loss in this cotton partnership. This presumably refers to the loss made in the year 1927-8. It would seem that the appellant in the year of assessment 1930-31 was allowed to deduct for Income-tax purposes his share of the rest of the partnership losses. In this way $\frac{5}{8}$ths of the total losses of the firm have in due course been deducted from his other profits. This was doubtless done in accordance with the ruling given by the Madras High Court in the case of *Commissioner of Income-tax, Madras* v. *M. Ar. Ar. Arunachelam Chettiar* I.L.R. 47 Mad. 660 where it was held that a partner in an unregistered firm which has made a loss in the year of account is entitled to set off his share of the loss against the profits and gains made by him in his individual trade and otherwise. At no time before the year of assessment with which we are now concerned (viz., 1931-32) does it appear that any attempt was made by the appellant to claim that, his partner Pillai being unable to meet any share of the firm's losses, the appellant, for

purposes of Income-tax could claim to deduct from his other profits any greater share than $\frac{5}{8}$ths of the losses of the cotton firm. In particular, although the cotton business was closed at the end of the year 1929-30, viz., on 31st March, 1930, no such claim was made in respect of the year of assessment 1930-31, for which assessment the last year of the cotton business was the year of account.

What happened after March, 1930, was as follows. On the 1st April, 1930, the debit against Pillai in the books of the cotton partnership was transferred to the account of the appellant's money-lending business at Perambalur. The meaning of this transfer and its justification invite comment which may be postponed for the present. On the 29th September, 1930, a further debit was made to this new account of Rs.2,569 by way of interest, bringing the total debit to Rs.36,638. On this date Pillai gave to the appellant a promissory note for this amount, and a fresh folio was opened in the books of the appellant's money-lending business styled " A. Soma-Sundaram Pillai, Promissory Note Account ". On the 28th March, 1931, the appellant took from Pillai a mortgage of certain house property for Rs.500. On 31st March, 1931, that is on the last day of the year of account with which the present assessment is concerned, the appellant wrote off the balance Rs.36,138 as a bad debt.

In his assessment for 1931-32 the appellant claimed to deduct the above sum of Rs.36,138 from the amount of the profits of his money-lending business at Perambalur for the year 1930-31. It would seem that apart from this deduction the money-lending business in the year of account made a loss, but the appellant in that year had other taxable profits.

The Income-tax authorities, supported by the High Court of Madras, have disallowed this claim, which in form, as already shown, was a claim to have an allowance in respect of a bad debt made in the year of account by the money-lending business at Perambalur. The question which the appellant desired the Commissioner to refer to the High Court was framed by him as follows:—

> " Whether the debt of A. Somasundaram Pillai written off as an irrecoverable loan in the year of account is not liable to be deducted from the assessee's income for the year ? "

The Commissioner being of opinion that in fact no loan was ever made by the appellant's money-lending business at Perambalur to Pillai, refused to state the question in this form, but referred for the decision of the High Court the following question :—

> " Whether the ex-partner's share of the loss in the cotton trade which the Petitioner had to bear by reason of the ex-partner being unable to meet his share of loss in the partnership business, can be set off against the Petitioner's other income, profits or gains as a loss of profits or gains within the meaning of section 24 of the Act ".

Upon this question, so referred as being the real question which arises in the case, the Commissioner gave as his opinion that as Pillai had no capital the appellant had to meet the loss from the capital contributed by him to the cotton partnership and that the loss claimed to be deducted was a loss of capital and not a loss of profits or gains within the meaning of section 24.

The learned Chief Justice of the High Court at Madras, with whom the other judges agreed, answered the question referred in the negative, holding that in the books of the cotton business there was nothing to show that the appellant had made any other or further loss in that business than his five-eighths share, and that as the money-lending business never lent any money to Pillai but only to the cotton partnership, Pillai never became a debtor of the money-lending business at all.

As it is reasonably clear that Pillai, who is described by the learned Chief Justice as "a man of straw", was at no material date possessed of any capital, it will be convenient to consider the question propounded by the Commissioner first of all from the point of view of the appellant as at the time when the cotton business was closed down. It appears to their Lordships to be reasonably clear that in respect of five-eighths of the loss made by the cotton partnership in its last year of trading, namely 1929-30, the appellant in the year of assessment, 1930-31 was entitled to claim a deduction from his other income. The same is true *mutatis mutandis* in respect of previous assessments. Their Lordships fully approve of the decision in the case already cited, *The Commissioner of Income Tax, Madras* v. *M. Ar. Ar. Arunachelam Chettiar* I.L.R. 47 Mad. 660, and of the reasons given in the judgment of Schwabe C.J. for so holding. In particular they are of opinion that the learned Chief Justice rightly rejected the contention put forward in that case, that an unregistered firm was for income tax purposes an "entity", or that the same person as an individual and as a partner of a firm is two separate "entities", merely because the business of the firm is a separate business, and the firm is treated as an assessee. From section 24 (2) of the Indian Income-tax Act it would seem that the Indian legislature thought it necessary to anticipate any possible apprehension that a partnership, by being registered as a registered firm within the meaning of section 26 of the Act, might be treated as a separate assessee in so absolute a sense as to prevent a partner's share of loss being set off against his individual profits or gains. In their Lordships' opinion whether a firm is registered or unregistered, partnership does not obstruct or defeat the right of a partner to an adjustment on account of his share of loss in the firm, whether the set off be against other profits under the same head of income within the meaning of section 6 of the Act or under a different head [in which case

only need recourse be had to s. 24 (1)]. So long as the set off is of his share of the loss made by the firm in the year of account, the adjustment does not involve the taking of any general or other account between the partners or indeed any examination of the accounts of the individual partners in the books of the firm. No question of the amounts paid by individual partners on the firm's behalf or of the right of one partner to contribution from another complicates the calculation which is based (*a*) upon the amount of profit or loss made by the firm as a firm, and (*b*) on the share or fraction attributable to each partner by the agreement of partnership between them.

If however a partner can claim to deduct against other profits or gains a sum which he has become liable to bear or pay (*a*) by reason that he has paid or will have to pay on account of the firm more than his share, (*b*) so as to give him a right of contribution from the other partner, (*c*) who is insolvent, the character of the investigation to be made is entirely altered. Logically, it may perhaps be said, the whole of the loss of the last year of trading at least is in a case like the present falling upon one partner and not merely his proper share of the loss. But for income tax purposes very different considerations arise. As the appellant on the conclusion of the last year of trading did not in his character of partner formulate any claim to a deduction of more than five-eighths of the loss in the cotton business, it is necessary now, if the question stated by the Commissioner is to be answered, to formulate precisely the further claim which is under discussion. Is the suggestion that at the end of any year's trading one partner in a continuing partnership, treating the other as insolvent, can claim to set off the whole of the firm's loss in the previous year? Or is it that he can do so on the dissolution of the firm? Or that later, according as the other partner's insolvency becomes established he can set off in one year the whole of such partner's shares of loss for several years? Looking at the matter as a question of what a partner in a firm may claim to deduct from his other income, their Lordships are not of opinion that in any of these forms the claim can be regarded as permissible.

In one year a partner may draw out more, in another year less, than his share of profits. In one year a partner may have expended money on behalf of his firm; in another year another partner may have done the like. Questions may arise, regardless of whether the firm has otherwise made a profit or loss, as to the firm's right to be indemnified by a partner for loss caused to it by his wilful neglect. (cf. Indian Partnership Act (No. IX of 1932) s. 13 (*e*) and (*f*)). Between partners any right of contribution has reference, *prima facie* at least, to the ultimate balance appearing as the result of a general account. For this purpose

let all questions of mere procedure for the enforcement of a partner's right be disregarded, and let the money owing from one partner to another be treated as in equity a debt. Whether the old rule as stated by Lord Cottenham in *Richardson* v. *Bank of England* (1838) 4 My. & Cr. 165 at 172 that " pending a partnership equity will not interfere to set right the balance between the partners ", is still to be adhered to rigidly or not, the kind of account which is necessary between partners to settle questions and cross-claims between them is beyond the scope of an Income-tax officer's investigation. His duty is to compute properly the profits made by the firm or the loss incurred by the firm. For this purpose he has no occasion to embark upon the computation of the exact value of any partner's interest in the capital or the details of the partners' accounts in the firm's ledger. He has only to enquire what is each partner's share. The firm is considered as doing business with third parties. For the present purpose individual partners are not to be considered as trading with or doing business with each other but as having shares in the profit or loss of the firm. On any other principle profits made by the firm may go untaxed and losses made by the firm may be allowed for more than once. The present case may be quite free from complication. But that the claim now in question clashes with the principles of the Indian Income-tax Act will be apparent from an examination of that statute.

Under the Act both the firm and the individual partners have to make returns and are assessed whether the firm is a registred firm or not. This principle or practice, for it is both, has sometimes been referred to as the principle of " double assessment " and was much discussed in the case of *In re Neemchand Daga* (1931) I.L.R. 58 Cal. 1204. An unregistered firm is treated as an individual both as regards rate of tax and as regards super-tax. The registered firm on the other hand pays income tax at the maximum rate in all cases independently of the amount of its total profits, but is not assessed to super-tax at all. In neither case does the individual partner have to *pay* again on his share of profits if the tax has already been assessed on the firm. (Section 14 (2) (*b*).) Moreover, in the case of a registered firm by the operation of section 48 the individual partner may obtain a refund of tax paid on his share if the rate at which he is chargeable to tax as an individual is not the maximum rate. This full procedure however is not always followed in the case of registered firms: in order to avoid unnecessary payments and unnecessary proceedings for a refund, the partner is sometimes taxed directly on his share at the rate ultimately payable by him. Now the basis of this system is that the individual partner is chargeable on his share of the firm's profit regardless of all question whether he actually receives it as income paid to him or whether under the articles of partnership he is entitled to

draw it out. Special stipulations between the partners may obstruct the partner's right in the year of account or at all to withdraw his aliquot portion of the total profit. All such matters are disregarded by the statute and save upon this principle the working of the Act could hardly proceed. That the tax is to be levied by reference (*a*) to the total profits of the firm, and (*b*) the particular partner's share in the profits, is manifest in section 14 (2) (*b*), 23 A (1) and 4 (i), 26 A, 48 (2) and 55.

It is in no way surprising therefore that in the only case in which express reference is made by the Act to the deduction which an individual partner may make from his other income in respect of his share of his firm's loss—the case, namely, of a registered firm—the same principle should be recognised. The words used in section 24 (2) are "Any member of such firm shall be entitled to have set off . . . such amount of the loss . . . as is proportionate to his share in the firm." The phrase "share in the firm" is not beyond criticism as it ignores the fact that however usual it is not actually necessary that the aliquot portion or interest of a partner should be the same in profits as in losses, but no reasonable doubt can exist that the measure of this right of set off, in the case of a registered firm, is given by the phrase. Both upon principle and as a matter of construction of the statute, the alternative in the case of an unregistered firm is between holding that the right of set off does not arise and holding that it is a right of the same character and measure to be worked out in the same way. After all, even if a partner is insolvent he may nevertheless have had in the year of account income from other businesses or sources against which his share of the firm's loss can be deducted for purposes of income tax. If B may get credit for his share of the loss there is at least a formidable difficulty in the way of giving credit to A for the whole. That persons without capital should be taken as partners in a business is doubtless at times both reasonable and desirable, but it is not clear that this would be unduly discouraged merely because in case of loss the capitalist partner might be better off if by the partnership articles in accordance with reality he took the whole responsibility for losses.

Their Lordships moreover can give no countenance to a suggestion that upon a dissolution of partnership a partner's share of the losses for several preceding years can be acccumulated and thrown into the scale against the income of another partner for a particular year. No principle of writing off a bad debt could justify such a course, whether in the year following the dissolution or, as logic would permit, in some subsequent year in which the partner's insolvency has crystalised. The "bad debt" would not, if good, have come in to swell the taxable profits of the other partner. In the present case the claim to set off is

in fact made in the second year of assessment after the dissolution of the business. It has already been observed that the scheme of the statute is not to treat partner A as if in connection with the firm's affairs he was trading *vis-a-vis* B, or doing business with B as the other party. Still less can it properly be held that years after the dissolution of the business A is doing business with B and making good debts or bad debts due from him. Their Lordships are accordingly of opinion that the question propounded by the Commissioner of Income-tax has been rightly answered by the High Court of Madras in the negative.

It remains, however, to note that the appellant in the year 1930-31 took steps to give another character to his partner's share of the losses made in the cotton business between 1926 and 1930. As the Income-tax Officer put it " on 1st April, 1930, the debit against A. Soma-Sundaram Pillai in the accounts of the partnership was transferred to the petitioner's money-lending business." On the 29th September, 1930, interest of Rs.2,569-6-0 was added, bringing the total amount to Rs.36,638-4-9. On the same day, 29th September, 1930, the appellant took a promissory note from Pillai and on 28th March, 1931, took a mortgage deed for Rs.500. On 31st March, 1931, he wrote off as bad the sum of Rs.36,138-4-9. These steps can only have been taken in order to found a claim that in the year of account, 1930-31, the appellant had made a loss in his money-lending business. But this claim was rejected by the Commissioner on the short ground that no loan was as a matter of fact advanced by the appellant's money-lending business to Pillai, though it is true that the appellant advanced monies to the cotton partnership. Their Lordships have the greatest difficulty in seeing how the circumstance that the appellant carries on business as a money-lender can affect his rights in respect of advances made to his own firm. It is no part of the business of a money-lender to finance the money-lender's ventures in the cotton market. Conversely, it is not a sign or index of the money-lender that one advances money to one's own firm. The basis of the right to deduct irrecoverable loans before arriving at the profits of money-lending is that to the money-lender, as to the banker, money is his stock in trade or circulating capital : he is dealing in money. But a solvent man can hardly make a loss by lending money to himself even if another be made responsible for the loan as well. And when the loan is in reality but a putting of the hand into the pocket to pay for cotton it seems desirable to ask what is the real equity between the parties. Their Lordships think that a reference to sections 24 and 44 of the English, and sections 13 and 48 of the Indian, Partnership Act provides a correct answer and that the true and ultimate right of the appellant against Pillai was a right to contribution in proportion to the *latter's* share of profits. This is none the less true that the money was not put up by way of

partner's capital. Even if three-fifths of the money can also be regarded as in equity a loan to Pillai it is very far from being money lent in the course of business as a money-lender, as is shown by the equities affecting the right to be repaid.

When A purports to lend money to A and B, much may be done with the consent of B. The transfer of the entry to the debit of Pillai from the books of the cotton partnership to the books of the appellant's money-lending business may in the circumstances of this case be taken as having been effected with the consent of Pillai. The element of novation, however, comes in too late. Pillai's inability to meet his share of the loss was just as hopeless by the end of March, 1930, as at any later time. The appellant's return for the year 1930-31 did not have to be rendered until months after March, 1930, and if he filled in time by making entries in his books at the beginning and end of the year 1930-31, that delay does not entitle him to chose the next year for his claim to a set-off. From before the moment at which this debt was transferred from the cotton business to the money-lending business it was altogether bad and its badness was the reason of the transfer. It cannot, therefore, be considered as a bad debt made by the appellant in the course of money-lending and still less can it be considered as becoming bad in the year of account: hence the process by which the transfer is made on the first day of the year 1930-31 and cancelled as a bad debt upon the last day of that year is of no avail to the appellant.

Their Lordships are not in any way disposed to criticise the decision of the Commissioner refusing to regard the transaction as an irrecoverable loan made in the course of a money-lending business. They think, however, that it would have been more convenient, and more strictly in accordance with s. 66 (2) of the Act, if the Commissioner had, after setting out the evidence upon this question and his findings thereon, stated and referred to the High Court the question of law, viz.: Whether it was open to him in law to hold that the loss in question was not a loss of profits or gains incurred by the appellant in the year of account by reason of an irrecoverable loan made in the course of his business as moneylender so as to entitle the appellant to have the amount thereof set off against his other income profits or gains in the said year.

They will humbly advise His Majesty that this appeal should be dismissed. The appellant must pay the costs.

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In the Privy Council.

RM. AR. AR. RM. ARUNACHALAM CHETTIAR

v.

THE COMMISSIONER OF INCOME TAX, MADRAS

DELIVERED BY SIR GEORGE RANKIN

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