

**आयकर अपीलिय अधिकरण, पुणे न्यायपीठ “बी” पुणे में**  
**IN THE INCOME TAX APPELLATE TRIBUNAL**  
**PUNE BENCH “B”, PUNE**

**श्री विकास अवस्थी, न्यायिक सदस्य एवं श्री प्रदीप कुमार केडिया, लेखा सदस्य के समक्ष**  
**BEFORE SHRI VIKAS AWASTHY, JM AND SHRI PRADIP KUMAR KEDIA, AM**

**ITA No.2000/PN/2014**  
**Assessment Year : 2010-11**

Quality Industries,  
W-50, M.I.D.C., Phase- II,  
Manpada Road, Dombivli (E),  
Thane – 421 204.

PAN : AAAFQ0728P

.... Appellant

Vs.

The Jt. Commissioner of Income Tax,  
Range- 2, Nashik.

.... Respondent

अपीलार्थी की ओर से / Appellant by : Shri Sachin Amdekar  
प्रत्यर्थी की ओर से / Respondent by : Shri P. S. Kureel

सुनवाई की तारीख / <b>Date of Hearing : 26.07.2016</b>	घोषणा की तारीख / <b>Date of Pronouncement: 09.09.2016</b>
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**आदेश / ORDER**

**PER PRADIP KUMAR KEDIA, AM :**

The captioned appeal filed by the assessee is against the order of CIT(A)-2, Nashik dated 05.09.2014 relating to assessment year 2010-11 passed under section 143(3) of the Income-tax Act, 1961 (in short “the Act”).

2. In this appeal, the assessee has impugned the action of the Assessing officer in invoking the provisions of section 14A and consequently making disallowance of interest and other common expenses by holding that such expenses are attributable to the dividend income exempt from taxation. The Grounds raised by the assessee are reproduced hereunder :-

*“1. The learned, CIT(A) has not considered any merit in disallowing Rs.29,25,362/- under section 14A rule 8D of the income Tax Act,1961.*

2. *The learned, CIT(A) has not considered the fact that the investment made by assessee are from retained surplus.*

*And no capital was introduced for investment purpose. So disallowance of interest on capital was unjustified.*

3. *Interest on partner's capital is not expenditure refer in Sec 14A , it is allowance given to partnership firm.*

*This interest on capital is taxable in hands of partners and disallowance will lead to double taxation in hands of partner as well as firm.*

4. *The appellant craves leave to add, alter, amend or delete any of the above grounds of appeal."*

3. The relevant facts germane to the issue in brief are that the assessee is a partnership firm which is engaged in the business of manufacturing of chemicals etc. The assessee firm filed return of income for the relevant assessment year 2010-11 under section 139(1) of the Act declaring total income of Rs.95,65,090/-. While making assessment under section 143(3), the Assessing Officer noticed that the assessee has *inter-alia* earned tax free dividend income amounting to Rs. Rs.24,63,700/- from investment in mutual funds which was claimed as exempt income under section 10(35) of the Act. The Assessing Officer in a sequel thereto, also noted that the assessee has shown investment of Rs.4,41,88,955/- held in various mutual funds as on 31.03.2010. The corresponding investment in the mutual fund as on the last day of the preceding financial year i.e. 31.03.2009 was stated to be Rs.3,18,39,548/-. It was thereafter observed that the Assessee has introduced certain capital in the firm on which interest has been charged by them. The interest so paid to the partners have been claimed by the assessee against taxable income. Interest on bank loans amounting to Rs.75,615/- and interest on partner's capital to the tune of Rs.74,88,000/- aggregating to Rs.75,63,615/- were charged against its taxable income. The Assessing Officer next observed that investment in mutual funds is made out of interest bearing funds which include interest bearing partner's capital also. In these factual background, the Assessing Officer was of the view that assessee has incurred expenditure including interest expenses which are attributable to earning dividend income from investment in mutual funds which is exempt and not includible in total income. Thus, the expenditure so incurred is required to be disallowed in

appropriate proportion. As a sequel thereto, he invoked provisions of section 14A of the Act r.w. Rule 8D of the Income Tax Rules, 1962 (in short “the Rules”) and proceeded to disallow estimated expenditure incurred in relation to dividend income so earned in terms of formula provided under Rule 8D of the I T Rules.

4. In response to show-cause notice proposing disallowance under section 14A, it was submitted on behalf of the assessee that Rule 8D(2)(ii) concerning disallowance of proportionate interest attributable to interest bearing partners’ capital is not permissible in the facts of the case. It was *inter-alia* submitted that interest on partner’s capital is not an ‘expenditure’ *per se* but is in the nature of a deduction under section 40(b) just as depreciation on business capital asset is an allowance and not expenditure.

4.1 In elaboration, it was submitted that payment of interest on partner’s capital is not an expenditure *per se* as specified under section 14A of the Act. It was contended that even Income Tax Law understands it this way as such interest in partners’ hand is taxable as ‘profit from business’ and not as ‘income from other sources’. It was next contended that expenditure needs presence of two parties i.e. spender and earner. It was submitted that interest and salary to partners is not expenditure as in view of mutuality. The firm has no separate existence from its partners. The assessee firm is a separate entity under Income Tax Act only for taxation purposes. These is the very reason that deduction of interest and salary to partners is allowed as separate deduction and not as an expenditure under separate section from sections 30 to 43 of the Act. These interests and salaries to partners for this very reason are not liable for TDS provisions under the Income Tax Act. It was further submitted on behalf of the assessee that section 14A covers amount in the nature of ‘expenditure’ and not all statutory allowances.

4.2 The assessee also contended before the Assessing Officer that no capital was introduced for investment purposes and therefore disallowance of interest on capital was not justified.

4.3 However, the Assessing Officer discarded the various pleas of the assessee. He observed that the investments in mutual fund giving rise to tax free dividend income is sourced out of partner's capital and loans and consequently interest paid on partner's capital is also susceptible to Rule 8D(2)(ii) of the Rules. The Assessing Officer accordingly invoked Rule 8D of the Rules and computed disallowance of interest at Rs.27,84,771/- in terms of Rule 8D(2) out of interest claims and Rs.1,40,591/- to cover up common administrative expenses etc. as per Rule 8D(3). Aggregate disallowance was thus worked out to Rs.29,25,362/- in terms of Rule 8D of the I. T. Rules.

5. Aggrieved by the action of the Assessing Officer, the assessee preferred an appeal before the CIT(A).

6. The CIT(A) took note of the contents of the Balance Sheet of the assessee firm for the financial year relevant to assessment year 2010-11 and noted that main source of investment in mutual funds have come from partner's capital. The partners had introduced capital in the partnership firm which bears interest @12% per annum. The interest charged to the assessee firm has been claimed as revenue expenditure against taxable income. However, such interest is relatable to dividend income which does not form part of the total income. This being so, the provisions of section 14A are attracted and expenses incurred in relation to income which does not form part of total income requires to be disallowed. He accordingly confirmed the action of the Assessing Officer and his working of disallowance under Rule 8D of the Statutory Rules.

7. Aggrieved by the order of the CIT(A), the assessee is in further appeal before the Tribunal.

8. The Ld. Authorized Representative (AR) for the assessee Shri Sachin Amdekar adverted our attention to the Balance Sheet as on 31.03.2010 relevant to assessment year 2010-11 and submitted that the assessee has obtained funds from partners which are in the nature of 'fixed capital' as well as 'current capital'. The 'fixed capital' received from partners as appearing on the last day of the financial year stands at Rs.6,24,00,000/- on which interest at the rate of 12% per annum has been charged to the partnership firm. There is no change in this fixed capital *qua* the preceding year. The Ld. AR thereafter averred that the assessee firm has also obtained current or fluctuating capital from the partners from time to time on which no interest is charged. The current capital as on last day of the financial year stands at Rs.1,14,35,375/-. It was next stated that an investment of Rs.4,41,88,955/- in mutual funds giving rise to tax free dividend income is correspondingly reflected as an asset of the partnership firm. Interest of Rs.74,88,000/- has accrued or arisen to the credit of the partners towards fixed capital which has been charged to profit and loss account of the partnership firm during the year. Similarly, another interest expenditure of Rs.75,615/- has been incurred on certain loans from banks etc. On these facts, the Ld. AR raised a substantial question in relation to disallowance of proportionate interest in relation to partners' capital by invoking Rule 8D(2)(ii) of the Act. It was contended on behalf of the assessee that interest payable on fixed capital received from its partners does not bear the characteristics of 'expenditure' *per se* as contemplated under S. 14A of the Act. Reference was invited to S. 28(v) of the Act and it was pointed out that as per the scheme of taxation, the payment to the credit of partners in the form of interest and salary is chargeable to tax in their respective hands as 'business income' by operation of law. He made reference to the decision of the Hon'ble Supreme Court in the case of CIT vs. R.M. Chidambaram Pillai reported in (1977) 106 ITR 292 (SC) and submitted that payment of salary to partners represent as special share of profits and therefore taxable as business income. He thus contented that on the same footing, the interest on partner's capital is a return of share of profit by the firm to the partners. Both interest and salary to partners are not subjected to TDS provisions and both fall under section 40 of

the Act. The Ld. AR submitted that section 40(b) is not just a limiting section notwithstanding the fact that some fetters on the rate of interest have been put. It was contended that salary to partners and interest paid on partners capital was made allowable in the hands of the firm only from AY 1993-94 subject to limits and restrictions placed under S. 40(b) of the Act. Salary and interest to partners were not allowable prior thereto which supports the view that S. 40(b) is not merely meant for limiting the deduction. Had it been so, the interest would have been allowed in the hands of the partnership firm since the birth of Income Tax Laws. The payment of interest to partners is allowable in the hands of partnership firm by virtue of S. 40(b) of the Act subject to some capping. He thereafter submitted that in the light of the scheme of the Act, section 14A is applicable only *qua* the 'expenditure' incurred and not in respect of any and every deductions or allowances. The Ld. AR also emphasized that expenditure needs two parties which is absent in view of the mutuality present in a partner's firm. The firm has no separate existence from its partners and the firm is separate assessable entity only for the purposes of Income Tax Act. The Partnership Act, 1932 does not recognize the firm as a separate entity. The Ld. AR also sought to contend that any disallowance of interest on capital would lead to double taxation of the same income as the partners are already subjected to tax on interest on capital in their respective personal returns. He accordingly submitted that the action of the Assessing Officer is contrary to legislative intention as well as statutory expressions employed in section 14A of the Act. He therefore pleaded that proportionate disallowance of interest on partner's capital under Rule 8D(2) of the I.T. Rules requires to be reversed. Without prejudice and in the alternative, it was contended that the assessee firm had certain amount of current capital at its disposal which was not subjected to any interest and therefore benefit as available to the assessee in respect of interest free capital lying at its disposal should be granted as per law. The Ld. AR, in conclusion, sought appropriate relief in accordance with law.

9. The Ld. Departmental Representative (DR) for the Revenue, on the other hand, relied upon the order of the CIT(A) and in furtherance submitted that while making the assessment of the firm, the Revenue is entitled to invoke section 14A of the Act together with Rule 8D of the Rules to deny deduction in respect of expenditure claimed towards interest on partner's capital. He therefore submitted that no interference with the order of the CIT(A) is called for.

10. We have carefully considered the rival submissions. The pre-dominant question that arises for our consideration is whether payment of interest to the partners by the partnership firm toward use of partner's capital is in the nature of 'expenditure' or not for the purposes of section 14A of the Act and consequently, whether interest on partners capital is amenable to section 14A or not in the hands of partnership firm.

11. In order to adjudicate this legal issue, we need to appreciate the nuances of the scheme of the taxation. We note that prior to amendment of taxation laws from AY 1993-94, the interest charged on partners capital was not allowed in the hands of partnership firm while it was simultaneously taxable in the hands of respective partners. An amendment was *inter alia* brought in by the Finance Act 1992 in section 40(b) to enable the firm to claim deduction of interest outgo payable to partners on their respective capital subject to some upper limits. Hence, as per the present scheme of taxation, the interest payment on partners capital in essence is not treated as allowable business expenditure except for the deduction available under S. 40(b) of the Act.

11.1 Ostensibly, with effect from assessment year 1993-94, partnership firms complying with the statutory requirements and assessed as such are allowed deduction in respect of interest to partners subject to the limits and conditions specified in section 40(b) of the Act. In turn, these items will be taxed in the hands of the partners as business income under s. 28(v). Share of partners in the income of the firm is exempt from tax under section 10(2A). Thus, the

share of income from firm is on a different footing than the interest income which is taxable under the business income.

11.2 Similarly, we note that interest and salary received by the partners are treated on a different footing by the Act and not in its ordinary sense of term. The Section 28(v) treats the passive income accrued by way of interest as also salary received by a partner of the firm as a 'business receipt' unlike different treatments given to similar receipts in the hands of entities other than partners. In this context, we also note that under proviso to section 28(v), the disallowance of such interest is only in reference to section 40(b) and not section 36 or S. 37. This also gives a clue that deduction towards interest is regulated only under section 40(b) and the deduction of such interest to partners is out of the purview of s. 36 or 37 of the Act. Notably, there has been no amendment in the general law provided under Partnership Act 1932. The amendment to section 40(b) as referred hereinabove has only altered the mode of taxation. Needless to say, the Partnership firm is not a separate legal entity under the Partnership Act. It is not within the purview of the Income-tax Act to change or alter the basic law governing partnership. Interest or salary paid to partners remains distribution of business income.

11.3 Relevant here to refer to decision of Hon'ble Supreme Court in the case of CIT vs. R.M. Chimbaram Pillai (1977) 106 ITR 292(SC) relied upon by the Assessee.

Supreme Court has held in the case of *R.M. Chidambaram Pillai, etc.* (supra) held that:

*"A firm is not a legal person, even though it has some attributes of personality. In Income-tax law, a firm is a unit of assessment, by special provisions, but it is not a full person. Since a contract of employment requires two distinct persons, viz., the employer and the employee, there cannot be a contract of service, in strict law, between a firm and one of its partners. Payment of salary to a partner represents a special share of the profits. Salary paid to a partner retains the same character of the income of the firm.*

*Held accordingly, the salary paid to a partner by a firm which grows and sells tea, is exempt from tax, under rule 24 of the Indian Income-tax Rules, 1922, to the extent of 60 per cent thereof, representing agricultural income and is liable to tax only to the extent of 40 per cent."*

Supreme Court has also held in the case of CIT vs. Ramniklal Kothari (1969) 74 ITR 57 (SC) that the business of the firm is business of the partners of the firm and, hence,



*salary, interest and profits received by the partner from the firm is business income and, therefore, expenses incurred by the partners for the purpose of earning this income from the firm are admissible as deduction from such share income from the firm in which he is partner.*

Thus, the 'partnership firm' and partners have been collectively seen and the distinction between the two was blurred in the judicial precedents even for taxation purposes.

11.4 Section 4 of the Indian Partnership Act 1932 defines the terms partnership, partner, firm and firm name as under :

*"Partnership" is the relation between persons, who have agreed to share the profits of a business, carried on by all or any of the partners acting for all. Persons who have entered into partnership with one another are called individually 'Partners' and collectively a 'firm' and the name under which their business is carried on is called the 'firm name.'"*

Thus, it is clear from the above that firm and partners of the firm are not separate person under Partnership Act although separate unit of assessment for tax purposes. There cannot therefore be a relationship inferred between partner and firm as that of lender of funds (capital) and borrowal of capital from the partners, hence section 36(1)(iii) is not applicable at all. Section 40(b) is the only section governing deduction towards interest to partners. In the light of what is already noted above that firm and partners not being two separate persons, the question of borrowing capital by the firm from its partners does not arise at all and, therefore, section 36(1)(iii) is not at all applicable for the purposes of computation of interest to partners under section 40(b) of the Act. To put it differently, in view of section 40(b) of the Act, the Assessing Officer purportedly has no jurisdiction to apply the test laid down under section 36 of the Act to find out whether the capital was borrowed for the purposes of business or not. Thus, the question of allowability or otherwise of deduction does not arise except for S. 40(b) of the Act.

11.5 As noted, as per the scheme of the Act, the interest paid by the firm and claimed as deduction is simultaneously susceptible to tax in the hands of its

respective partners in the same manner. In the same vain, the firm is merely a compendium of its partners and its partners do not have separate legal personalities under the basic law as discussed. The interest paid to partners and simultaneously getting subjected to tax in the hands of its partners is merely in the nature of contra items in the hands of the firms and partners. Consequently interest paid to its partners cannot be treated at par with the other interest payable to outside parties. Thus, in substance, the revenue is not adversely affected at all by the claim of interest on capital employed with the firm by the partnership firm and partners put together. Thus, capital diverted in the mutual funds to generate alleged tax free income does not lead to any loss in revenue by this action of the assessee. In view of the inherent mutuality, when the partnership firm and its partners are seen holistically and in a combined manner with costs towards interest eliminated in contra, the investment in mutual funds generating tax free income bears the characteristic of and attributable to its own capital where no disallowance under S. 14A read with Rule 8D is warranted. Consequently, the plea of the assessee is merited in so far as interest attributable to partners. However, the interest payable to parties other than partners, in our view, would be subjected to provisions of Rule 8D(2)(ii) of the Rules. Similarly, in the absence of any specific plea from assessee towards disallowance under Rule 8D(3), we hold it sustainable in view of express mandate of law. The matter is accordingly remanded back to the file of the Assessing Officer for re-computation of disallowance under Rule 8D r.w.s. 14A of the Act in terms of our opinion expressed hereinabove.

12. In the result, appeal of the assessee is partly allowed.

Order pronounced on this 09<sup>th</sup> day of September, 2016.

**Sd/-**  
**(VIKAS AWASTHY)**  
न्यायिक सदस्य / **JUDICIAL MEMBER**

**Sd/-**  
**(PRADIP KUMAR KEDIA)**  
लेखा सदस्य / **ACCOUNTANT MEMBER**

पुणे Pune; दिनांक Dated : 09<sup>th</sup> September, 2016.

सुजीत

**आदेश की प्रतिलिपि अग्रेषित/Copy of the order is forwarded to :**

- 1) The Assessee;
- 2) The Department;
- 3) The CIT(A)-2, Nashik;
- 4) The CIT-II, Nashik;
- 5) The DR "B" Bench, I.T.A.T., Pune;
- 6) Guard File.

आदेशानुसार/ BY ORDER,

सत्यापित प्रति //True Copy//

वरिष्ठ निजी सचिव / Sr. Private Secretary  
आयकर अपीलीय अधिकरण, पुणे / ITAT, Pune