



Issue:

Whether Interest paid by the partnership firm to the partners on their capital contribution can be disallowed on the ground that partnership firm has made investment in tax free securities?

M/s XY is a partnership firm consisting of partners X and Y. Firm has raised capital from partners on which interest of Rs 10 Lacs have been paid. Partnership firm has made investments in Mutual Funds to the extent of Rs 40 Lacs on which dividend of Rs 12 lacs is earned by the firm. The A.O. is of the view that interest paid by the firm of Rs 10 Lacs to the partners has to be disallowed under section 14A as the firm has earned tax free income of Rs 12 lacs.

Proposition:

· Let me refer to the provisions of **Section 14A:**

- “(1) For the purpose of computing total income under this chapter, no deduction shall be allowed in respect of **expenditure incurred** by the assessee in relation to income which does not form part of total Income under this act.
- (2) The Assessing Officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under this Act in accordance with such method as may be prescribed, if the Assessing Officer, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee in respect of such expenditure in relation to income which does not form part of the total income under this Act.
- (3) The provisions of sub-section (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act.”

- Now let me refer to provisions of **section 40(b):**
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 authorised 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 authorised 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 authorised 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 40[twelve] per cent simple interest per annum; or
 - (v) any payment of remuneration to any partner who is a working partner, which is authorised 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:—

Controversies

(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;

· Lastly it is useful to refer to provisions of **section 36(i)(iii)**:

The amount of the interest paid in respect of capital borrowed for the purposes of the business or profession.

Provided that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalised in the books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

It is respectfully proposed that interest paid to the partners by the partnership firm on the capital contribution cannot be disallowed u/s 36(i)(iii) nor u/s 14A.

View against the Proposition:

Referring to the Mumbai ITAT Judgment in the Case of ACIT v. PahilrajaiJaikishin(2016)66 taxmann.com 30(Mum. Trib.),

“During the course of assessment of partnership firm the AO noticed that the firm has paid Rs. 1.39 crores as interest to the partners on the capital raised from them. The assessee made investment in the mutual funds to the tune of Rs 4.75 crores on which it received dividend which was exempt from Tax. The Firm has claimed various expenses including interest paid to the partners. It did not disallow any expense under section 14A. The A.O. disallowed the interest paid to the partners against which following arguments were given:

· The interest paid on capital of the partners is statutory allowance allowable under section 40(b) of the act and same cannot be held as an expenditure incurred for earning exempt income.

· Further according to Section 14A:

“For the purpose of computing total income under this chapter, no deduction shall be allowed in respect of **expenditure incurred** by the assessee in relation to income which does not form part of total Income under this act”

The section refers to the words “expenditure incurred” for earning exempt income. Interest paid on capital of the partners is appropriation of profit and not expenditure for the firm.

However the Hon. ITAT held as under:

(i) ‘Expenditure’ as envisaged by section 14A of the Act, duly includes interest paid to the partners by the assessee firm if the same is incurred in relation to the income which is not includible in the total income under section 14A of the Act.

(ii) Interest paid to the partners is to be considered as allowable expenditure only against the exempt under section 14A of the Act provided other conditions are fulfilled.

(iii) Deductions of expenditures against the exempt income under section 14A of the Act or in other disallowance under section 14A of the Act, will not entitle the partners to claim relief in their individual return of income which shall be chargeable to tax as per the existing and applicable provisions of sections 28(v) of the Act, read with sections 2(24)(ve) of the Act after including the aforesaid interest income in the hands of the partners.

The Hon. Tribunal relied on the decision of the supreme court in Munjal Sales corporation vs. CIT reported in 298 ITR as well as decision of Ahmedabad ITAT in the case of Shankar Chemicals Works vs. DCIT reported in 47 SOT 121.

View in favour of the Proposition:

It is submitted that Hon. ITAT in the case of ACIT vs. PahilrajaiJaikishin has relied on the observations of the Hon. Supreme Court in the case of Munjal Sales Corporation which was apparently an obiter dicta.

With respect it is submitted that the decision of Ahmedabad ITAT in Shankar Chemicals Works does not lay down the correct law. There are other two decisions of the Hon. ITAT, one Decided in favour of the assessee and other against the assessee and hence, judicial precedence required to follow the view in favour of the assessee.

Now question arises whether interest paid to the partners was for earning tax free income, whether there was a direct nexus of interest paid to the partners with a earning of tax free income? It also required to answer the meaning and scope of the expression "in relation to" used in section 14A. Does it envisage a direct nexus of expenditure with the exempt income or a distant relationship would also result in disallowance? In this regard one may refer to the judgment of the Hon. Karnataka State Industrial & Infrastructure development Corporation Ltd. wherein it was held that the A.O. has to establish direct nexus between borrowed funds and tax free investment for making disallowance under section 14A. Similar view can be found in several other cases.

Summation:

It is submitted that as per decision of the Hon. Supreme Court in case of Walfort Share & Stock Brokers (P) Ltd. interest paid to partner on capital contribution cannot be treated as an expenditure being incurred or attributable to earn exempt income under section 14A of the act as the said interest is itself not 'expenditure' but a 'statutory allowance'.

The Hon. Apex Court in Walfort Share & Stock Brokers (P) Ltd.'s case (supra) held that

1. The basic principal of taxation is to tax the net income i.e. gross income minus the expenditure. On the same analogy, the exemption is also in respect of net income. This is the purport of section 14A.
2. In section 14A, the first phrase is "for the purposes of computing the total income under this chapter" which makes it clear that various heads of income as prescribed under Chapter IV would fall within section 14A.
3. The next phrase is 'in relation to income which does not form part of total income under the Act'. It means that if as income which does

not form part of total income, then the related expenditure is outside the ambit of the applicability of section 14A.

4. The permissible deductions enumerated in sections 15 to 59 are now to be allowed only with reference to income which is brought under one of the above heads and is chargeable to tax.
5. Reading of section 14 in juxtaposition with sections 15 to 59, it is clear that the words 'expenditure incurred' in section 14A refers to expenditure on rent, taxes, salaries, interest etc. in respect of which allowances are provided for every payout is not entitled to allowances for deduction. These allowances are admissible to qualified deductions. These deductions are for debits in the real sense.

The decision of the Hon. Supreme Court in Walfort Share & Stock Brokers (P) Ltd.'s case (supra) was a later decision and should have been given judicial priority. Notwithstanding once it was held in this case that what is considered for disallowance under section 14A are only 'expenditure incurred' in section 14A refers to expenditure on rent, taxes, salaries, interest, etc. in respect of which allowances are provided for', and this interpretation of section 14A was not considered in Munjal Sales Corporation's case (supra) then it would have been appropriate on the part of the tribunal to recommend to the President of The ITAT to constitute a larger bench to consider the effect of two decisions of the Hon. Apex Court as in one case (Munjal Sales Corporation (supra)) discussion and effect of section A was missing while in other case (Walfort Share & Stock Brokers (P) Ltd.'s case (supra)) effect of section 40(b) was missing. Without a sustainable justification to follow one decision without sufficiently laying down the reasons for not following the other decision could not be judicially acceptable.

Lastly it is submitted that the decision of Hon. Supreme court in Walfort Shares and Stock Brokers Case is a later decision and should have been given judicial priority. Particularly in view of the fact that Munjal Sales corporation case contains an Obiter dicta and only the opinion expressed on a question discussed and deliberated for the determination of a case is only binding.
