# DAVOODBHOY v. COMMISSIONER-GENERAL OF INLAND REVENUE

SUPREME COURT,
SAMARAKOON, C.J., SAMERAWICKREMA, J. AND WANASUNDERA, J.
S.C. APPEAL NO. 9/79. BRA 365 COURT OF APPEAL (SC) C.A. 1/77
JULY 3, 4, 5, 1979.

*Inland Revenue Act, sections 79(7) and 52 - Agreement by partner to share with children his profits of a business partnership - Whether agreement is artificial and fictitious - Does it form a sub-partnership which is liable to be taxed - Does it result in a diversion of profits by overriding title -Is the assessee liable to be assessed for the entirety of the profits.*

The appellant Abasbhoy Davoodbhoy was one of five partners of a firm carrying on business under the name of 'Abdul Hassen Davoodbhoy' and was entitled to one fifth share of its profits. In order to provide for his children he entered into an agreement (A I) with them, whereby they agreed "to be partners in regard to the one fifth share of the profits and losses of the said Abasbhoy Davoodbhoy." The agreement stated that the share of the capital and the goodwill in the said business which was the property of the appellant was to remain his separate asset. The only asset of this venture therefore was the one fifth share of the profits received by the appellant. The agreement A1 and the rights claimed under it were rejected by the Assessor in terms of section 79(7) of the Inland Revenue Act and the whole of the one fifth share of the profits was assessed as the income of the appellant and not as the income of the parties to the agreement A1.

Appeals to the Commissioner General of Inland Revenue and the Board of Review were dismissed. On a case stated by the Board of Review the matter was heard by the Court of Appeal and answered against the appellant. The Court of Appeal granted the appellant leave to appeal to the Supreme Court as substantial questions of law were involved.

It was contended on behalf of the respondent that A1 was "artificial and fictitious", that it did not create a sub-partnership but was merely a family arrangement and that the one fifth share of the profits was the income of the appellant which should be assessed in terms of section 52 of the Inland Revenue Act, since, A1 results in an application of income and not a diversion of same. It was argued that, for a diversion of income there must be a transfer of its source.

**Held** :

(i) The agreement Al is not "artificial and fictitious". It incorporates a family arrangement which is genuine and very common in our society. The accounts show that this agreement has been acted upon and profits divided accordingly. It cannot be rejected under 79(7) of the Inland Revenue Act.

(ii) An arrangement to share profits only, can constitute in law, a partnership between the parties to the agreement. A1 created a "sub-partnership" which term is merely a convenient name used in law and in commercial circles to describe a partnership which is dependent on another partnership. Such an agreement is perfectly valid in civil law and must therefore attract the provisions of the Inland Revenue Act.

(iii) The question whether the income of the appellant has been diverted by overriding title or whether it is a mere application by him must in the main depend on the very nature and effect of the transaction. In the instant case, the one fifth share of profits derived from Abdul Hassen Davoodbhoy accrued to the benefit of several partners. The entirety of it was not the income of the appellant alone and he could not deal with it as he liked without incurring legal liability in terms of A1. For alienation of income there need not be an alienation of its source. The appellant was therefore wrongly assessed. The parties to the agreement A1 are liable to be assessed under section 52 of the Inland Revenue Act in respect of their portions of the divisible profits.

**Cases referred to** :

(1) *Snook* v. *London & W. Riding Invest. Ltd., (1967) 1 All E.R. 518; (1967)2 W.L.R. 1020.*
(2) *Raja Bejoy Singh Dudhuria* v. *Commissioner of Income Tax, Bengal, (1933) 1 I.T.R. 135.*
(3) *Murlidhar Himatsingka and Another* v. *Commissioner of Income Tax Calcutta, (1966) 62 I.T.R. 323.*
(4) *Commissioner of Income Tax* v. *Sitaldas Tirathdas, (1961) 41 T.L.R. 367 I.T.R. 219.*
(5) *Official Trustees of West Bengal* v. *Commissioner of Income Tax (1979) 116 I.T.R. 219.*

**APPEAL** from a judgment of the Court of Appeal.

*S. Ambalavanar,* with *C. Thangarajah* and *Miss M.P.C. Joseph,* for the appellant.

*G.P.S. de Silva, Additional Solicitor-General,* with *K.C. Kamalasabayson, State Counsel,* for the respondent.

*Cur, adv, vult.*

July 20, 1979
**SAMARAKOON, C.J.**

The appellant in this case was granted leave to appeal to this court by the Court of Appeal as it was of the opinion that "Substantial questions of law are involved" in the interpretation of the instrument which is the subject matter of the assessment of tax. There is in the Pettah an old firm by name Abdul Hassen Davoodbhoy carrying on business at No. 50, Dam Street. The founder of the business died leaving 5 sons and the five sons owned and ran the business in partnership, each partner being entitled to 1/5 share of the profits. Disputes seem to have arisen among the partners on the question of employment in the firm of the children of each of the partners. Females were not eligible for employment. The sons of each of the partners were admitted as employees but the salary paid to each was paltry on account of the necessity to maintain high profits. Abasbhoy Davoodbhoy (assessee) was one of the five partners and his only son Asgar was employed at a salary of Rs. 150 per month. Asgar considered this poor remuneration for the work he was doing and therefore Abasbhoy Davoodbhoy decided to remedy this situation. He, his son Asgar (28 years) his daughters, Hassina (23 years), Nafeesa (19 years) and Rasheeda (15 years) entered into an agreement in writing signed by all parties which was produced marked A1. It is dated 1st April, 1965. By the said agreement the father and children agreed "to be partners in regard to the share of the profits and for losses of the said Abasbhoy Davoodbhoy". It stated categorically that "the share of the capital and the goodwill in the said business which is the property of Abasbhoy Davoodbhoy shall remain the separate asset of Abasbhoy Davoodbhoy". The only asset of this venture, therefore, was the 1/5 share of the profits received by Abasbhoy. The manner of sharing the profit and losses is set out in clause 4 of A1. Clause 7 of A1 gave Abasbhoy the right to vary and/or terminate the interests of any one or all of the parties with a month's notice. This document and the rights claimed under it were rejected by the assessor for the year of assessment 1966/67. He assessed the whole of the 1/5 share as the income of Abasbhoy (assessee) and not as the income of the parties to the agreement A1. The amount of tax in dispute is Rs. 18,521.

The assessee appealed to the Commissioner-General of Inland Revenue who dismissed the appeal. The assessee then appealed to the Board of Review. The Board also dismissed the appeal but stated a case to the Supreme Court under the provisions of section 102 of the Inland Revenue Act. This was heard by the Court of Appeal and answered against the assessee. It has now reached this court on leave to appeal being granted by the Court of Appeal.

The Commissioner-General held *inter alia* that "a sub-partnership like the one created by A1 does not find a place" in the scheme of taxation under the Inland Revenue Act. He also held that it was artificial and fictitious and therefore rightly rejected by the assessor in terms of section 79(7) of the Inland Revenue Act. The Board of Review also held that the agreement was artificial and fictitious and also held that the income was the sole income of the assessee as the income was the income of the assessee alone and had not been diverted before reaching the assessee. The Court of Appeal while agreeing that A1 was artificial and fictitious also held that the 1/5 share of profits was the income of the assessee alone and the agreement resulted in the application of that income and not a diversion by overriding title.

I will deal first with the finding that the agreement is artificial and fictitious. Section 79(7) of the Inland Revenue Act, No. 4 of 1963, reads as follows:-

> "(7) Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the persons concerned shall be assessable accordingly."

If A1 was rightly rejected under the provisions of section 79(7) then there was no necessity to go into the question whether it was a sub-partnership recognised by the revenue laws or even to consider the nice question as to whether there was merely an application of income or whether it was a diversion of income by overriding title. In view of the rejection under section 79(7) the latter exercise was futile. Counsel for the assessee contended that it was wrongly rejected while State Counsel maintained that it was in fact artificial and fictitious. Is it in fact unreal and a sham? State Counsel pointed to a number of factors. He referred to the evidence of Hassima before the Board of Review where she stated:-

> "The sub-partnership did not transact any business. My father formed this partnership not to do any business, but only to share his profits with us, his children."

Following the reasoning of the Court of Appeal, State Counsel pointed to the provisions of clause 6 of A1 and stated that Account Books will show only profits and losses. But this is a wrong construction of the clause, as it does not provide for such kind of accounting. No doubt the assessee has the right to terminate the agreement and until such termination he remains the owner of the capital and goodwill. This is a perfectly legal document. It incorporates a family arrangement by which a father is seeking to provide for his children - a most natural desire, and if so minded, the children could even enforce it in law. This kind of family arrangement is not only genuine but very common in our society. To brand it as artificial and fictitious is unwarranted and unjust. It incorporates a perfectly legitimate family transaction. "For acts and documents to be a 'sham' with whatever legal consequences to follow from this, all the parties thereto must have a common intention that the acts and documents are not to create the legal rights and obligations which they give the appearance of creating" per Diplock, L.J. in *Snook* v. *London and W. Riding Invest., Ltd.* (1) The accounts up to 31.3.1968 show that this agreement has been acted upon and profits divided in terms of A1. I therefore reject the contention that it is artificial and fictitious. It cannot be rejected under the provisions of section 79(7) of the Inland Revenue Act.

The Commissioner-General was of the opinion that a sub-partnership of the kind established by A1 found no place in the scheme of taxation under our Inland Revenue Act. If that be so then a perfectly legitimate source of income is not taxable. Does the assessee then go scot free? If so then the Act needs amendment to make it taxable. The Commissioner-General states that the "partners in A1 have not come together to carry on a trade or business in partnership" and therefore chargeability to tax of a partnership under the provisions of section 52 does not arise. The term "sub-partnership" is merely a convenient name used in law and in commercial circles to describe a partnership which is dependent on another partnership commonly called a "principal partnership". These are merely nomenclature that have no significance in law. They are well known to the law of Sri Lanka. The position in English law which should also be the applicable law here, is described by Lindley as follows:-

> "A sub-partnership is, as it were, a partnership within a partnership: it presupposes the existence of a partnership to

> which it is itself subordinate. An agreement to share profits only constitutes a partnership between the parties to the agreement. If, therefore, several persons are partners and one of them agrees to share the profits derived by him with a stranger, this agreement does not make the stranger a partner in the original firm. The result of such an agreement is to constitute what is called a *sub-partnership,* that is to say, it makes the parties to it partners *inter se;* but it in no way affects the other members of the principal firm. In the language of civilians, *Socius mei socii, socius meus non est.* In *Ex p. Barrow,* Lord Eldon puts the law on this subject very clearly: "I take it," he says, "to have been long since established that a man may become a partner with A where A and B are partners and yet not be a member of that partnership which existed between A and B. In the case of Sir Chas. Raymond, a banker in the city, a Mr. Fletcher agreed with Sir Chas. Raymond that he should be interested so far as to receive a share of his draw profits of the business, and which share he had a right to draw out from the firm of Raymond & Co. But it was held that he was no partner in that partnership; had no demand against it; had no account in it; and that he must be satisfied with a share of the profits arising and given to Sir Chas. Raymond." (Vide Lindley on Partnership, Ed. 12. p. 99).

It will be seen that an agreement to share profits only, can constitute in law, a partnership between the parties to the agreement. The Commissioner-General therefore correctly referred to A1 as a sub-partnership. A transaction such as the one in A1 is perfectly valid in Civil Law and must therefore attract the provisions of the Revenue Act. It is not necessary to go further into this aspect in view of the opinion I have formed with regard to the chargeability for the income derived by the sub-partnership.

The case stated by the Board of Review poses the questions "Whether the assessee is liable to be assessed under section 52 in respect of the 1/5th share of the divisible profits of Abdul Hassan Davoodbhoy for the year of assessment 1966/67" or "Whether the assessee's children are liable to be assessed under section 52 in respect of any portion of the divisible profits?" and "whether the income of Asgar accruing to him by virtue of the agreement entered into by him on 3rd April, 1965, and embodied in agreement 'A' can be assessed as the income of the assessee?" State Counsel contended that this 1/5th share of the profits was the statutory income of the assessee accruing to him from the business of Abdul Hassan Davoodbhoy and therefore the assessor "shall apply" the provisions of section 52 to make this assessment. The crucial section, he contends is section 52 (4) which leaves him no alternative but to assess it as the income of the assessee as this is not a diversion of income but by the operation of A1 only an application of income. He further contended that A1 is not a sub-partnership but merely a family arrangement. I have already held that A1 creates a sub-partnership. The question for decision then is whether A1 results in a mere application of profit or whether there is a diversion of income by overriding title. State Counsel argued that for a diversion of profits there must be a transfer of the source of income. He cited a statement contained in "The Law and Practice of Income Tax" by Kanga and Palkivalla (Vol. 1, Ed. 6, p. 97) which reads as follows :-

> "If a person has alienated or assigned the source of his income so that it is no longer his, he may not be taxed upon the income arising after the assignment of the source."

By way of illustration he cited the decision of the Privy Council in the case of *Raja Bejoy Singh Dudhuria* v. *Commissioner of Income Tax, Bengal* (2). The appellant (assessee) in this case had succeeded to ancestral property on the death of his father. His step mother - sued him for maintenance and a consent decree was entered by court declaring that the lady's maintenance was a legal liability of the appellant and that this maintenance was a charge on the ancestral estate in the hands of the appellant. The appellant had paid the lady a sum of Rs. 9,900 in terms of the decree in the year of assessment 1924-25 but this was taxed on his income and no deduction was allowed. In allowing the appeal and the deduction claimed the Privy Council said :-

> "In the present case the decree of the court by charging the appellant's whole resources with a specific payment to his step-mother has to that extent diverted his income from him and has directed it to his step-mother; to that extent what he receives for her is not his income. It is not a case of the application by the appellant of part of his income in a particular way, it is rather the allocation of a sum out of his revenue before it becomes income in his hands."

This is a case where by virtue of a decree the assessee was compelled to allow a part of his income to be diverted to his step-mother. A clear case of diversion by overriding title.

The question whether the income of an assessee has been diverted by overriding title or whether it is a mere application by him must in the main depend on the very nature and effect of the transaction in each case. In this case it is the agreement A1. Counsel for the assessee contended that by reason of the fact that losses, and not merely profits, were shared by the partners, it was conclusive proof that there is an alienation of income. Motives, good or bad, he stated, were irrelevant. He relied strongly on the decision in the case of *Murlidhar Himatsingka and Another* v. *Commissioner of Income Tax, Calcutta* (3). This was a case decided by the Supreme Court of India on July 19, 1966. The facts were these. Murlidhar was carrying on business under the name and style of "Fatehchand Murlidhar". He was also a registered partner of Messrs. Basantal Ghanshyamdas having 2 as. 8ps. share. On 21.12.1949 he entered into a Deed of Partnership with two sons and one grandson whereby they agreed to become partners of "Fatehchand Murlidhar" and contributed capital in the sums of Rs. 10,000, Rs. 5,000 and Rs. 5,000 respectively. Clause 5 of the partnership agreement reads as follows:-

> "The profits and losses for the share of the said Murlidhar Himatsingka as partner in the said partnership firm of Basantal Ghanshyamdas shall belong to the present partnership and shall be divided and borne by the parties hereto in accordance with the shares as specified hereafter, but the capital with its assets and liabilities will belong exclusively to Murlidhar Himatsingka the party hereto of the first part and the parties hereto of the second, third and fourth parts shall have no lien or claim upon the said share capital or assets of the party hereto of the first part in the business of the said Messrs. Basantal Ghanshyamdas."

Clause 10 provided that the profits and losses of the partnership "including the shares of the profits and losses of the said firm of Basantal Ghanshyamdas" shall be divided in the proportions therein set out. Clause 13 gave the sole control and direction of the business to Murlidhar. For the year of assessment 1955-56 the taxing officer included the income from the share in Basantal Ghanshyamdas in the individual assessment of Murlidhar Himatsingka. On a case stated the Supreme Court decided that the agreement created a sub-partnership stating the reasons thus -

> "In arriving at this conclusion we attach importance to the fact that losses were also to be shared and the right to receive profits and pay losses became an asset of the firm, Fatehchand Murlidhar."

The Court cited with approval the test laid down by Hidayatullah, J. in *Commissioner of Income Tax* v. *Sitaldas Tirathdas* (4) which reads as follows:-

> "In our opinion, the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligations, no doubt, there are in every case, but it is the nature of the obligation which is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of the income of the assessee. Where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow. It is the first kind of payment which can truly be excused and not the second. The second payment is merely an obligation to pay another a portion of one's own income, which has been received and is since applied. The first is the case in which the income never reaches the assessee, who even if he were to collect it, does so, not as part of his income, but for and on behalf of the person to whom it is payable."

Applying this test the Supreme Court held that the income was that of the partnership of "Fatehchand Murlidhar" and not that of Murlidhar (assessee). The reasoning was as follows:-

> "The question then arises whether the interest of the sub-partnership in the profits received from the main partnership is of such nature as diverts the income from the original partner to the sub-partnership. Suppose that A is carrying on a business as a sole proprietor and he takes another person B as a partner. There is no doubt that the income derived by A after the date of the partnership cannot be treated as his income; it must be treated as the income of the partnership consisting of A and B. What difference does it make in principle where A is not carrying on a business as a sole proprietor but as one of the partners in a firm? There is no doubt that there is this difference that the partners of the sub-partnership do not become partners of the original partnership. This is because the law of the partnership does not permit a partner, unless there is an agreement to the contrary, to bring strangers into the firm as partners. But as far as the partner himself is concerned after the deed of agreement of sub-partnership, he cannot treat the income as his own. Prior to the case of *Cox* v. *Hickman,* (1860) 8 H.L. Cas,

> 268, sub-partners were even liable to the creditors of the original partnership. Be that as it may, and whether he is treated as an assignee within section 29 of the Indian Partnership Act, as some cases do, a sub-partner has definite enforceable rights to claim a share in the profits accrued to or received by the partner."

State Counsel contended that this case was wrongly decided and invited this Court to so hold. I do not agree. Murlidhar's case has not taken the narrow view looking solely for alienation of the source of income as there are other means of alienating income. It has taken the larger view based on the nature of the obligation on account of which the partner (assessee) could not "treat the income as his own". After the agreement the income "was no longer his" (Kanga and Palkhivala, p. 97). In effect it decided that the sub-partnership agreement affected the very source of Murlidhar's income in the first partnership. Murlidhar's case has been approved by the Indian Supreme Court in *Official Trustee of West Bengal* v. *Commissioner of Income Tax* (5). I am of the view that this is the correct approach in deciding the legal effect of A1. The 1/5 share of the profit derived by the assessee from Abdul Hassen Davoodbhoy ceased to be the assessee's sole property. He could not deal with it or spend it as he liked without incurring legal liability under A1. The whole of it was not income accruing to his benefit (vide section 12 of the Inland Revenue Act, No. 4 of 1963). It accrued to the benefit of several partners. The whole of it was not the real income of the assessee alone. It must be noted that in Murlidhar's case the profits from the firm of Basantal Ghanshyamdas did not form the capital of the firm of "Fatehchand Murlidhar". It was only income of the latter. One of the reasons given by the Court of Appeal for deciding that Murlidhar's case was not applicable to the case under consideration is that in Murlidhar's case the partners contributed capital. This fact has little relevance when we consider the real principle on which that decision was based. In Murlidhar's case as in this case the profits did not form any part of the capital and was treated solely as income of the partnership. For the above reasons I hold that the assessee was wrongly assessed.

The Commissioner-General feared that if this appeal is upheld taxpayers would resort to this device to reduce their tax. I am alive to this problem. Indeed it could be resorted to in such a way as to avoid payment altogether. But this is a matter for the legislature to remedy and not a matter for us to consider as interpreters of the law as it exists today.

I set aside the order of the Court of Appeal and answer the questions posed in the case stated as follows:-

1. Agreement A1 is not artificial and/or fictitious and has been acted upon.

2. No.

3. Yes.

4. Income derived by Asgar on A1 is his separate income and must be assessed separately from that of the assessee.

The assessee will be entitled to costs here and in the Court of Appeal.

**SAMERAWICKREMA, J.** — I agree.
**WANASUNDERA, J.** — I agree.

*Appeal allowed.*