



Interest paid on partners' capital is an expenditure and not a statutory allowance and hence liable for disallowance under Section 14A of the Income-tax Act

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Pahilajrai Jaikishin¹ (the taxpayer) held that interest paid on partners' capital is an expenditure under Section 36(1)(iii) of the Income-tax Act, 1961 (the Act). Such interest is not a statutory allowance under Section 40(b) of the Act. Therefore, such interest expenditure on the partner's capital shall be liable for disallowance under Section 14A of the Act read with Rule 8D of the Income-tax Rules, 1962 (the Rules).

Facts of the case

- During the year under consideration, the taxpayer had invested in mutual funds, shares, etc. income there-from would be exempt from tax. While in the profit and loss account, the taxpayer claimed several expenses including interest expenses; however, no expenditure was disallowed by the taxpayer firm in relation to earning of exempt income in the computation of income.
- The taxpayer claimed that interest paid to the partner on their capital under Section 40(b) of the Act cannot be considered as an expenditure in the hands of the taxpayer

firm for the purpose of disallowance under Section 14A of the Act. The taxpayer claimed that since interest paid on capital of partners is only a statutory allowance allowable under the provisions of Section 40(b) of the Act, the same cannot be held as an expenditure incurred for earning of exempt income within the ambit of Section 14A of the Act.

- The Assessing Officer (AO) observed that the taxpayer firm received dividend income which is exempt from tax. The taxpayer firm incurred interest on borrowed funds. Accordingly, the AO held that the taxpayer's case falls under Section 14A(3) of the Act and hence a disallowance was to be made under Section 14A of the Act read with Rule 8D of Rules.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.

Tribunal's ruling

- The Mumbai Tribunal in the taxpayer's case² deleted the addition to the extent of a disallowance under Section 14A of the Act on account of interest expenditure which is not on borrowed fund but the capital contributed by the partners.

¹ ACIT v. Pahilajrai Jaikishin (ITA No.1562/Mum/2014) – Taxsutra.com

² ITA No. 6870/Mum/2012, dated 11 March 2015

- The decision of the Supreme Court in the case of R.M. Chidambaram Pillai³ relied on by the taxpayer rendered prior to the substantial amendments made in the scheme of taxation of partnership firms and partners by the Finance Act, 1992. However, the decision of the Supreme Court in the case of Munjal Sales Corporation⁴ has considered the substantial and major amendment to the scheme of taxation of the partnership firm and the partners by the Finance Act, 1992.
- The decision in the case of Munjal Sales Corporation was not brought to the notice of the Mumbai Tribunal in the taxpayer's case while adjudicating the appeal for the assessment year 2009-10.
- The Tribunal is bound by law to follow the decision of the Supreme Court vide Article 141 of the Constitution of India, whereby the law declared by the Supreme Court is binding on all Courts within the territory of India. The Principle of *Res-judicata* is strictly not applicable to income tax proceedings as was held by the Supreme Court in the judgment of Radhasoami Satsang⁵.
- The Supreme Court in the case of Munjal Sales Corporation has held that the taxpayer has to first establish its claim of deduction with respect to the payment of interest under Section 36(1)(iii) of the Act and then the same shall be subject to a limitation placed by Section 40(b) of the Act as this section is not a standalone section but a corollary to Section 30 to 38 of the Act.
- The Ahmedabad Tribunal in the case of Shankar Chemicals Works⁶ held that interest paid to a partner on capital is an expenditure covered under the provisions of Section 36(1)(iii) of the Act and is not a statutory allowance under Section 40(b) of the Act. If the expenditure is incurred in relation to or attributable to earning of exempt income as envisaged under Section 14A of the Act, the

same shall be allowed as an expense/deduction only against the exempt income earned by the taxpayer under Section 14A of the Act or in other words shall suffer a disallowance under Section 14A of the Act being incurred in relation to earning of an income which does not form a part of the total income of the taxpayer.

- The decision of Shankar Chemicals Works was also not brought to the notice of the Tribunal while adjudicating an appeal for the assessment year 2009-10.
- The decisions⁷ relied on by the taxpayer are distinguishable on the facts of the present case. The Tribunal was bound by the decision of the Supreme Court in the case of Munjal Sales Corporation and also agreed with the decision of the Ahmedabad Tribunal in the case of Shankar Chemical Works.
- Moreover, under the new scheme of taxation of a partnership firm, the interest paid to the partner on capital has to be claimed as a deduction under Section 36(1)(iii) read with Section 40(b) of the Act, from the income of the firm. However, if after allowing such interest, if the loss results in the hands of the firm, it will be allowed to be carried forward by the firm. While the partner shall be charged to tax for the total interest paid by the firm despite the fact that the firm could not claim the entire deduction due to the absence of profits and the resultant loss is to be carried forward to be set off against income of the subsequent years.
- Thus, it has been held that interest paid by the taxpayer firm to the partners on capital contribution is covered by an 'expenditure' under Section 36(1)(iii) of the Act. The taxpayer has to first establish its claim of deduction of interest on capital by satisfying the provisions of Section 36(1)(iii) of the Act and then, Section 40(b) of the

³ CIT v. R.M.Chidambaram Pillai [1977] 106 ITR 292 (SC)
⁴ Munjal Sales Corporation v. CIT [2008] 298 ITR 298 (SC)
⁵ CIT v Radhasoami Satsang [1992] 193 ITR 321 (SC)
⁶ Shankar Chemicals Works v. DCIT [2011] 11 taxmann.com 461(Ahd)
⁷ CIT v. Walfort Share & Stock Brokers Private Limited [2010] 326 ITR 1 (SC), CIT v. R M Chidambaram Pillai [1977] 106 ITR 292 (SC), Nectar Beverages Private Limited v. DCIT [2009] 314 ITR 314 (SC), Vishnu Anant Mahajan v. ACIT [2012] 22 taxmann.com 88 (Ahd)(SB), Maxopp Investments Limited & Ors. v. CIT [2012] 247 CTR 162 (Del), Kodak India Private Limited v. ACIT (ITA No. 7349/Mum/2012), ACIT v. SIL Investment Limited [2012] 50 SOT 54 (Del), CIT v. Hero Cycles Limited [2010] 323 ITR 518 (P&H)

³ CIT v. R.M.Chidambaram Pillai [1977] 106 ITR 292 (SC)

⁴ Munjal Sales Corporation v. CIT [2008] 298 ITR 298 (SC)

⁵ CIT v Radhasoami Satsang [1992] 193 ITR 321 (SC)

⁶ Shankar Chemicals Works v. DCIT [2011] 11 taxmann.com 461(Ahd)

Act puts a limitation on the allowability of interest once it passes through the requirements of the provisions of Section 36(1)(iii) of the Act. Thus, interest paid to partners on capital contribution is not a statutory allowance under Section 40(b) of the Act but is expenditure under Section 36(1)(iii) of the Act.

- If expenditure is incurred in relation to income which does not form part of the total income under the Act under Section 14A of the Act, the same shall only be allowed as a deduction against the exempt income under Section 14A of the Act or in other words, such interest expenditure on the partner capital shall be disallowed under Section 14A of the Act.
- Accordingly, the disallowance of interest on partners' capital under Section 14A of the Act read with Rule 8D(2)(ii) of the Rules has been upheld.
- Further this will not entitle the partner to claim relief on their individual return of income which shall be chargeable to tax as per the existing and applicable provisions of Section 28(v) of the Act read with Section 2(24)(ve) of the Act after including the aforesaid interest income in the hands of the partners.

Our comments

The issue with respect to disallowance of interest paid on partners' capital under Section 14A of the Act has been a matter of debate before the courts.

The Mumbai Tribunal in this case held that interest paid by the taxpayer firm to the partners on their capital contribution is not a statutory allowance under Section 40(b) of the Act but an expenditure under Section 36(1)(iii) of the Act. Therefore, such interest expenditure is to be disallowed under Section 14A of the Act read with Rule 8D of the Rules.



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