

1953

Present : Gratiaen J. and Gunasekara J.

COMMISSIONER OF INCOME TAX, Appellant, and
A. H. M. ALLAUDIN, Respondent

S. C. 367—Case stated under the provisions of Section 74 of the Income Tax Ordinance (Cap. 188)

Income Tax Ordinance (Cap. 188)—Excess Profits Duty Ordinance, No. 38 of 1941—Partnership with capital exceeding Rs. 1,000—No written agreement—Prevention of Frauds Ordinance (Cap. 57), s. 18 (c)—Scope of evidentiary prohibition contained therein—Executor—Transaction with himself in personal capacity—Validity.

By section 18 (c) of the Prevention of Frauds Ordinance: "No. . . . agreement, unless it be in writing . . . shall be of force or avail in law . . . for the purpose of . . . establishing a partnership where the capital exceeds one thousand rupees: provided that this shall not be construed to prevent third parties from suing partners, or persons acting as such, and offering in evidence circumstances to prove a partnership existing between such persons".

Held, that, in computing under the provisions of the Excess Profits Duty Ordinance the profits of a *de facto* partnership the initial capital of which exceeded Rs. 1,000, an Assessor was not precluded by the evidentiary prohibition contained in section 18 (c) of the Prevention of Frauds Ordinance from proving (1) that, although there was no written agreement of partnership in operation, a *de facto* partnership subsisted and (2) that a particular person, who had managed the business and who had been paid a monthly allowance as well as a share of the profits of the business, was in truth a partner and not merely an employee in the business.

Held further, that an executor may enter into a partnership with himself in his personal capacity if such a transaction is authorised by the will or is subsequently adopted by the beneficiaries under the will. It is not correct to state, as an absolute proposition of law, that a transaction which a man enters into *qua* executor with himself in his personal capacity is automatically void on the ground that it gives rise to a conflict between his interest and his duty.

CASE stated under the provisions of section 74 of the Income Tax Ordinance upon the application of the Commissioner of Income Tax.

T. S. Fernando, Acting Solicitor-General, with *M. Tiruchelvam* and *G. Sethukavaler*, Crown Counsel, for the Commissioner of Income Tax, appellant.

S. Nadesan, with *N. Nadarasa*, for the asséssee respondent.

Cur. adv. vult.

February 27, 1953. GRATIAEN J.—

This is a case stated by the Board of Review for the opinion of the Supreme Court on the application of the Commissioner of Income Tax. The dispute is as to whether, in computing the profits of the business

of the Colombo Cargo Boat Company for the year 1944, under the provisions of the Excess Profits Duty Ordinance, No. 38 of 1941, certain payments made to T. V. Edwards, who had admittedly managed the business during the relevant accounting period, were permissible deductions.

The assessee claimed that these payments, which took the form of a monthly allowance as well as a share of the profits of the business, had been made to Edwards as an employee who had no proprietary interest in the business. It is common ground that in that event the deduction claimed would be permissible. The Assessor contended, however, and the Commissioner decided in appeal, that Edwards was in truth a partner of the Company. The assessee concedes that if that be so, the deduction could not properly be claimed.

The Board of Review set aside the Commissioner's decision and held that during the relevant accounting period "the Company was not carried on as a partnership business. Accordingly the appellant is entitled to have the payments of profits given to T. V. Edwards deducted from the assessment for Excess Profits duty".

The learned Solicitor-General has argued before us that the Board misdirected itself in law in arriving at this conclusion, and that, upon the facts set out in the case stated, there was no evidence to support the decision that Edwards was not a partner of the business.

It is convenient at this stage to refer to the history of the Company since the date of its commencement on 6th May, 1919. It had been carried on in partnership from that date until 17th May, 1934, by Ahamadasan (to whom I shall hereafter refer as "the deceased"), Meera Saibo and T. V. Edwards. Meera Saibo then died, and his surviving partners carried on the business as *de facto* partners until 29th June, 1936, when a formal agreement of partnership R1 came into operation, whereby they mutually agreed to, and did in fact continue, to carry on the business in partnership on the terms set out in the agreement.

The assessee was "prepared to concede" that the deceased and Edwards were partners in the business during the period when the agreement R1 was in operation. I do not see how their relationship could be interpreted otherwise. The deceased had contributed the entire capital of the business, whereas Edwards contributed his skill and experience which were regarded as invaluable to the success of the undertaking. It is correct that under the agreement the deceased indemnified Edwards against liability for any losses which might be incurred by the Company. Nevertheless, Edwards, who alone was to manage the affairs of the business, was in fact and in law "a partner acting on behalf of the firm (introducing the notion of the firm as a separate entity from the existence of its individual members) of which he and the deceased were members, partly for himself and partly as agent for the deceased"—*per* Jessel M.R. in *Pooley v. Driver*¹. There are many clauses in the agreement which negative entirely the alternative theory that he was merely a servant carrying on the business on behalf of his employer. The stipulation that, upon a dissolution, the

¹ (1877) 5 Ch. D. 458.

deceased would receive back all the capital and goodwill of the partnership does not affect the true relationship of the parties during the subsistence of the business.

Four months after the agreement R1 came into operation the deceased executed a last will dated 5th November, 1936, which was admitted to probate when he died on 2nd September, 1937. The following provision was made in respect of his share of the business of the Colombo Cargo Boat Company :—

- (1) I devise and bequeath all my share of the business carried on at Colombo under the name, style and form of the "Colombo Cargo Boat Company" and all sailing vessels, boats and all other movable articles necessary for carrying on the said business unto my son Mahooden Alawooden and to any other male child or children who may be born to me hereafter share and share alike.
- (2) Mr. Thomas Vedanayagam Edwards shall be the manager as heretofore of the said entire business during his lifetime.
- (3) On the death of Thomas Vedanayagam Edwards the said Company shall be conducted by my son Mahooden Alawooden and my son-in-law Kalingu Mohideen, and my son is authorised to give $\frac{1}{2}$ share to my son-in-law so long as they are harmonious.

Edwards and another gentleman were appointed executors of the will until the deceased's son Allaudin attained the age of twenty seven, after which the executors were directed to hand over the administration of the estate to him.

The deceased died leaving an only son Allaudin to whom his entire interest in the business passed under the will. The earlier partnership with Edwards was automatically dissolved upon the deceased's death, but the Board of Review has held as a fact that "notwithstanding the dissolution, the business of the Company was carried on *as usual and on the same lines as before* by T. V. Edwards, the manager of the business who continued to draw his allowance and his share of the profits". Allaudin did not apparently attain the age of twenty seven until nine years later when, on 11th December, 1946, he and Edwards entered into a formal agreement R2 in which they recited that they had been previously "carrying on business in Colombo under the name, style and form of the Colombo Cargo Boat Company" and mutually agreed "to continue the said partnership business". The terms of R2 were substantially the same as those set out in the agreement R1 under which the deceased and Edwards had previously carried on business in partnership.

It is necessary to determine Edwards' precise relationship to the business (which he carried on "as usual and on the same terms as before") during the period 2nd September, 1937, to 11th December, 1946. The assessee argued that after the deceased died Edwards ceased to be a managing partner and commenced to manage the business as an employee of Allaudin who had become the sole proprietor of the Colombo Cargo Boat Company by virtue of his father's will; that this alleged

change of status had taken place in strict accordance with the instructions contained in the will; and that in any event Edwards, as an executor, derived no "power" under the will to continue to occupy his former role as a partner of the business. The Assessor's contention on the other hand was that the testator's direction was that Edwards should continue to manage the business as a partner "as heretofore", and that he did in fact continue to do so in that capacity.

Admittedly no written agreement was in operation during the relevant period from which one can ascertain whether Edwards carried on the business as an employee or as a partner until 11th December, 1946, but the facts, as set out in the case stated, may be summarised as follows :

On 9th September, 1937, Edwards, as surviving partner of the Company, sent a notification to the Registrar of Business Names declaring that his former partner (the deceased) had died on 2nd September, 1937. On 23rd May, 1939, the names of Edwards and his co-executor were included in the Register as "added partners" who were carrying on the business in partnership with Edwards in his personal capacity, and a contemporaneous document was registered stating, in conformity with the provisions of section 3 of the Business Names Ordinance (Cap. 120), that "the added partners" were functioning in a representative capacity for the benefit of Allaudin. In 1940 and from time to time thereafter both Allaudin and Edwards submitted their respective Income Tax returns disclosing, in the columns specially reserved for "income received from a business carried on in partnership", the amounts each of them had received out of the profits of the Colombo Cargo Boat Company. The distribution of profits between the partners was on each occasion calculated in the proportions stipulated in the earlier agreement R1 (and subsequently in R2). Eventually, as I have said, Allaudin entered into a formal agreement with Edwards in 1946 to *continue* to carry on the business on the basis of a partnership, and their association as partners was duly registered under the Business Names Ordinance. There is no evidence to indicate that Edwards was at any stage regarded by himself or by his co-executor or by Allaudin as a mere employee who had no proprietary interest in the business which he was managing. Upon these facts, I conceive that it was not possible for any tribunal to come to any other conclusion than that a *de facto* partnership was subsisting during the relevant accounting period between Edwards on the one hand and himself and his co-executor on the other, the executors functioning in a representative capacity for the benefit of Allaudin who was the survivor-in-interest of the deceased's share in the business; and that the profits had in fact been distributed between Edwards and Allaudin on that basis.

I now proceed to examine the grounds upon which the Board considered themselves precluded from holding that Edwards was a partner in the business during the relevant accounting period. They first decided,

as a matter of law, that it was not open to the Assessor to prove the existence of the partnership because the initial capital of the business exceeded Rs. 1,000 and there was no written agreement of partnership in operation until 1946. In the second place they decided, also as a matter of law, that in any event "T. V. Edwards as the executor of the will marked A could not enter into a partnership with himself, that being a breach of trust". In my opinion the Board misdirected itself on both these questions, and wrongly applied the law in pronouncing that "*for these two reasons* the assessee had established his contention that from the death of the deceased in 1937, until December, 1946, the Company was not carried on as a partnership business". The Board has not found as a fact that Edwards was Allaudin's employee.

Section 18 (c) of the Prevention of Frauds Ordinance (Cap. 57) declares that "No. . . . agreement, unless it be in writing shall be of force or avail in law for the purpose of *establishing a partnership* where the capital exceeds one thousand rupees : provided that this shall not be construed to prevent third parties from suing partners, or persons acting as such, and offering in evidence circumstances to prove a partnership existing between such persons". The true meaning of section 18 (c) has been authoritatively explained by the Judicial Committee of the Privy Council in *Pate v. Pate*¹. Apart from cases to which the proviso applies, the existence of a partnership (whose capital exceeds Rs. 1,000) cannot, in the absence of a written agreement, be established "*as the basis of a suit*", or, to put it in another way, as the foundation of a claim in proceedings before the appropriate tribunal vested with jurisdiction in the matter. Can it be said that in the present case the Assessor, in offering circumstantial proof of the *de facto* partnership, was seeking to "establish the partnership" as the basis of a claim to recover excess profits duty from the assessee? The answer is to be found, I think, in the provisions of the Income Tax Ordinance and the Excess Profits Duty Ordinance. If an assessee is dissatisfied with an assessment of his income or of the profits of a business in which he has an interest, the only proceedings which can be equated to a "suit" would be his appeal to the Commissioner for the purpose of having the assessment amended, revised, or set aside. The onus of proof of the character of payments claimed as admissible deductions in the computation of profits is upon him.

It was the assessee who, in a sense, "sued" the Assessor before the Commissioner, and later before the Board of Review, claiming a reduction of the assessment on the ground that the payments to Edwards were permissible deductions. The basis of his claim on each occasion was that Edwards was a mere employee in the business, and the Assessor relied on the evidence of a partnership for the purpose only of rebutting that allegation. In *Balasubramaniam v. Valiappa Chettiar*² Poyser J. and Keuneman J., in separate judgments, decided that, even in an action between two *de facto* partners, one of them might lead evidence, "by way of defence", to prove the existence of the partnership in order to negative the other partner's claim to an accounting based on the

¹ (1915) 18 N. L. R. 289.

² (1938) 39 N. L. R. 553.

allegation that their true relationship was only that of principal and agent. *Vide* Bonser C.J.'s judgment to the same effect in *Silva v. Nelson*¹. *A fortiori*, the Assessor was not precluded from proving the partnership for the purpose of resisting the assessee's claim to have the assessment reduced upon a false hypothesis. The evidentiary prohibition contained in section 18 (c) does not apply to such a situation, and there is really no need to resort to the proviso in order to arrive at this conclusion. ✓

I shall now examine the second ground which forms the basis of the Board's decision. It is not correct to state, as an absolute proposition of law, that a transaction which a man enters into *qua* executor with himself in his personal capacity is automatically void. Such a situation without doubt gives rise to a conflict between his interest and his duty. If, however, that conflict was "brought about by a situation created by the testator", the transaction is perfectly valid unless, of course, it can be attacked on the ground of fraud or bad faith. *Hordern v. Hordern*². If, on the other hand, the transaction was not authorised by the will or sanctioned by the Court, the beneficiaries affected by it would be entitled to have the transaction set aside; equally, they would have a right, if they so choose, to adopt the transaction. *Wright v. Morgan*³. In other words, the transaction is not void at its inception but avoidable. As Lord Buckmaster pointed out in *Costa v. Silva*⁴, "a party entitled to affirm or disaffirm it is sure to regulate his action by the consideration of which course will in the end prove to be the most profitable. It is primarily this right which is given to a person in that position, and it is this risk that is run by any (executor) who enters into a transaction subject to such defect". I do not agree that Wood Renton C.J. intended to lay down a different rule of equity in *Fernando v. Matheu*⁵.

These general principles must now be applied to the facts of the present case. Even if we were to assume that the establishment of the partnership between Edwards and the executors (including himself) was not an authorised transaction, the facts set out in the case stated establish beyond doubt that it was affirmed and adopted by Allaudin for whose benefit the executors had acted in the transaction. Allaudin cannot now be heard to disaffirm the partnership retrospectively. Besides, I think that, upon a proper interpretation of the will A1, there is a clear indication that the testator, by directing the business to be managed by Edwards "as heretofore", did intend that Edwards should continue to function as the managing partner of the business. Very different language would have been necessary to give expression to a testamentary direction that Edwards' connection with the business should be converted into that of a mere employee.

For the reasons which I have set out, I take the view that the decision of the Board is insupportable. The particular questions submitted for our opinion, as questions of law, are—

- (1) Was the business of the Colombo Cargo Boat Company carried on as a partnership during the fourth accounting period?
- (2) Are the profits paid to T. V. Edwards during the period to be deducted from the assessment of Excess Profits Duty?

¹ (1898) 1 Broune 75.

² (1910) A.C. 465.

³ (1926) A.C. 789.

⁴ (1917) 19 N. L. R. 481.

⁵ (1917) 4 C. W. R. 22.

Upon the facts set out in the case stated and summarised in my judgment I would answer the first of these questions in the affirmative. In that view of the matter, the second question must admittedly be answered in the negative. In accordance with this decision, I would restore the order of the Commissioner of Income Tax confirming the Assessor's basis of assessment and fixing the duty payable for the fourth accounting period at Rs. 235,814. The assessee must pay the Commissioner's costs of this appeal, and also a sum of Rs. 50 representing the fee delivered to the Clerk to the Board of Review under section 74 (1) of the Ordinance.

GUNASEKARA J.—I agree.

Appeal allowed.

