

**IN THE INCOME TAX APPELLATE TRIBUNAL
COCHIN BENCH, COCHIN**

Before Shri Chandra Poojari, AM & Shri George George K, JM

ITA No.90/Coch/2018 : Asst.Year 2010-2011

M/s.K.Venkatachalam Aiyer & Co., 28/2816, Srinikethan Kuthiravattom Road Chettikulangara Thiruvananthapuram Pin – 695001 PAN : AAEFK0880A.	Vs.	The Dy.Commissioner of Income-tax, Circle 1(2) Thiruvananthapuram.
(Appellant)		(Respondent)

Appellant by : Sri. T.V.Hariharan
Respondent by : Smt.A.S.Bindhu, Sr.DR

Date of Hearing : 19.02.2019	Date of Pronouncement : 01.03.2019
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ORDER

Per George George K, JM

This appeal at the instance of the assessee is directed against CIT(A)'s order dated 01.02.2018. The relevant assessment year is 2010-2011.

2. The solitary issue that is raised is whether the CIT(A) is right in confirming the assessment order, wherein an amount of Rs.19,45,455 paid to the legal heirs of one of the deceased partners was disallowed.

3. The brief facts of case are as follows:-

The assessee is a firm of Chartered Accountants. For the assessment year 2010-2011, the return of income was filed

on 30.09.2010 disclosing a total income of Rs.29,06,860. The return of income was processed u/s 143(1) of the I.T.Act on 18.05.2011 accepting the total income disclosed. Subsequently, notice was issued u/s 143(2) of the I.T.Act was issued on 29.08.2011. In the course of assessment proceedings, it was noticed that the assessee-firm had debited a sum of Rs.19,45,455, towards the sum paid to the legal heirs of one of the deceased partners, Shri K.L.Kulathu. The Assessing Officer while completing the assessment u/s 143(3) of the I.T.Act (order dated 19.12.2012) held that the above said payment is a diversion of income. Further, the A.O. held that payment cannot be stated to be for the purpose of business of the assessee-firm and added back to the total income a sum of Rs.19,45,455.

4. Aggrieved by the assessment order, the assessee preferred appeal to the first appellate authority. The CIT(A) confirmed the disallowance made by the Assessing Officer. The CIT(A) held that the case laws relied on by the assessee-firm is distinguishable on facts since in those cases the payments were made to the ex-partners and not to the legal heirs of the deceased partners. Further, the learned CIT(A) by relying on clause 24 of the partnership deed dated 31.12.2007 was of the view that there was no necessity of payment of Rs.19,45,455 to legal heirs of the deceased partners. It was further concluded by the learned CIT(A) that the payment of Rs.19,45,455 to the legal heirs of one of the deceased partners is not a business expenditure of the

assessee-firm. The relevant finding of the learned CIT(A) reads as follows:-

“3. I carefully examined the facts of the case and also gone through the decisions relied on by the assessee. The decisions relied on by the assessee are not applicable to the case of the assessee since the Hon'ble ITAT decisions are on partners who retired but not on legal heirs as in the case of the assessee. Hence, the reliance is totally misplaced. The other argument of the assessee that the legal heirs were paid as per the Partnership Deed. If this is what the fact then clause 24 of the Partnership Deed only is applicable to the assessee as per which the legal heirs are entitled only for a sum of Rs.3,000/- per month for a period of 3 years from the date of death of the deceased partner. As per this clause, the assessee may claim a sum of Rs.36,000/- only for the year under consideration and this is subject to the maximum period of 3 years and the partner dies during his continuation as a partner in the firm. This apart, whatever the payment the assessee claimed to have made to the legal heirs of the deceased partner, the same should necessarily be paid in accordance with the provisions of section 37 of the Act. As per section 37, the amount which is to be debited to the profit & loss account should have been incurred wholly and exclusively for the purpose of business and towards earning of income during the course of business carried out during the year under consideration. The amount which was paid to the legal heirs in the instant case literally fails to fulfill both the important conditions contemplated in the Act and thereby disentitle the assessee to make the claim. To my understanding of the whole issue, the assessee still pay the amount to the legal heirs but after paying tax on the gross earning. The assessee could have paid to the legal heirs from the amount still left with but after paying the tax. Resorting to making the payment prior to paying the tax had resulted in a condition wherein neither the provisions

of the Act nor the clauses of Partnership Deed strictly been followed up by the assessee. It is not case of the assessee that the payment was made wholly and exclusively for the purpose of business carried out during the year under consideration. It is also not the case of the assessee that the Partnership Deed provides for payment prior to paying tax on the gross earning. In the absence of both the above, the payment made to the legal heirs of the deceased partner cannot be said as paid within the permissible limit of the Act. In the backdrop, I find no infirmity in the decision the Assessing Officer has taken to disallow the wrong claim of deduction made and accordingly, the same is confirmed. As a result, the appeal filed on this ground stands dismissed."

5. Aggrieved by the order of the CIT(A), the assessee preferred appeal to the Tribunal raising the following grounds:-

1. *On the facts and in the circumstances of the case, the learned Commissioner of Income Tax (Appeals) erred in not accepting the claim of the appellant that the expenditure for a sum of Rs.19,45,455/- paid to the legal heirs of one of the deceased partner Shri. K L Kulathu in terms of the partnership deed is an allowable deduction.*

2. *The learned Commissioner of Income Tax (Appeals) should have appreciated the fact that the deduction claimed for the payment made to legal heirs of one of the deceased partner in terms of partnership deed, is a diversion of income to this extent as per clause 23 of the partnership deed dated 31-12-2017 and this could not be included in the total income of the appellant.*

3. *The learned CIT (A), Thiruvananthapuram erred in interpreting clause 23 of the Partnership Deed. He ought to have read clauses 22 and 23 of the Deed together to come to the correct conclusion that*

payment to late Sri. K.L.Kulathu upon his death was strictly in conformity with the Partnership Deed. He ought to have appreciated that clause 24 is not applicable to the issue in question.

4. *The learned CIT (A), Thiruvananthapuram erred in mixing the payment to late Sri. K.L.Kulathu with the tax payment. Both were unrelated. Tax payment should not decide the eligibility of our otherwise legal & valid claim.*

5. *Even after endorsing the view of Assessing Officer that it was diversion of income still the learned CIT (A), Thiruvananthapuram upheld the disallowance which is not justified.*

6. *The appellant, with all humbleness, reserves its right to make addition, alteration, modification and or withdrawal of any of its grounds at the time of the hearing.*

Whereof it is prayed that the order of the learned Commissioner of Income Tax (Appeals) be modified in the manner mentioned above and justice be rendered by deleting the addition of Rs.19,45,455/- made on assessment."

6. The learned AR has filed a paper book containing 58 pages, *inter alia*, enclosing the case laws relied, two partnership deed dated 31.12.2001 and deed dated 20.01.2010. The learned AR has also filed details of the working of the amount of Rs.19,45,455 that was paid to the legal heirs of the deceased partner. The brief written submission given by the learned AR reads as follows:-

"Sri. K.L. Kulathu, the Senior most partner of our firm (assessee) then in charge of Quilon office expired on 20 January 2010. The Partnership deed of the firm obligates payment of a sum arrived at as per clauses 23 & 24 of the deed to a retired/deceased partner satisfying these clauses.' Copies of deed post reconstitution upon his death & the immediately preceding period spelling out the obligation to pay are enclosed. Late Sri. K.L.Kulathu having duly satisfied the respective clauses of the said deed was thus eligible for receiving the payment of ~ 19,45,455 by the firm. Accordingly upon his death, his legal heirs were paid the same in accordance with the deed before end of financial year 2009-10 relevant to assessment year 2010-11 and the amount so paid was claimed as a revenue expenditure.

Assessing Officer disallowed the claim even while observing that it was a diversion of income. CIT (A) overlooked the relevant clauses of the partnership deed. He failed to appreciate the similarity of the facts of the case with that obtaining in the case laws quoted during hearing. CIT(A) also ought to have appreciated that it is a case of diversion of income with overriding charge and not an application of income.

The said payment being diversion of income by overriding title was hence an allowable expenditure in computing the assessable profits of the firm for the relevant assessment year. It is an expenditure laid out wholly & exclusively for the purpose of profession & hence allowable as a revenue expenditure.

In support of our submissions, copies of relevant decisions of Mumbai bench and Bombay High Court recent decision are enclosed. In particular, in the absence of further appeal by the revenue, it is to be presumed that the decision of Bombay High Court in (2016) 133 DTR 257 has attained finality.

Thus it is humbly prayed that the appeal of the assessee be allowed."

7. The learned Departmental Representative, on the other hand, strongly supported the orders of the Income-tax authorities.

8. We have heard the rival submissions and perused the material on record. The solitary issue for our consideration is whether the CIT(A) is justified in confirming the assessment wherein the sum of Rs.19,45,455 paid by the assessee-firm to the legal heirs of the deceased partners is an allowable deduction? The legal heirs of the deceased partner was paid a sum of Rs.19,45,455 as per the terms mentioned in clauses 23 and 24 of the partnership deed dated 31.12.2007. The detailed working of the claim is enclosed at page 37 of the paper book filed by the assessee. Clauses 23 and 24 of the partnership deed dated 31.12.2007 reads as follows:-

"23. Any partner may retire from the firm, after giving three months notice in writing to the other partners in which case he shall be entitled to all moneys standing to his credit in his capital and current accounts including his share of profit or loss upto the date of retirement less any amounts due by him to the firm but such retiring partner shall not be entitled to any share on account of the goodwill of the firm which shall absolutely belong to the continuing partners only. Provided however, that if a partner retires or dies after attaining the age of sixty five, he or his legal heirs shall also be entitled for a lump sum payment as retiring benefit equal to two years share of his net earnings including salary and interest from the firm worked out at the average share of such income from the firm in the immediately three preceding financial years prior to the date of his retirement / death.

24. If a partner dies during the continuance as a partner in the firm, his legal heirs shall be entitled to all the monies

standing to the credit of the deceased partner in his capital and current accounts together with his share of profits or losses upto the date of his death and if he dies after attaining the age of 65, including the lumpsum payment under clause 23, less any monies due by the deceased to the firm but shall not be entitled to any share on account of the good will of the firm. Provided however, that if the deceased partner has completed not less than 15 years service as a partner in the firm before attaining the age of 65, his widow / minor children collectively shall be entitled to a pension of Rs.3000/- (Rupees Three thousand only) per month from the firm for a period of three years from the date of death of the deceased partner."

8.1 The CIT(A) only considered clause 24 of the above said partnership deed and came to the conclusion that a sum of Rs.19,45,455 was not the correct working. According to us, the CIT(A) has overlooked the relevant clause, viz., clause 23 of the partnership deed dated 31.12.2007.

8.2 The assessee had claimed the above said payment as diversion of income by way of overriding title. The true test of overriding title as laid down by various Courts is to know whether the amount sought to be deducted never reached the assessee as his income. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by nature of the obligation cannot be said to be a part of the income of the assessee. Whereby by the obligation the income is diverted before it reaches the assessee, it is deductible, but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence in law does not follow. The payment conditional on properly being ascertained may also be diverted by overriding title. The Hon'ble Apex Court in the case of *CIT v. Sitaldas Tirathdas* [(1961) 41 ITR

367 (SC)] has held that whereby an obligation the income is diverted before it reaches the assessee, it is deductible. In the case of *CIT v. Mulla & Mulla & Craigie Blunt & Careo [(1991) 191 ITR 198 (Bom.)]*, the Hon'ble Bombay High Court held that the assessee firm was under a legal obligation to pay to the legal heirs the share of the deceased partners in the income of the firm for work done by the firm upto the date of death of the partners. It was held by the Hon'ble Bombay High Court that the amount was paid by the assessee firm to the legal heirs of the deceased partners could not be assessed as income of the firm. It was concluded by the Hon'ble High Court that the amount so paid to the legal heirs of the late deceased was under legal obligation and the amount never was received by the assessee-firm as its income but was diverted at source. The Hon'ble Bombay High Court relied on the following judicial pronouncements in reaching the above conclusion :-

- (i) *CIT v. G.Basu & Co. (1990) 182 ITR 472 (Cal.)*;
- (ii) *V.N.N.Devarajulu Chetty & Co. v. CIT (1950) 18 ITR 357 (Mad)*; and
- (iii) *CIT v. Crawford Bayley & Co. (1977) 106 ITR 844 (Bom.)*

8.3 Thus, in case of diversion of income by overriding title the obligation is imposed on the source while in case of application of income, the obligation is on the receiver of income. Diversion of income at source is synonymous with

the creation of an overriding or superior title in favour of some other person. There is some overlapping between the doctrine of real income and the doctrine of diversion of income at source. Wherever there is diversion of income at source, the doctrine of real income also applies and on either ground the diverted income cannot be included in the total income of the assessee who claims that there has been a diversion. Indeed, the doctrine of real income has greater force, and is applied even where technically there has been no diversion of income at source. Diversion of income at source can take place either under a legal compulsion or under a contractual obligation or else under a statutory provision. In the case of CIT v. Smt.Kamlabai Juthalal (1977) 108 ITR 755 (Bom.), it was held that where obligation is undertaken by the assessee to apply the income in a particular way before being received by the assessee or its accrual, the same results in the diversion of income. On the other hand, where the obligation to apply income is undertaken after being received or accrued to the assessee, it will be the case of application of money and will be liable to be taxed in hands of assessee. The underlying test, therefore, is whether the income in question ever reaches to the assessee.

8.4 In the instant case, the effect of creation of the overriding of income is achieved by clause 23 of the partnership deed dated 31.12.2007. In identical factual situation, the Mumbai Tribunal in the case of ACIT v. Deloitte Haskins & Sells [(2018) 196 TTJ (Mumbai) 355] had held that the payment made by a firm to the ex-partners and spouses /

legal heirs of the deceased partners would be paid part of the income of the assessee-firm for the services rendered by them. Hence, it was concluded by the Mumbai Bench of the Tribunal that it was a case of diversion of income by way of overriding title. Similar view was taken by the Mumbai Tribunal in the cases of A.F.Ferguson & Co. v. ACIT [ITA No.663/Mum/2010 – order dated 10.08.2011] and R.S.M. & Co. v. Addl.CIT [(2010) 10 ITR (Trib.) 0614].

8.5 The Mumbai High Court in case of CIT v. Kanga & Co. reported in 133 DTR 257 had confirmed the Tribunal order, wherein the Tribunal held that payment by firm relatable to retired / deceased partner's would tantamount to diversion of income by overriding title. Therefore, in view of the above said reasoning and the judicial pronouncements cited supra, we are of the view that the amount of Rs.19,45,455 should be allowed as deduction in the case of the assessee-firm. It is ordered accordingly.

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

Order pronounced on this 01st day of March, 2019.

Sd/-
(Chandra Poojari)
ACCOUNTANT MEMBER

Sd/-
(George George K.)
JUDICIAL MEMBER

Cochin ; Dated : 01st March, 2019.
Devdas*

Copy of the Order forwarded to :

1. The Appellants
2. The Respondent.
3. The CIT (Appeals) Thiruvananthapuram
4. The Pr.CIT Thiruvananthapuram.
5. DR, ITAT, Cochin
6. Guard file.

BY ORDER,

(Asstt. Registrar)
ITAT, Cochin