FULL BENCH

Before Mr. Justice Iqbal Ahmad, Mr. Justice Allsop and Mr. Justice Bajpai

1939 *March*, 30

CHANDRIKA PRASAD RAM SWARUP (APPLICANT) *v.* COMMISSIONER OF INCOME-TAX (OPPOSITE PARTY)*

Partnership—Firm—Firm as such can not be a partner in another firm—Contract Act (IX of 1872), section 239—Members individually can be partners with others in a new firm—Old firm investing funds in business of new firm—Loss—Assessment of old firm to income-tax should take into account the loss—Legality or illegality of transactions immaterial for purposes of income-tax—Income-tax Act (XI of 1922), section 10.

The assessee firm entered into a partnership with another firm and invested its funds in the business of the new larger firm: this business resulted in loss. The main question that arose in connection with the assessment to income-tax was whether this loss could be taken into account in making the assessment:

Held that although a firm as such, not being a juristic person or a legal entity, can not enter into a contract of partnership, there is nothing in law to bar the individual members of a firm from entering into partnership with other individuals or with the partners of another firm. The two firms *as such* could not have entered into a valid agreement of partnership, but the partners of the two firms were competent to agree to a larger partnership coming into existence. The partnership, described as being between the two firms, was in fact a partnership between the partners of the assessee firm and the partners of the other firm, and was therefore valid in law.

As the partnership between the assessee firm and the other firm was valid, and the assessee firm had invested its funds in the business of that partnership and sustained loss, the loss must be treated as loss suffered by the assessee firm in the course of its business and must be taken into account in making the assessment.

Even if it were assumed that the larger partnership was illegal, the assessee firm would still be entitled to have the loss suffered by it in the larger partnership taken into account

*Miscellaneous Case No. 415 of 1936.

in computing its income for the year in question. The question of the legality or illegality of transactions entered into by a firm is totally irrelevant in calculating the net profits or the loss incurred by the firm, for the purpose of assessment to income-tax.

Dr. *N. P. Asthana* and Messrs. *S. K. Dar* and *S. N. Seth*, for the applicant.

Mr. *Ram Prasad Verma*, for the opposite party.

IQBAL AHMAD, J.:—This is a reference under section 66(3) of the Income-tax Act (No. XI of 1922) by the Commissioner of Income-tax in accordance with the order of this Court passed on an application filed by firm Chandrika Prasad Ram Swarup hereinafter referred to as the assessee firm, and the questions of law that fall to be decided are as follows:

"(1) Whether the partnership between Chandrika Prasad Ram Swarup and Bulaqidas Ramgopal was a valid partnership in law in view of the provisions of the Partnership Act of 1932.

"(2) Whether the assessee firm in its corporate capacity being in point of fact a partner in another firm and having as such invested its funds in such partnership and having sustained losses by reason of such partnership, such losses cannot in law be treated as the losses suffered in the course of business by the assessee firm, and whether such losses cannot be allowed in the course of assessment.

"(3) Whether the sum of Rs.51,000 interest paid to Bihari Lal Ram Charan in the 'previous year' can, in law and in view of the assessee's account books be taken into consideration in the assessment year."

It is agreed on all hands that the present case is governed not by the provisions of the Indian Partnership Act of 1932 but by the Indian Contract Act and reference to the Partnership Act in question No. (1) is, therefore, erroneous.

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The facts that led to the reference are as follows. The assessee firm carries on cloth business in the city of Cawnpore and its partners are:

	Extent of share
(1) Messrs. Behari Lal Ram Charan	.. 7/16
(2) Chandrika Prasad Ram Swarup	.. 4/16
(3) Mullan Dalal	.. 4/16
(4) Mutsaddi Lal	.. 1/16

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It is stated in the reference that the first partner, Messrs. Behari Lal Ram Charan, is a firm and is the principal financier of the assessee firm. The assessee firm is a partner and owns a six annas share in another firm known as Bulaqidas Ramgopal, which firm also carries on cloth business. In response to a notice issued by the Income-tax Officer the assessee firm submitted a return for the assessment year 1933-34 showing a loss of Rs.24,208-4. It is not disputed that the firm Bulaqidas Ramgopal incurred heavy losses and the proportionate loss debited to the assessee firm in the accounting year ("previous year") was Rs.48,546. The assessee firm, however, made profits in the cloth business carried on by it with the result that the total loss incurred by the assessee firm in the accounting year was Rs.24,208-4. In computing its income for the year under consideration the assessee firm claimed exemption from liability to pay income-tax with respect to certain items. The Income-tax Officer, however, disallowed items amounting to Rs.6,994 and, further, relying on the decision of this Court in *In the matter of Jai Dayal Madan Gopal* (1) declined to take into account the loss incurred by the assessee firm in the business of Bulaqidas Ramgopal on the ground that a firm cannot legally be a partner in another firm. In the result the Income-tax Officer made the assessment on an income of Rs.31,331.

The assessee firm appealed to the Assistant Commissioner of Income-tax who with a slight modification which is immaterial for the decision of the present

(1) (1932) I.L.R. 54 All. 846.

reference, sustained the assessment made by the Income-tax Officer. In appeal before the Assistant Commissioner the assessee firm put forward an argument in the alternative claiming allowance for a further sum of Rs.51,090 on the allegation that this amount was paid by it to one of its partners, viz. to the firm Messrs Behari Lal Ram Charan, on account of interest on the advances made to the assessee firm. It was stated before the Assistant Commissioner of Income-tax that this item of interest was not claimed in the course of assessment before the Income-tax Officer, as interest paid to Behari Lal Ram Charan in previous years was not allowed on the ground that advances made by a partner cannot be treated as a loan to the firm, and it was contended that, if as a matter of law one firm cannot be a partner with another firm, Messrs. Behari Lal Ram Charan being a firm cannot be legally held to be a partner of the assessee firm, and, as such, the interest paid to Behari Lal Ram Charan by the assessee firm should be taken into account in making the assessment This argument, for certain reasons which it is unnecessary to state, was rejected by the Assistant Commissioner.

Thereafter two applications, one for review under section 33 and the other for statement of case to the High Court under section 66(2) of the Income-tax Act, were made by the assessee firm to the Commissioner of Income-tax who rejected both the applications. Then on the 4th of May, 1936, the assessee firm applied to this Court under section 66 (3) of the Act praying that the Commissioner be called upon to state the case. This application was allowed by this Court with the result that the present reference has been made by the Income-tax Commissioner.

A mass of case law has clustered round question No. (1) referred to this Court. "Partnership" is defined by section 239 of the Indian Contract Act as "the relation which subsists between persons who have agreed to combine their property, labour or skill in some

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business, and to share the profits thereof between them", and it is further provided by that section that "persons who have entered into partnership with one another are called collectively a firm". It is manifest from this provision that the partnership can be the outcome only of a combination of *persons* and it is well settled that a firm is not a person, is not a legal entity nor a juristic *persona* to be taken cognizance of as such by the law, such as an idol or corporation is; but is a mere collective name for the individuals who are members of a partnership: vide *Brojo Lal Saha* v. *Budh Nath Pyarilal* (1) *Janki Nath Paul* v. *Dhokar Mall Kedar Bux* (2) and *Ram Das* v. *Ram Babu* (3). To the same effect are the decisions in England, *vide per* JAMES, L.J., *in Ex parte Blain; In re Sawers* (4) and *per* FARWELL, L.J., in *Sadler* v. *Whiteman* (5).

As a firm is not a "person" nor a legal entity it has been held in a number of cases that a firm *as such* cannot be a member of a partnership: *vide Basanti Bibi* v. *Babu Lal Poddar* (6), *In the matter of Jai Dayal Madan Gopal* (7), *Parbhu Lal Pearey Lal* v. *Income-tax Commissioner* (8), *Naraindas Lachhmandas* v. *Dina Nath* (9) *Hakmaji Meghaji* v. *Punnaji Devichand* (10), *Seodoyal Khemka* v. *Joharmull Manmull* (11), *Ram Singh* v. *Ramchand Tirath Ram* (12) and *Kanhaya Lal* v. *Devi Dayal Brij Lal* (13).

But although a firm *as such* cannot enter into a contract of partnership, because it is not a legal entity, there is nothing in law to bar the individual members of a firm from entering into partnership with other individuals or with the partners of another firm. Ordinarily the business of a partnership is transacted by the managing partner in the name of the firm and contracts on behalf of

(1) (1927) I.L.R. 55 Cal. 551.
(2) A.I.R. 1935 Pat. 376.
(3) A.I.R. 1936 Pat. 194.
(4) (1879) 12 Ch.D. 522 (533).
(5) [1910] 1 K.B. 868 (889).
(6) [1930] A.L.J. 1517.
(7) (1932) I.L.R. 54 All. 846.
(8) [1935] A.L.J. 554.
(9) [1935] A.L.J. 938.
(10) A.I.R. 1938 Bom. 453.
(11) (1923) I.L.R. 50 Cal. 549.
(12) A.I.R. 1936 Lah. 78.
(13) A.I.R. 1936 Lah. 514.

the partnership are usually for brevity's sake entered into in the name of the firm. Nevertheless every partner of the firm is in the eye of law a party to the business and to the contract entered into in the name of the firm. The reason for this is, as pointed out in *Seodoyal Khemka's* case, that "A firm name, in truth, is merely a description of the individuals who compose the firm. It is that, and it is nothing more." Whatever is done in the name of the firm is in fact and in substance done by and on behalf of the partners of the firm. A firm not being a legal entity is incapable of entering into a contract and a contract entered into in the name of a firm must, therefore, unless there be cogent reasons to the contrary, be regarded as a contract entered into by the partners. A firm name is a mere alias for the collective names of the partners, and, as such, a contract entered into in the name of a firm is really a contract entered into by all the partners thereof. To this effect is the decision of this Court in *Brij Kishore Ram Sarup* v. *Sheo Charan Lal* (1). It was observed in that case that though a firm *as such* cannot enter into partnership with other individuals, "at the same time it must be held that a firm is only an association of persons which has no corporate capacity and that if a partnership is in fact entered into and if all the partners of the firm are consenting parties to the agreement of partnership or are represented by a duly authorized person when the contract of partnership is concluded between the firm and others or subsequently ratify it, a partnership will come into existence, though it will not be regarded as a partnership of which a firm as such is a partner. Such a partnership will have for its members all the partners of the partner firm and the others." To the same effect is the decision of the Calcutta High Court in *Kader Bux Omer Hyat* v. *Bukt Behari* (2). It was held in that case that a partnership described as between a firm and other individuals is not illegal as in fact such a

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(1) I.L.R. [1938] All. 100. (2) (1932) 36 C.W.N. 489.

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partnership is between the members of the firm, collectively or distributively as the case may be, and those individuals.

In the present case it is not disputed that a contract of partnership was entered into between the assessee firm and the firm of Bulaqidas Ramgopal and I shall assume that this contract was entered into in the name of the two firms. Nevertheless I cannot hold that the partnership was illegal. The two firms *as such* could not have entered into a valid agreement of partnership, but the partners of the two firms were competent to agree to a larger partnership coming into existence. We know that the larger partnership did materialize and did transact business. Law leans in favour of validating and not invalidating an accomplished act, and, as the names of the two firms were merely descriptive of the names of the partners of those firms, it must be held that the larger partnership was as a matter of fact between the partners of the two firms. At least one partner of each firm must have been a party to the agreement to bring into existence the larger partnership and that partner of each firm must be deemed to have acted as agent of the remaining partners of the particular firm and not as agent of the particular firm which had no legal entity. The partnership referred to in question No. (1) was, therefore, a partnership between the partners of the assessee firm and the partners of Bulaqidas Ramgopal and was valid in law. I shall, therefore, answer question No. (1) in the affirmative.

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The second question referred to this Court to my mind presents no difficulty. If the partnership between the assesse firm and firm Bulaqidas Ramgopal was valid, as I have held, and the assessee firm invested its funds in that partnership and sustained loss the loss must be treated as the loss suffered by the assessee firm and must be allowed in the course of assessment. But even if it be assumed that the larger partnership was illegal, the assessee firm, in my judgment, is entitled to have the loss

suffered by it in the larger partnership taken into account in computing its income for the year in question. It is not denied that the assessee firm invested its funds in the larger partnership and there was huge loss in the business of that partnership. The mere illegality of the agreement relating to the larger partnership cannot entitle the Income-tax department to ignore the fact that the assessee firm did as a matter of fact suffer loss in the transaction in question. The question of the legality or illegality of transactions entered into by a firm is totally irrelevant in calculating the net profits or the loss incurred by the firm in a particular year. For example if the assessee firm had entered into a wagering contract which resulted in huge loss it would not have been open to the Income-tax department to decline to take that loss into account simply because the contract by way of wager was void in law. The income assessable to tax is the actual income of an individual or of a firm irrespective of the manner in which the income was derived. Legality or illegality of transactions culminating in profit or loss is, therefore, foreign to the scope of an inquiry into the income of an individual or of a firm for the purpose of taxing the same. I shall, therefore, answer the second question in the negative.

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In the view that I have taken as regards question No. (1) it must be held that the partners of Behari Lal Ram Charan and not that firm *as such* were the partners of the assessee firm and the advances made to the assessee firm cannot, therefore, be regarded as loan advanced to the assessee firm. The answer to question No. (3) must, therefore, be in the negative.

ALLSOP, J.:—I agree with my brother IQBAL AHMAD, J., that the answer to the first question should be in the affirmative, to the second in the negative in the sense that the losses mentioned can be treated as losses suffered in the course of business by the assessee firm and the answer to the third question in the negative.

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It has always been held that a firm as such cannot enter into partnership with another firm, but the reasons have been that a firm is not a legal entity or a juristic person. There can be no doubt that this view of the law is right, but all logical results must follow. The term "firm" is only a convenient name for the individual partners acting under their contract of partnership in pursuance of their object to carry on an enterprise or business. The firm as such in the sense of a legal entity cannot enter into any contract or incur any liability because in that sense it does not exist. The partners bind themselves jointly and severally and in the ordinary way each partner is assumed to be the agent of the others for the purpose of carrying on the business. Under the provisions of the Indian Income-tax Act the terms "firm", "partner" and "partnership" have the same meaning as under the Indian Contract Act (or now under the Indian Partnership Act). When the Income-tax authorities are permitted to tax the income of a firm they are permitted to tax the partners in the firm jointly and severally on the profits accruing to the firm in the course of its business. When a firm enters into partnership with another firm or with individuals it does not enter into partnership as a legal entity or juristic person, but there is nothing to prevent the members of the firm from entering jointly into such a contract just as they are allowed to enter into any other contract.

In order to explain the position it is convenient to consider a concrete case. Say that *A*, *B* and *C* enter into a contract of partnership to carry on a business for the purchase and sale of cotton. Say that they agree that they will contribute to the funds of the firm in the proportion of 3, 2 and 1 and that they will distribute profits and be responsible for losses in the same proportion. Say that they decide that it would be advantageous for them in some particular town to carry on their business in partnership with two other people *D* and *E*. Say they decide that they will contribute to this new firm

from the funds which they have jointly invested in their own partnership and say that the agreement entered into by them with *D* and *E* is that they will jointly receive one-third of the profits of the new firm and that *D* and *E* will each receive one-third of the profits. There is no legal bar to such an agreement. The result would be that one-third of the profits of the new firm would go to *A, B* and *C* jointly and according to the terms of the original contract between *A, B* and *C* those profits would be divided between them in the proportions of 3, 2 and 1. Under the law of partnership all property acquired out of the partnership assets becomes part of those assets. There can be no doubt then that the profits in the new firm would be part of the assets of the original firm of which *A, B* and *C* are partners, because those profits would accrue from the investment of the partnership assets of the original firm. In the same way, if any losses were incurred in the new firm for which *A, B* and *C* were jointly and severally liable those losses would be the losses of the original partnership because they would be incurred in the course of business carried on by the original partnership. Although it is true that a firm cannot enter into a partnership with another firm or with individuals as a legal entity or juristic person it is not correct to say that a firm in the sense in which that term is used in the Indian Contract Act and Indian Partnership Act cannot enter into another partnership.

In the case with which we are dealing the assessee firm, i.e., the individual partners in that firm, entered into a larger partnership in pursuance of their business as a firm and consequently any losses for which they were responsible in the larger partnership were part of the losses of their firm, that term being understood in the sense in which it is used in the Indian Contract Act, the Indian Partnership Act and consequently the Indian Income-tax Act. The assessee firm were therefore entitled to set off the losses incurred by them in the

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larger partnership against the profits accruing to them from other business which they conducted.

I am also inclined to agree with my brother IQBAL AHMAD, J., that losses actually incurred must be set off against profits even if they are incurred in pursuance of activities which are illegal. The Income-tax authorities would presumably not have refrained from assessing a tax on the profits of the larger firm, if such had accrued, on the ground that the partnership was illegal. Nor would they have refused to take into consideration any profits accruing to the assessee firm from the business conducted by that larger partnership. If profits are to be assessed losses cannot in fairness be ignored.

BAJPAI, J.:—The facts giving rise to this reference by the learned Commissioner of Income-tax, Central and United Provinces, are stated at length in the judgment of my brother IQBAL AHMAD J., and it is not necessary for me to recapitulate them. Three questions have been referred to us and they were so referred because of a direction given by this Court. It is clear from the statement of the case that the assessee firm Chandrika Prasad Ram Sarup consists of four partners and also owned as a firm a six-anna share in another firm known as Bulaqidas Ramgopal, and the first question which we have got to decide is: "Whether the partnership between Chandrika Prasad Ram Sarup and Bulaqidas Ramgopal was a valid partnership in law in view of the provisions of the Partnership Act of 1932." On a discussion of the facts of the case it became clear that the reference to the Partnership Act of 1932 was inaccurate as the transactions with which we are concerned in the present case took place before the Partnership Act of 1932, and the Act with which we have to deal is the Indian Contract Act, 1872. There are, however, no provisions of the Partnership Act of 1932 which would bring about any material change in the answer which, I think, ought to be given in this connection. It has been held in a number of cases that a firm *as such* is not

a person or a legal entity and therefore a firm *as such* cannot enter into a partnership with another firm *as such*: see *Basanti Bibi* v. *Babu Lal Poddar* (1), *In the matter of Jai Dayal Madan Gopal* (2), *Parbhu Lal Pearey Lal* v. *Income-tax Commissioner* (3), *Naraindas Lachhmandas* v. *Dina Nath* (4), *Hakmaji Meghaji* v. *Punnaji Devichand* (5), *Seodoyal Khemka* v. *Joharmull Manmull* (6), *Ram Singh* v. *Ram Chand Tirath Ram* (7) and *Kanhaya Lal* v. *Devi Dayal Brij Lal* (8).

The words "firm", "partner" and "partnership" have the same meanings so far as the Income-tax Act is concerned as they have in the Indian Contract Act; section 2(6A) of the Income-tax Act. Section 239 of the Contract Act says that "'partnership' is the relation which subsists between persons who have agreed to combine their property, labour, or skill in some business, and to share the profits thereof between them" and "persons who have entered into partnership with one another are called collectively a 'firm'." A firm, therefore, is a collective name for persons who have agreed to combine their property, labour or skill in some business and to share the profits between them. As long as the number of such persons does not exceed the limit that may be given in any enactment, there is nothing illegal in a number of persons entering into a partnership, and if this collective group of persons agrees to combine its property, labour or skill with some other collective group of persons, who had prior to this fresh agreement agreed to combine their property, labour or skill, then there is nothing in any law which says that this fresh agreement is illegal. The fresh agreement will be considered to be an agreement between the persons constituting the first group and the persons constituting the second group and, as such, the new relationship cannot be called invalid or ille-

(1) [1930] A.L.J. 1517.
(2) (1932) I.L.R. 54 All. 846.
(3) [1935] A.L.J. 554.
(4) [1935] A.L.J. 938.
(5) A.I.R. 1938 Bom. 453.
(6) (1923) I.L.R. 50 Cal. 549.
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gal. A partnership will thus come into existence, though it will not be regarded as a partnership between the two firms *as such*. Whatever may be the status of a firm in law, it is clear that the Income-tax department treats it as a unit for purposes of assessment (*see* the definition of assessee in the Act and section 3 of the Act), and the department should not, therefore, be permitted to say that no fresh assessee comes into existence when two firms or the members constituting the two firms enter into an agreement simply because the law says that a firm *as such* cannot enter into a partnership with another firm *as such*. My answer, therefore, to the first question is in the affirmative.

I now come to the second question. I have already held that the partnership between the assessee firm and the firm of Bulaqidas Ramgopal was not necessarily illegal, and it is common ground that the assessee firm invested some of its funds in the partnership with Bulaqidas Ramgopal and sustained some losses in the year the income of which has got to be ascertained for the purposes of assessment. The question is whether such losses can in law be treated as the losses suffered in the course of business by the assessee firm and whether such losses can be allowed in the course of assessment. SULAIMAN, C.J., in *In the matter of Jai Dayal Madan Gopal* (1) observed at page 852: "If . . . . the money belonged to the Benares firm and was invested by the Benares firm as such and profits on the amount had been received back by the Benares firm, the capital continues to belong to the Benares firm and the income earned thereon is the property of the Benares firm, although the Benares firm cannot in the eye of the law have the status of a partner in the other firms." In that case a certain firm of Benares had entered into partnership with some other firms and the learned CHIEF JUSTICE was of the

(1) (1932) I.L.R. 54 All. 846.

opinion that the income earned by the Benares firm in such a partnership could be a part of its own income, and it is clear that if the Benares firm had sustained certain losses the decision would have been that the losses could be the losses of the Benares firm. I agree with the view taken by SULAIMAN, C.J., in that case, and I am of the opinion that in the present case the losses that have been sustained by the assessee firm by reason of its partnership with the firm Bulaqidas Ramgopal are losses suffered by the assessee in the course of business and such losses ought to be allowed in the course of assessment. As the second question is whether such losses cannot be treated as the losses suffered in the course of business by the assessee firm and whether such losses cannot be allowed in the course of assessment, my answer to the second question is in the negative.

It is conceded by the assessee firm that if the answer to the second question be in the negative, the answer to the third question should be in the negative, and this is not disputed by the department. Under the circumstances it is not necessary to discuss the third question at length, and I agree that the third question should be answered in the negative.

BY THE COURT:—The answer to the first question referred to this Court is in the affirmative and the answer to the second question is in the negative in the sense that the losses mentioned should be treated as losses suffered in the course of business by the assessee firm. The answer to the third question is in the negative.