

आयकर अपीलीय अधिकरण, राजकोट न्यायपीठ
**IN THE INCOME TAX APPELLATE TRIBUNAL,
RAJKOT BENCH, RAJKOT**

**BEFORE SHRI WASEEM AHMED, ACCOUNTANT MEMBER
And
SHRI SIDDHARTHA NAUTIYAL, JUDICIAL MEMBER**

आयकर अपील सं./ITA No. 91/Rjt/2022
निर्धारण वर्ष/Asstt. Years: 2017-2018

M/s. Khedut Cold Storage Co., Head off at officer No11, Jitendra Complex, Kalwa Chock, Junagadh-362001. PAN: AANFK8513F	Vs.	The Principal Commissioner of Income Tax, Rajkot-1, Rajkot.
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(Applicant)		(Respondent)
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Assessee by :	Shri Mehul Ranpura, A.R
Revenue by :	Shri Sanjeev Jain, CIT.D.R

सुनवाई की तारीख / **Date of Hearing** : **01/07/2022**
घोषणा की तारीख / **Date of Pronouncement**: **30/09/2022**

आदेश/ORDER

PER BENCH :

The captioned appeal has been filed at the instance of the Assessee against the order of the Learned Principal Commissioner of Income, Rajkot-1, dated 07/02/2022 arising in the matter of assessment order passed under s. 263 of the Income Tax Act, 1961 (here-in-after referred to as "the Act") relevant to the Assessment Year 2017-18.

2. The only interconnected issue raised by the assessee is that the learned Principal CIT erred in holding the assessment framed under section 143(3) of the Act as erroneous insofar prejudicial to the interest of Revenue.

3. The brief facts are that the assessee is a partnership firm. The PCIT on examination of the case records of the assessee, found that the assessee was having only interest bearing fund in form of partner's capital of Rs. Rs. 2,14,66,138/-, secured loan of Rs. 9,26,80,448/- and unsecured loan of Rs. 4,09,94,651/- on which, it was paying huge interest but on the other hand, the assessee has advanced interest free loan amounting to Rs. 1,27,90,000/- to M/s Patel Punit Builders Pvt Ltd without having any business transaction. Thus, the PCIT was of the view that the assessee has diverted interest bearing fund other than the business purpose. But the AO during the assessment proceedings failed to make proportionate disallowances of interest expenses which tantamount to a mistake due to lack of enquiry and incorrect application of mind on the facts. Accordingly, the PCIT initiated the proceedings under section 263 of the Act vide show cause notice dated 29 January 2022.

3.1 The assessee in response to such show cause notice submitted that during the assessment proceeding, vide notice under section 142(1) of the Act, the AO required necessary details with regard to loans and advances which were duly complied and thereafter, the assessment was framed. Therefore, in such facts and circumstances, the modification/ revision of the assessment order under section 263 of the Act will amount to change of opinion which is not permissible under the Act. It was further submitted that the party to whom interest free advance was provided was an associate concern and both the parties provided fund to each other on short term requirement basis without charging interest. If the view of the learned PCIT complied then assessee has to pay excess interest on the amount provided by its associate concern.

4. However, the Id. PCIT rejected the contention of the assessee with regard to the change of opinion by holding that the AO has not examined the issue of diversion of fund before allowing the interest expenses. Therefore, the question of change of opinion does not arise when the AO does not make conscious attempt to examine the issue on the basis of materials available on record.

5. With regard to assessee submission that associate concern also provided interest free advances to it on requirement basis, the learned PCIT held that this submission and working was not available before the AO. Therefore, the same needs to be verified at AO level. Thus, the learned PCIT held the assessment framed under section 143(3) of the Act as erroneous insofar prejudicial interest of Revenue for the reason of inadequate inquiry and incorrect application of mind on the facts available on record.

6. Being aggrieved by the order of the learned PCIT, the assessee is in appeal before us.

7. The learned AR before us filed a paper book running from pages 1 to 25 and contended that owned fund of the assessee exceeds the amount of interest and therefore, no disallowance is warranted.

8. On the other hand, the learned DR vehemently supported the order of the authorities below.

9. We have heard the rival contentions of both the parties and perused the materials available on record. The assessee being a partnership firm is paying interest to partners on their capital as well as on the money borrowed from different parties. At the same time, the assessee has also made advances amounting to Rs. 1,27,90,000/ without charging any interest. Thus, it was alleged by the learned PCIT that the assessee on one hand is paying interest on the borrowed fund and on the

other hand it has provided interest free loans amounting to Rs. 1,27,90,000/- to the party namely M/s Patel Punit Builders Pvt Ltd. Thus, the PCIT was of the view that the interest-bearing borrowed fund has been diverted to non-interest bearing loans and advances. But this fact has not been verified by the AO during the assessment proceedings, therefore the order of the AO was held as erroneous insofar prejudicial to the interest of revenue on account of non-verification of diversion of interest bearing loan to non-interest-bearing advances.

9.1 On perusal of the records and other evidences filed by the assessee, we note that there was no query raised by the AO during the assessment proceedings with respect to the diversion of interest bearing loan to non-interest-bearing advances. Thus to the extent, the order of the AO appears to be erroneous insofar judicial to the interest of revenue.

9.2 However, before parting we observe important things. Firstly, there was a contention of the assessee before the learned PCIT that it was having the running account with the party to whom interest free loans and advances have been provided as alleged by the learned PCIT. According to the assessee, there were many occasions in the year under consideration when the assessee has borrowed money from the party namely M/s Patel Punit Builders Pvt Ltd which is in dispute. As such, if the borrowing of the assessee from the impugned party is taken into consideration, then the assessee will end up paying interest to the party despite the fact that at end of the financial year, the assessee has shown debit balance/advances to such party. The copy of the working of interest to be paid by the assessee in the event, the borrowing is considered in the hands of the assessee from the party, is placed on page no. 18 of the paper book. Thus, we are of the view the working filed by the assessee is very crucial decide to the issue on hand which is to be considered by the AO in the consequential proceedings.

9.3 The 2nd observation of ours is that if own fund of the assessee exceeds the interest free loans and advances, then a presumption can be drawn that the interest free loan has been advanced by the assessee out of its own capital. A controversy also arises whether the interest paid by the assessee on the partner's capital should be considered for the purpose of the disallowance. In this regard, we note that the ITAT Pune Benches in the case of Quality Industries vs. JCIT Reported in 161 ITD 217 has held that interest on partner's capital is not an expenses as the same is an appropriation of profit only. The relevant observation of the tribunal reads as under:

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 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.

9.4 The above order of the ITAT reveals that interest paid by the assessee on the partners' capital is not an expense rather it represents the appropriation of profit. Thus, in such circumstances we can hold that the partners' capital account represents the interest free fund available with the assessee. Thus in a situation where the own fund of the assessee including the partners' capital and other interest-free borrowing exceeds interest-free loans and advances, then no disallowance of interest expenses on account of diversion of interest-bearing fund

does not arise. In holding so we draw support and guidance from the judgment of Hon'ble jurisdictional High court in the case of CIT vs. Torrent Power Ltd reported in 363 ITR 474 where it was held as under:

It was noted from records that the assessee was having share holding funds to the extent of 2607.18 crores and the investment made by it was to the extent of `Rs.195.10 crores. In other words, the assessee had sufficient funds for making the investments and it had not used the borrowed funds for such purpose. This aspect of huge surplus funds is not disputed by the revenue which earned it the interest on bonds and dividend income. [Para 7]

9.5 In view of the above and after considering the facts as discussed above, we uphold the finding of the learned PCIT with the direction to the AO to frame the assessment de-novo in the light of the above stated discussion and as per the provisions of law. Hence, the ground of appeal of the assessee is hereby dismissed in terms of the above direction.

10. In the result, the appeal filed by the assessee is dismissed.

Order pronounced in the Court on 30/09/2022 at Ahmedabad.

**Sd/-
(SIDDHARTHA NAUTIYAL)
JUDICIAL MEMBER**

**Sd/-
(WASEEM AHMED)
ACCOUNTANT MEMBER**

Ahmedabad; Dated **(True Copy)**
30/09/2022
Manish