

आयकर अपीलीय अधिकरण, जयपुर न्यायपीठ, जयपुर
IN THE INCOME TAX APPELLATE TRIBUNAL, JAIPUR BENCHES-A, JAIPUR

श्री विजय पाल राव, न्यायिक सदस्य एवं श्री विक्रम सिंह यादव, लेखा सदस्य के समक्ष
BEFORE: SHRI VIJAY PAL RAO, JM & SHRI VIKRAM SINGH YADAV, AM

आयकर अपील सं./ITA No. 187/JP/2017
निर्धारण वर्ष/Assessment Year :2013-14

M/s ASK Partners, C/o Sunil Porwal & Co. Radhey Prem, 19A, Sobhag Club, Civil Lines, Ajmer (Raj.)	बनाम Vs.	ACIT, Circle-2, Ajmer
स्थायी लेखा सं./जीआईआर सं./PAN/GIR No.: AAQFA7969J		
अपीलार्थी/ Appellant		प्रत्यर्थी/ Respondent

निर्धारिती की ओर से/ Assessee by : Shri Subhash Porwal (CA)
राजस्व की ओर से/ Revenue by : Shri J. C. Kulhari (JCIT)

सुनवाई की तारीख/ Date of Hearing : 10/12/2018
उदघोषणा की तारीख/Date of Pronouncement: 31/12/2018

आदेश/ ORDER

PER: VIKRAM SINGH YADAV, A.M.

This is an appeal filed by the assessee against the order of Id. CIT(A), Ajmer dated 30.01.2017 for A.Y. 2013-14 wherein the assessee firm has challenged the sustenance of disallowance of interest paid to its partners.

2. Briefly stated, the facts of the case are that the assessee is a partnership firm engaged in business of trading of shares, derivatives, futures, call and options on registered stock exchanges. During the course of assessment proceedings, on examination of assessee's financial

statement, the Assessing Officer observed that the assessee firm has made investment in mutual funds and has earned dividend from such mutual funds which have been claimed as exempt in its return of income. The Assessing Officer held that the partners have made investment in the firm's capital and the said capital is used for making investment in the mutual funds. Therefore, he held that the interest payment on partner's capital is not an allowable expenses against the dividend income which has been claimed as exempt and therefore, invoking provisions of section 14A read with Rule 8D, he worked out the disallowance of interest amounting to Rs. 9,11,054/-. Further, the AO disallowed an amount of Rs. 52,069/- under Rule 8D(iii) of the Act. On appeal, the disallowance has been confirmed by the Id. CIT(A) and now, the assessee is in appeal against the said disallowance of interest paid to partners.

3. During the course of hearing, the Id. AR submitted that the assessee has not incurred any expenditure in relation to exempt income and the provisions of section 14A can only be applied where the AO records the finding that he is not satisfied about the correctness of claim of the assessee in respect of such expenditure. It was submitted that there is no such finding recorded by the AO. In support, reliance was placed on the decision of Hon'ble Delhi High Court in case of Maxopp Investment Ltd. & Ors v. CIT [2011] 347 ITR 272.

4. It was further submitted that the payment of interest to the partners by the assessee firm as per the provisions of the partnership deed is not an expenditure which is subject to the provisions of section 14A and in support, reliance was placed on the decision of **Co-ordinate**

Bench in case of **Quality Industries v. JCIT** [2016] 73 taxmann.com 363 wherein it was held as under:-

"10. We have carefully considered the rival submissions. The predominant 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 R.M. Chimbaram Pillai (supra) 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 v. 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."

5. The Id. DR is heard who has relied on the order of the lower authorities.

6. We have heard the rival contentions and perused the material available on record. Following the decision of the Coordinate Bench in case of Quality Industries (Supra), payment of interest to the partners towards the use of the partner's capital as per the provisions of the partnership deed is held not subject to disallowance under Section 14A read with Rule 8D(ii) of the Act. However, in respect of disallowance under Rule 8D(iii), no specific ground or plea has been taken by the Id AR on behalf of the assessee, hence the same is confirmed.

In the result, appeal filed by the assessee is partly allowed.

Order pronounced in the Open Court on 31/12/2018.

Sd/-

(विजय पाल राव)
(Vijay Pal Rao)

न्यायिक सदस्य / Judicial Member

Sd/-

(विक्रम सिंह यादव)
(Vikram Singh Yadav)

लेखा सदस्य / Accountant Member

जयपुर / Jaipur

दिनांक / Dated:- 31/12/2018.

*Ganesh Kr.

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

1. अपीलार्थी / The Appellant- M/s ASK Partners, Ajmer
2. प्रत्यर्थी / The Respondent- ACIT, Circle-02, Ajmer
3. आयकर आयुक्त / CIT
4. आयकर आयुक्त / CIT(A)
5. विभागीय प्रतिनिधि, आयकर अपीलीय अधिकरण, जयपुर / DR, ITAT, Jaipur.
6. गार्ड फाईल / Guard File {ITA No. 187/JP/2017}

आदेशानुसार / By order,

सहायक पंजीकार / Asst. Registrar