IN THE INCOME TAX APPELLATE TRIBUNAL
"A" BENCH: BANGALORE

BEFORE SHRI CHANDRA POOJARI, ACCOUNTANT MEMBER
AND
SHRI ANIKESH BANERJEE, JUDICIAL MEMBER

ITA Nos.1073 to 1075/Bang/2022
Assessment Years: 2013-14 to 2015-16

Century Sheltors No.10/1, Lakshminarayana Complex Palace Road Vasanthnagar Bangalore 560 052 **PAN NO : AAFFC5111R**	**Vs.**	ACIT Circle-2(2) Bangalore
APPELLANT		**RESPONDENT**

ITA Nos.1100 to 1102/Bang/2022
Assessment Years: 2013-14 to 2015-16

Century Silicon City No.10/1, Lakshminarayana Complex Palace Road Vasanthnagar Bangalore 560 052 **PAN NO : AAFFC5112N**	**Vs.**	ACIT Circle-1(2)(1) Bangalore
APPELLANT		**RESPONDENT**

Appellant by	:	Smt. Sheetal Borkar, A.R.
Respondent by	:	Shri K. Sankar Ganesh, D.R.

Date of Hearing	:	02.02.2023
Date of Pronouncement	:	10.03.2023

O R D E R

PER CHANDRA POOJARI, ACCOUNTANT MEMBER:

These appeals by above two assessees for the assessment years 2013-14 to 2015-16 are directed against different orders of CIT(A) wherein issues in both the appeals are common in nature. Hence, they are clubbed together, heard together and disposed of by this common order for the sake of convenience.

1.1 For brevity, we consider grounds in ITA No.1073/Bang/2022 for the AY 2013-14, where there is only change in figures in other appeals, which are reproduced below:

ITA 1073/Bang/2022 (AY 2013-14):

1. *The ld. CIT(A) has erred in confirming the action of Assessing Officer in making the disallowance of Rs.4,80,00,000/- on account of interest on capital paid to the partner.*

2. *The Assessing Officer and the ld. CIT(A) have failed to appreciate that the expenditure on interest payment is for the purpose of business and has been incurred on account of commercial expediency.*

3. *The Assessing Officer and the ld. CIT(A) should have appreciated that the revaluation of assets and consequent credit to the accounts of the retiring partners, as also the payment of interest on capital of the existing partner is in accordance with the accounting principles and in terms of the Partnership Deed.*

4. *The appellant craves leave to add, alter, substitute or delete any or all of the grounds of appeal urged above.*

2. The facts of the case are that the assessees herein are partnership firms in Real Estate business and filed returns of income for these assessment years as follows:

(i) **Century Shelters, Bangalore**:

Sl.No.	Assessment year	Declared income (Loss) (Rs.)	Claim of payment of interest (Rs.)
1.	2013-14	(-)7,31,59,321/-	4,80,00,000/-
2.	2014-15	(-) 8,19,56,557/-	4,89,13,370/-
3.	2015-16	(-) 9,15,43,286/-	5,36,92,085/-
		Total	15,06,05,455/-

(ii) **Century Silicon City, Bangalore**:

Sl.No.	Assessment year	Declared income (Loss) (Rs.)	Claim of payment of interest (Rs.)
1.	2013-14	(-) 19,59,61,563/-	9,13,90,665/-
2.	2014-15	(-) 21,94,64,054/-	11,47,14,845/-
3.	2015-16	(-) 24,58,17,366/-	12,85,55,078/-
		Total	33,46,60,580/-

3. In these cases, assessment orders were framed u/s 143(3) of the Income-tax Act,1961 ['the Act' for short] disallowing the interest on borrowed capital paid to the partners by these firms. While disallowing interest payment, the A.O. enquired with the assessees the necessity of paying such interest to the partners. The assessees herein explained that the said amount was paid as interest on capital to the partner M/s Century Real Estate Holdings Pvt Ltd. The assessee is a partnership firm, constituted on 13.02.2007 to carry on the business of buying, selling and developing immovable property. The partners Shri P. Ashwin Pai and Shri P. Ravindra Pai introduced capital of Rs. 50,000/- each in the firm. The partnership was reconstituted on 28.05.2007 and Shri Ramakrishna was added as new partner to the firm. Shri Ramakrishna contributed the immovable property, owned by him, measuring 1 Acre 20 Guntas as capital to the firm. The value of the property, held by the firm, as per the sale deeds, was Rs

24,00,000/-. The partnership was again reconstituted on 23.06.2008 and the company M/s Century Real Estate Holdings Pvt Ltd *(in which Shri Ravindra Pai and Shri Ashwin Pai are Managing Director and Executive Director respectively)* was added as partners to the firm, along with Shri Dev S. Patel, Shri P. Dayanand Pai and Shri P. Satish Pai. The new partner M/s Century Real Estate Holdings Pvt Ltd. contributed capital of Rs 67 Crore (*approximately)* to the firm. Out of this, an amount of Rs. 40 Crore was transferred to Shri Ashwin Pai and Shri Ravindra Pai, retiring partners. On admission of the new partner, the property held by the firm was revalued at Rs 40,40,06,650/-. There was no actual increase in the value of the asset in the market.

3.1 The AO has noted that the assets of the partnership firm were revalued so as to facilitate the transfer of the amount brought in as capital by the new partner M/s Century Real Estate Holdings Pvt Ltd to the retiring partners Shri Ashwin Pai and Shri Ravindra Pai, who are also the Directors in the said company. Thus, the assessee firm was used as a conduit to transfer the money from M/s Century Real Estate Holdings Pvt Ltd to its Directors Shri Ashwin Pai and Shri Ravindra Pai. The payment of interest by the firm to the retired partners was a colourable device to transfer the money and also reduce tax liability in the hands of the firm. AO has also taken note of the fact that a firm and its partners are separate entities for the purpose of taxation; and therefore, regardless of an amount being offered as income in the hands of partners, an expenditure not allowable in the hands of the firm has to be disallowed. On these facts, AO has found that this amount of Rs.40 Crore which was transferred to the retiring

partners, has not been utilized wholly and exclusively for the purpose of the business. Therefore, the proportionate interest of Rs 4,80,00,000/- on the said capital cannot be said to be incurred wholly and exclusively for the purpose of business. Therefore, AO has held that the interest expenditure of Rs 4,80,00,000/- was not allowable, under section 37(1) or section 36(1)(iii), as the expenditure was not laid out wholly and exclusively for the purpose of business.

3.2 Same is the position in the case of M/s. Century Silicon City, Bangalore. Against this, assessees carried on appeals before the ld. CIT(A) in all these assessment years. The ld. CIT(A) observed that there is no economic rationale for the transfer of sum of Rs. 20 Crore each by the assessee firm to the retiring partners. The transaction has been arranged only with a view to transfer the total amount of Rs 40 Crore from the company M/s Century Real Estate Holdings Pvt Ltd. to its Directors, Shri P. Ravindra Pai and Shri P. Ashwin Pai, who are also the retired partners, by using the assessee firm as a conduit. The ld. CIT(A) observed that there are certain glaring discrepancies, in the facts noted above, which add credence to this conclusion, -

(i) The immovable properties are vacant pieces of land, vested with the assessee firm with book value of Rs. 24,00,000/-. As per the valuation Report, the properties were revalued at Rs 40,40,03,490/- as on 01.04.2010. Thus, there was an increase of Rs. 40 Crore (*approximately)* in value of the assets held by the firm. Against this increase on asset side, an equivalent amount of Rs.40 Crore was credited to the Revaluation account of the assessee firm, as on the date of

revaluation i.e. 01.04.2010. Thereafter, this amount was transferred to the capital accounts of Shri P. Ravindra Pai and Shri P. Ashwin Pai only, in equal ratio, i.e. Rs 20 Crore each. However, as on 01.04.2010, the assessee firm had seven partners namely Shri P. Ravindra Pai, Shri P. Ashwin Pai, M/s Century Real Estate Holdings Pvt Ltd., Shri A. Ramkrishna, Mr Dev S Patel, Mr Dayananda Pai and Mr P Satish Pai. Their shares in profits of the firm were 23%, 22%, 51%, 1%, 1%, 1% and 1% respectively, as per the deed of reconstitution dated 23.06.2008. An increase in value of assets on revaluation is in the nature of an unrealised gain in the hands of the assessee firm. As per applicable accounting standards, the net increase in value of assets is credited to the Revaluation Account and thereafter transferred to the capital account of all partners, including retiring or deceased partners, in their old profit sharing ratio. Therefore, in the instant case, the amount of Rs 40 Crore was required to be transferred from the Revaluation account to the capital account of all seven partners of the firm in the profit sharing ratio fixed as per the existing partnership deed, and not only to the accounts of Shri P. Ravindra Pai, Shri P. Ashwin Pai.

(ii) The purpose of said revaluation, as stated in the valuation report, was to assess the Fair Market Value of the properties. However, the fact remains that both the properties, being vacant pieces of land, continued to remain vested with the firm even long after such revaluation. There appears to be no rationale for such

revaluation of vacant land, when there was no plan, either in the near future or on long term, to sell the land or develop any residential or commercial project thereon.

(iii) Shri A. Ramkrishna had contributed one of the residentially converted immovable property *(bearing Survey No 107/2 and Survey No 116/2 totally measuring 1 Acre 20 Gunthas)* as capital to the assessee firm. However, it is ironical that upon revaluation of the properties vested with the firm *(which included the property contributed by Shri A. Ramkrishna),* no amount from the Revaluation account was transferred to the current or capital account of Shri A. Ramkrishna, though he was continuing as partner to the firm as on the date of revaluation.

(iv) The revaluation of properties was done on 01.04.2010. In the same Financial Year 2010-11, five partners of the firm, namely Shri P. Ravindra Pai, Shri P. Ashwin Pai, Shri Dev S Patel, Shri Dayananda Pai and Shri P Satish Pai retired from the partnership, as per the reconstitution and retirement deed dated 18.01.2011. However, the gains of Rs 40 Crore arising on Revaluation were transferred to the capital accounts of Shri P. Ravindra Pai and Shri P. Ashwin Pai only (*in equal ratio),* and not to other retiring partners.

(v) Shri P. Ravindra Pai and Shri P. Ashwin Pai are also the Directors in the company M/s Century Real Estate

Holdings Pvt Ltd, which is the majority stake holder in the assessee firm. It is holding 51% in the firm, as on the date of revaluation, and 99% after the retirement of other partners. This company has brought in a capital of Rs. 67 Crore approximately, out of which Rs. 20 Crore each has been transferred to the accounts of Shri P. Ravindra Pai and Shri P. Ashwin Pai, on retirement, against the capital outstanding in their accounts, comprising the introductory capital of Rs 50,000/- each and amount of Rs 20 Crore each credited on Revaluation. Thus, in effect, an amount of Rs 20 Crore has been transferred to the two Directors from the said company, routing the same through the assessee firm as capital. Had the same amount been transferred to the Directors from the company in the form of loan or advance etc., the same would have been taxed as deemed dividend under the provisions of section 2(22)(e) of the Act.

3.3 In view of the above, the ld. CIT(A) found considerable force in the view taken by the AO that the impugned transaction is only a colourable device, by way of which the total amount of Rs 40 Crore has been transferred to Shri P. Ravindra Pai and Shri P. Ashwin Pai *(the retiring partners),* from the company M/s Century Real Estate Holdings Pvt Ltd *(in which the retiring partners are Directors),* using the assessee firm as a conduit. The transaction has been so arranged with the twin objective of reducing the tax liability in the hands of the assessee firm *(by claiming deduction of interest on capital)* as also avoiding incidence of Dividend

Distribution Tax (DDT) in the hands of the company *(in respect of deemed dividend under section 2(22)(e)).*

3.4 The ld. CIT(A) observed that the distinction between legitimate tax planning and use of colourable devices has been summed up by Hon'ble Supreme Court, in the landmark judgement delivered by five-judge bench in case of **Mc Dowell and Company Ltd Vs CTO** (1985) (154 ITR 148) (SC), in following words (per the judgement authored by Justice Ranganath Misra), -

> *"Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges."*

3.5 The ld. CIT(A) further observed that Justice Chinnappa Reddy, while concurring with the judgement proposed to be delivered by Justice Ranganath Misra in the aforesaid case, has also made very pertinent observations regarding the consequences of tax avoidance and duty of Courts to intervene therein;-

> *"The evil consequence of tax avoidance are manifold: (i) there is substantial loss of much needed public revenue particularly in a welfare State like ours; (ii) there is the serious disturbance caused to the economy of the country by the piling up of mountains of black money directly causing inflation; (iii) there is "the large hidden loss" to the community by some of the best brains in the country being involved in the perpetual war waged between the tax avoider and his expert team of advisers, lawyers and accountants on the side and the tax-gatherer and his perhaps not so skillful, advisers on the other side: (iv) there is the sense of injustice and inequality which tax avoid ancearouses in the breasts of those who are unwilling or unable to profit by it and (v) last but not least is the ethics (to be precise, the lack of it) of transferring the burden of tax liability to the shoulders of the guideless, good citizens from those of the "artful doggers"....*

We now live in a welfare state whose financial needs. if backed by the law, have to be respected and met. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that It stands on no less moral plane than honest payment of taxation. The proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax. and whether the transaction is such that the judicial process may accord its approval to it....

It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is upto the Court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of 'emerging' techniques of interpretation, to expose the devices for what they really are and to refuse to give Judicial benediction,

3.6 The ld. CIT(A) further observed that the assessee has also taken a plea that the admissibility of interest paid to partners of the firm was governed by specific provisions of section 40(b)(iv) of the Act and therefore the same could not be disallowed in terms of section 36(1)(iii) of the Act. The contention of the assessee is based on a wrong appreciation of statutory provisions, as applicable on facts of the case. In this regard, the ld. CIT(A) briefly analysed the relevant statutory provisions. Section 30 to Section 38 provide for various deduction while computing the income under the head profits or gains from business or profession. Section 40 is an overriding section, which provides that notwithstanding anything contained in section 30 to section 38, certain specified amounts shall not be deductible in computing income under the head profits or gains from business or profession. In particular, clause (b) of section 40 provides that any payment of interest,

bonus, commission, remuneration etc. shall not be deductible if the same is paid to a nonworking partner, or not authorized by the partnership deed, or relates to some other period, or exceeds certain prescribed monetary limit etc. The issue at hand in the instant case is the admissibility or otherwise of interest expenditure on capital in the hands of partnership firm. It is clear from the overall scheme of the provisions under Chapter IV (Computation of Business Income) that the claim of deduction of interest on capital has to be examined first under the specific provisions of section 36(1)(iii), and then under the residuary provisions of section 37. In the event that the interest expenditure *per se* is found to be admissible under any of these provisions, then, in the case of partnership firms, it has to further found whether the claim is not expressly inadmissible, either in whole or in part, by virtue of applicability of clause (b) of section 40. Therefore, it is not correct to state that admissibility of interest to partners of firm is governed by section 40b, and therefore the same cannot be disallowed under section 36(1)(iii). Section 40 is not a standalone section, it has to be read with section 30 to section 38.

3.7 The ld. CIT(A) observed that this issue came up for adjudication before the Hon'ble Supreme Court in the case of **Munjal Sales Corporation Vs CIT** (2008) (298 ITR 298) (SC). The legal position on this issue has been succinctly summed up by Hon'ble Supreme Court in the aforesaid case, as under,-

> *"ISSUE*
>
> *13. Whether the claim for special deduction made by the assessee exclusively came only under Section 40(b)(iv) and that it never came under Section 36(1)(iii) of the 1961 Act as argued on behalf of the assessee?*

Legal Position Explained

14. Before enactment of FA 1992, broadly speaking, payment of interest by the firm to any partner of the firm constituted Business Disallowance per se. After FA 1992, Section 40(b)(iv) of the 1961 Act places limitations on the deductions under Sections 30 to 38. Prior to FA 1992, payment of interest to the partner was an item of Business Disallowance. However, after FA 1992 the said Section 40(b) puts limitations on the deductions under Sections 30 to 38 from which it follows that Section 40 is not a stand-alone section. Section 40, before and after FA 1992, has remained the same in the sense that it begins with a non-obstante clause. It starts with the words "Notwithstanding anything to the contrary in Sections 30 to 38" which shows that even if an expenditure or allowance comes within the purview of Sections 30 to 38 of the 1961, the assessee could lose the benefit of deduction if the case falls under Section 40. In other words, every assessee including a firm has to establish, in the first instance, its right to claim deduction under one of the sections between Sections 30 to 38 and in the case of the firm if it claims special deduction it has also to prove that it is not disentitled to claim deduction by reason of applicability of Section 40(b)(iv). Therefore, in the present case, the assessee was required to establish in the first instance that it was entitled to claim deduction under Section 36(1)(iii) and that it was not disentitled to claim such deduction on account of applicability of Section 40(b)(iv). It is important to note that Section 36(1) refers to Other Deductions whereas Section 40 comes under the heading Amounts not Deductible. Therefore, Sections 30 to 38 are Other Deductions whereas Section 40 is a limitation on that deduction. It is important to note that Section 28 to 43C essentially deal with Business Income. Sections 30 to 38 deal with Deductions. Sections 40A and 438 deal with Business Disallowances. Keeping in mind the said scheme the position is that Sections 30 to 38 are deductions which are limited by Section 40. Therefore, even if an assessee is entitled to deduction under Section 36(1)(iii), the assessee(firm) will not be entitled to claim deduction for interest payment exceeding 18/12% per se. This is because Section 40(b)(iv) puts a limitation on the amount of deduction under Section 36(1)(iii).

15. It is vehemently urged on behalf of the assessee that partner's capital is not a loan or borrowing in the hand of a firm. According to the assessee, Section 40(b)(iv) applies to partner's capital whereas Section 36(1)(iii) applies to loan/borrowing. Conceptually, the position may be correct but we are concerned

with the scheme of Chapter IV-D. After the enactment of FA 1992, Section 40(b)(iv) was brought to the statute book not only to avoid double taxation but also to bring on par different assesses in the matter of assessment. Therefore, the assessee-firm, in the present case, was required to prove that it was entitled to claim deduction for payment of interest on capital borrowed under Section 36(1)(iii) and that it was not disentitled under Section 40(b)(iv). There is one more way of answering the above contention. Section 36(1)(iii) and Section 40(b)(iv) both deal with payment of interest by the firm for which deduction could be claimed, therefore, keeping in mind the scheme of Chapter IV-D every assessee who claims deduction under Sections 30 to 38 is also requires to establish that it is not disentitled under Section 40. It is in this respect that we have stated that the object of Section 40 is to put limitation on the amount of deduction which the assessee is entitled to under Sections 30 to 38. In our view, ***Section 40 is a corollary to Sections 30 to 38 and, therefore, Section 40 is not a stand-alone section. "***

3.8 Furthermore, the ld. CIT(A) observed that the assessee has taken another legal plea that in the light of specific provisions of section 28(v) of the Act, where any interest etc. has not been allowed as deduction in the hands of firm; income by way of interest etc. received by partner of the firm has to be adjusted accordingly. In this regard, the ld. CIT(A) referred to the relevant provisions. Section 28(v) provides that any income by way of interest, salary, bonus etc. received by a partner from the partnership firm shall be chargeable to tax under the head profits and gains from business or profession. The provisions are reproduced as under, -

"28(v) any interest, salary, bonus, commission or remuneration, by whatever name called. due to, or received by, a partner of affirm from such firm:

Provided that where any interest, salary, bonus, commission or remuneration. by whatever name called, or any part thereof ***has not been allowed to be deducted under clause (b) of section***

40, *the income under this clause shall be adjusted to the extent of the amount not so allowed to be deducted."*

3.9 Thus, the ld. CIT(A) observed that it is evident on a plain reading, that the proviso to section 28(v) would only apply where any interest etc. has been disallowed in the hands of the partnership firm, by virtue of applicability of clause (b) of section 40. In the instant case, proportionate interest expenditure on capital has been disallowed in the hands of the partnership firm, to the extent the capital was not utilized for business purpose, both under the specific provisions of section 36(1)(iii) and general provisions of section 37. Therefore, no corresponding adjustment of interest income assessable in the hands of partners of the firm is permissible in the instant case, as the disallowance of interest has not been made under clause (b) of section 40 and as such, proviso to section 28(v) does not apply. This view has been upheld by ITAT, Ahmedabad Bench in case of **Shankar Chemicals Works Vs ACIT** (2011)(12 taxmann.com 461)(Ahmedabad-Trib.). The relevant part of the judgement is reproduced as under, -

"From the proviso to section 28(v), it is seen that if there is any disallowance of interest in the hands of the firm due to clause (b) of section 40. income in the hands of the partner has to be adjusted to the extent of the amount not so allowed to be deducted in the hands of the firm. Hence, it is seen that the operation of the proviso to section 28(v) will come into play only if there is some disallowance in the hands of the firm under clause (b) of section 40 but in the instant case, the disallowance is under section 14A and not under section 40(b) and, therefore. the proviso to section 28(v) is not applicable and the partner of the firm did not deserve any relief on this account."

3.10 In view of the facts and circumstances of the case `and the prevailing position of law applicable on such facts, as discussed

in the preceding paragraphs, the ld. CIT(A) observed that the disallowance of sum of Rs 4,80,00,000/-, **being proportionate interest paid on capital not utilized for the purpose of business** has been correctly made by the AO and does not call for any interference. Accordingly, the total disallowance of Rs 4,80,00,000/-made by the AO on this account was confirmed and all the grounds of appeal urged by the assessee were **dismissed by** the ld. CIT(A)**.** Similar is the position in all other appeals. Against this now assessees are in appeals before us.

4. We have heard the rival submissions and perused the materials available on record. In the case of Century Sheltors, this firm was constituted on 13.2.2007 with Shri P. Ashwin Pai and P. Ravindra Pai as its partners. The partnership was constituted to carry on the business of buying, selling and developing immovable property. On 28/05/2007 the firm was reconstituted in which Shri. A. Ramakrishna was inducted as the new partner. The new partner brought in his immovable property as his share of capital. The partnership was again reconstituted on 23-06-2008 in which M/s Century Real Estate holdings Pvt. Ltd., Shri. Dev S. Patil, Shri. P. Dayanand Pai and Shri. P. Satish Pai were inducted as a new partner M/s CREHPL brought in capital of Rs. 67 crores.

4.1 Further, in the case of M/s. Century Silicon City, this firm was constituted on 21.3.2007 with Shri P. Ashwin Pai and Shri. P. Ravindra Pai as partner. The partnership was constituted to carry on the business of buying, selling and developing immovable property. On 07/08/2007 the firm was reconstituted with the

retirement of Shri. Ashwin Pai and induction of M/s Century real estate holdings Pvt. Ltd. as the new partner. The new partner brought in capital, on which interest at 12% was paid as authorised by the partnership deed. This interest has been disallowed by lower authorities.

4.2 According to the assessing officer interest paid is not for business purpose. He made this observation without appreciating that interest paid to partners i.e M/s Century Real Estate holdings Pvt. Ltd. is for the business purpose since the same is authorised by sec 40(b)(iv) of Income tax act and was incorporated by Finance Act 1992 and said section puts limitation on the deduction under section 30 to 38 therefore same cannot be disallowed in any other sec that is 36(i)(iii) or sec 37 of the Act and further sec 40 is an overriding section which provides that notwithstanding anything contained in sec 30 to sec 38. Hence clause (b) of the sec 40 provides that any payment of interest, bonus, remuneration etc. shall be deductible if following conditions are satisfied and further to allow the payment of interest.

a) It should be authorized by the partnership deed.
b) It should not pertain to a period prior to partnership deed.
c) It should not exceed the permissible limit.

4.3 Same is the position in the case of M/s. Century Silicon City for the assessment year 2013-14, 2014-15 and 2015-16. Now the contention of ld. AR is that this payment has been made in the course of business for the purpose of carrying out the business of the assessee. Now the question that arises for our consideration is whether payment of interest by these two partnership firms towards use of partners' capital is in the nature of "expenditure" or not for the purpose of section 36(1)(iii) read with section 40(b) of the Act or

whether interest payment is allowable under the provisions of the Income Tax Act.

4.4 In order to adjudicate this legal issue, we need to appreciate the nuances of the scheme of the taxation. We note that prior to the amendment of taxation laws from assessment year 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) of the Act to enable the firm to claim deduction of interest out go payable to partners on the respective capital subject to some upper limits. Hence, as per the present scheme of taxation, the interest payment of partners' capital in essence is not treated as allowable business expenditure except for the deduction available u/s 40(b) of the Act.

4.5 Ostensibly w.e.f. assessment year 1993-94, partnership firms complying with the statutory requirements and as such are allowed deduction in respect of interest to partners subject to 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 u/s 28(v) of the Act towards 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 the entities other than partners. In this context, we also note that under proviso to section 28(v) of the Act, the disallowance of such interest is only in reference to section 40(b) of the Act and not u/s 36(1)(iii) or 37 of the Act. This also gives a clue that deduction towards interest is regulated only u/s 40(b) of the Act and deduction of such interest to partners is out of the purview of section 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) of the Act as referred herein above 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 is paid to partners remains distribution of business income.

4.6 Relevant here to refer decision of Hon'ble Supreme Court in the case of CIT Vs. R.M. Chidambaram (1977) 106 ITR 292 (SC), wherein held as under:

"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 u/s. 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 u/s. 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."

4.7 As noted, as per the scheme of Act, the interest paid by the firm and claimed as a 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 do not have separate legal personalities under the basic law as discussed. The interest paid to partners and simultaneously getting subject to

taxation in the hands of its partners is merely in the nature of contra items in the hands of firm and the 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 the partners put together. Thus, interest paid to the partners if allowed as a deduction in the hands of assessee's firms does not lead to any loss in revenue to the department as the same was taxable in the hands of the partners. In view of the inherent mutuality, when the partnership firm and its partners are seen holistically and in combined manner, the payment of interest to partners and its allowability in the hands of the partners does not lead to deriving of any additional advantage by a firm since the same interest is taxable in the hands of the partners simultaneously. Being so, in our opinion, the interest payment to partners by these firms to be allowed as a deduction while computing the income of these firms. However, the same shall be limited to the extent of allowability u/s 40(b) of the Act.

4.8.

(a) In the present case, it is admitted fact that in the case of M/s. Century Sheltors vide Deed of Reconstitution of Partnership dated 23.6.2008, clause No.14 reads as follows:

"Clause 14. The partners shall be paid such other remuneration, interest and commission as may be mutually agreed to upon by the parties time to time."

(b) Vide deed of Reconstitution and Retirement of partnership dated 18.1.2011, clause no.13 reads as follows:

"Clause 13. The partners shall be paid such other remuneration, interest and commission as may be mutually agreed to upon by the parties time to time."

4.9.

(a) In case of M/s. Century Silicon City, the partnership deed dated 21.3.2007 clause no.15 reads as follows:

"Clause 15. In all matters not expressly provided for herein, the provisions of the Partnership Act, 1932 shall apply."

(b) The deed of Retirement of Reconstitution of partnership dated 7.8.2007 clause no.15 reads as follows:

"Clause 15. The partners shall be paid such other remuneration, salary as may be mutually agreed to upon by the partners from time to time.

*(c) "Clause 21. **In** clause in the partnership deed may be varied with mutual consent of all the parties."*

(d) Consequent to this, the assessee firm passed the following resolution **of First deed** on First day of April, 2010, which reads as follows:

We the Partners of **M/S. CENTURY SILICON CITY** do hereby on this the **1st day of April, 2010** mutually agree as follows:

- The Managing Partner may charge an interest upto 12% p.a. or as may be mutually agreed from time to time between all the Partners on the investments (current and capital account balances) made by the Managing Partner into the Firm.
- The interest shall be paid/accrued on yearly basis and no TDS is deductable as per Section 194A (3) IV of Income Tax Act, 1961.
- The Profit/Loss earned from the operations of the partnership firm shall be retained in the "Profit/(Loss) Account" in the Firm and shall not be transferred to Partners' Capital Account / current account till the time the project achieves 75% of total sales (in terms of units) or as may be mutually agreed by the Partners from time to time. The profit / loss earned by the firm does not accrue to the partners till such time the same is credited / debited to their capital / current account.
- In case of reconstitution of the Firm, the balance lying in Profit and Loss Account will be transferred to Partners' Capital /current account in the Profit/Loss ratio existing before the Reconstitution.

For CENTURY REAL ESTATE HOLDING PRIVATE LIMITED

(M.S. MAHADEVAIAH)
PARTNER

DIRECTOR
PARTNER

Century Real Estate Holding Pvt. Ltd. Bangalore

(H.YESHWANT SHENOY)
PARTNER

(K.N. YELLAPPA)
PARTNER

(e) On the basis of above Resolution, M/s. Century Silicon City has paid the interest to partners in these assessment years. Section 40(b) of the Act reads as follows:"

"In the case of any firm assessable as such—

(i) Any payment of salary, bonus, commission or remuneration, by whatever name called (hereinafter referred to as "remuneration") to any partner who is not a working partner; or

(ii) Any payment of remuneration to any partner who is a working partner, or of interest to any partner, which, in either case, is not authorized by, or is not in accordance with, the terms of the partnership deed; or

(iii) Any payment of remuneration to any partner who is a working partner, or of interest to any partner, which, in either case, is authorized by, and is in accordance with, the terms of the partnership deed, but which relates to any period (falling prior to the date of such partnership deed) for which such payment was not authorized by, or is not in accordance with, any earlier partnership deed, so, however, that the period of authorization for such payment by any earlier partnership deed does not cover any period prior to the date of such earlier partnership deed; or

(iv) Any payment of interest to any partner which is authorized by, and is in accordance with, the terms of the partnership deed and relates to any period falling after the date of such partnership deed in so far as such amount exceeds the amount calculated at the rate of [twelve] per cent simple interest per annum; or

(v) Any payment of remuneration to any partner who is a working partner, which is authorized by, and is in accordance with, the terms of the partnership deed and relates to any period falling after the date of such partnership deed in so far as the amount of such payment to all the partners during the previous year exceeds the aggregate amount computed as hereunder:-

(a) on the first Rs.3,00,000 of the book profit or in case of a loss	*Rs.1,50,000 or at the rate of 90 per cent of the book profit, whichever is more;*
(b) on the balance of the book profit	*at the rate of 60 per cent:]*

4.10 Being so, the payment of interest to these partners by these firms was duly authorised by the partnership deed or Resolution mutually passed by the partners of that firm M/s. Century Silicon City Ltd. Hence, it cannot be said that the payment of interest is without any authority, however, it should be limited to the rate of interest at 12% p.a. as prescribed in section 40(b)(iv) of the Act. If it is paid within that limit, the interest paid to the partners by these firms respectively to be allowed as a deduction in computing the income of these assessees. Further, it has to be noted that the interest has been paid to the partners by these two firms on the opening balance standing at the beginning of the each assessment year and the quantification of the amount of respective partners of these firms are quantified not in these assessment years under consideration and which has been quantified when they brought in

the capital to the firm either in cash or kind. As held by the jurisdictional High Court in the case of CIT Vs. Sridev Enterprises cited (supra) that status of the amount standing as outstanding on the first day of accounting year is the amount that stood outstanding on the last day of the previous accounting year; therefore, its nature and status cannot be different on the first day of current accounting year, from its nature and status as on the last day of previous accounting year. In the present case, in the assessment years 2011-12, 2012-13, 2016-17 and 2017-18 has been allowed. The same cannot be questioned in the assessment years 2013-14 to 2015-16. Similarly, in the case of M/s. Century Silicon City it has been allowed in the assessment years 2012-13, 2016-17 & 2017-18. Hence, it cannot be questioned in the assessment years 2013-14 to 2015-16 and the revenue cannot be allowed to take different view in different assessment year as the judicial discipline requires consistency in these proceedings. On this count also, this disallowance is not justified.

4.11 Further, the lower authorities have applied the ratio laid down in the case of Mc Dowell and Company Ltd. Vs. CTO (1985) 154 ITR 148) (SC) for the proposition that assessee has evaded the tax by deliberately manipulating the accounts, which is illegal and unfair. This contention of the lower authorities, which is not based on any corroborative materials in the assessment years under consideration as the interest paid to partners by these two firms on the opening outstanding balance brought forward from earlier previous years and the quantification of principal amount has not been doubted or questioned by income tax authorities when the transaction was took place. Being so, the payment of interest on opening balance of outstanding capital account i.e. (principal amount) in these

assessment years cannot be doubted to say that it is a deliberate manipulation in accounts with illegal means so as to evade tax liability.

4.12 The ld. D.R. relied on judgement in the case of M/s. Shankar Chemicals Works, Ahmedabad cited (supra). This case law cannot be applied to the facts of the present case since in the case on our hand, the disallowance was made on account of interest payment on capital brought in by the partners. On the other hand, in the case of M/s. Shankar Chemicals Works, the assessee challenged the disallowance of expenditure incurred in relation to earning of exempted dividend income and taken a plea that the assessee has paid interest to its depositors from whom the deposits were obtained in earlier years where there was no investments by the assessee. Therefore, the interest paid to deposit is not in relation to dividend income. Answering this issue raised by the assessee, the Tribunal held that:

"if any expenditure has been incurred for earning exempt income, the same has to be disallowed even if there is no actual earning of any exempt income. If interest-bearing borrowed funds are utilized for the purpose of investment in shares and there is no receipt of dividend income or if there is only meagre amount of dividend income, even then, the whole amount of interest expenditure incurred for this purpose will be subject to disallowance under section 14A of the Act because the same has been incurred for earning exempt income. Hence, the actual earning of exempt income is not relevant. In the earlier period, when dividend income was not exempt, interest expenditure incurred on borrowed funds used for investment in shares was held to be fully allowable expenses, even if, there was no actual receipt of dividend or insufficient/meagre amount of dividend income. The logic was that the entire expenditure has been incurred for earning taxable dividend income and hence, it is allowable, even if there is nil or small amount of dividend income and hence, it is allowable, even if there is nil or small amount of dividend income. This aspect has been approved by various courts and hence, the same judgement supports this view also that even in case of 'nil' or small amount of dividend income, the entire interest expenditure incurred for making investment in shares is to be considered as expenditure incurred for earning exempt income and the same has to be disallowed under section 14A of the Act. Hence, this plea is also rejected."

Being so, the ratio laid down in the case of M/s. Shankar Chemical Works cited (supra) have no application to the facts of the present case.

4.13 One more contention of the ld. Counsel for the assessee is that if at all any disallowance has to be made in the hands of the firm, the same cannot be taxed in the hands of concerned partners. In this regard, she drew our attention to the section 28(v) of the Act, which reads as follows:-

> *"28.(v) any interest, salary, bonus, commission or remuneration, by whatever name called, due to, or received by, a partner of a firm from such firm:*
>
> *Provided that where any interest, salary, bonus, commission or remuneration, by whatever name called, or any part thereof has not been allowed to be deducted under clause (b) of section 40, the income under this clause shall be adjusted to the extent of the amount not so allowed to be deducted"*

4.14 From the above proviso to section 28 (v) of the Act, it is seen that if there is any disallowance of interest in the hands of the firm due to clause (b) of section 40, income in the hands of the partner has to be adjusted to the extent of the amount not so allowed to be deducted in the hands of the firm. Hence, it is seen that the operation of the proviso to section 28(v) of the Act will come into play only if there is some disallowance in the hands of the firm under clause (b) of section 40 of the Act.

4.15 In our opinion, the argument of the ld. A.R. is justified. Therefore, on this count also, we are of the opinion that since the amount has been taxed in the hands of partners u/s 28(v) of the Act same to be allowed in the hands of the assessee u/s 40(b) of the Act, otherwise it amounts to double taxation.

4.16 In the present case, it is not the case of either of the parties' interest payment is not exceeding the limit provided in section 40(b) of the Act. Hence, we direct the AO to allow the deduction to the extent of limit prescribed in section 40(b) of the Act. It is needless to mention herein that what is allowed in the hands of these assessees u/s 40(b)(iv) of the Act as a deduction, same to be taxed in the hands of the respective partners u/s 28(v) of the Act. In view of the above, we allow the grounds of appeals raised by both the assessees. Ordered accordingly.

5. In the result, the appeals of the assessees are allowed.

Order pronounced in the open court on 10th Mar, 2023

Sd/-	**Sd/-**
(Anikesh Banerjee)	**(Chandra Poojari)**
Judicial Member	**Accountant Member**

Bangalore,
Dated 10th Mar, 2023.
VG/SPS
Copy to:

1. The Applicant
2. The Respondent
3. The CIT
4. The CIT(A)
5. The DR, ITAT, Bangalore.
6. Guard file

By order

Asst. Registrar,
ITAT, Bangalore