**SUPREME COURT OF INDIA**

Munjal Sales Corporation

Vs.

Commissioner of Income Tax, Ludhiana & Anr.

C.A.No.1378 of 2008

(S.H. Kapadia and B. Sudershan Reddy JJ.)

19.02.2008

**JUDGMENT**

**Kapadia, J.**

1. Leave granted.

2. This batch of civil appeals filed by the assesses is directed against judgments dated 12.10.06 and 16.10.06passed by the Punjab and Haryana High Court whereby the High Court has upheld the disallowance of interest claimed under Section 36(1)(iii) of the Income-tax Act, 1961 ("1961 Act", for short), placing reliance on its judgment in the case of *Commissioner of Income-tax v. Abhishek Industries Ltd*[1].

3. In this batch of civil appeals we are concerned with Assessment Years 1993-94, 1994-95, 1995-96, 1996-97 and 1997-98.

4. Facts:

> "In August/September 1991, appellant assesses granted interest free advances to its sister concerns which were disallowed by the Department on the ground that the said advances were not given from the firm's Own Funds but from interest bearing loans taken by the assesses-firm from third parties. Accordingly, the assessor's claim for deduction under Section 36(1)(iii) was disallowed by the Department for the AY 1992-93. However, vide order dated 3.1.03, the Tribunal deleted the disallowance saying that the assesses had given such advance from its Own Funds."

5. In the next AY 1993-94, the same situation took place. Once again vide order dated 1.1.03, the Tribunal deleted disallowance for AY 1993-94. It is important to note that the Department accepted the orders passed by the Tribunal in favor of the assesses for both the

AYs 1992-93 and 1993-94. At the same time, we need to emphasize, at this stage, that the interest free advance given to the sister concern was repaid on year to year basis. The said advance/loan got finally repaid in AY 1997-98.

6. During the AY 1994-95 no further advances were made by the assesses-firm in favor of its concerns. However, during AY 1995-96, a small interest free loan of Rs.5 lacs was advanced by the assesses-firm to its sister concern as during the year in question the assesses had profits of Rs.1.91 crores.

7. At this stage, it may be noted that before Finance Act 1992, payment of interest to the partner was an item of disallowance. Therefore, it had to be added back to the assessable income of the firm. But, after 1.4.93, vide Finance Act 1992, the said interest became an item of deduction, provided that the amount of deduction does not exceed 18/12% interest per annum [See: Section 40(b)(iv) of the 1961 Act]. For the AY 1994-95, Department in this case, therefore, disallowed the claim for deduction under Section 40(b)(iv) saying that in this case there was diversion of funds by raising of interest free loans. The AO did not accept the submission of the assesses that advance(s) made by the assesses were out of income of the firm. According to the AO, the said interest free advances to sister concerns were out of monies borrowed by the firm from third parties on payment of interest, hence the assesses was not entitled to deduction under Section 40(b) of the 1961 Act. This view was confirmed by the Tribunal.

8. For the AYs 1995-96 and 1996-97, Tribunal held that during the said years, no interest free advances to sister concerns were made and, therefore, there was no nexus between "interest bearing loans" taken and "interest free advances". However, the Tribunal found that there was no material to show that advances were made to sister concerns out of the firm's own income and, therefore, the assesses was not entitled to deduction under Section 40(b)(iv) of the 1961 Act.

9. The basic question which arises for determination is:

> "Whether Section 40(b) of the 1961 Act is a stand-alone section or whether it operates as a limitation to the deduction under Sections 30 to 38 of the 1961 Act?"

10. On the above question of law, Mr. S. Ganesh, learned senior counsel appearing on behalf of assesses, contended that prior to 1.4.93, Section 40(b) referred to disallowances per se but after the Finance Act 1992 the said Section 40(b)(iv) allows deduction, subject to the above limit of 18/12% per annum. According to learned counsel, Section 40(b)(iv) talks about statutory deduction and that the question of disallowance comes in only to the extent that payment of interest to the partner exceeds 12/18% per annum. In this case, according to learned counsel, all the conditions of Sections 40(b) (iv) have been satisfied and, therefore, the assesses was entitled to the benefit of deduction there under. In this connection, it was further argued that deduction under Section 40(b)(iv) is not for expenditure; that it was a statutory deduction and that the contribution by the partner to the firm cannot be equated to a

loan to the firm and that the former falls only under Section 40(b)(iv) and, therefore, the said Section 40(b) was a stand-alone section having no connection with the provisions of Section 36(1)(iii) of the 1961 Act. Further, according to learned counsel, in this case Section 36(1)(iii) had no application as this was a case of payment of interest to the partner on his capital contribution which cannot be equated to monies borrowed by the firm from third parties, hence the present case fell only under Section 40(b)(iv)
and not under Section 36(1)(iii) of the 1961 Act.

11. Mr. Prag P. Tripathi, learned Addl. Solicitor General appearing for the Department, submitted that object behind enactment of Finance Act 1992 is not only to avoid double taxation but also to put the firm as an assesses on par with other assesses. In this connection, learned counsel submitted that in view of the changed language of Section 40(b)(iv) of the 1961 Act, which is in the nature of a proviso, it can no longer be said that Sections 30 to 38 are not applicable to the firm as an assesses and that it will apply to all other assesses. That, prior to 1.4.93, Section 40(b)(iv) disallowed interest paid to the partners but after 1.4.93 the firm has to establish its claim for deduction under Sections 30 to 38 and that it was not disentitled under Section 40(b) would apply. According to learned counsel, Section 40 is in nature of a proviso to Sections 30 to 38 and, therefore, even if the assesses establishes its claim for deduction under Section 36(1) (iii), it has still to prove that it is not disentitled under Section 40(b)(iv). Therefore, according to learned counsel, after Finance Act 1992 the assesses has to establish deductions under Sections 30 to 38 and it has also to prove that it is not disentitled under Section 40 of the 1961 Act, like any other assesses.

12. We quote herein below Sections 36(1) (iii), 40(b) as it existed before 1.4.93 and 40(b)(iv) after Finance Act 1992 w.e.f. 1.4.93 which read as follow:

> "Other Deductions
>
> (i) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in Section 28-
>
> (iii) The amount of the interest paid in respect of capital borrowed for the purposes of the business or profession. Explanation: Recurring subscriptions paid periodically by share-holders, or subscribers in Mutual Benefit Societies which fulfill such conditions as may be prescribed, shall be deemed to be capital borrowed within the meaning of this clause. Amounts Not Deductible."

13. Notwithstanding anything to the contrary in Sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession, -

> "(a) in the case of any firm, any payment of interest, salary, bonus, commission or remuneration made by the firm to any partner of the firm.

Explanation 1: Where interest is paid by a firm to any partner of the firm who has also paid interest to the firm, the amount of interest to be disallowed under this clause shall be limited to the amount by which the payment of interest by the firm to the partner exceeds the payment of interest by the partner to the firm.

Explanation 2: Where an individual is a partner in a firm on behalf, or for the benefit, of any other person (such partner and the other person being hereinafter referred to as "partner in a representative capacity" and "person so represented" respectively,)-

(i) Interest paid by the firm to such individual or by such individual to the firm otherwise than as partner in a representative capacity, shall not be taken into account for the purposes of this clause;

(ii) Interest paid by the firm to such individual or by such individual to the firm as partner in a representative capacity and interest paid by the firm to the person so represented or by the person so represented to the firm, shall be taken into account for the purposes of this clause.

Explanation 3 : Where an individual is a partner in a firm otherwise than as partner in a representative capacity, interest paid by the firm to such individual shall not be taken into account for the purposes of this clause, if such interest is received by him on behalf, or for the benefit, of any other person;"

14. Section 40(b)(iv) after Finance Act 1992 w.e.f.1.4.93:

"Amounts Not Deductible. Notwithstanding anything to the contrary in Sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession", -

(a) In the case of any firm assessable as such, -

(b) 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 insofar as such amount exceeds the amount calculated at the rate of eighteen per cent simple interest per annum;"

15. Issue:

“Whether the claim for special deduction made by the assesses 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 assesses?”

16. Legal Position Explained.

"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 assesses could lose the benefit of deduction if the case falls under Section 40. In other words, every assesses 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 assesses 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 43B 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 assesses is entitled to deduction under Section 36(1)(iii), the assesses(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)."

17. It is vehemently urged on behalf of the assesses that partner's capital is not a loan or borrowing in the hand of a firm. According to the assesses, 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 assesses-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 assesses 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

assesses 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. Application of the 1961 Act to the facts of this case

18. As stated above, in this batch of civil appeals we are concerned with the Assessment Years 1993-94, 1994-95, 1995-96, 1996-97 and 1997-98. At this stage, it may be mentioned that as far back as in August/September 1991 assesses herein had given interest free advances to its sister concerns. These advances stood reduced over a period, till AY 1997-98. Each year the balances stood reduced. Further, vide Order dt.3.1.03 the Tribunal held, for AY 1992-93, that the assesses had given interest free loans from its Own Funds and not from interest bearing loans taken by the firm from third parties and consequently the assesses was entitled to claim deduction under 36(1)(iii). In other words, the Tribunal held that loans were given for business purposes. Similarly, for AY 1993-94, the Tribunal had taken the view that the said loans given to the firm's sister concerns were for business purposes. Accordingly, the Tribunal had deleted the disallowances during the AYs 1992-93 and 1993-94. It is equally true that for the AY 1994-95 the Tribunal took a contrary view in view of change in law brought about by Finance Act 1992. Prior to 1.4.93 payment of interest to the partner had to be added back to the assessable income of the firm whereas after Finance Act 1992 such payment became an item of deduction for computing the assessable income of the firm and it became part of the business income of the partner. In view of this change of law, the Tribunal disallowed payment of the interest in the present case for AYs 1994-95, 1995-96, 1996-97 and 1997-98. However, the point which has been left out from consideration is that the loans which were given in August/September 1991 to the sister concerns got wiped out only in AY 1997-98. As stated above, for AY 1992-93 and AY 1993-94, the Tribunal held that the loans given to the sister concerns were out of the firm's Funds and that they were advanced for business purposes. Once it is found that the loans granted in August/September 1991 continued up to AY 1997-98 and that the said loans were advanced for business purposes and that interest paid thereon did not exceed 18/12% per annum, the assesses was entitled to deductions under Section 36(1)(iii) read with Section 40(b)(iv) of the 1961 Act.

19. One aspect needs to be mentioned during the AY 1995-96, apart from the loan given in August/September 1991, the assesses advanced interest free loan to its sister concern amounting to Rs.5 lacs. According to the Tribunal, there was nothing on record to show that the loans were given to the sister concern by the assesses-firm out of its Own Funds and, therefore, it was not entitled to claim deduction under Section 36(1) (iii). This finding is erroneous. The Opening Balance as on 1.4.94 was Rs.1.91 crores whereas the loan given to the sister concern was a small amount of Rs.5 lacs. In our view, the profits earned by the assesses during the relevant year were sufficient to cover the impugned loan of Rs.5 lacs.

20. Before concluding, we may mention that the importance of the judgment is the clarification which we were required to give in the context of deductions under Sections 30 to 38 to be read with the limitation prescribed under Section 40. Since there was some confusion with regard to the status of Section 40, particularly, after enactment of Finance Act 1992, we have explained the law in the context of deductions under Chapter IV-D of the

1961 Act. We have accepted the submissions advanced by the learned Addl. Solicitor General in that regard. However, the assesses succeeds in this batch of civil appeals on the peculiar facts of this case.

21. Accordingly, the impugned judgments of the High Court are set aside and the civil appeals preferred by the assesses stand allowed with no order as to costs.

[1] *(2006) 286 ITR 1 (P&H)*