

**IN THE INCOME TAX APPELLATE TRIBUNAL  
LUCKNOW BENCH 'A', LUCKNOW**

**BEFORE SHRI SUDHANSHU SRIVASTAVA, JUDICIAL MEMBER  
AND SHRI ANADEE NATH MISSHRA, ACCOUNTANT MEMBER**

I.T.A. No.1288/Lkw/1993  
Assessment Year: 2090-91

M/s Rajkumar Singh & Co., 5, Park Road, Lucknow. (Appellant)	Vs.	Dy.C.I.T., Special Range-II, Lucknow. (Respondent)
---	-----	---

Appellant by	Shri B. P. Yadav, Advocate
Respondent by	Shri Gaysuddin, CIT (D.R.)

**ORDER**

**PER ANADEE NATH MISSHRA:A.M.**

(A) In this case assessment order dated 30/12/1992 was passed by the Assessing Officer whereby the assessee's total income was determined at Rs.4,74,81,785/- as against the returned income of Rs.2,34,68,130/-. The dispute in the present appeal before us pertains to disallowance of interest amounting to Rs.1,58,01,118/-. The entire claim of interest of Rs.1,58,01,118/- was disallowed by the Assessing Officer on the ground that the partners of the assessee firm had withdrawn heavy amounts and utilized for their private purposes, without paying any interest to the assessee firm. The relevant portion of the assessment order is reproduced below:

"5.1 During the year the assessee firm has claimed an expenditure of Rs.1,58,01,118/- on interest as follows:

(i)	M/s Jaiprakash Associates (a division of Jaiprakash Industries Ltd.) @15% per annum	3,65,459
(ii)	Jai Prakash Enterprises @18%	9,20,080
(iii)	M/s Friends Construction Corporation @25% per annum	66,47,653
(iv)	Interest paid to 303 depositors @24% per annum	78,67,926
		----- 1,58,01,118

Out of these 303 depositors 35 depositors are fresh. In some cases of old depositors, further deposits have been received whereas in some cases old deposits have been re-paid fully or in part. As per audit report, 49 depositors are the relatives of the partners and 12 are directors/relatives of Directors of M/s Sidharth Construction Co. which is a partner in the assessee firm. A further scrutiny of the depositors, names and addresses indicated that most of these depositors are connected directly or indirectly with the directors/partners of this firm or connected company/concerns. The deposits have been received regularly throughout the year in different amounts varying from Rs.5,000/- onwards. The total amount of un-secured loans shown in the balance sheet stands at Rs.6,32,67,421/-.

5.2 On the liability side of the balance sheet, partner's capital accounts reflect credit balances of R.20,75,16,624/- as against Rs.9,89,96,467/- during immediately preceding year. The increase in the credit balances is mainly due to conversion of its investments into stock in trade by the assessee at market price on 1.1.90 resulting into surplus of Rs.11,68,08,126/-. This surplus has been credited into partners capital account. Further scrutiny of the partners accounts for earlier years revealed that similar surpluses were credited into the partners accounts in the past as under:-

- (i) *Goodwill of Rs. 35,00,000/- was created in the year 1981 and was credited in the partners a/c of the firm;*
- (ii) *A surplus of Rs.1,12,40,729/- arose because of machinery revaluation on 1.8.1984 which was credited to the account of the partners.*
- (iii) *A surplus of Rs.12,87,58,000/- arose out of the revaluation of equity shares of M/s Jaiprakash Industries Ltd. held by the firm on 31/03/87 and was credited into partners account. Total amount of surplus so credited in the partners account is aggregated as under:*

(i)	<i>Goodwill</i>	<i>35,00,000</i>
(ii)	<i>Machinery Revaluation</i>	<i>1,12,40,729</i>
(iii)	<i>Shares revaluation</i>	<i>12,89,58,000</i>
(iv)	<i>Conversion of investments into stock in trade</i>	<i>11,68,08,126</i>
		<i>-----</i>
		<i>26,03,06,855</i>

*Less: Reversal of goodwill and machinery revaluation done during the year. This entry has been reversed during the year.*

*1,47,40,729*  
*24,55,66,126*

*If the above amounts of notional surpluses are excluded from the partners account, the partner a/c would result into debit balances at Rs.4,80,41,502 (24,55,66,126 - 20,75,16,624). The A.R. was confronted with the query that if partners account are recasted by excluding the entries of these surpluses, substantial borrowed funds were represented in these debit balances and therefore, interest thereon was disallowable. In the written reply dated 24.11.92 it was argued that aforesaid credit entries in the partner accounts were not the notional entries but they represented the real accretion in the capital of partners as the physical receipt of an amount in cash or by a cheque was not necessary for an entry being a real. It was also argued that if one of the partner chose to retire from the firm, he was entitled to withdraw all his sums including these accretions in his capital. The partnership deed of the firm also provided to this effect. The plea was also that the partners of the firm need not necessarily*

*bring their own capital for carrying on the business of the firm and they were free to carry on the business exclusively on borrowings from outsiders. Similarly partners were equally free to withdraw their own capital irrespective of nature of composition of their capital account since in the instant case Partnership Deed did not place any restriction on its withdrawal. Finally it was contended that it was incorrect to say that substantial part of borrowings had been diverted into accounts of partners because the firm received dividend of Rs.3,93,76,175/- and hire charges of machinery at Rs.38,92,200/- during the year. Total amount of withdrawals by the partners during current year amounting to Rs.2,27,08,772/- was stated to be fully covered by non-interest bearing funds.*

*5.3 On careful consideration of contentions, they are not found convincing. Since these surpluses were not available to the firm in the form of liquid funds, its apportionment and credit in the account of the partners would not enable them to withdraw that much amount from their capital accounts as it was not physically possible to withdraw the money in the absence of liquid funds. To this extent these entries are not the real entries and are to be treated as entries representing the unrealised appreciation/ gains which were notionally distributed and apportioned between the partners. The example given by the firm in respect of profits represented by sundry debtors is not correct as in that case the profits of the firm become subjected to tax and therefore the balance profits are apportioned in the accounts of the partners. The analogy of retiring partner being entitled to withdraw the funds to the extent of credit in his capital account is not comparable with that of existing partner. As regards the third contention, it is correct that partners need not necessarily bring their own capital and can agree to carry on business exclusively on borrowed funds, but facts are different in this case. The partners have brought their capital first and then the same has been withdrawn in addition to withdrawals out of borrowed funds. It is now well settled that having once contributed towards capital of the firm, the partner ceases to have exclusive right over this capital which becomes the capital of the firm. The relevant clauses of the partnership deed of re-constituted partnership dated 4.11.85 are reproduced as under : -*

*"Clause 4 - The capital of the firm shall consist of the respective balances of party no. 4 to 17 (both inclusive) as appearing in*

*the books of account of the firm as as 1<sup>st</sup> November 1985 and incoming partner i.e. party nos. 1,2,3,18 and 19 shall contribute Rs.10,000/- each and the party No. 20 shall contribute Rs.25,00,000/- as their respective contributions towards the capital.*

*Clause 5 - No interest shall be allowed or charged on the balance in the capital account of the partner.*

*Clause 6 - Further funds/finances required for the partnership business may be arranged for from such persons and on such terms and conditions as the partners may mutually decide from time to time."*

*The above clauses make it clear that as per re-constituted arrangement, the above partners were required to contribute capital as laid down in clause 4 and only further funds were to be arranged from out-side. The last argument that the total withdrawals of partners amounting to Rs.2,27,08,772/- during the year were covered by dividend income and hire charges receipts is also not correct. Firstly the dividend income was received towards the end of the year where-as the substantial withdrawals by partners were made much before the receipt of dividend income and therefore, these withdrawals cannot be covered by dividend income. Besides part of the income by way of dividend and hire charges receipts was spent on the substantial expenses incurred during the year. Secondly partners become entitled to the profit of the firm as on last day of the accounting year as per partnership deed and therefore they were not entitled to any withdrawals out of these dividends before the last day of accounting year. Besides, the point at issue is not limited to the withdrawals of Rs.2,27,03,772/- by partners during the year only as the withdrawals have been made in earlier years also and the same are represented in the opening balances of partners accounts which would stand at substantial debits if the surpluses are excluded therefrom.*

*5.4 It would be pertinent to high-light some further facts on the point. The business of the assessee originally consisted of civil construction work which has been suspended for the last three years. Income now has been derived mainly from dividend and machinery hire charges receipts. Negligible work has also been done by way of*

*purchase and sale of shares. Thus the assessee firm was not engaged in finance business where it is usual to receive deposits from public at large. In the circumstances the continuous receipt of deposits by the assessee firm from partners', relatives, Directors of connected concerns and their connected persons at exorbitant rate of interest, cannot be accepted as regular business activity of the assessee. It is now well settled that the burden of proof that the monies borrowed in had not been utilized for non-business purposes is on the assessee (CIT vs. Coimbatore Salem Transport (P) Ltd. (1966) 61 ITR 480, 487 (Mad.). The assessee was required to furnish a chart showing utilization of borrowed funds and prove that borrowed money was not used for non-business purposes. The chart has been furnished in respect of big amounts of deposits. On perusal of the chart so furnished, it is seen that substantial borrowed funds have been directly utilized for purposes of withdrawals by the partners. A few such instances may be indicated us below :*

<i>Date</i>	<i>Deposit amount</i>	<i>Withdrawals by partners</i>
-----	-----	-----
<i>23/06/89</i>	<i>5,00,000</i>	<i>2,58,000</i>
<i>28/06/89</i>	<i>11,65,000</i>	<i>5,30,000</i>
<i>03/09/89</i>	<i>5,00,000</i>	<i>5,02,000</i>
<i>04/10/89</i>	<i>10,00,000</i>	<i>3,80,000</i>
<i>28/10/89</i>	<i>15,00,000</i>	<i>5,81,000</i>
<i>08/12/89</i>	<i>10,00,000</i>	<i>12,89,500</i>

*The assessee has also not discharged its onus that various amounts given to different partners throughout the year were for business purposes or it was expedient for the business of the assessee to have lent money to partners. Some of the instances cited above prove to the contrary that borrowed money has been lent to partners for non business purposes. Had the assessee not given the substantial amounts to partners, there was no need for the assessee firm to obtain loans on such exorbitant rates or to retain them. From the perusal of capital a/cs of the partners it is clear that the practice of diverting the borrowed funds into the partners accounts has been a continuing course of conduct during the year. Similar diversion of borrowed funds had been made during the earlier year also. On examination of the charts of deposit and withdrawal by partners it is evident that diversion of funds to the partners is not an isolated transaction in this case but a continuing course of conduct. Since*

*borrowed funds have not been used for business purposes, interest paid on borrowed funds used by partners deserves to be disallowed. The facts on this point are similar to the facts in the case of CIT vs. Saraya Sugar Mills (P) Ltd. reported in 193 ITR 575 wherein their lordship of High Court Allahabad held as under:-*

*"that out of the moneys borrowed, a substantial portion was lent to the directors free of interest. Similar loans were also extended to a firm in which the directors of the assessee were interested. The amounts advanced to the directors and their firms, free of interest, were quite substantial and it was a continuing course of conduct and not an isolated transaction. The Tribunal was not legally justified in reducing the disallowance of interest by Rs.23,733/-.*

*5.5 For the purpose of disallowance of interest, extent of borrowed funds used for non business purposes is to be ascertained. If the total surplus of Rs.24,55,66,126/- is excluded out of the credit balances of Rs.20,75,16,624/-, partners account would result into debit balances at Rs.14,80,41,502/-. If the share of profits credited in the partner's account on the last day of accounting year at Rs.1,27,54,430/- is excluded, the partner's debit balances would further increase to Rs.6,07,95,982/-. Since as per the Deed, the partners become entitled to apportionment of profits as on the last day of accounting year and major receipts by way of dividend have come towards the close of the year, the debit balances arrived at by further excluding the entries of the profits correctly represent the extent of further by the partners towards the end of the year. Thus clearly the unsecured loans at Rs.6,32,67,425/- are employed in the debit balances of partners to the extent of Rs.6,07,95,902/-. The amount of balance unsecured loans not represented by the debit balances of the partners stands at Rs.24,71,439/- only.*

*5.6 If the clause 1 of re-constituted partnership deed dated 4.11.85 is kept in mind, one of the partners viz. M/s Sidhartha Construction Co. alone was to contribute a capital of Rs.25 lacs. apart from small capital of Rs.10,000/- each by other partners. On perusal of relevant records it is seen that capital of Rs.25,00,000 and Rs.10,000/- each was contributed by M/s Sidhartha Construction Co. and other partners respectively. However, subsequently substantial withdrawals were made by M/s Sidhartha Construction Co. and other partners so much*

*so that not only the capital contributed by them stood totally withdrawn but over and above further debits were allowed to them. Having once contributed the capital, as required under the Partnership Deed, the partners had no exclusive right over the capital so contributed. As per the clause 6 of the Deed dated 4.11.85 only further funds or finance required for the business could be arranged from the out-siders. However, in this case the funds had to be borrowed because the capital initially contributed by the partners also withdrawn. If the partners had not withdrawn the capital contributed by them, there was no necessity to borrow funds even to the extent of Rs.24,71,439/- since the capital contribution by M/s Sidhartha Construction Co. alone to the tune of Rs.25,00,000/-. The withdrawals by the partners out of the capital contributed by them cannot be treated as having been done for any business purposes. Once the capital was contributed by the partner, it became the capital of the firm und the partners ceased to have exclusive right on the capital, contributed by it. The exclusive right of the partners over capital so contributed stands reduced to shared interest in the assets of the firm alongwith other partners of the firm. The above view finds support from the decision of Supreme Court in the case of Sunil Sidhurth Bhai vs. CIT reported in 156 ITR 509 wherein their Lordship of Supreme Court held as under:*

*"Therefore, when a partner brings in his personal asset into the capital of the partnership firm as his contribution to its capital, he reduces his exclusive rights in the asset to shared rights in it with the other partners of the firm. While he does not lose his rights in the asset altogether, what he enjoys now is an abridged right which cannot be identified with the fullness of the right which he enjoyed in the asset before it entered the partnership capital."*

*Similarly, their Lordship of Supreme Court held in Addanki Narayanappa vs. Bhaskara Krishnappa (1966) 3 SCR 400 AIR 1966 SC 1300 that :*

*"The whole concept of partnership is to embark upon a joint venture and for that purpose to bring in as capital money or even property including immovable property. Once that is done whatever is brought in would cease to be the exclusive property of the person who brought it in. It would be the trading asset of*

*the partnership in which all the partners would have interest in proportion to their share in the joint venture of the business of partnership. The person who brought it in would, therefore, not be able to claim or exercise any exclusive right over any property which he had brought in, much less over any other partnership property. He would not be able to exercise his right even to the extent of his share in the business of the partnership."*

*5.7 In view of the above finding it becomes clear that the partners did not have exclusive right over the capital contributed by them since the capital, contributed became the capital of the firm and had this capital not withdrawn by the partners, there was no need to borrow the funds even to the extent of Rs.24,71,439/-. On the basis of facts as stated above, it is held that entire borrowings to the extent of Rs.32,67,425/- have been used for non business purposes, as the major part of the borrowings at Rs.6,07,95,902/- is represented as employed in debit balance of partners and the balance un-secured loan of Rs.24,71,439/- had to be borrowed because the firm's capital (contributed by partners) was utilized for non business purposes. One possible argument on behalf of the assessee that debit balances are represented by the reserves and current liabilities and provisions is not workable as there is a meagre sum of Rs.8,53,336/- under the head "reserve and surplus" and the figures of current liabilities and provisions at Rs.1,23,849/- are mainly represented by TDS and Advance Taxes at Rs.1,51,03,537/-.*

*5.8 In the reply dated 3.12.92, the assessee has tried to establish the business purposes of borrowings by stating that the total amounts of fresh borrowings at Rs.5,92,46,394/- during the year was utilised for the purposes of repaying the old borrowings to the extent of Rs.7,75,53,488/-. This plea of the assessee is also not correct due to two reasons. Firstly all the borrowings taken during the year have not been utilised for the purposes of repayments. Some clear instances indicating the nexus between the money borrowed and withdrawals allowed to the partners have already been indicated in para 2.4. Secondly even the old borrowings which have been partly paid out of the fresh borrowings were also not made for business purposes. As discussed in detail, the borrowings have been continuously made by the firm in various years and have been used for the purpose of withdrawals by the partners. Since the old borrowings were not for*

*business purposes, the fresh borrowings utilised for re-payment of those old borrowings would have to be held for non business purposes. On this point the assessee was required to furnish the chart showing the incoming and outgoing of funds for various earlier years. The chart for the assessment year 89-90 only has been furnished before me. A perusal of this chart also indicates the same course of conduct on the part of the assessee. In some cases the funds borrowed have been directly used by the partners for their withdrawals. The charts for the earlier years i.e. asstt. year 85-86, 86-87, 88-89 etc. have not been furnished before me. However, on perusal of relevant records it is seen that the course of conduct in so far as employment of borrowed funds are concerned has consistently remained the same with the assessee. Since each and every assessment year is separate and independent, any finding given in any earlier year cannot have any effect only finding with reference to the character and use of un-secured loans.*

*5.9 Yet the assessee may possibly come up with another argument that the borrowed funds have to mixed with interest free funds in the bank accounts where from the funds have been given/lent to partners and therefore, the funds so diverted to the partners cannot be said out of borrowed funds exclusively and no interest as such can be disallowed there-on. However, this contention is also not correct and convincing. Their Lordship of Delhi High Court in the case of R. Dalmia vs. CIT 1982 reported in 133 IIR 169 held that where the interest paid concerns the borrowed money for business as well as non business purposes, the claim may be disallowed in its entirety if no adequate material is adduced by the assessee to determine the portion of the interest which pertains to business purposes. In the instant case the assessee had not been able to segregate the portions of borrowed funds used for business and non business purposes and therefore, the entire sums deserves to be disallowed.*

*5.10. In the circumstances it is established that the assessee firm has borrowed funds without any business purposes at exorbitant rates for giving un-due benefits to its partners, relatives and Directors of the connected concerns and various persons related to Directors and partners. Partners of the firm have also taken un-fair advantage by withdrawing borrowed funds without paying any interest and utilizing them for their private purposes. The assessee firm has paid huge amounts of interest on heavy borrowings hardly bearing any relation*

*with the business purposes of the assesses. The assessee firm has given a colour to its affairs in such a way that huge debit balances in the partners' accounts have been made to appear as credit balance because of huge surpluses created on various accounts. This is a case where profits of the firm have substantially been reduced by claiming huge expenses on interest paid on exorbitant rates to a closed group of persons. The funds so borrowed have been diverted for non business purposes of giving advances to its partners. The facts of the present case are broadly similar to those in the case of CIT vs. H.R. Sugar Factory (P) Ltd. reported in 187 ITR 363 in which their Lordship of Allahabad High Court held that "the assessee was not a finance company. It was engaged in the manufacture of sugar. No business purpose was served by the advances to its directors. The amount of interest payable in each year on account of the loans to the directors was very large and this fact could not be glossed over by saying that the amount was not substantial in each of the relevant years. The company might have borrowed large amounts for the purposes of its business every year, but that did not explain the huge advances to the directors/ share holders. Had this money been not advanced to the Directors, it would have been available to the assessee for its business purposes and to that extent it might not have been necessary to borrow from the bank. Therefore, the Income Tax Officer was right in disallowing the difference between interest paid to the banks and interest recovered from the directors under Sec. 36(1)(iii) of the IT Act.*

*5.11 On the basis of above discussion, I hold that interest claimed at Rs.1,58,01,118/- is not allowable u/s 35(1)(iii) of IT Act and therefore, the same is being disallowed and added into the net income of the assesses. The reasons for disallowance already discussed in detail are briefly stated as under for sake of precision:-*

- (a) On examination of relevant facts as discussed above, it is clear that the borrowed funds have been used for non-business purposes by way of substantial withdrawals by the partners. Having once brought in the initial capital, the partners ceased to have any exclusive right on the capital so contributed, which became the capital of the firm. Had the partners not taken huge withdrawals from the firm, capital of the assessee firm would have been available for its business purposes and there was no need to borrow unsecured loans at Rs.6,32,67,421/- at all. The*

*unsecured loans were utilized by the partners to withdraw huge amounts for their personal purposes on various dates throughout the current as well as earlier years. Since the unsecured loans were not required and used for business purposes, interest paid thereon at Rs.1,58,01,118/- is not allowable u/s 35(1)(iii) of I.T. Act. Reliance is placed on the Judgment of Allahabad High Court in the case of CIT vs. H. R. Sugar Factory (P) Ltd. reported in 187 ITR 363 and CIT vs. Saraya Sugar Mills (P) Ltd. 193 IIR 575.*

- (b) *Since the borrowings have been made in different amounts on different dates during the current year as well as in earlier years, it is not practicably possible to ascertain the nexus in each and every case. In view of judgment of Allahabad High Court cited in (a), it is not necessary for Revenue to establish nexus in each and every case of borrowing with its use for non business purposes as the overall use of funds is to be evaluated in the light of necessity to borrow them. However, on examination it has been found that there is a direct nexus between borrowings taken and withdrawals made by the partners in a number of cases. In the circumstances, the assessee's contention that funds were borrowed for business purposes and there was a nexus between borrowings and its use for business purposes is not correct and cannot be accepted.*
- (c) *The assessee has failed to prove that the borrowed funds have not been utilized for non-business purposes. On the other hand there are clear instances of borrowed funds directly utilized by partners by way of withdrawals in many cases. Since the assessee has not been able to segregate the borrowed funds utilized for business and non-business purposes, the claim of interest is disallowable in its entirety in view of the decision of their Lordship of Delhi High Court in the case of R. Dalmia vs. CIT 1982 reported in 133 ITR 169.*
- 5.12 *The reasons stated in (b) and (c) above shall be operative without any prejudice to the main reason as indicated in (a) as the correct test for allowability of interest is to see whether the borrowings were at all necessary, had the partners not withdrawn huge amounts from the firm.*

*5.13 Since in the earlier years, certain deposits have been held as non genuine and therefore, interest paid thereon is disallowable. Since the entire interest paid has been disallowed, separate determination of disallowance of interest paid on such deposit is not considered necessary.*

(A.1) The assessee filed appeal in the office of the learned CIT(A) in which, inter alia, the aforesaid disallowance of Rs.1,58,01,118/- was disputed. Vide impugned appellate order dated 26/03/1093 in appeal No.79/DC(1)/Range-III/Lko/92-93, the learned CIT(A) confirmed the aforesaid disallowance of interest thereby sustaining the addition of Rs.1,58,01,118/- as aforesaid. The relevant portion of the order of learned CIT(A) is reproduced as under:

*(4) I have considered this issue very carefully. This issue has been discussed in detail in the impugned assessment order at pages 12 to 23. After discussing the facts of the case and replies of the appellant, the Assessing Officer disallowed appellant's claim for interest at Rs.1,58,01,118/- u/s 36(1) (iii) of the Act and have summarized his reasons for coming to this conclusion in the impugned order as under:-*

*(a) On examination of relevant facts as discussed above, it is clear that the borrowed funds have been used for non business purposes by way of substantial withdrawals by the partners. Having once brought in the initial capital, the partners ceased to have any exclusive right on the capital so contributed, which became the capital of the firm. Had the partners not taken huge withdrawals from the firm, capital of the assessee firm would have been available for its business purposes and there was no need to borrow unsecured loans at Rs.6,23,67,421/- at all. The unsecured loans were utilized by the partners to withdraw huge amounts for their personal purposes on various dates throughout the current as well as earlier years. Since the unsecured loans were not required and used for business purposes, interest paid thereon at Rs.1,58,01,118/- is not allowable u/s 36(1)(iii) of the IT*

*Act. Reliance is placed on the judgment of Allahabad High Court in the case of CIT Vs. HR Sugar Factory (P) Ltd. reported in 187 ITR 363 and CIT Vs. Saraya Sugar Mills (P) Ltd., 193 ITR 575.*

- (b) *Since the borrowings have been made in different amounts on different dates during the current year as well as in earlier years, it is not practicably possible to ascertain the nexus in each and every case. In view of judgments of Allahabad High Court cited in (a), it is not necessary for Revenue to establish nexus in each and every case of borrowings with its use for non business purposes as the overall use of funds is to be evaluated in the light of necessity to borrow them. However, on examination it has been found that there is a direct nexus too between borrowings taken and withdrawals made by the partners in a number of cases. In the circumstances the assessee's contention that funds were borrowed for business purposes and there was a nexus between borrowings and its use for business purposes is not correct end cannot be accepted.*
- (c) *The assessee has failed to prove that the borrowed funds have not been utilized for non business purposes. On the other hand, there are clear instances of borrowed funds directly utilized by partners by way of withdrawals in many cases. Since the assessee has not been able to segregate the borrowed funds utilized for business and non business purposes, the claim of interest is disallowable in its entirety in view of the decision of their Lordship of Delhi High Court in the case of R. Dalmia Vs. CIT 1982 reported in 133 ITR 169.*

5.12 *The reasons in (b) and (c) above shall be operative without any prejudice to the main reason as indicated in (a) as the correct test for allowability of interest is to see whether the borrowings were at all necessary, had the partners not withdrawn huge amounts from the firm.*

5.12. *Since in the earlier years, certain deposits have been held as non genuine and, therefore, interest paid thereon is*

*disallowable. Since the entire interest paid has been disallowed, separate determination of disallowance of interest paid on such deposit is not considered necessary.*

*Now the first issue for determination before me is whether or not the credit entries made to the partners' accounts on creation of goodwill, revaluation of machinery and shares revaluation on 1.5.1981, 1.8.1984 and 31.3.1987 respectively were real or these were not to be taken into consideration for finding out the correct credit or debit balances of the partners of the appellant firm as on 1.4.1989? Appellant's contention is that these are real and genuine entries and hence these shall have to be taken into consideration. The Assessing Officer has held that these are only notional entries/unrealized gains and therefore, do not represent physical incoming of the funds. In other words, he held that these were notional credits given to the partners' accounts end, therefore, partners could not withdraw the corresponding amounts therefrom. I am of the view that since monies on account of these entries have not come to the business of the appellant in physical terms, these entries, therefore, represented the notional credits or unrealised gains and, hence for considering the actual credit or debit balances of the partners of the appellant firm as on 1.4.1989 these entries were, therefore, to be ignored. I hold sc. Now the second question arises whether after ignoring these entries the net result of the partners accounts as on 1.4.1989 gives a credit balance or a debit balance? In the chart given by the appellant during the course of Appellate hearing it had excluded two sums of Rs.5,25,000/- and Rs.45,38,440/- on account of goodwill and revaluation of machineries respectively only. Both together amounted to Rs.50,63,444/-. It had not, however, excluded credit entries given to the partners' accounts on account of revaluation of shares and such entries amounted to R.12,87,58,000/- as the cost of those shares was only at Rs91,97,000/- for which on revaluation credit entries for Rs.13,79,55,000/- were made to the partners' accounts on 31.3.1987. Appellant's contention for not excluding surplus amount of Ps.12,87,58,000/- (13,79,55,000 - 91,97,000) is that these represented true and real value of these shares, and, therefore, these entries were real. But, I have already held above that since the appellant did not receive in physical terms the sum of R.12,87,56,000/- on account of revaluation of shares corresponding credits given to the accounts of the partners in the books of the appellant firm were, therefore, to be ignored for finding out the*

*correct debit or credit balances of these partners. Thus, after ignoring all the three entries, namely, on account of creation of goodwill, revaluation of machineries, and revaluation of shares according to the Assessing Officer, the partners' accounts revealed a debit balance of Rs.3,28,93,607/- i.e. Rs.9,89,96,467 shown in the partners accounts as on 1.4.1989 minus surplus in their accounts on account of goodwill, revaluation of machineries and revaluation of shares as on 1.4.1989 at Rs.5,25,000/-, Rs.45,38,444/- and Rs.12,68,26,630/- respectively. The difference between the aforementioned mounts of Rs.12,87,58,000/- and Rs.12,68,26,630/- is on account of an entry of Rs.19,31,370/- in the account of Smt. Mithli Srivastava, who retired from the partnership of the appellant firm in the year relevant to assessment year 1989-90. Thus, as on 1.4.1989, the partners account altogether disclosed a debit balance of Rs.3,28,93,607/- after ignoring the aforementioned notional entries made therein. Now the third question which arises is whether for allowing or disallowing appellant's claim for interest payment of Rs.1,58,01,118/- in the year under consideration, nexus between the interest bearing borrowings made by it and withdrawals made by the partners and their relatives is necessary? I hold that it is not. Because their Lordships of Hon'ble High Court of Allahabad has already held in the case of CIT Vs. H.R. Sugar Factory (P) Ltd, reported in 187 ITR 363 that "had the money not been advanced to the Directors, it would have been available to the assessee for its business purposes and to that extent it might not have been necessary to borrow from the Bank." In this case, the assessee was a company engaged in manufacture of sugar and it had given huge advances to its directors at very low rate of interest and interest payable in each year on account of loans to directors was very large and this fact could not be glossed over by saying that the amount was not substantial in each of the relevant year. The company might have borrowed large amounts for the purposes of its business every year, but that did not explain the huge advances to the directors/share holders. The appellant's contention before me is that this decision is not applicable to the case of the appellant as it was in the case of Company whereas the appellant is a Registered Firm. But I am of the opinion and I hold so that the ratio decidendi of their Lordship in this case is material irrespective of the status of the assessee. Further it may be mentioned here that the appellant is also not a finance company and it had also to borrow huge funds only as its partners have been making heavy withdrawals every year as also in the year under consideration. Accordingly, I hold that the ratio laid*

*down by their Lordship is fully applicable to the case of the appellant. In this regard, reliance placed by the Assessing Officer on another decision of Hon'ble High Court of Allahabad reported in 193 ITR 575 is also Justified. In addition, I place reliance on the decision of the Hon'ble High Court of Karnataka in the case of CIT Vs. V. M. Salgaonkar & Bros (P) Ltd. 198 ITR 738.*

*5. Fourth aspect of this issue is regarding reasonable rate of interest u/s 40A(2)(b) of the Act. In the impugned order the Assessing Officer has held 18% rate of interest as reasonable. Appellant's contention is that the Assessing Officer was not justified to hold that the reasonable rate of Interest in cases covered by section 42A(2)(b) is 18%. Because, it contended, the Banks charge 20% interest on secured loans whereas the loans given to the appellant by the specified persons were unsecured and hence interest rate of 24% or 25% so charged on those was fully justified. On this issue, I hold that provisions of section 40A (2) (b) of the Act are applicable only in respect of persons specified in Section 40A (2) (b) of the Act. So far as outside creditors are concerned interest payable or paid cannot be regulated under section 40A (2) (b) of the Act. In the cases of Creditors covered u/s 40A (2) (b) I hold that interest rate of 20% is reasonable as loans given by them to the appellant are in reality not the unsecured loans i.e. because the partners of the borrowing firm are related to them and hence their loans are not that much unsecured.*

*6. Fifth aspect of this issue is regarding impact of credit entries made in the partner's accounts on conversion of its capital stock of shares into the stock-in-trade on 1-1-1990. Those credit entries in the partner's accounts are again notional entries as no monies in reality have come to their accounts as also to the business of the appellant. Hence, I hold, that for consideration of appellant's mode for borrowings in the year under consideration as also for consideration of withdrawals made by the partners of the appellant in the year under consideration these credit entries shall be ignored. In other words, these credit entries will not be taken into consideration for deciding appellant's claim for interest paid u/a 36(1)(iii) of the IT Act.*

*6.A Another aspect of this issue is the impact of borrowings made in earlier years but held not genuine. Certainly, interest paid on such borrowings in the year under consideration, I hold, is not allowable.*

7. *Since nexus between interest bearing borrowings made by the appellant firm and the withdrawals by its partners has been held as not relevant, then for determining the amount of disallowable interest relevant facts to be taken into consideration are:-*

- (i) the debit balance of Rs.3,28,93,607/- in the partner's account as on 1-4. 1989;*
- (ii) the difference between the credits in the partners account and the withdrawals made by them during the year: As per the appellant such deposits made by the partners in their capital accounts amounted to be Rs.1,64,97,050/- and withdrawals at Rs.2,20,90,072/-. It has also claimed that profit of Rs.1,27,54,481/- credited into their accounts as on 31.3.1990 is also to be taken into consideration. But in this regard I hold that the profit accrued to the appellant only on the last date of accounting year i.e. 31.3.1990, this amount, therefore, cannot be taken into consideration. In this regard reliance is so placed on the decision of Hon'ble Supreme Court in the case of CIT vs. Ashokbhai Chimenbhai, 56 ITR 42. As per the Assessing Officer the credits in the account of the appellant on account of dividend etc. during the year amounted to Rs.1,64,97,050/- and the withdrawals made by the partners during the year are to the tune of Rs.2,26,97,282/-.*
- (iii) The impact of borrowings made in earlier years but held as not genuine. Certainly, interest paid on such deposits, I hold, is not allowable in the year under consideration also.*
- (iv) As per Clause 4 of the partnership deed the partners were to contribute some fixed capital. These have been mentioned by the Assessing Officer in para-5.6 at pages 14 and 17 of the impugned order. Main amount Rs.25,00,000/- which M/s Sidharth Construction Company was to contribute as its contribution to become a partner of the appellant firm. These amounts are relevant because if the partners' such fixed contributions had remained in the business of the appellant firm it would not have been forced to borrow interest bearing funds to the extent from outside parties. Here, it may also be mentioned that as per Clause 6 of the reconstituted partnership deed dated 4.11.85, the appellant was to raise "further*

*funds/finances required for the partnership business". And thus words "further/finances connote that these were to be raised only after taking into consideration the contributions which the partners were to make as per clause 4 of this deed. In this regard reliance placed by the Assessing Officer on the decision of the Hon'ble Supreme Court reported in 156 ITR 509 is justified. Thus the impact of these initial fixed capital contribution by the partners is to be taken into consideration for considering the business necessity of the borrowing and hence appellant's claim u/s 36(1)(iii) of the Act.*

*Since there is a difference between the amounts stated by the appellant as a debit balances in the account of the partners as on 1.4.1989 after ignoring the notional entries on account of three items mentioned above and the amounts of such debit balances worked out by the Assessing Officer, and there is also a difference between the amounts of deposits mentioned by the appellant and the Assessing Officer. I, therefore, hold and direct that the disallowance out of appellant's claim for interest payment of Rs.1,58,01,118/- should be determined by the Assessing Officer in the light of above decisions and the amount of disallowance so worked out by the Assessing Officer, (no doubt, it has to be factually correct) shall be the amount confirmed by me through this appellate order.*

(B) The assessee filed appeal in Income Tax Appellate Tribunal vide I.T.A. No.1288/Alld/93 wherein the disallowance of the aforesaid amount of Rs.1,58,01,118/- and consequent addition was disputed. Vide order dated 23/12/93, Allahabad Bench of the Income Tax Appellate Tribunal ["ITAT" for short], deleted the aforesaid disallowance and consequent addition amounting to Rs.1,58,01,118/-. Vide order dated 15/05/2007 in Income Tax Reference No. 80 of 1995, Hon'ble Allahabad High Court sustained the aforesaid order dated 23/12/1993 of ITAT. Vide order dated 01/02/2012 in Civil Appeal No. 1426 of 2012 [Arising out of SLP(C) No.4780 of 2009] Hon'ble Supreme Court set aside the aforesaid order dated 23/12/1993 of

ITAT and also set aside aforesaid order dated 15/05/2007 of Hon'ble Allahabad High Court; and the matter was remitted to Income Tax Appellate Tribunal. The relevant portion of the aforesaid order dated 01/02/2012 of Hon'ble Supreme Court is reproduced as under:

*"Having heard learned counsel on both sides at length, we are of the view that, in this case, the High Court has not considered Question No.3 before it, which reads as follows:*

*"3. Whether the circumstances of the facts and law justified in case, the in surplus taking Tribunal the of into was in consideration amalgamation Rs.12,87,58,000/- arising of the Hon'ble shares out as of High Court when it had approved by the generation increase not resulted in of any surplus cash funds and the in the capital corresponding increase was set off by in the value of assets which were not available for withdrawals by the partners and only the borrowings from depositors were available for withdrawal?"*

*Since we are required to remit the case to the Income Tax Appellate Tribunal ('ITAT', for short), we hereby reframe the above question as follows:*

*"Whether, on the facts and in the circumstances of the case, the surplus cash of Rs.12.87 crores, arising out of amalgamation, credited to the partners' capital accounts and forming part of the opening credit balance, as on 01/04/1989, was available for withdrawal by the partners' ?*

*In the event of ITAT coming to the conclusion that there was no cash surplus, then the effect of such finding on the question of allowability of deduction under Section 36(1) (iii) of Income Tax Act, 1961, would also be determined.*

*Consequently, the impugned orders of the High Court and ITAT are set aside and the matter is remitted to ITAT for answering the afore-stated question in accordance with law.*

*The civil appeal filed by the Department is accordingly, allowed with no order as to costs."*

(B.1) Thereafter hearings were fixed in Income Tax Appellate Tribunal from time to time and the matter was finally heard on 9<sup>th</sup> September, 2024. In the course of appellate proceedings in Income Tax Appellate Tribunal, pursuant to aforesaid order dated 01/02/2012 of Hon'ble Supreme Court, the paper book in two volumes, containing 198 pages, was filed from the assessee's side, containing the following particulars:

S.No.	Particulars
1.	Copy of audited balance sheet and profit & loss account for the financial year 1985-86
2.	Copy of audited balance sheet and profit & loss account for the financial year 1986-87
3.	Copy of audited balance sheet and profit & loss account for the financial year 1987-88
4.	Copy of audited balance sheet and profit & loss account for the financial year 1988-89
5.	Copy of audited balance sheet and profit & loss account for the financial year 1989-90
6.	Cash flow statement showing availability of own funds
7.	Copy of cash flow statement for the period from financial year 1985-86 to 1989-90
8.	Brief facts of the case
9.	Copy of assessment order dated 30/12/1992
10.	Copy of ITAT order dated 23/12/1993 in assessee's own case in assessment year 1990-91
11.	Brief synopsis
12.	Copy of Hon'ble Supreme Court order
13.	Year Wise details of capital accounts of partners
14.	Year Wise details of unsecured loans
15.	Year Wise details of scrutiny assessments
16.	Copy of CIT vs. Sri Dev Enterprises [192 ITR 165-Ker]
17.	Copy of Income Tax Officer vs. Anjani Synthetics [2011-10 ITR (Trib) 291-Hyd]

Further summary of partners' accounts from financial year 1986-87 to 1989-90. Details of year-wise assessment proceedings from assessment year 1884-85 to 1989-90 were also furnished from assessee's side.

(C) At the time of hearing, Revenue was represented by Shri Gayasuddin, learned CIT (D.R.) and the assessee was represented by Shri B. P. Yadav, learned counsel.

(C.1) At the time of hearing before us, the learned Counsel for the assessee submitted that no fresh unsecured loan was taken by the assessee during the year, and that entire unsecured loan amounting to Rs.6,32,67,425/- stood already utilized for the purpose of the assessee's business before this year. He further submitted that the withdrawal totaling Rs.2,27,08,772/- made by partners during the year was out of cash surplus available with the assessee. He also contended that no nexus was established between borrowings and withdrawals made by the partners. He placed strong reliance on these submissions and on the various documents filed in the course of appellate proceedings in Income Tax Appellate Tribunal as discussed earlier in paragraph No. (B.1) of this order. He contended that the addition of Rs.1,58,01,118/- on account of interest made by the Assessing Officer and confirmed by the learned CIT(A) should be deleted. Without prejudice to these submissions, he contended that the disallowance should be restricted to proportionate interest expenditure attributable to withdrawals made by partners.

(C.2) The CIT (D.R.) for Revenue placed strong reliance on the aforesaid order dated 01/02/2012 of Hon'ble Supreme Court.

He submitted that the opening credit balance in partners' accounts was an inflated figure on account of revaluation of assets in the nature of shares. The shares, which were revalued by the assessee in financial year 1986-87, were acquired for the cost of Rs.91,97,000/-. However, they were revalued

at Rs.13,79,55,000/-; and the difference between 13,79,55,000 and 91,97,000 (amounting to Rs.12,87,58,000/-) was credited in the partners' accounts in financial year 1986-87 corresponding to assessment year 1987-88. He submitted that the aforesaid amount of Rs.12,87,58,000/- credited in partners' accounts did not represent any real cash flow in the hands of the assessee, and were merely notional book entries in the assessee's accounts. In view of these facts, he submitted that the disallowance of interest of Rs.1,58,01,118/- made by the Assessing Officer deserves to be upheld.

(C.2.1) We have heard both sides. We have perused materials on record. There is no dispute on the relevant facts. It is not in dispute that the aforesaid amount of Rs.12,87,58,000/-, credited to partners' accounts, do not represent any real cash flow in the hands of the assessee; and that this amount credited in partners' accounts, were merely notional book entries in assessee's accounts. It is also not in dispute that if the aforesaid amount of Rs.12,87,58,000/-, which continued to inflate the credit balance in partners' account since assessment year 1987-88 is excluded, then the opening balance in partners' accounts as on 01/04/1989 would be negative. In other words, if the aforesaid amount of Rs.12,87,58,000/- is excluded, there would be debit balance in partners' accounts as on 01/04/1989. In view of foregoing undisputed facts, it can be readily inferred that the amount of Rs.12,87,58,000/- credited to partners' capital account and forming part of the opening credit balance in partners' accounts as on 01/04/1989 was not available for withdrawal by the partners. This is so because the withdrawal made by the partners was a real cash outflow in the books of the assessee whereas the opening credit balance in partners' accounts was inflated due to notional book entries amounting to

Rs.12,87,58,000/- in partners' capital accounts without there being any real inflow of cash in assessee's books of account. A notional book entry in the books of account cannot be said to be available for withdrawal by the partners leading to real cash outflow. The limited point that is required to be looked into by ITAT, vide aforesaid order dated 01/02/2012 of Hon'ble Supreme Court, is; *On the facts and in the circumstances of the case, the surplus cash of Rs.12.87 crores, arising out of amalgamation, credited to the partners' capital accounts and forming part of the opening credit balance, as on 01/04/1989, was available for withdrawal by the partners'. We are bound by the aforesaid order dated 01/02/2012 of Hon'ble Supreme Court. The Hon'ble Supreme Court has held in aforesaid order dated 01/02/2012 that the question of allowability of deduction (of interest) u/s 36(1)(iii) of the IT Act would be determined on the basis of finding whether cash surplus was available in partners' capital accounts on 01/04/1989. For this reason, following the yardstick prescribed by Hon'ble Supreme Court, the alternate plea advanced by learned Counsel for the assessee, to disallow; proportionate interest also deserves to be rejected. We have already mentioned earlier in this order that the amount of Rs.12,87,58,000/-, credited to partners' capital accounts in financial year 1986-87 (assessment year 1987-88) was not available in the form of cash as on 01/04/1989 in the partners' capital account; and that there was debit balance in partners' account on 01/04/1989 if the aforesaid amount of Rs.12,87,58,000/- is excluded. In view of the foregoing and respectfully following the aforesaid order dated 01/02/2012 of Hon'ble Supreme Court, we sustain the aforesaid addition of Rs.1,58,01,118/-. In the aforesaid order dated 23/12/1993 of Allahabad Bench of the Income Tax Appellate Tribunal, the assessee was allowed relief also on issues other than on the issue of the aforesaid addition of Rs.1,58,01,118/-. Therefore, although we have sustained the*

aforesaid addition of Rs.1,58,01,118/-, having regard to remaining relief given to assessee in aforesaid order dated 23/12/1992, the appeal of the assessee in ITAT is treated as partly allowed for statistical purposes.

(F) In the result, the appeal of the assessee is partly allowed.

(Order pronounced in the open court on 26/09/2024)

**Sd/.**  
**(SUDHANSHU SRIVASTAVA)**  
**Judicial Member**

**Sd/.**  
**(ANADEE NATH MISSHRA)**  
**Accountant Member**

Dated:26/09/2024

\*Singh

**Copy of the order forwarded to :**

1. The Appellant
2. The Respondent
3. Concerned CIT
  
4. D.R., I.T.A.T.,
5. CIT(A)

Assistant Registrar