आयकर अपीलीय अधिकरण, 'सी' न्यायपीठ, चेन्नई
IN THE INCOME TAX APPELLATE TRIBUNAL
BENCH 'C', CHENNAI

श्री संजय अरोड़ा, लेखा सदस्य एवं
श्री धुव्वुरु आर.एल रेड्डी, न्यायिक सदस्य के समक्ष।
BEFORE SHRI SANJAY ARORA, ACCOUNTANT MEMBER
AND SHRI DUVVURU RL REDDY, JUDICIAL MEMBER

आयकर अपील सं./ITA Nos.1186, 1631, 1632 & 1633/Mds/2015
COs. 27 & 28/Mds/2016
(in ITA Nos. 1631 & 1632/Mds/2015)
निर्धारण वर्ष / Assessment Years : 2010-11, 2008-09, 2009-10 & 2012-13

Dy. Commissioner of Income Tax, Circle-1, Kumbakonam – 612 001.	Vs.	Kali BMH Systems Pvt. Ltd., No.42/6, B.2, Chennai Road, Melacauvery, Kumbakonam – 612 002. [PAN: AADCK 0974H]
(**अपीलार्थी /Appellant**)		(**प्रत्यर्थी/Respondent**)

अपीलार्थी की ओर से / Appellant by	:	Shri Ashish Tripathi, Jt. CIT
प्रत्यर्थी की ओर से/Respondent by	:	Shri T.Banusekar, C.A
सुनवाई की तारीख/ Date of hearing	:	02.08.2017
घोषणा की तारीख /Date of Pronouncement	:	31.10.2017

आदेश /ORDER

Per Bench:

This is a set of four Appeals by the Revenue and two Cross Objections (COs) by the Assessee, agitating two separate Orders by the Commissioner of Income Tax (Appeals)-2, Tiruchirapalli ('CIT(A)' for short) dated 23.02.2015 & 30.04.2015, allowing the assessee's appeals contesting its assessments under section 143(3) of the Income Tax Act, 1961 ('the Act' hereinafter) for the Assessment Years (AYs) 2010-11 & 2012-13, and u/s. 143(3) r/w s. 147 for

AYs. 2008-09 & 2009-10. The assessee's COs are for the earlier years, challenging the reopening of the assessments.

2. At the outset, it was observed that the assessee's COs are delayed by a period of 149 days, being filed on 01.02.2016, even as the acknowledgment-cum-notice in respect of the appeals filed by the Revenue is stated as received on 06.08.2015. It was pleaded by the ld. Authorized Representative (AR), Shri T.Banusekar, that it was while preparing for the appeals in the first week of January, 2016, that he realized that the reopening of the assessment could also be challenged. The Cross Objections were accordingly filed on 01.02.2016. A perusal of the case record reveals that the hearing of the Revenue's appeals was fixed for the first time in July, 2015, and on regular intervals thereafter; the relevant dates being 22.07.2015, 29.09.2015, 30.09.2015 and 08.12.2015, i.e., prior to 01.02.2016. On each of these occasions, except 30.09.2015, the assessee sought adjournment through the ld. AR (copy on record). Firstly, therefore, the appeal papers were communicated to the assessee on 16.06.2015, i.e., as per the acknowledgment-cum-notice on record, so that the delay would run from 16.07.2015 onwards, working to 200 days. Why, the authorization on record for representing before the Tribunal (in the favour of its' counsel) is dated 18.7.2015, with the first adjournment by the counsel being sought on 22.07.2015. It is clear that the decision by the assessee to file COs was taken much later/after the communication of the appeal papers, perhaps sometime in January, 2016. This could not be a valid ground for condoning a delay of over six months or even, as stated, five months. We, accordingly, find no reasonable cause for condoning the delay. The assessee's COs are accordingly dismissed as not maintainable.

We are, however, impressed by the ld. counsel's alternate plea that the assessee could in any case support the orders appealed against (by the Revenue) on any other ground, i.e., while defending the respondents' case. And, therefore,

admit the assessee's right to plead the legal issue where the relevant facts are on record and not disputed, as to the notice u/s. 148 being bad in law inasmuch as the relevant material is on record. The law in the matter is well settled, and the assessee's reliance on the decision in *Dy. CIT v. Turquoise Investment & Finance Ltd.* [2008] 299 ITR 143 (MP) for the purpose, apposite, with in fact Rules 11 & 27 of the Income Tax (Appellate Tribunal) Rules, 1963 being also abundantly clear.

3. The appeals raise a simple, yet interesting issue, which is a mixed question of facts and law, i.e., whether the directors of the assessee-company can be said to have 'lent' moneys to it, i.e., to the extent of ₹ . 202.8 lacs (of the total of ₹ . 3 crs., for which debentures stand issued to them), entitling it to deduction of interest in respect thereof, being the proportionate premium on the debentures issued, in the computation of business income, which stands disallowed in the sum of ₹ . 64.60 lacs, ₹ . 62 lacs, ₹ . 62 lacs and ₹ . 98 lacs for the four successive years under appeal respectively (working the same at 2/3 of the assessee's total claim for the relevant year/s). Surely, once the impugned borrowing is validated, allowance of interest (or the proportionate premium relatable to each year) follows where the borrowing is for the purpose of the assessee-company's business, which aspect therefore is the second aspect of the matter that needs to be considered and decided.

At this stage we may introduce the background, principal facts of the case, which are largely undisputed; in fact, stand explicitly exhibited by the company through a flow chart (of funds). The assessee-company is a Part IX (of the Companies Act, 1956) company, formed on conversion of a partnership firm M/s. Kali Material Handling Systems, on 01.04.2007. Prior to the conversion, in March, 2007, the said firm revalued its' land, increasing its value by ₹ . 202.8 lacs, crediting ₹ . 67.6 lacs to each of the three partners. Each of the partners was then paid ₹ . 1.1 cr. by the firm by overdrawing on its bank account, which

amount was debited in the books of the firm to their respective capital accounts, reducing the capital of the firm to that extent, i.e., ₹ . 3.30 cr. This money was deposited by them in their saving bank (s/b) accounts, where it stood parked as on 31.03.2007, and continued to be so up to 27/6/2007, whereat the same was brought back to the firm (since converted into a company – the assessee), issuing them debentures (partly convertible and partly non-convertible) for an aggregate of ₹ . 1 cr. each, i.e., for ₹ . 3 cr. In the view of the Assessing Officer (AO), there was no fresh infusion of funds to the extent of ₹ . 202.8 lacs. He, accordingly, disallowed 2/3 of the assessee's claim for the proportionate premium for the relevant year/s. These facts came to light in the course of assessment proceedings for AY 2010-11, so that reassessment proceedings were initiated for AY 2008-09 and 2009-10 by issuing notices u/s. 148 on 03.06.2013.

The respective cases

4. As afore-noted, the Revenue considers the transaction of withdrawal and introduction of funds to the extent it relates to the revaluation of the land of the firm (₹ . 2 cr. approx.) as a mere gimmick, employed, through a series of deliberate and premeditated transactions, to create an 'impression'of borrowing, which is only a colourable device, so that it denies the assessee-company's claim for interest (premium) on debentures as relatable thereto (2/3), making reference to *McDowell & Co. Ltd. v. CTO* [1985] 154 ITR 148 (SC). It is not a case of, as claimed, withdrawal of accumulated profits, and its reinvestment, so that there is no infusion of fresh funds for reinvestment in business, for a valid claim for deduction of interest on the borrowing to the extent it relates to the revaluation of land (₹ . 202.8 lacs). The assessee, on the other hand, claims, with reference to the physical flow of funds, i.e., from the firm's (bank) account to the partners s/b accounts prior to 01.04.2007, and from the latter to the company's bank account (after 01.04.2007), as exhibiting an inflow of funds

thereto after its formation on 01.04.2007, so that no part of the debentures issued to the erstwhile partners (now directors) could be impugned, so as to disallow interest (premium) thereon to any extent. That is, as long as the funds have gone out of or flown into the firm (company)'s kitty, it cannot be considered as a non infusion funds. There has been no violation of the provision of s. 47 (xiii) of the Act. Further, in-as-much as the assessee had disclosed all material facts in relation to its claim for interest (premium) on debentures, notwithstanding that the 'assessment' for AYs 2008-09 and 2009-10 was u/s. 143(1), the same could not be subject to reassessment proceedings u/s. 147, relying on the decision in *TANMAC India v. Dy. CIT* [2017] 78 taxmann.com 155 (Mad). Though the jurisdictional issue stands raised by the assessee for the first time before us (by way of COs), in-as-much as the same is a legal issue, with the relevant facts being not in dispute, the same was admitted, even as the COs themselves were, for the reasons stated earlier, not. This, then, forms the third question which arises for being answered in the present case.

5. We have heard the parties, and perused the material on record.

5.1 We shall take up the disallowance of (proportionate) interest (premium) on debentures, i.e., the merits of the issue, first. This is as the same is in any case to be decided, i.e., for AYs 2010-11 & 2012-13, and which would though hold for all the four years, being independent of the legal issue, raising a jurisdictional question. The ld. CIT(A) has regarded the withdrawal of their capital by the erstwhile partners of the firm as a simple case of reduction in the firm's capital, i.e., to the extent of the withdrawal. That is, as independent of the revaluation by the firm of it's land, so that the AO had been unduly influenced by the said revaluation, i.e., of one of its' capital assets by the firm. Delinking the two, i.e., the credit on account of revaluation and withdrawal by the partners of their capital, it is a clear case of succession of a firm by a company, which is not regarded as a transfer u/s.47(xiii), subject to the satisfaction of the

conditions stated therein, principally being the taking over of all the assets and liabilities of the successee-firm by the successor-company following the due process of law. The monies have actually gone out of, and into the, firms'/company's bank account, so that there is nothing to doubt the genuineness of the transactions. *The debentures have not been issued out of the revaluation reserve, as inferred by the AO*. This sums up the basis on which deduction to the assessee has been allowed by the ld. CIT(A). We find the said understanding of the ld. CIT(A) to be misconstrued and misconceived, both on facts and in law. What, we may ask, is the whole purpose of the revaluation of the firms' property (land), crediting the partner's capital accounts. That is, if it was not for being withdrawn, or if the capital of the firm would remain positive, i.e., even subsequent to the withdrawal, representing the capital of the firm as on 31.03.2007, which would get, upon conversion into a company, transmuted into its capital (equity). This is more so as sec. 47(xiii), reproduced as under, postulates no change in the capital structure of the firm being succeeded:

> **'Transactions not regarded as transfer.**
> **47.** Nothing contained in section 45 shall apply to the following transfers:-
> (*i*) to (*xii*)……
> (*xiii*) any transfer of a capital asset or intangible asset by a firm to a company as a result of succession of the firm by a company in the business carried on by the firm, or any transfer of a capital asset to a company in the course of demutualisation or corporatisation of a recognised stock exchange in India as a result of which an association of persons or body of individuals is succeeded by such company:
> **Provided** that—
> *(a)* all the assets and liabilities of the firm or of the association of persons or body of individuals relating to the business immediately before the succession become the assets and liabilities of the company;
> *(b)* all the partners of the firm immediately before the succession become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the succession;

(c) the partners of the firm do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company; and

(d) the aggregate of the shareholding in the company of the partners of the firm is not less than fifty per cent of the total voting power in the company and their shareholding continues to be as such for a period of five years from the date of the succession;

(e) the demutualisation or corporatisation of a recognised stock exchange in India is carried out in accordance with a scheme for demutualisation or corporatisation which is approved by the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);'

We may exhibit this by way of an example, assuming (for the sake of simplicity) land as the only capital asset of the firm:

Table – 1A

Liabilities	**(₹.)**	**Assets**	**(₹.)**
Capital	2000	Fixed Assets – Land	1000
		Net Current Assets (NCA) (current assets – current liabilities)	1000
Total	2000	Total	2000

Clearly, any withdrawal up to ₹. 2,000/- (by assuming bank credit, or from other sources), depicted as under, would only imply withdrawal of capital:

Table – 1B

Liabilities	**(₹.)**	**Assets**	**(₹.)**
Bank Borrowings	2000	Fixed Assets – Land	1000
		Net Current Assets (NCA) (current assets – current liabilities)	1000
Total	2000	Total	2000

Any withdrawal beyond this would result in negative capital, a case of withdrawal by the partners of the firm's resources (in excess of their contribution thereto). The contribution toward a fixed asset would, in nominal terms, stand enhanced in case of revaluation, say by ₹. 4000/- (Table 2A),

without having any material impact in-as-much as the firm's capital (equity) finances its assets, the purpose of which (revaluation) would presumably be to state the firm's assets and liabilities at their realistic values and, thus, represent more truly its net worth. A consideration which becomes largely irrelevant as the firms' intrinsic worth remains the same, and is not to be altered in case of succession. Why, the revaluation could as well be undertaken after the succession, increasing the net-worth of the transferee-company (in nominal terms) to the same extent. Be that as it may, this enhanced net worth would not therefore stand to reduce, except by operation of economic forces/reasons, viz. fall in the market price of land; depletion of capital on account of business losses, et. al. It is, therefore, the withdrawal of this 'enhanced' capital (Table 2B) that presents a host of questions. To begin with, it defeats the very purpose of revaluation. Further on: Could, the revaluation credit be made to the partner's capital accounts; Could, assuming so, the same be withdrawn; Does it not defeat the very purpose of revaluation; What, where permissible, does the said withdrawal represent; Would the partners be entitled to interest under the partnership law and, consequently, under the Act (which is assessable u/s. 28) on such enhanced capital; What is the accounting prescription – including its rationale, in the matter, etc. We depict the said scenarios as under:

Table – 2A

Liabilities	**(₹ .)**	**Assets**	**(₹ .)**
Capital	6000	Fixed Assets	5000
		Net Current Assets (NCA)	1000
Total	6000	Total	6000

Table – 2B

Liabilities	**(₹ .)**	**Assets**	**(₹ .)**
Capital	Nil	Fixed Assets	5000

Bank Borrowings	6000	Net Current Assets (NCA)	1000
Total	6000	Total	6000

Now, surely if this (Table 2B) position obtains as on 31st March, i.e., immediately prior to the conversion, any introduction of (up to) ₹. 6,000/- could not be said to be non-infusion of funds, the 'new' borrowings (from the erstwhile partners) going to either finance acquisition of further assets and/or repayment of the firm's borrowings to any extent. There should apparently be therefore no disallowance of interest on debentures (say) issued against such infusion of funds (or borrowing). This in fact is also the premise of the impugned order. However, we say 'apparently' in-as-much as the same would require, apriori, examining the facts as well as the legal position, delineated in the form of various questions, to none of which the impugned order refers, much less addresses. Could, for instance, the bank borrowings, which stand utilized for withdrawal of capital, be said as made or utilized for business purposes, entitled to interest deduction? Could the capital introduced, restoring *status ante,* be regarded as infusion of capital? That apart, the fact of the borrowing being from the erstwhile partners is inconsequential insofar as the deduction of interest thereon, and which is what the premium on the redemption of debentures essentially is, is concerned. However, any withdrawal in excess of ₹. 2,000/- (or ₹. 6,000/- in case of revaluation) surely cannot be regarded as valid inasmuch as the same is clearly a diversion of capital of the firm for personal (non-business) purposes. The excess is only a withdrawal by the partners of the firm's resources in excess of their contribution thereto, or an appropriation of its liabilities by them, which we may depict as per the Tables below:

Table – 3A

Liabilities	**(₹ .)**	**Assets**	**(₹ .)**
Bank Borrowings	6000	Fixed Assets	1000
		Net Current Assets (NCA)	1000
		Partner's Capital	4000
Total	6000	Total	6000

Table – 3B

Liabilities	**(₹ .)**	**Assets**	**(₹ .)**
Bank Borrowings	10000	Fixed Assets	5000
		Net Current Assets (NCA)	1000
		Partner's Capital	4000
Total	10000	Total	10000

Tables 3A & 3B represent equivalent scenarios as, in either case, no debentures could possibly be issued to the directors (erstwhile partners) on infusion of funds to the extent of ₹ .4,000/- (in our example). As afore-noted, any infusion (of funds by the directors) in excess of ₹ . 4,000/-, in either case, may be eligible to the regarded as, as per the terms of the introduction, either capital or borrowing, with the interest on the latter being ostensibly entitled for deduction in case of a company. We may, therefore, state that the impugned order, in which the assessment order has since merged, requires to be modified to state that only infusion in excess of the deficiency in capital (what had been earlier referred to by us as negative capital), ₹ . 4000 in our example, that may arise if the capital is reckoned without revaluation in-as-much as the same is only a case of withdrawal of the firm's resources in excess of the contribution thereto, appropriating thus the liability of the firm, would be entitled to deduction on account of interest. We shall revert to Table 3B subsequently as well.

We may now dwell on certain aspects arising for consideration, enumerated earlier. The credit of the revaluation of the partner's capital account

is inconsistent with the partnership law. This is as no partner can, during the subsistence of a firm, claim credit in respect of increased valuation (of any of the firm's assets) to any extent, as no partner can predicate his share in any of the assets of the firm. It is only at the time of the dissolution of the firm that its' assets, in excess of that required for meeting its liabilities, can be distributed amongst the partners in the ratio of their respective capitals. And whereat, therefore, in-as-much as an asset may not admit of physical division or be otherwise desirable, revalued to obtain parity between those (partner/s) taking over the asset/s and those not. Equally, a partner, on retirement, can, similarly, instead of being paid in cash, choose his capital to be discharged, wholly or partly, by being allotted a particular asset/s. A revaluation in such a case may follow; would, rather, even as explained in *A.L.A. Firm v. CIT* [1991] 189 ITR 285 (SC), be desirable in-as-much as it enables the partners to settle their accounts on a more realistic basis. The (Income Tax) law recognizes such situations, contemplating it to be a transfer of the specified asset by the firm to the partner/s (or vice-a-versa, in the event of introduction of an asset by a partner in the firm), deeming in case of distribution or allotment the fair market value thereof as its transfer consideration (ss. 45(3) and 45(4)). There is no question of any partner in a firm having a defined share in any of the firm's assets during its subsistence. *As afore-noted, succession of a partnership firm by a company is not regarded as a transfer under the Act where its business is transferred as a going concern, provided, of course, it is not a device to evade tax by realizing the value of the assets by its partners, by sale of shares or otherwise.* The credit on the revaluation of the asset by a firm could not therefore be made to the capital account of any of its partners (and, by implication, to all the partners), during its subsistence. This is in view of the nature of the relationship, and notwithstanding the fact that under partnership law there is no difference between a firm and the partners constituting it for the

time being; the partnership only signifying a contractual relationship between them, and its name a compendious manner of referring to the partners together and their defined relationship. As explained, such a credit is not admissible under the Act as well, which regards partnership as a different person, separate and distinct from the partners, so that the transfer of an asset by one to the other is liable for capital gains u/s. 45. *In view of the clear bar on such a credit, the question of its withdrawal does not arise*. This in fact is also the accounting prescription for any business enterprise. The credit, on revaluation, which may be undertaken for any business purpose, is to a separate account titled 'revaluation reserve'. *The same is barred for being withdrawn*. Reference in this regard may be made to para 13 of the Accounting Standard (AS)-10, titled 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, the more relevant part of which reads as under:

> '13.3 The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. *An upward revaluation does not provide a basis for crediting to the profit and loss statement the accumulated depreciation existing at the date of revaluation*.
>
> 13.4 Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis.
>
> 13.5 *Selective revaluation of assets can lead to unrepresentative amounts being reported in financial statements*. Accordingly, when revaluations do not cover all the assets of a given class, it is appropriate that the selection of assets to be revalued be made on a systematic basis. For example, an enterprise may revalue a whole class of assets within a unit.
>
> 13.6 It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class.

> 13.7 An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests *under the heading of revaluation reserves and is regarded as not available for distribution*. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease.'
>
> [emphasis, supplied]

Further, depreciation on such revalued asset/s, where depreciable, is to be provided on the enhanced value and, two, debited to the revaluation reserve to the extent it relates to the increased amount. And which, it would be noted, is consistent with the premise that what all is being done is to restate the asset at an enhanced value, *and does not entail or involve any flow of funds*. Thus, the withdrawal of funds by the partners in the present case is to be considered *de hors* the credit on account of revaluation.

The withdrawal of the credit on account of revaluation (i.e., even granting the credit) suffers from another basic infirmity in law as well as accounts – the mandate of both of which we have afore-noted, and which becomes apparent when one considers as to what does the same represent, also explaining indirectly the premise of the revaluation of a capital asset for an economic entity. The asset, land in the present case, continuing to be a part of the firm's assets, how, one wonders, could the credit of revaluation be withdrawn on payment of funds to the partners? Each accounting entry represents the relevant transaction; its purport, and considered along with the narration thereto, the purpose thereof. *The credit on account of revaluation represents a part of the value of the relevant asset*. The only manner, therefore, whereby the said credit could be debited (neutralized) or diminished is by transfer of the said asset to a partner/s withdrawing it from the firm – in whole or in part, as explained earlier

in the context of dissolution of a partnership or retirement of a partner/s there-from. It could not be otherwise. For example, if 50 per cent. of the land is transferred to a partner/s, his account/s would stand debited by 50% of the value (₹ . 5,000/-, in our example), i.e., by ₹ . 2,500/-. A debit balance in his account upon such debit only makes him the firm's – which now has only 50 per cent. of the land, debtor to that extent. The entire value of the asset (land), at ₹ . 5,000/- in our example, is one, single amount, representing and forming part of the firm's equity (net worth). The firm's capital to that extent (₹ . 5,000/-) would therefore represent the said asset. As long as therefore the said asset of the firm is retained by it, its' capital cannot be regarded as below the said amount (refer Table-1A/2A). Proceeding further on this conceptual framework, what, then, does the scenarios at Tables 1B/2B represent? The firm has leveraged its capital, reckoned with or without revaluation, to secure borrowings, and no further. That is, the withdrawal by the partners reflects a diversion of the firm's borrowings by them to that extent, which may depict as under:

Table – 1C

Liabilities	**(₹ .)**	**Assets**	**(₹ .)**
Partner's capital	1000	Fixed Assets – Land	1000
		Net Current Assets (NCA) (current assets – current liabilities)	1000
Bank Borrowings	2000		
		Partner's capital	1000
Total	3000	Total	3000

Table – 2C

Liabilities	**(₹ .)**	**Assets**	**(₹ .)**
Partner's capital	1000	Fixed Assets	5000
Revaluation reserve	4000	Net Current Assets (NCA)	1000

Bank Borrowings	6000	Partner's capital	5000
Total	11000	Total	11000

Tables 1C and 2C are thus a more correct representation of the scenarios at Tables 1B and 2B respectively. Not so considering would only imply a transfer of the fixed asset/s to the partners, i.e., not in specie, but in effect, realizing its value by monetizing it. This, it may be appreciated, is an equivalent manner of transferring a capital asset; the partners being credited the difference between the market (transfer) value and the book value, and, then 'withdraw' their capital. This, where coupled with a reorganization of the firm, i.e., introduction and retirement of partner/s, even if in a graded manner, amounts to a change of ownership through the medium of partnership. The practice stands cautioned against time and again by the Hon'ble Apex Court per its decisions prior to the introduction of ss. 45(3) and 45(4) (of the Act), while at the same time confirming that there could be no transfer of an asset between a firm and its partners, who have an undefined share in each of them, inasmuch as the exclusive interest of a partner gets converted into a shared interest, the same is not chargeable to capital gains u/s. 45 (viz. *Sunil Siddarthabhai v. CIT* [1985] 156 ITR 509 (SC) – on which reliance is placed). The withdrawal of 'capital attributable to a fixed asset, intended to be retained as part of the capital structure of the firm, amounts to it's monetization by the partners for their personal purposes, and is clearly impermissible, both from the stand-point of credit to the partner's capital account (on revaluation) and its withdrawal, considered from any perspective – legal, accountancy, and also tax. Coming back to the facts of the present case, it would be now clear as to what precisely the AO means when he speaks of non infusion of funds; the partners only restoring the value of the fixed assets, since withdrawn, and which could not be regarded as infusion of fresh capital in-as-much as the fixed asset continues

throughout to be the firm's property. The other import of the foregoing is that on an introduction of ₹ . 2,000/- in Scenario 1, debentures could be issued to the partners only for ₹ . 1,000/-, the balance going to neutralize (credit) the negative capital.

Could the assessee possibly be entitled to deduction of interest on such borrowings, i.e., to that extent these represent the increase in valuation of a firm's (entity's) fixed (capital) asset/s forming part of the capital structure. *We think not; it being without any business purpose*. That is, while the inflow of funds by the directors, to the extent of ₹ . 2,000/-, substituting bank borrowings, would qualify for deduction of interest thereon (or, strictly speaking, on ₹ . 1000/-), that in excess, representing only an increase in the valuation by the firm of its capital asset/s, shall not; the same being *sans* any business purpose, which alone would entitle the borrowing by an assessee for deduction of interest thereon u/s. 36(1)(iii). This, thus, answers the second question arising in the instant case (refer para 3). It may not be out of place to state here that the disallowance of interest (to the proportionate extent), i.e., on ₹ . 4,000/- (i.e., the enhanced valuation), has nothing to do either with s. 47(xiii) or the swapping of bank borrowings with that by the directors, being issued debentures. Irrespective of the extent of the swapping, the borrowing in excess of ₹ . 2,000/- (or, strictly speaking, ₹ . 1,000/-), representing the firm's assets, serves no business purpose and, accordingly, interest thereon is disallowable u/s. 36(1)(iii). The same, in fact, represents a swapping of funds by leveraging the value of the firm's asset/s. *The position would be different, we may clarify, where the bank borrowings were assumed to finance genuine business losses*. Though this has nothing in common with or to do with revaluation of assets by a business entity, *credit on account of which and its subsequent withdrawal is the issue in the present case*, we yet consider it relevant to state this as it may well be that revaluation in a given case is resorted so as to not reflect negative capital on

account of operational losses, since financed by bank borrowings. The bank borrowings in such a case represent financing of such losses; the firm's capital being insufficient to absorb the same. There is no depletion or withdrawal of capital by the equity holders, as in the present case, in such a case. The inference of the borrowing (debentures) as being not against revaluation reserve (funds) by the ld. CIT(A) is clearly misplaced; in fact, contrary to the basic facts of the case. This in fact is precisely why the same has been regarded as not genuine by the Revenue, a gimmick, and, in any case, not relating to the business of the assessee. We have already shown the *modus operandi* adopted as being in violation of the accounting principles and the partnership law. The same is also proscribed under the Act, being inconsistent with the clear terms of the relevant provision (s.36(1)(iii)), which allows interest only on the borrowings made for business purposes, while the borrowing in the present case is made only to enable siphoning of funds under the guise of enhanced capital.

The foregoing would also resolve the anomaly in Scenario-3, represented by Tables 3A and 3B. While Table 3A would bar interest on bank borrowings to the extent of ₹ . 4,000/-, allowing it thus only on ₹ . 2,000/-, Table-3B, again, apparently allows interest on bank borrowings up to ₹ . 6,000/-. The assessee, thus, merely by enhancing fixed asset/s, is able to obtain interest deduction on capital to that extent, i.e., ₹ . 4,000/-. As discussed hereinbefore, this would not be a business purpose (except where the funds released by the bank are deployed in business, though lost through losses, so that it does not result in any increase in net current assets or the net worth of the company), and therefore disallowable u/s. 36(1)(iii). Our graded approach, however, necessitated drawing a distinction between the three categories/scenarios, marked by respective tables, which we may summarize as under:

Scenario-1:Borrowing represents the firm's capital (Table-1A/1B).

Scenario-2: Borrowing includes enhanced capital, on account of revaluation (Table-2A/2B).

Scenario-3: Borrowing includes diversion of capital, i.e., even in excess of capital/enhanced capital (Table-3A/3B).

Clearly, only the borrowing, be it from bank or that by the directors, as reflected under Scenario-1, more correctly represented by Table 1C, would be eligible for deduction of interest thereon. Considered thus, the proposition advanced for being accepted by us is in principle very simple. Shorn of all nuances, regard for which however had to be made by us, the simple question that arises for answer in the present case can be presented, with reference to a partnership firm, which entity is entitled to deduction of interest on partner's capital, as: Whether the interest on partner's capital could be allowed in computing the firm's business income to the extent the said capital consists of increased valuation of the firm's fixed asset/s? That is, could, for example, a firm claim interest on enhanced partner's capital merely by revaluing an asset? This is as, if, yes, there is no reason for not allowing deduction of interest on the entire debentures issued in the present case. The answer to the two questions is though clearly in the negative, and for the same reasons discussed at length in this order. It is only the partner's capital, which is by definition the positive difference between the firm's assets and liabilities, which could be regarded as the firm's capital, on which deduction of interest, subject to the relevant conditions, is allowable under the Act (s. 36(1)(iii) r/w. s. 40(b)(iv)). The firm's assets are recorded at cost, defined u/s. 43(1), subject to the exceptions laid u/s. 43A and *proviso* to s. 36(1)(iii). The same, as shall be noted, are largely in agreement with the accounting standards, being AS-10. It is in view of this settled position of law that we also endorse the AO's construing the assessee's claim, referring to *McDowell & Co. Ltd.* (supra), as largely an exercise in tax evasion. The revaluation in the present case has no purpose except to claim tax deduction on interest on a higher level of borrowings. An analogy, to our mind, would be a firm (or any entity) claiming depreciation on the enhanced value of an asset,

otherwise eligible for depreciation under the Act, using the tax neutral event of succession, as u/s. 47(xiii), for the purpose. The ld. CIT(A) clearly has misdirected himself in the instant case.

We, in view of the foregoing, accordingly, uphold the AO's action *qua* the disallowance of the interest (premium) on the debentures, i.e., as relatable to the revaluation of land by the successee firm, Kali Material Handling Systems.

5.2 We next consider the jurisdictional issue raised by the assessee for AYs. 2008-09 and 2009-10. The assessee's grievance, as projected by the ld. AR during hearing, is that as the particulars in respect of the assessee's claim for premium on debentures are on record, the assessments for those years could not be reopened, placing reliance on the decision in *TANMAC India* (supra). We have perused the reasons recorded by the AO (copy on record), as well as the cited decision by the Hon'ble jurisdictional High Court. The reasons recorded bring forth the background facts of the case which, as afore-stated, came to surface only during the course of assessment proceedings for AY 2010-11, while verifying the assessee's claim for that year. The assessment for that year was finalized only on 28.03.2013, disallowing the claim for that year. The *modus operandi* adopted by the assessee-company for issuing debentures to its directors for ₹. 3 cr. in June, 2007 was discovered only during the said proceedings while verifying the assessee's claim for interest on debentures for that year. It is on the basis of these facts, detailed in the reasons recorded, that the AO disallowed the assessee's claim for that year as not genuine but a colorable device and, in any case, the interest expenditure incurred in its respect as not relating to the assessee's business. *De hors* these reasons, based on the facts that came to light subsequently, the AO could not entertain any reason to believe, which is a prerequisite, a threshold condition, for assuming jurisdiction to initiate proceedings u/s. 147. It is trite law that there should be a direct nexus between the material coming to the notice of the AO and the formation of the

belief that there is an escapement of income from assessment (refer, inter alia, *ITO v. Lakhmani Mewal Das* [1976] 103 ITR 437 (SC)). How, we wonder, then, is the assessee's charge valid? Rather, in the facts of the case, the returns for the relevant years, i.e., AYs. 2008-09 and 2009-10, were only processed u/s. 143(1), which procedure bars the examination of the assessee's return or the claims preferred thereby, with as much as even the *prima facie* adjustments, i.e., on the basis of a return and the accompanying material, also barred w.e.f. 01.06.1999. The disallowance under reference, as afore-stated, is even otherwise not a subject matter of a *prima facie* adjustment, entails as it does, a complete understanding and knowledge of the primary facts leading to the issue of the debentures to the directors of the assessee-company, who, as it transpires, are the erstwhile partners of the successee-firm. And, accordingly, there is no question on either formation of reason to believe or an opinion by the AO in the matter, and which, as apparent from its' reading, guided the decision in *TANMAC India* (supra). Rather, as afore-stated, any issue of notice u/s. 148 without the knowledge of the relevant facts would be violative of s.147, being not supported by any reason/s to believe. The charge of change of opinion, which is the basis of the assessee's legal plea, is misplaced in view of the admitted position that the relevant facts along with the materials came to light only during the course of the assessment proceedings for AY 2010-11. Further, the claim of formation of opinion in s. 143(1) proceedings is, again, unfounded, both in facts and in law. As clarified in *CIT (Asst.) v. Rajesh Jhaveri Stock Brokers (P.) Ltd.* [2007] 291 ITR 500 (SC), the same cannot be regarded as an assessment as no opportunity to the assessee is contemplated thereunder. And, further, a failure to take steps u/s. 143(3) would not render the AO powerless to initiate reassessment proceedings when the return had been earlier subject to processing u/s. 143(1). The ambit of the two procedures is completely different. The decision in *TANMAC India* (supra), as also afore-noted, is on the basis of a

change of opinion on the basis of the same material, already on record, and which the Hon'ble Court refers to as stale material (refer para 12). There is no reference to any material in the present case. It is in fact nobody's case that the background facts, unearthed or revealed during assessment proceedings for AY 2010-11; the assessee itself submitting detailed flow charts and submissions, were either not required or already on record, much less perused, or even subject to examination, for the said decision to apply in the present case. The assessee's legal plea is without merit and, accordingly, not maintainable. We decide accordingly, rejecting the assessee's legal issue, and answering thus the third question arising in the present case by validating the initiation of reassessment proceedings. We decide accordingly.

6. In the result, the Revenue's appeals are allowed, and the assessee's COs are dismissed as not maintainable.

Order pronounced on October 31, 2017 at Chennai.

Sd/-	Sd/-
(धुव्वुरु आर.एल रेड्डी)	(संजय अरोड़ा)
(Duvvuru RL Reddy)	(Sanjay Arora)
न्यायिक सदस्य/Judicial Member	लेखा सदस्य/Accountant Member

चेन्नई/Chennai,
दिनांक/Dated, October 31, 2017
EDN

आदेश की प्रतिलिपि अग्रेषित/Copy to:

1. अपीलार्थी/Appellant 2. प्रत्यर्थी/Respondent 3. आयकर आयुक्त (अपील)/CIT(A)
4. आयकर आयुक्त/CIT 5. विभागीय प्रतिनिधि/DR 6. गार्ड फाईल/GF