

आयकर अपीलीय अधिकरण, अहमदाबाद न्यायपीठ
IN THE INCOME TAX APPELLATE TRIBUNAL,
“SMC”BENCH, AHMEDABAD

BEFORE SHRI RAJPAL YADAV, JUDICIAL MEMBER And
SHRI WASEEM AHMED, ACCOUNTANT MEMBER

आयकर अपील सं./ITA Nos.2771 & 2772/AHD/2016
निर्धारण वर्ष/Asstt. Years: 2013-2014 and 2014-2015

M/s. R. Kumar 2, Swastik Super Market, Opp. Popular House, Ashram Road, Ahmedabad-380009 PAN:AACFR1720J	Vs.	ITO, Ward-5(2)(4), Ahmedabad-380009
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(Applicant)		(Responent)
Assessee by :	Shri G.C. Pipara, AR	
Revenue by :	Shri Kamlesh Makwana, Sr.DR	

सुनवाई की तारीख/Date of Hearing : 10/09/2018
घोषणा की तारीख /Date of Pronouncement: 18/09/2018

आदेश/O R D E R

PER WASEEM AHMED, ACCOUNTANT MEMBER:

The captioned appeals have been filed at the instance of the Assessee against the separate orders of the Commissioner of Income Tax (Appeals), Ahmedabad-5, [CIT(A) in short] vide appeal nos.CIT(A)-5/ITO Wd.5(2)(4)/372/2015-16 & CIT(A)-5/ITO Wd.5(2)(4)/373/2015-16 dated 16.09.2016 arising in the matter of assessment order passed under s.143(3) of the Income Tax Act, 1961 (here-in-after referred to as "the Act") dated 29.01.2016 relevant to Assessment Years (AYs) 2013-14 & 2014-15.

First we take up ITA No.2771/Ahd/2016 for A.Y 2013-14

2. Assessee has raised following grounds of appeal.

1. *“The learned CIT(A) has erred in law as well as on facts in confirming the addition of Rs.2,39,317/- out of total addition of Rs 3,58,059 /- made by the AO u/s. 14A r.w.r, 8D without proper consideration and appreciation of the specific facts of the case duly supported by settled legal position rendered by the jurisdictional court of law i.e. **Hon'ble Gujarat High Court in a host of decisions**. In view of facts and elaborate submissions filed coupled with settled legal position, the impugned addition of Rs.3,58,059/- requires to be deleted and restricted to only Rs.39,271/-already disallowed by the appellant in the return of income.*
2. *The Id. CIT(A) has further erred in not appreciating and/or ignoring the fact that the **investments have not been made out of borrowed funds but out of own sufficient interest free funds notwithstanding the fact that part of the same has also been made in earlier years** in which case, no disallowance is warranted as held by the jurisdictional court of law i.e. **Hon'ble Gujarat High Court in a host of decisions cited before the Id. CIT(A.)** Thus, the id. AO as well as Id. CIT(A) were duty bound to follow the said decisions of the jurisdictional! court of law and delete the impugned addition of Rs.3,58,059/-.*
3. *The appellant states that as recently held by the **Hon'ble Karnataka High Court in the case of Canara Bank vs. ACIT (2014) 265 CTR 385 (Kar.)**, since the dividend income is directly credited in the bank account no human agency is involved in collecting such exempt income for which the assessee has to incur any expenditure and hence the provisions of Section 14A would not apply in such cases.*
4. *The Id. CIT(A) has also failed to appreciate the fact that it would be **wholly illogical to presume that the assessee would have incurred an expenditure of Rs,2,39,317/- being the entire amount of exempt income for earning the amount of dividend income of Rs.2,39,317/-** which has even otherwise been directly credited in the bank account through ECS. Thus, without prejudice to the facts of the case and legal position, the suo-motto disallowance of Rs.39,271/-made by the appellant in the return of income ought to have been accepted.*

The appellant craves leave to add, amend, alter, modify or delete any of the above grounds as well as to submit additional grounds at the time of hearing of the appeal.”

3. The assessee before us has raised four grounds of appeal but the single issue is involved in all these grounds which is that Ld.CIT(A) erred in confirming the addition of Rs.2,39,317/- u/s.14A r.w.r. 8D of the Income Tax Act.

4. Briefly stated facts are that the assessee is partnership and engaged in the retail trading of spectacles, sunglasses and lenses. The assessee during the year has earned dividend income which was claimed as exempted income u/s.10(34) of the Act. The assessee against such exempted income has made the disallowance of expense for Rs. 39,271/- as per the provision of section 14A r.w.r 8D of the Income Tax Rule.

4.1 However, the AO during the proceedings observed that the assessee has not considered the interest expenses for Rs.18,37,220/- which was paid to the partners of the firm while computing the disallowance u/s14A of the Act.

4.2 On question by the AO, the assessee submitted that no money was invested in the mutual funds out of the loan/ capital received from the partner. The assessee claimed that investment was made either out of the sale proceeds in cash on day to day basis, which was deposited in the bank account or out of the proceeds of mutual funds matured in the relevant year. The assessee in support of his claim filed the statement demonstrating the source of investment in the mutual funds. The AO disregarded the contentions of the assessee and worked out disallowance of interest expenses after considering the interest paid to the partners. The disallowance as worked out by the AO stands as under:

Sr. No.	Particulars	Amount(Rs.)
1.	Direct Expenses	1,200
2.	Interest Expenses	3,31,295
3.	Administrative Expenses	25,564
Total		3,58,059

4.3 In view of the above, the AO disallowed the balance expenses at Rs. 3,18,788/- (Rs.3,58,059/- - Rs.39,271/- amount already disallowed) and added to the total income of the assessee.

5. Aggrieved assessee preferred an appeal before the Ld. CIT(A) who has confirmed the order of AO in part by observing as under:

“Decision:

3.3. This appeal has been preferred against the disallowance made by the AO. u/s.14A of the Act amounting to Rs.3,18,788/- after giving the credit for the disallowance of Rs.39,271/- made by the appellant in the computation of the income. The AO was of the opinion that the appellant has failed to follow the formula mentioned in Rule-8D of the I.T Rules as the appellant firm has not included the interest payment made to the partners for Rs.18,37,220/- in the interest expenses incurred during the year under consideration.

3.4. During the appellate proceedings the appellant has contended that during the year the appellant firm has make new investment in the mutual funds amounting to Rs.22,38,117/- only and same is either out of sale proceeds in cash on day to day basis which has been deposited in the bank account or from the maturity proceeds of the mutual funds itself. It is further contended that during the year none of the partners of the appellant firm have introduced any fresh/additional capital. It is further contended that the capital has not been utilized for the purpose of investment in the mutual funds and there is no fresh/additional introduction of capital by any of partners. Therefore, there is no question of considering the interest paid to partners for the purpose of disallowance u/s.14A of the Act. It is further submitted that disallowance U/S.14A cannot exceed the tax exempt income. In support of this the appellant has relied upon following judgments:-

1. Joint Investment Pvt. Ltd. Vs. CIT (ITA No. 117/2015 - Taxsutra.com) (Delhi High Court)

2. *Daga Global Chemicals Pvt. Ltd.. WMCIT (ITA No. 5592/Mum/2012 Order dated 01/01/2015 - ITAT Mumbai)*

3.5. *The facts of the case and the submissions are considered. The contention of the appellant that the capital has not been utilized for the purpose of investments in mutual funds and there is no fresh/additional introduction of capital by any of partners cannot be accepted as the appellant has failed to establish the nexus of the same. However, in the case of Joint Investment Pvt. Ltd. the Hon'ble Delhi High Court has held as under:-*

"By no stretch of imagination can section 14A or Rule-8D be interpreted so as to mean that the entire tax exempt income is to be disallowed. The window for disallowance is indicated in Section 14A, and is only to the extent of disallowing expenditure "incurred by the assessee in relation to the tax exempt income". This proportion of portion of the tax exempt income surely cannot swallow the entire mount as has barren in this case".

In the present case the appellant firm has earned the exempt income of dividend of Rs.2,39,317/- and has already disallowed a sum of Rs.39,271/- whereas the AO has determined the total disallowance at Rs.3,58,059/-. Considering the proposition given in the above cited judgments, the disallowance is restricted to the exempt income of dividend of Rs.2,39,317/- instead of Rs.3,58,059/-. Thus the ground of appeal is partly allowed."

5.1 Being aggrieved by the order of Id. CIT(A), assessee is in appeal before us.

6. The Ld.AR before us filed a paper book running from page nos. 1 to 77 and submitted that interest to the partners is allowable deduction u/s 40(b) of the Act.

6.1 The Ld.AR further submitted that interest to the partner is not governed by the provision of section 36(1)(iii) of the Act. Thus, Ld.AR claim that no reference could be made for disallowance of such interest expenses u/s 14A of

the Act. The Ld.AR in support of his claim relied on the order of ITAT, Tribunal, Pune in case of Quality Industries in ITA NO. 2000/PN/2014 vide order dated 09/09/2016.

7. On the other hand the Ld. DR, vehemently supported the order of authorities below.

8. We have heard rival contention and perused the materials available on record. In the instant case the AO made the disallowance u/s 14A r.w.r 8D of the I.T. Rules on account of dividend income after considering the interest expenses paid to the partners of the firm. The view taken by the AO was subsequently confirmed by the Ld. CIT(A).

8.1 The limited issue which required to be adjudicated is whether the interest paid to the partners of the firm should be considered for the purpose of disallowance u/s 14A r.w.r 8D of the Income Tax Rule. In this connection, we note that the Hon'ble ITAT, Pune Bench in case of Quality Industries (Supra) has passed a detailed and speaking order holding that the interest paid to the partners cannot be considered for the purpose of disallowance u/s. 14A r.w.r 8D of Income Tax Rule. The relevant extract of the order is reproduced below:

'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 a/so 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(l)(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(l)(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 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.’’

8.2 In view of the above, we hold that the interest paid to the partners of the firm cannot be considered for making the disallowance u/s 14A r.w.r 8D of the Income Tax Rule. The issue involve in the appeal before us is identical to the issue in the case of Quality Industries, as discussed above, therefore, respectfully following the same, we direct the AO to make the disallowance u/s.14A r.w.r 8D of the Income Tax Act for the interest expenses, after excluding the interest paid to the partners of the firm. Hence, ground of appeal of assessee is **allowed**.

9. In the result, appeal of the assessee in ITA No.2771/Ahd/2016 is allowed.

10. Now coming to the ITAT No.2772/Ahd/2016 for A.Y.2014-15. The assessee has raised following grounds of appeals:

- ‘1. *The learned CIT(A) has erred in law as well as on facts in confirming the addition of Rs.4,65,783/- out of total addition of Rs.5,10,615/- made by the AO u/s. 14A r.w.r. 8D without proper consideration and appreciation of the specific facts of the case duly supported by settled legal position rendered by the jurisdictional court of law i.e. **Hon'ble Gujarat High Court in a host of decisions.** In view of facts and elaborate submissions filed coupled with settled legal position, the impugned addition of Rs.4,65,783/- requires to be deleted and restricted to only Rs.2,62,561/-already disallowed by the appellant in the return of income.*
2. *The Id. CIT(A) has further erred in not appreciating and/or ignoring the fact that the **investments have not been made out of borrowed funds but out of own sufficient interest free funds notwithstanding the fact that part of the same has also been made in earlier years** in which case, no disallowance is warranted as held by the jurisdictional court of law i.e. **Hon'ble Gujarat High Court in a host of decisions cited before the Id. CIT(A.)** Thus, the Id. AO as well as Id. CIT(A) were duty bound to follow the said decisions of the jurisdictional court of law and delete the impugned addition of Rs.4,65,783/-.*
3. *The appellant states that as recently held by the **Hon'ble Karnataka High Court in the case of Canara Bank vs. ACIT (2014) 265 CTR 385 (Kar.)**, since the dividend income is directly credited in the bank account no human agency is involved in collecting such exempt income for which the assessee has to incur any expenditure and hence the provisions of Section 14A would not apply in such cases.*
4. *The Id. CIT(A) has also failed to appreciate the fact that it would be **wholly illogical to presume that the assessee would have incurred an expenditure of Rs.4,65,783/- being the entire amount of exempt income for earning the amount of dividend income of Rs.4,65,783/-**, which has even otherwise been directly credited in the bank account through ECS. Thus, without prejudice to the facts of the case and legal position, the suo-motto disallowance of Rs.2,62,561/-made by the appellant in the return of income ought to have been accepted.*

The appellants crave leave to add, amend, alter, modify or delete any of the above grounds as well as to submit additional grounds at the time of hearing of the appeal.”

11. At the outset, we note that the identical issue was raised in ITA No.2771/Ahd/2016, which has been decided by us in favour of the assessee vide paragraph no. **8 to 8.2** of this order. Therefore, respectfully following the same, the grounds of appeal of assessee is allowed.

12. In the result, both the appeals of the assessee are allowed.

Order pronounced in the Court on_18_September, 2018 at Ahmedabad.

Sd/-
(RAJPAL YADAV)
JUDICIAL MEMBER
Ahmedabad; Dated 18/09/2018

Sd/-
(WASEEM AHMED)
ACCOUNTANT MEMBER

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आदेश की प्रतिलिपि भेजित/Copy of the Order forwarded to :

1. अपीलार्थी / The Appellant
2. प्रत्यर्थी / The Respondent.
3. संबंधित आयकर आयुक्त / Concerned CIT
4. आयकर आयुक्त(अपील) / The CIT(A)
5. विभागीय प्रतिनिधि, आयकर अपीलीय अधिकरण / DR, ITAT,
6. गार्ड फाईल / Guard file.

आदेशानुसार/BY ORDER,

उप/सहायक पंजीकार (Dy./Asstt.Registrar)
आयकर अपीलीय अधिकरण, अहमदाबाद / ITAT, Ahmedabad

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