## APPELLATE CIVIL—SPECIAL BENCH.

*Before Sir Murray Coutts Trotter*, Kt., *Chief Justice*, *Mr. Justice Ramesam*, *Mr. Justice Wallace*, *Mr. Justice Beasley and Mr. Justice Tiruvenkata Achariyar.*

COMMISSIONER OF INCOME-TAX, MADRAS (REFERRING OFFICER),

1928, March 20.

*v.*

SUBRAMANIAM CHETTIAR (ASSESSEE).*

*Indian Income-tax Act (XI of 1922), sec. 10 (2) (iii)—Partner lending to his firm—Interest paid for loan, whether an allowable deduction.*

Where a partner as partner genuinely lends money, beyond the initial capital, to the partnership at an agreed reasonable rate of interest and the money is used for capital expenditure, the interest paid by the partnership to him in the year of assessment must be deducted in computing the profits or gains of the partnership as provided by section 10 (2) (iii) of the Indian Income-tax Act.

CASE stated under section 66 (3) of Act XI of 1922 by the Commissioner of Income-tax in the matter of assessment of A. L. S. P. P. L. Subramaniam Chettiyar and another, for the opinion of the High Court on the question, viz.,

"If a partner, in addition to the subscribed capital, lends to the partnership of which he is a member, a certain sum of money on the distinct understanding that in respect of this loan he is to receive interest from the partnership, whether or not the interest paid to the partner is a legitimate item of business expenditure within the meaning of section 10 (2) (iii) of the Indian Income-tax Act."

The facts appear from the judgment.

*K. S. Krishnaswami Ayyangar* (with *V. Rajagopala Ayyar*) for assessee.—The deduction claimed should be allowed as

* Referred Cases Nos. 21 and 22 of 1926.

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interest on borrowed capital, as per section 10 (2) (iii) of the Income-tax Act. For the facts found in the case are that as per terms of the partnership deed there was an initial capital of Rs. 21,000 put in by the two partners in the proportion of three to one for which no interest was payable to them and that profit and loss should be divided between the partners in the same proportion, that if necessary further sums may be contributed by either party towards any additional capital of the business and that the current rate of interest should be charged for it. It has also been found that the partner who had three-fourths share in the business lent nearly four lakhs of rupees towards additional capital at various times. If the transaction is a loan between the parties it cannot be taken to be otherwise as between the Crown and the assessee and the Commissioner had no right to find that the additional capital lent was really meant by the lender to form part of the initial capital, and he has arrived at this finding not as a finding of fact but on wrong inferences of law. This lending, though not under any document, is not a blind to hide the real nature of the transaction, but is a genuine lending for running the business, made on various occasions according to the requirements of the business, though allowed to remain in the business for six years without being demanded. It is not to the interest of this lender to treat the amounts lent as additional capital, for he would then not only lose the interest payable for the loan but will not on that account be entitled to any higher proportion of the profits than three-fourths and one-fourth. Interest was actually paid in the year of assessment by means of credit entry. The lending partner could have demanded the amount at any time and he could have sued the firm for it, under Order XXX, Civil Procedure Code corresponding to Order XLVIII of the Supreme Court Rules in England, though payment for it could be made only when taking accounts between the partners. The distinction between initial capital and capital lent subsequently by the partners to the firm is clearly drawn in Lindley on Partnership, 9th Edition, page 407. The facts that at Common Law no suit could be maintained by a partner against the firm or that outside lenders to the partnership are, at the time of taking accounts, preferred to lending partners, cannot change the nature of the loan as borrowed capital. See Lindley on Partnership, 9th Edition, page 720 and section 44 of the English Partnership Act. The reasoning why outside lenders are

preferred to lending partners is that the whole firm including the lending partners is liable to them. If there is an eventual loss, the loan given by the partner has to be repaid in full to the extent of his share by the other partners; see Lindley, page 721. A partner can sue the firm and yet continue as a member of the firm; see *Rustomji* v. *Sheth Purshotamdas*(1), *Karri Venkata Reddi* v. *Kollu Narasayya*(2).

*M. Patanjali Sastri* for Referring Officer.—Though this is capital, it is not borrowed capital; for when a partner contributes money for re-production in the business it is not a loan but additional capital embarked or sunk in the business. Only an outsider can lend capital but not a partner. There is also a finding by the Commissioner in this case that this additional capital was not really meant as a loan but was put in only as an addition to the initial capital which was small, the partners knowing from the beginning that such additional sums would be required for the business. According to English Law interest paid even to an outside lender is not allowed to be deducted, for the repayment of such sum can be demanded at any time and it cannot be sunk in the business as capital for any length of time. But under section 10 (2) (iii) it is otherwise. Even in the case of a loan from a stranger it can be treated as capital borrowed only if it is large enough to be employed as capital and if it could be utilized for a long time; otherwise not. *Farmer* v. *Scottish North American Trust, Ltd.*(3), *Alexandria Water Co.* v. *Musgrave*(4). The Crown is entitled to assess all the profits earned by the firm; the interest payable to the partner who lends is only a portion of the profits and hence it cannot be deducted. Annuities payable out of profits cannot be deducted; *Gresham Life Assurance Society* v. *Styles*(5). A firm is not a legal entity distinct from the partners; see *The Commissioner of Income-tax* v. *Arunachelam Chetty*(6). One partner cannot sue his firm for money lent; *Kashinath Kedari* v. *Ganesh*(7). A thing can be considered as a loan only if there is a right of suit for it and if there is an absolute obligation to pay it and not an obligation to pay it only at the time of taking accounts. The distinction drawn in page 407 of Lindley is between initial capital and subsequent

(1) (1901) I.L.R., 25 Bom., 606.
(2) (1909) I.L.R., 32 Mad., 76.
(3) [1912] A.C., 118.
(4) (1883) 11 Q.B.D., 174.
(5) [1892] A.C., 309, 320.
(6) (1924) I.L.R., 47 Mad., 660.
(7) (1902) I.L.R., 26 Bom., 739.

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advances as loans and not between initial capital and subsequent capital.

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COUTTS TROTTER, C.J., and RAMESAM, J.—This case has been referred to us under section 66 (3) in pursuance of an order of this Court requiring the Commissioner of Income-tax to state a case and refer it.

The facts of the case are as follows:—According to a deed of partnership, dated 29th July 1921, Exhibit A, A. L. S. P. P. L. Subramanian Chettiar and A. R. S. S. P. Subramanian Chettiar entered into a partnership according to the terms of which, the former contributed Rs. 15,750 as his three-fourth share of the capital and the latter contributed Rs. 5,250 being one-fourth share of the capital, the initial capital agreed being Rs. 21,000 and they were to share the profit and loss in the ratio of 3 to 1. The document also contemplates that if necessary further sums may be contributed by either party towards the additional capital of the business and that interest should be charged on it. The Commissioner has found that the senior partner advanced a sum of Rs. 4,01,251, as additional capital in parts at various times and that the junior contributed comparatively a very small sum. The amount of interest on the senior partner's advances comes to Rs. 40,757 and the interest on the junior partner's advances to Rs. 78. It is now claimed on behalf of the partnership that the total of these two amounts of interest paid to the partners for sums advanced by them should be deducted in estimating the amount on which the partnership should be assessed for income-tax under section 10 (2) (iii). The Assistant Commissioner held that the whole of the additional sums advanced by the partners must be regarded really as the capital of the firm. On appeal, the Commissioner in his

order conceded that a partner may sometimes occupy a dual capacity, that is, he may lend a definite sum of money to the firm on a formal document, in which case it would be regarded as a loan; but in the present case the sums advanced by the partners cannot be regarded as loans but as "surplus capital". The question to be decided by us is whether the sums advanced by the partners should be regarded as "capital borrowed for the purposes of the business" within the meaning of section 10 (2) (iii). In the argument before us the learned vakil who appeared for the Commissioner admitted that the sums advanced by the partners were capital, but he denied that it is capital "borrowed". The proposition of law for which he contended is, that though a partner may make a loan to the partnership, he cannot lend capital to the partnership and that additional capital required for the purposes of the partnership can be borrowed only from outsiders, in other words, though capital may be borrowed from outsiders, capital cannot be borrowed from a partner. He cited no authority for this proposition. The sub-clause itself does not contain any limitation as to the person from whom capital is to be borrowed. Once it is conceded that a partner can lend money just like any other third person, it is difficult to see why he cannot lend capital also. Whether the money lent is capital or a mere loan really depends on the use to which it is put and not on the person from whom it was borrowed. If it is used for purposes similar to those for which initial capital is used, then it is capital in the hands of the partners by reason of the use which it is put to, though it was money borrowed from the partners. It is not the character of the lender that determines whether the sum borrowed is capital or not. The Commissioner seems to think that if a sum of money is deposited with the

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partnership temporarily for reasons unconnected with the business, it is a loan, but if it is invested for a much longer time than the business required it, the initial capital being insufficient, then it becomes surplus capital and not a loan. We are not able to follow these distinctions of the Commissioner. All sums lent to the partnership are loans, whoever the parties and whatever the purpose for which they are lent. After being borrowed if they are used like capital they become borrowed capital and if they are not so used they continue to be mere loans, the expenditure not being in the nature of capital expenditure (vide clause 9 of the same sub-section). In the present case, the Commissioner himself found that it was capital and there is no doubt also that it was borrowed from the partners. That being so, we are of opinion that section 10 (2) (iii) applies.

It is said that there is a finding of fact by the Commissioner that the sums in question in this case are not capital borrowed within the meaning of the clause in question. The so-called finding of fact is really based upon certain facts as to which there is no dispute and which are accepted on all hands *plus* certain supposed legal principles on which the Commissioner relies but for which there is really no authority. Whenever a sum is borrowed and it is afterwards used for capital expenditure, it is not open to the Commissioner to find that it is not borrowed capital as there is no such principle of law as is contended before us on behalf of the Commissioner. It is also said that there is a finding that the initial capital was nominal and from the beginning additional capital was intended. Here again there is no dispute about the facts. The initial capital consisting of two amounts which the parties were bound to contribute, is known. So far as

additional or surplus capital is concerned, no partner is bound to advance any particular sum. All that the deed provides is that if a partner chooses to advance certain sums, he will be entitled to interest, but he is not compellable to do so. It is clear therefore that what is called surplus capital has different characteristics from the initial capital and it is not open to ignore this difference. The fact that a large business was contemplated for which the small initial capital would not be enough and additional capital would therefore be required has really no bearing on the legal aspect of the question, additional capital having different incidents from initial capital. Moreover, however high may be the proportion one partner may contribute in the form of additional capital relatively to the other partner, it will have no bearing on the proportion in which the profits are to be taken. This again shows that it is not open to regard additional capital as really initial capital. The Commissioner's findings being based on misconceptions of law cannot be accepted as findings of fact binding upon us.

The only other question is whether interest paid on the sums advanced can be said to be in any way dependent on the earning of profits. It is clear that the clause "Where the payment of interest thereon is not in any way dependent on the earning of profits" relates to the payability of interest, that is, the clause excludes cases where interest is payable in some manner dependent on the earning of profits. If interest is payable whether profits are earned or not, the clause applies. The learned vakil for the Commissioner argued that the scheme of the Act showed that wherever profits are earned, they were intended to be wholly assessed and the construction we are placing on this clause is inconsistent with the scheme of the Act. There is no

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such general scheme in the Act. In this respect the law in India seems to be different from that in England and the English cases mentioned by the learned vakil for the Commissioner have really no bearing on the construction of the Indian Act and need not be referred to. It is hardly necessary to observe that, when interest is deducted from the earnings under this clause by the partnership as its expenditure, it is really profit earned by the individual partner who takes the interest and it will be added to his income in assessing him individually. The actual rate of assessment and to what extent the State is profited or loses by the change in the assessee depends really on the actual income of the individual partner for the particular year and in the case where he has lost in his trade in any year, the transfer of the amount as his income may merely reduce his losses and may not result in any assessment. But these are all accidental circumstances which may vary year after year. One year the State may lose and another year the partnership may lose. Gain or loss to the State is really irrelevant for our purpose.

There is one further observation to be made. It is only where interest is paid that the deduction contemplated by section 10 (2) (iii) is permissible. Payment need not be actually in cash but may be by adjustment of accounts; but in whatever manner it is done it must be a real out-going. In the present case the Commissioner has found that interest has been paid as the question referred to us shows. There may be cases where no interest has yet been paid but may be due only. In such a case the partnership cannot ask for deduction of the interest merely on the ground that it is due. Therefore no question arises before us on this aspect of the matter.

We therefore answer the question referred to us as follows:—

Where a partner as partner lends money beyond the initial capital to the partnership at an agreed rate of interest and the money is used for capital expenditure, the interest paid by the partnership to him in the year of assessment must be deducted in computing the profits or gains of the partnership within the meaning of section 10 (2) (iii).

Costs Rs. 500 will be paid by the Commissioner of Income-tax to the assessees.

The above judgment represents the joint view of RAMESAM, J., and myself and was drafted by him after full discussion between us.

*Referred Case No.* 22 *of* 1926.

This is governed by our opinion in the other case.

Costs Rs. 100 will be paid by the Commissioner of Income-tax to the assessees.

WALLACE, J.—I agree with the statement of the law applicable to this case as expounded by my learned brother, the case being one where, on the facts found, there was a genuine borrowing of capital at the prevailing market rate of interest. I only wish to guard myself against the supposition that in other cases it will not fall to be decided as a point of fact whether the alleged borrowing of capital was not a genuine loan but a mere device to evade the Act. To take an extreme case :—Where two partners agree on a nominal capital and then each lends additional capital at a fancy rate of interest calculated so high or with so little relation to the market rate as to be obviously designed to absorb all probable profits, and thus enable them to submit a nil profits return, it would surely be open to the Commissioner to find that there was no genuine borrowing

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of capital. I agree that the present case falls under section 10 (2) (iii) of the Indian Income-tax Act.

BEASLEY, J.—I agree and make the same reservation as WALLACE, J.

TIRUVENKATA ACHARIYAR, J.—The answer to the question referred to the Full Bench depends upon the meaning which should be ascribed to the expression "capital borrowed for the purposes of the business" in section 10, clause 2 (iii) of the Indian Income-tax Act. It was argued by the learned vakil for the Commissioner that any sum of money which a partner puts into the business of a firm for being used as capital cannot be treated as a loan from him to the partnership, even though the firm purports to borrow the amount from him as a loan; in other words a firm cannot legally borrow its capital from its partners. This proposition would be quite correct if by "capital" is meant the sum which a partner contributes under the agreement of partnership for the purpose of commencing or carrying on the business and which is intended to be risked by him in the business. That is the true sense of the word "capital", and so far as the contribution made by a partner relates only to capital so understood, he is not a creditor of the firm. He has no right to sue the firm for the recovery of such contributions or advances and he can only get back his capital on the dissolution of the firm, out of any surplus assets which may remain after meeting all its liabilities. But in the clause we have to construe, the word "capital" appears to be used not in the sense of a partner's contribution as capital which as pointed out cannot be treated as borrowed capital but as meaning sums borrowed for capital expenditure. Such a borrowing by a firm whether from an outsider or from one of its partners

cannot have the effect of increasing the capital of the firm. As observed in Lindley on Partnership, "If a firm borrows money so as to be itself liable for it to the lender, the capital of the firm is no more increased than is the capital of an ordinary individual increased by his getting into debt." So it is that the advances made by a partner to a firm over and above the amount which he has agreed to subscribe towards the capital of that business, cannot be treated as an increase of his capital but as a loan made by him, and if such advances are made for being used for the same purposes for which the original capital was intended to be used, they will be capital borrowed for the purpose of business within the meaning of section 10, clause 2 (iii), and if the other requirements of that clause are satisfied, the payment of interest on such borrowings should be deducted from the profits of the business. It is a question of fact in each case whether the further advance made by a partner over and above the capital agreed to be put in by him is really a loan by him to the partnership or an increase of his capital in the business made with the consent of the other partners. So far as the present case is concerned, the question referred treats the advances in question as loans made by the partner to the firm for being utilized as capital and there seems to be no valid ground for questioning that fact. I therefore agree that the question should be answered in the affirmative.

N.R.