

**IN THE INCOME TAX APPELLATE TRIBUNAL
ALLAHABAD 'SMC' BENCH, ALLAHABAD
BEFORE SHRI.VIJAY PAL RAO, JUDICIAL MEMBER**

**ITA No.28/ALLD/2022
Assessment Year: 2011-12**

SAVLA AGENCIES, 26, M.G. Marg, Civil Lines, Allahabad-211001 PAN-AAWFS0816J	v.	Joint Commissioner of Income Tax, Range-I, Allahabad
(Appellant)		(Respondent)

Appellant by:	Mr. Tanmay Sadh, Adv
Respondent by:	Mr. A.K. Singh, Sr. DR
Date of hearing:	05.01.2023
Date of pronouncement:	06.01.2023

ORDER

SHRI VIJAY PAL RAO, JUDICIAL MEMBER:

This appeal by the assessee is directed against the order dated 30.06.2022 of CIT(A) (National Faceless Appeal Centre, Delhi) for the assessment year 2011-12. The assessee has raised the following grounds.

- 1. Because the Ld. CIT (A) has erred in law of facts in rendering any finding or decision with regard to the issue of disallowance of interest on capital of Rs.3,27,465 as so called excess interest paid on capital account of partners.*
- 2. Because the impugned order dated 30.06.2022 passed by the Ld. CIT (A) is clearly illegal and arbitrary to the extent that in para 5.2 of the impugned order dated 30.06.2022 the Ld. CIT(A) has discussed the issue regarding the addition of Rs.3,27,465 on account of payment of excess interest to the partner of the firm, however, the same has not been adjudicated nor any decision with regard to the said issue has been rendered by the CIT(A).*
- 3. Because the Ld. CIT(A) failed to considered that the assessing authority has erred in law and on fact in holding that natural inference of the clause 6 of partnership deed is that the amounts outstanding at the end of the year shall be the amount for calculation of interest @12% which is permissible under Section 40(b) of the Income Tax Act and thereby meeting the said disallowance of interest on capital of Rs.3,27,465 as so called excess interest paid on capital account of partners.*
- 4. Because the Ld. CIT(A) has failed to considered that the appellant has correctly calculated the interest and capital account on daily product basis method which is widely accepted and most appropriate method of calculating interest and has been consistently followed by the appellant firm.*

5. *Because the Ld. CIT(A) has failed to considered that the assessing authority has misinterpreted the clause 6 of the partnership deed which categorically provide for interest @ 12% p.a. or at such maximum rate as may be prescribed under Section 40 (b)(iv) of the Income Tax Act, 1961 or any other applicable provision as may be provided in the income tax act for the assessment of the partnership firm in the relevant accounting period which shall be payable to the partners on the amount outstanding to the credit of the account of the partners. Such interest shall be calculated and credited to the account of each partner at the close of the accounting rate.*
6. *Because Ld. CIT(A) failed to considered that the partnership deed clearly provides calculation of interest on the credit balance appearing to the credit of capital account of the partners and this exercise of calculation of interest shall be made only at the close of the year and to be credit only on the annual interval.*
7. *Because Ld. CIT(A) has erred in directing the assessing officer to verify whether the new partner Shri Devaang Savla was legal heir of the dead partner Shri Chetan Savla and if so may, as per law, to give relief to the appellant firm.*
8. *Because Ld. CIT(A) failed to considered that Shri Devaang Savla was only taken into the firm pursuant to the death of one of the partner Shri Chetan Savla on 05.04.2010 and he is not the legal heir of the deceased partner. Further, the amount of interest of Rs.5,71,172 was paid to the legal heir of the deceased partner who is Mrs. Chhaya Savla and therefore, the same has nothing to do with the newly inserted partner Devaang Savla.”*

2. The issue raised by the assessee in ground nos. 1 to 7 is regarding disallowance made by the AO of Rs. 3,27,465/- on account of excess payment of interest on capital account of the partners of the firm. The assessee is a partnership firm and engaged in the business of Wholesale Trading. The assessee filed revised return of income on 19.11.2011 declaring total income of Rs. 23,53,830/-. The case was selected for scrutiny through CASS. During the scrutiny assessment, the AO raised queries about the payment of interest on capital account of the partners. The Assessing Officer has recorded the facts regarding the number of partners and profit sharing ratio in para no. 3 of the assessment order as under:-

“3. After perusal of books of a/cs, queries raised and submissions made following observations are made

1. *During the year under consideration the partnership was constituted of following partners having their share mentioned against each.*
 - a) Chandra Kant 20%
 - b) Tarun Savla 20%
 - c) Chetan Savla 20%
 - d) Smt. Sangeeta Savla 20%

e) Smt. Chhaya Savla 20%

This partnership is evidenced by the partnership deed dated 01.04.2004. As per clause no. 6 of this deed it is stated- "that the firm shall pay interest at the rate of 12% per annum on the capital contribution of the partners. The rate of interest can be changed by the mutual consent of the partners." No other clause is there in the aforesaid partnership deed for the calculation or allowability of interest to the partners.

On 05-04-2010 unfortunate demise of Sri Chetan Savla occurred as in@dent of robbery took place in his person and he was shot dead in the said incident. Thereafter, partnership was reconstituted w.e.f. 8 April 2010 with following partners with equal share in profit/loss:

- a) Chandra Kant*
- b) Tarun Savla*
- c) Devaang Savla*
- d) Smt Sangeeta Savla*
- e) Smt Chhaya Savla*

*As per clause 6 of this deed interest to the partners shall be allowed as under:
"that interest at the rate of 12% per annum or such maximum rate as may be prescribed under section 40(b) (iv) of the Income Tax Act, 1961 or any other applicable provision as may be enforced in the income tax assessment of the partnership firm in the relevant accounting period shall be payable to the partners on the amount outstanding to the credit of the account of the partners. Such interest shall be calculated and credited to the account of each partner at the close of the accounting year."*

2. *Perusal of the above clauses of the deeds and capital a/cs of the partners following queries were made vide order sheet entry dated 14-02-2014*
- i) Sri Chetan Savia was partner for 5 days only during the year. Therefore, interest on his capital as a partner is allowable only for 5 days i.e. Rs 8193/- and not Rs 12928/-@ 12% p.a.. Therefore please explain as to why Rs 4,735/- should not be disallowed being excess interest debited in p & a/c.*
 - ii) After 05-04-2010, Shri Chetan Savla remains no longer partner of the firm and so he is not entitled for interest as a partner. His deposit has been converted into unsecured loan on 31-03-2011. So as unsecured loan interest is allowable from 01- 04-2011 only. Thus please explain as to why interest debited to p&l a/c and credited to a/c of Sri Chetan Savia amounting to Rs 5,81,781/- should not be disallowed.*
 - iii) You have claimed interest on partner's capital @ 12% on amount credited in partners' capital a/c at the end of the accounting year. Remuneration, Interest and profit share is credited in partners' capital a/c on 31-03-2011. Deducting the said sums from the credit entries, balances in partners' capital a/c at the end of the year comes as under:-*

a) Chandra Kant Savla Rs. 17,28,364/- Cr

b) Sangeeta Savla	Rs. 34,92,002/- Cr
c) Tarun Savla	Rs. 15,54,351/- Cr
d) Devaang Savla	Rs. 2,87,073/- Cr

Interest @ 12% on the above credit balances comes to Rs 2,07,404/-, Rs 4,19,040/ Rs 1,86,522/- & Rs 33,971/- respectively whereas you have credited above partners capital a/c by Rs 2,66,322/-, Rs 5,48,881/-, Rs 3,06,876/- and 52,323/- respectively. In this way you have debited your P&L a/c under this head by a sum of (Rs 58918/+ 1,29,841/+1,20,354/- + 18,352/-) Rs 3,27,465/- more than that was admissible. Please explain as to why Rs 327,465/-should not be disallowed and added towards your income for the year under consideration."

3. Thus, the AO propose to disallow the interest payment of Rs. 3,27,465/- on account of excess payment by calculating interest @ 12% on the credit balance in the capital account as on 31st March, 2011 as against the claim of the assessee for interest payment on the capital account of partners on the basis of the actual period of credit balances in the respective accounts during the year under consideration. Thus, the assessee calculated the interest on the daily product basis whereas the AO took the closing balance in the capital account and re-computed the allowable interest under section 40(b)(iv) of the Income Tax Act read with Clauses of the partnership firm which allows interest payment to the partners @ 12%. The AO has not disputed the fact of demise of one of the partners Sh. Chetan Savla on 5th April, 2010.

4. Aggrieved by the order of the Assessing Officer, the assessee filed the appeal before the CIT(A) but could not succeed on this issue.

5. Before the Tribunal, the learned AR of the assessee has submitted that the AO is not justified in making the disallowance of interest paid on the capital account of the partners by re-calculating the interest on the closing balance as on 31st March, 2011 instead of considering the actual period of credit balance in the capital accounts. The learned AR has further submitted that the interest paid to the partners on capital account @ 12% is as per the terms and conditions of partnership deed as well as the conditions prescribed under section 40(b)(iv) of the Income Tax

Act. Therefore, the payment of interest @ 12% calculated on the basis of the actual period of credit in the respective capital accounts of the partners cannot be disallowed. He has referred to Clause 6 of the partnership deed which provides the payment of interest @ 12% per annum payable to the partners on the amount outstanding to the credit of the account of the partners. The AO has misinterpreted the clause which only provides that the credit of the interest on the capital account of partners will be at the close of the accounting year whereas the AO took it as the interest has to be calculated only on the closing balance in the capital account of the partners. The assessee has been following this method of calculating the interest for past many years and the same has been accepted by the Department in the assessment made in the preceding years. Therefore, this method of calculating the interest on the actual period and balance in the capital account of the partners has been consistently followed by the assessee which was accepted by the AO in the earlier years. He has further submitted that the CIT(A) has directed the AO to verify whether the new partner Sh. Devaang Savla is a legal heir of deceased partner, Sh. Chetan Savla and then decide the issue of claim of interest payment of capital account. The learned AR has pointed out that Sh. Devaang Savla is not a legal heir of Lt. Sh. Chetan Savla, as it is clear from the payment of interest made in respect of the balance in the capital account of Sh. Chetan Savla which was treated as loan and payment was made to Smt. Chhaya Savla, the legal heir of the Lt. Sh. Chetan Savla. He has further pointed out that Sh. Devaang Savla is the son of Sh. Tarun Savla, the another partner of the firm and therefore, this direction of the CIT(A) is without any basis and contrary to the fact. He has referred to para no. 5.2.3 of the CIT(A) and submitted that though the CIT(A) has recorded the relevant facts on this issue but no finding has been given by the CIT(A).

6. On the other hand, the learned DR has submitted that the AO has considered Clause 6 of the partnership deed which provides payment of interest to the partners on the amount outstanding in their capital account and the interest shall be

calculated and credited to account of each partner at the close of accounting year. Therefore, the interest is required to be calculated on the closing balance at the end of the accounting year. He has relied upon the orders of the authorities below.

7. I have considered the rival submissions as well as relevant facts recorded by the AO. The Assessing Officer has disallowed the interest of Rs. 3,27,465/- on account of excess payment to the partners on the capital account. The AO has calculated the interest @ 12% on the closing balance in the partner's capital account as on 31st March, 2011. The AO has supported his decision by referring to the Clause 6 of the partnership deed which reads as under:-

"6. That interest @ 12% per annum or at such maximum rate as may be prescribed under section 40(b)(iv) of the Income Tax Act, 1961 or any other applicable provisions as may be enforced in the Income Tax Assessment of the Partnership Firm in the relevant accounting period shall be payable to the partners on the amount outstanding to the credit of the account of the partners. Such interest shall be calculated and credited to the account of each partner at the close of the accounting year."

8. Thus, it is clear that the partnership deed provides payment of interest @ 12% per annum or any rate applicable as per the provisions of section 40(b)(iv) of the Income Tax Act. It further provides that such interests shall be calculated and credited to the account of the each partner at the close of the accounting year which means that the interest will be credited only at the end of the accounting year / financial year and does not mean that the interest will be calculated on the credit balance in the capital account at the end of the accounting year. Even otherwise the interests on the credit balance in the capital account has to be calculated on the actual duration of the credit remains in the capital account and not on opening or closing day of financial year. In such a case, if a partner keeps a credit balance on the opening day but subsequently withdraws the amount then payment of interest on the opening balance will not be proper and justified. Similarly, if the partner withdraws the amount at the fag end of the financial year then the payment of interest only on the closing balance would also be not proper and justified when a

credit balance remained for the whole financial year except on the last date of financial year. Therefore, the approach of the Assessing Officer in calculating the interest by considering only the closing balance as on the end of the financial year is not proper and justified. Accordingly, so far as the interest calculated by the assessee firm on daily product basis is concerned, the same is proper and justified. The CIT(A) though taken up this issue in para no. 5.2.3 but it was not adjudicated. The said part of the impugned order is as under:-

“5.2.3 All the facts and circumstances related to the impugned addition of Rs. 3,27,465 are duly considered. It is noted that while making the disallowance the Ld. AO observed that the appellant firm have 5 partners with each one having 20% share. On 05.04.2010 after unfortunate demise of one of the partners viz Shri Chetan Savla (who died unfortunately in an incident of robbery in which he was shot dead) partnership deed was reconstituted w.e.f. 08.04.2010 and in place of late Shri Chetan Savla one Devaang Savla was made partner and other 4 partners remain the same. Further, the Ld AO also observed that as per clause 6 of the New Partnership Deed "interest to the partners was to be allowed @ 12 % per annum or such maximus rate as may be prescribed u/s 40 (b) (iv) of the Act or any other applicable provision as may be enforced in the income tax assessment of the partnership firm in the relevant accounting period shall be payable to the partners on the amount outstanding to the credit of the account of the partners. Such interest shall be calculated and credited to the account of each partner at the close of the accounting year.”

9. Thus, the CIT(A) has not adjudicated the issue by giving a concluding finding. However, since the method of calculating the interest by the assessee is a proper and consistently followed year after year therefore, the same cannot be disturbed for the year under consideration. Accordingly, the disallowance made by the AO on account of excess payment of interest to the partners is deleted. The ground no. 1 to 7 of the assessee's appeal are allowed.

10. Ground no. 8 is regarding disallowance of interest paid to the legal heirs of the deceased partners. The Assessing Officer has disallowed the claim of interest payment to the legal heirs of the deceased partners Sh. Chetan Savla in para 3.3 of assessment order as under:-

“3.3. Regarding query no. 2, the assessee's main argument is that the funds remained with the assessee firm and the said fund is utilized by the assessee firm during the period 06-04-10 to 31-03-11 and therefore, legal heir of Shri Chetan Savia are entitled to interest over such amount.. The assessee has also recalculated the interest and admitted that Rs. 10,609/- has been excess claimed. I am not convinced with the argument of the assessee. The interest can be claimed as a deduction as per scheme of the Act. Interest paid to partner is allowed as a deduction as per provisions contained in Sec. 40(b) of the Income Tax Act as per terms of the partnership deed. With effect from 06-04-2010, Shri Chetan Savla no longer remained the partner of the firm and so on his capital remained with the assessee firm, no interest shall be allowed u/s 40(b). Furthermore, interest is allowed as a deduction on borrowed capital u/s 36(1)(ii) of the income Tax Act, 1961. In the case of Madhav Prasad Jatia Vs CIT(1979) 118 ITR 200, their lordships have held that under sec.36(1)(ii) three conditions are required to be satisfied in order to enable the assessee to claim a deduction in respect of interest on borrowed capital, namely.(a) that money(capital) must have been borrowed by the assessee, (b) that it must have been borrowed for the purpose of business, and (c) that the assessee must have paid interest on the said amount and claimed it as deduction. In the instant case, the first ingredient is not fulfilled. The money was capital of erstwhile partner, late shri Chetan Savla lying idle with the assessee firm even after reconstitution of the firm on 08-04-2010 and the said capital has been converted into unsecured loan on 31-03-2011 only. Therefore, the money in question has become borrowed money as on 31-03-11 only and legal heir of late Shri Chetan Savia are entitled for the interest in subsequent year and not in the year under consideration. In Concise Law Dictionary of P. Ramanatha Aiyar. the definition of "Borrowed Money" is given as under:-

"The words "borrowed money" are used to indicate and denote money actually borrowed as a loan in the ordinary sense and not also to indicate and denote money which, though obtained on some other basis and in some other kind of transaction, could be, on the failure of such basis and such transaction, made out to be "borrowed money" in essence and in law. The term "borrowed money" must be construed in its natural and ordinary meaning and implies a real borrowing and a real lending. Lakshmanier & v. Income Tax and Expenses Profits Tax Commissioner, AIR 1953 SC 145, 147. [Excess Profits Tax Act (1940), Sch. II, R.2-A]."

In view of the above discussion I hold that money lying in the capital account of Shri. Chetan Savla after 05.04.2010 is not entitled for any interest. Consequently interest on this account amounting to Rs. 5,81,781/- debited in Profit & loss a/c and claimed as deduction is disallowed and added towards the income of the assessee for the year under consideration."

11. The learned AR of the assessee has submitted that once the partner of the firm expired, he ceases to be a partner and consequently the credit balance in the

capital account of the partner is treated as loan and the interest on such loan is an allowable deduction. The AO has disallowed the claim of the assessee only on the ground that the assessee has passed the entry only on 31st March, 2011 at the end of the financial year transferring the amount from the capital account of Sh. Chetan Savla to the loan account in the name of the legal heirs. He has pointed out that once the partner expired, the credit balance in the capital account gets converted into the loan account and therefore, the interest payment on the said amount is an allowable claim. The CIT(A) has remanded the matter to the AO and also directed to verify the fact whether Sh. Devan Savla was the legal heir of the deceased Sh. Chetan Savla.

12. On the other hand, the learned DR has submitted that the CIT(A) has already directed the AO to consider the claim as per law.

13. I have considered the rival submissions as well as relevant material on record. The CIT(A) has considered this issue in para 5.3.2 to 5.3.5 as under:-

“5.3.2 In this regard, out of submission of the appellant (reproduced entirely in Para no. 4 supra), following points being relevant for adjudication of the impugned addition of Rs. 5,81,781 are as under:-

a) That Money must have been borrowed - It is not disputed that

** Death of partner occurred on 05-04-2010*

** Partnership firm continued as it is without dissolution*

** Amount remained invested with the firm*

** No assets/investments were liquidated so as to interpret that amount firm*

** Legal Heir was entitled to the balance of capital account*

Therefore, immediately after the death of partner till the time the amount due to the legal heir of deceased partner is not returned by the firm, the nature of amount held with the firm is liability as its character has been changed from capital to borrowed fund due to legal heir.

The Ld. AO has also accepted the fact that amount on which interest is claimed will become borrowed fund on 31-03-2011 when the entry in books of account has been passed and interest in question will be allowed in subsequent year and not in the year under consideration,

Thus, the basic question that money is borrowed fund has been addressed now when this money has become borrowed fund on 05-04-2010 or 31-03-2011.

It may be reiterated that entries have been passed on 31-03-2011 only after ascertaining final balance due to deceased partner after the closing book entries were made.

Thus, mere passing of entries on 05-04-2010 or 31-03-2011 will not change the character as the amount was never withdrawn from firm and also that no assets has been liquidated in the re-constituted firm to release the amount of erstwhile capital.

Further immediately after the death of partner the amount does not remain capital then the question arises what is the nature of such amount remaining with the firm Thus, it is submitted that such amount takes the character of loan to be repaid to legal heir of deceased immediately after death and re-constitution of firm and it cannot be denied that money is not borrowed fund.

b) That it must have been borrowed for the purpose of its business:

The money in question was always used for the purposes of business as interest over such amount was always allowed as deduction in the form of interest on partner's capital in previous years and also till 05-04-2010 (date of death).

After the date of death when the money was never withdrawn from firm it cannot be said that it is not used for the purposes of business. No assets have been liquidated and no investments has been sold so the amount was used in business as before the date of death and after also.

c) That the assessee must have paid interest on the said amount and claimed it as deduction.

The amount in dispute is interest claimed as deduction of Rs 5,81,781 this amount has been paid/ credited to the loan account after deduction of TDS u's 194A.

Hence interest is also paid and also such amount has been declared as income and tax paid by legal heir of deceased partner.

5.3.3 All the facts and circumstances related to the impugned addition of Rs. 5,81.781 are duly considered. It is found that Ld. A.O. in his detailed discussion made in the impugned assessment order mixed interest on borrowed capital dealt with in Section 36(1)(iii) and the admissibility of interest paid to partners of a firm which is dealt in Section 40(b)(iv) of the Act.

5.3.4 In light of the entire discussion made from para no. 5.3 to 5.3.3, as above, the impugned addition of Rs. 5,71.172 is not fully sustainable in the facts and in law. The Ld. AO is directed to restrict the addition to the amount to be calculated @ 12% on the balance of partners in the capital account. Moreover, the Ld AO may also verify whether the new partner Shri Devaang Savla was legal heir of the dead partner Shri Chetan Savla and if so may, as per law, give relief to the appellant firm. It is also noted that in the written submission dated 21.02 2014 given during assessment proceedings the Ld A/R of the appellant firm accepted that an amount of Rs. 10,609 was claimed in excess of the admissible amount of interest. This may be kept in view by Ld. AO while recalculating the amount of admissible interest payable to partners.

5.3.5 Subject to the above observation, the Ld. AO is directed to recalculate the admissible interest and restrict to impugned addition of Rs. 5,81,781(after deducting inadmissible amount by the appellant Rs. 10,609, Rs.5,71,172) to that extent and give balance relief to the appellant, as admissible in law and as per the facts of the case. Ground No.2,3&4 are, therefore, partly allowed.”

14. Though the CIT(A) has noted that the mere passing of entry on 5.4.2010 or 31.3.2011 will not change the character as the amount was never withdrawn from the firm. Further, the CIT(A) observed in the impugned order that this payment of interest to the legal heirs does not fall under section 40(b)(iv) of the Income Tax Act and it can be considered under section 36(1)(iii) or section 37 of the Income Tax Act. Since the CIT(A) has no jurisdiction to remand the matter therefore, the impugned order of the CIT(A) *qua* this issue is not in conformity with provisions of section 250 and 251 of the Income Tax Act. Further, the AO has made the disallowance by considering the entries made on 31st March, 2011 without considering the fact that after the death of the partner of the firm this amount ceases to be the credit in the capital account of the partner and consequently takes the character of loan from the deceased partner / legal heirs of the deceased partner. The capital introduced by a partner of the partnership firm is always for business purposes and it is not an amount which is kept with the partnership firm only for earning the interest because it was also the need of the partnership firm for doing the business by utilizing the said amount. Accordingly, the claim of interest paid to the legal heirs on this amount which is in the nature of loan and the interest was already subjected to TDS under section 194A of the Act, the same cannot be disallowed merely on the ground of passing an entry on 31st March, 2011 or on the ground that it is not an loan amount. Accordingly, the impugned order of the CIT(A) is modified and the matter is remanded to the record of the Assessing Officer for re-adjudication of this issue as per law.

15. In the result, the appeal of the assessee is partly allowed.

Order pronounced in the open Court on 06.01.2023 at Allahabad, U.P.

Sd/-
[VIJAY PAL RAO]
JUDICIAL MEMBER

DATED: 06/01/2023

sh

Copy forwarded to:

1. Appellant –
2. Respondent –
3. CIT(A) , Allahabad
4. CIT
5. DR -

By order
Sr. P.S.