



Disallowance under Section 14A will not apply to interest paid on partner's capital

Background

Recently, the Pune Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Quality Industries¹ (the taxpayer) held that interest on partner's capital is not an 'expenditure' per se but is in the nature of a deduction under Section 40(b) of the Income-tax Act, 1961 (the Act). Thus, such interest is not expenditure specified under Section 14A. The deduction towards such interest is regulated only under Section 40(b), and the same is not within the purview of Section 36 or 37.

The interest paid to partners and simultaneously being subjected to tax in the hands of its partners is merely in the nature of contra items in the hands of the firms and partners. Therefore, the investment in mutual funds generating tax-free income bears the characteristic of and is attributable to its capital where no disallowance under Section 14A read with Rule 8D the Income-tax Rules, 1962 (the Rules) is warranted. However, the interest payable to parties other than partners would be subject to disallowance under Section 14A read with Rule 8D(2)(ii).

Facts of the case

- The taxpayer is a partnership firm and filed its return of income for the Assessment Year (AY) 2010-11 declaring certain income.
- While making the assessment under Section 143(3), the Assessing Officer (AO) noticed that the taxpayer has inter-alia, earned tax-free dividend income from investment in mutual funds, which was claimed as exempt under Section 10(35). Also, the investment in mutual funds has increased during the relevant year. Certain capital was introduced in the firm on which interest was paid to the partners and claimed as a deduction by the taxpayer against taxable income.

- Further, the investment in mutual funds is made out of interest bearing funds, which include interest-bearing partner's capital. Accordingly, the taxpayer has incurred expenditure including interest expenses, which are attributable to earning dividend income from investment in mutual funds. Thus, the AO proceeded to disallow the expenditure incurred in relation to dividend income so earned in terms of formula provided under Rule 8D read with Section 14A.
- In response to the show cause notice issued by the AO, the taxpayer submitted that interest on partner's capital is not an 'expenditure' per se but is in the nature of a deduction under Section 40(b), just as depreciation on a business capital asset is an allowance. Accordingly, it is not expenditure per se as specified under Section 14A. The firm has no separate existence from its partners, and in view of the mutuality, interest and salary to partner are not the expenditure. Section 14A covers amount in the nature of 'expenditure' and not all statutory allowances.
- However, the AO held that the investments in mutual fund giving rise to tax-free dividend income are sourced out of partner's capital and loans, and consequently, the interest paid on partner's capital is also susceptible to Rule 8D(2)(ii). Thus, the AO invoked Rule 8D and computed disallowance of interest and certain expenses that cover up common administrative expenses.

¹ Quality Industries v. JCIT (ITA No.2000/PN/2014, AY: 2010-11)

The Tribunal's decision

- An amendment was brought in by the Finance Act 1992 in Section 40(b), inter alia, to enable the firm to claim a deduction of the interest outgo payable to partners on their respective capital, subject to some upper limits. Hence, as per the present scheme of taxation, the interest payment on partners' capital, in essence, is not treated as allowable business expenditure except for the deduction available under Section 40(b).
- Ostensibly, with effect from AY 1993-94, partnership firms complying with the statutory requirements and 'assessed as such' are allowed deduction in respect of interest to partners, subject to the limits and conditions specified in Section 40(b). In turn, these items will be taxed in the hands of the partners as a business income under Section 28(v).
- The share of partners in the income of the firm is exempt from tax under Section 10(2A). Thus, the share of income from a firm is on a different footing than the interest income, which is taxable under the business income. Interest and salary received by the partners are treated on a different footing by the Act, and not in its ordinary sense of term.
- Section 28(v) treats the passive income accrued by way of interest and salary received by a partner of the firm as a 'business receipt', unlike different treatments given to similar receipts in the hands of entities other than partners. Under proviso to Section 28(v), the disallowance of such interest is only in reference to Section 40(b), and not Section 36 or 37. This also gives a clue that deduction towards interest is regulated only under Section 40(b), and the deduction of such interest to partners is out of the purview of Section 36 or 37.
- Notably, there has been no amendment to the general law provided under the Partnership Act 1932. The amendment to Section 40(b) has only altered the mode of taxation. The Partnership firm is not a separate legal entity under the Partnership Act. It is not within the purview to change or alter the basic law governing partnership. Interest or salary paid to partners is considered as the distribution of business income.
- Perusal of the Supreme Court decision in the case of R.M. Chimbaram Pillai² indicates that the 'partnership firm' and partners have been collectively seen, and the distinction between the two was blurred in the judicial precedents even for taxation purposes.
- A perusal of Section 4 of the Indian Partnership Act 1932 indicates that the firm and partners of the firm are not separate persons under the Partnership Act, although the separate unit of assessment for tax purposes. Therefore, there cannot be a relationship inferred between a partner and a firm as that of lender of funds (capital) and borrower of capital from the partners. Hence, Section 36(1)(iii) is not applicable. Section 40(b) is the only section governing the deduction towards interest to partners.
- In view of Section 40(b), the AO has no jurisdiction to apply the test laid down under Section 36 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 Section 40(b).
- The interest paid to partners and simultaneously being subjected to tax in the hands of its partners is merely in the nature of contra items in the hands of the firms and partners. Consequently, the 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 by the claim of interest on capital employed with the firm, by the partnership firm and partners put together. Thus, capital diverted in the mutual funds to generate alleged tax-free income does not lead to any loss in revenue by this action of the taxpayer.
- In view of the inherent mutuality, when the partnership firm and its partners are seen holistically and in a combined manner with costs towards interest eliminated in contra, the investment in mutual funds generating tax-free income bears the characteristic of and is attributable to its capital where no disallowance under Section 14A read with Rule 8D is warranted.
- Consequently, the plea of the taxpayer in relation to the interest attributable to the partners is accepted. However, the interest payable to parties other than partners would be subjected to provisions of Rule 8D(2)(ii). Similarly, in the absence of any specific plea from the taxpayer towards disallowance under Rule 8D(2)(iii), it is upheld in view of express mandate of law.
- The matter is accordingly remanded back to the file of the AO for re-computation of disallowance under Rule 8D read with Section 14A in terms of the opinion expressed above.

² CIT v. R.M. Chimbaram Pillai [1977] 106 ITR 292(SC)

Our comments

The issue with respect to disallowance of interest paid on partner's capital under Section 14A has been a matter of debate before the Courts/Tribunal.

The Mumbai Tribunal in the case of *Pahilajrai Jaikishin*³ held that interest paid on partners' capital is expenditure under Section 36(1)(iii). Such interest is not a statutory allowance under Section 40(b). Therefore, such interest expenditure on the partner's capital shall be liable for disallowance under Section 14A read with Rule 8D. The Ahmedabad Tribunal in the case of *Shankar Chemicals Works*⁴ held that Section 40(b) is restricting and regulating deduction allowable to the firm because of payment of interest to partners and is not an allowing section. Hence, the section for allowing deduction of interest is Section 36(1)(iii) and therefore, the payment of interest to partners is also an expenditure. Therefore, such expenditure is hit by the provisions of Section 14A; if it is found that the same has been incurred for earning exempt income.

However, the Tribunal in the present case held that under the proviso to Section 28(v), the disallowance of such interest is only in reference to Section 40(b), and not Section 36 or 37. There cannot be a relationship inferred between a partner and a firm as that of lender of funds (capital) and borrower of capital from the partners; hence Section 36(1)(iii) is not applicable. Section 40(b) is the only section governing the deduction towards interest to partners. In substance, the revenue is not adversely affected by the claim of interest on capital employed with the firm, by the partnership firm and partners put together. Accordingly, the investment in mutual funds generating tax-free income is attributable to its capital, where no disallowance under Section 14A is warranted.



³ ACIT v. Pahilajrai Jaikishin [2016] 66 taxmann.com 30 (Mum)

⁴ Shankar Chemicals Works v. DCIT [2011] 12 taxmann.com 461 (Ahd)

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