

ANDHRA PRADESH HIGH COURT

Commissioner of Income-Tax

Vs

T.V. Ramanaiah & Sons

(A Raghuvir, CJ. Y Anjaneyulu, J.)

10.10.1984

JUDGMENT

Y.V. Anjaneyulu, J.

1. The Income-tax Appellate Tribunal referred the following question of law under Section 256(1) of the Income-tax Act, 1961, for the opinion of this court : "Whether, on the facts and in the circumstances of the case, the Tribunal was correct in law in holding that the net interest payable to the partners by the firm, i.e., the interest payable to the partners after deducting therefrom the interest due by the partners to the firm on their borrowings was the only amount to be disallowed under Section 40(b) of the Income-tax Act, 1961 ?"

2. A narrow controversy arose in this case as regards the extent of interest which fell to be disallowed under Section 40(b) of the Income-tax Act, 1961 (for short "the Act"). The assessee is a partnership firm. Some of the partners invested capital and were paid interest by the assessee-firm. These partners also borrowed monies from the partnership firm and paid interest to the assessee. In the computation of income of the assessee-firm for the assessment year 1975-76, the question arose regarding the amount of interest paid to the partners which is liable to be disallowed under Section 40(b) of the Act. The Income-tax Officer was of the view that the entire interest paid by the assessee to the partners has to be added back in terms of Section 40(b) of the Act, whereas the assessee claimed that it is only that portion of the interest, which is in excess of the interest received by the assessee-firm that could be disallowed under Section 40(b). In other words, the assessee's claim was that, from out of the interest paid to the partners, the interest received from the same partners has to be set off and the effective amount, which may be described as the net interest for purposes of convenience, could be disallowed in terms of Section 40(b). The Income-tax Officer declined to accept this contention and added back the entire interest paid to the partners by the assessee-firm disregarding the amount of interest received from the partners. On appeal, the Appellate Assistant Commissioner accepted the assessee's contention and held that only the net amount of interest could be added back under Section 40(b) following the decision of the Allahabad High Court in *Sri Ram Mahadeo Prasad v. CIT*¹. The Income-tax Officer filed an appeal before the Income-tax Appellate Tribunal against the order of the Appellate Assistant Commissioner. The Income-tax Appellate Tribunal affirmed the view of the Appellate Assistant Commissioner and upheld the assessee's contention that only the net amount of interest could be added back under Section 40(b) of the Act. It is against this decision

of the Tribunal that the Commissioner has carried the present reference under Section 256(1) of the Act.

3. Learned standing counsel for the Revenue contended that, in terms of Section 40(b) of the Act, whatever interest is paid by the assessee has to be added back. According to him, there was no provocation for interpreting the clear provisions of Section 40(b) as requiring the Income-tax Officer to add back only the net amount of interest. We may, for purposes of convenience, extract below the relevant provisions of Section 40 :

"40. Notwithstanding anything to the contrary in Sections 30 to 39, the following amounts shall not be deducted in computing the income chargeable under the head ' Profits and gains of business or profession '

(b) 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."

4. Learned standing counsel states that the clear implication of Section 40(b) of the Act was that whatever interest is paid by the assessee-firm to its partners has to be added back and there was no justification for the claim that the interest paid by the assessee-firm to its partners has to be reduced by the amount of interest received by the assessee-firm from the partners. Learned standing counsel relied on the decision of the Madras High Court in *CIT v. Sankaralinga Nadar & Co*². in support of his contention.

5. Sri Srirama Rao, learned counsel appearing for the assessee, contends that so far as Section 40(b) is concerned, the reference to payment of interest must necessarily be understood as the effective amount of interest paid. He also relies on the decisions of the Allahabad High Court in *Sri Ram Mahadeo Prasad v. CIT [1953] 24 ITR 176 (Supra)(Supra) and CIT v. Kailash Motors [1982] 134 ITR 312(Supra)*, in support of his proposition that it is only the net interest that has to be added back. Learned counsel also relied on a Central Board of Direct Taxes Circular bearing No. 33-D(XXV-24) of 1965, which was reproduced in Direct Taxes Circulars, Vol. I, by J. P. Bhatnagar (1984 edition) at page 449. It would be appropriate to quote below the circular :

"Income--Computation of--Interest charged to a partner on debit balance--Whether the income of the firm.A reference is invited to Board's Circular No. 55 of 1941 on the above subject. In the above circular, it was stated that interest charged to a partner on his overdrawn account should not be included in the total income of the firm. It was further stated that where it appears that the capital borrowed for the purpose of business was partly diverted towards overdrawn account, the correct procedure would be to disallow the proportionate share of the interest payable on this capital in computing the income of the firm.

2. It has been brought to the notice of the Board that under the law as it stands, it would not be correct to exclude interest received by a firm from its partners while computing the total income of the firm. Whereas the interest paid to partners has to be disallowed in the assessment of the firm under the provisions of Section 40(b) of the Income-tax Act, 1961, there is no provision to exclude any portion of the interest or other income received by the firm from its total income. The matter has been examined by the Board and it has been decided that the interest received by a firm from its partners should be assessed as the income of the firm. However, where a firm pays interest to as well as receives Interest from the same partner, only the net interest can be

stated to have been received or paid by the firm, as the case may be, and only the net interest should be taken into consideration. This view also finds support in the decision of the Allahabad High Court in the case of :Sn Ram Mahadeo Prasad [1953] 24 ITR 176 (*Supra*)(*Supra*). In view of the above, the instructions contained in Board's Circular No. 55 of 1941 may be treated as modified accordingly. Circular No. 33-D(XXV-24) of 1965."

6. It will be seen from the above circular that the Central Board of Direct Taxes, after referring to the decision of the Allahabad High Court in Sri Ram Mahadeo Prasad v. CIT [1953] 24 ITR 176 (*Supra*)(*Supra*), expressed the view that, where a firm pays interest to as well as receives interest from the same partner, only the net interest can be stated to have been received or paid by the firm, as the case may be, and only the net interest should be taken into consideration. The Central Board of Direct Taxes accordingly instructed its officers to follow the above instructions. Learned counsel points out that the above circular issued by the Central Board of Direct Taxes, in exercise of the powers vested in it under Section 119 of the Act, is binding on all the Income-tax Officers in the execution and administration of the Act and that it is not open to the Income-tax Officers to violate the instructions issued by the Central Board of Direct Taxes and add back the gross amount of interest disregarding the interest received by the assessee-firm from its partners. Learned counsel, therefore, submitted that, based on the Central Board of Direct Taxes Circular, the assessee's claim for disallowance of only the net amount of interest should have been accepted.

7. We have considered the submissions made by the learned counsel for both sides. As a matter of interpretation of Section 40(b) of the Act, we find that there is nothing in the provision which expressly states that the amount to be added back is either gross or net. The provision requires that "any payment of interest" by a partnership firm to a partner shall not be deducted in computing the income of the partnership firm. For the purpose of finding out the amount paid by way of interest, it is necessary for the Income-tax Officer to find out the amount of interest paid by the partnership firm to the partner and also see if the same partner paid any interest to the partnership firm and ascertain the amount of interest effectively paid by the partnership firm to the partner. It is unnecessary to go into a detailed consideration of the question because the Central Board of Direct Taxes itself had accepted that the real purport of Section 40(b) of the Act was to add back only the net amount of interest and not the gross amount. There is no doubt that the decision of the Allahabad High Court in Sri Ram Mahadeo Prasad v. CIT [1953] 24 ITR 176 (*Supra*), supports the view that only the net amount of interest has to be added back. The Central Board of Direct Taxes, after referring to the abovesaid decision of the Allahabad High Court, directed the officers of the Income-tax Department to add back under Section 40(b) only the net amount of interest and not the gross amount. Examining the provision independently, we are in agreement with the view that Section 40(b) of the Act confers power on the Income-tax Officer to add back only the effective amount of interest paid by the firm to the partner, as was held by the Allahabad High Court in Sri Ram Mahadeo Prasad v. CIT [1953] 24 ITR 176 (*Supra*). We may point out that this principle, which was accepted by the Central Board of Direct Taxes in the circular above referred, was given statutory recognition by the Taxation Laws (Amendment) Bill, 1984, which introduced Explanation 1 to Section 40(b) of the Act, which reads as under :

"Amendment of Section 40.--In Section 40 of the Income-tax Act, after Clause (b), the following Explanations shall be inserted, namely :--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."

8. It is true that the above provision is effective from the assessment year 1985-86. It must, however, be borne in mind that the present amendment reiterated what has already been stated by the Central Board of Direct Taxes to be the real purport of Section 40(b) in its circular above referred to and we are clearly of the view that, even prior to the amendment taking effect from the assessment year 1985-86, the position of law was the same. It is as well to bear in mind that, in the Statement of Objects and Reasons introducing the Taxation Laws (Amendment) Bill, 1984, it has been specifically mentioned that the amendments introduced in the Bill are intended mainly to streamline procedures in the interest of better work management, avoid inconvenience to taxpayers, reduce litigation, remove certain anomalies in, and rationalise some of, the provisions of, these enactments and counteract tax avoidance and tax evasion. We consider that the present amendment to Section 40(b) of the Act is to avoid inconvenience to taxpayers and reduce litigation and in that view, the spirit of Explanation 1 introduced by the Taxation Laws (Amendment) Bill, 1984, should be followed with respect to the preceding assessment years also in order to avoid unnecessary litigation.

9. Learned counsel for the Revenue invited our attention to the decision of the Madras High Court in *CIT v. O.M.S.S. Sankaralinga Nadar & Co.* [1984] 147 ITR 332(supra), where the Madras High Court referred to the above circular of the Central Board of Direct Taxes and observed as under (at page 337) :

"Learned counsel pressed on us the departmental circular which was relied on by the Tribunal. When a matter comes before this court for an advisory opinion on the state of the law or of a fiscal principle, or on the construction of any provision in the taxing enactment, the last place where we should look for aid or guidance would be a circular from the Central Board of Direct Taxes on the subject. We are not bound by the Board circulars. Besides, these circulars have the knack of being inconsistent. For, they are, for the most part, circulars for the occasion. We are not, therefore, inclined even to take a look into the circular referred to us. If the circular has expressed a view which the Department has not followed in this case, the remedy is not to ask this court to render an opinion in accordance with the circular. The relief has to be sought elsewhere. It would be quite different from what or how a court of advisory jurisdiction would render on the merits."

10. With respect, we are unable to subscribe to the above view. Learned standing counsel for the Revenue stated that whatever may be the efficacy of the circular of the Central Board of Direct Taxes so far as the Department is concerned, it does not bind this court and, therefore, the decision should necessarily depend upon the interpretation of the statutory provisions. We are unable to accept this submission. The law is fairly settled that the instructions and directions given by the Central Board of Direct Taxes under Section 119 of the Act are binding on all the subordinate officers in the execution of the Act. Reference may be invited to the decisions of the Supreme Court in *Navnit Lal C. Javeri v. K. K. Sen, AAC*³, *Ellerman Lines Ltd. v. CIT*⁴ and *K. P. Varghese v. ITO*⁵ In *Navnit Lal C. Javeri's* case [1965] 56 ITR 198, the instructions given by the Central Board of Direct Taxes ran counter to the provisions of Section 2(6A)(e) and Section 12(1B) of the Indian Income-tax Act, 1922. Even so, the Supreme Court held that the instructions given by the Central Board of Direct Taxes were binding on the Revenue. Similarly,

the instructions contained in the circular, which was considered by the Supreme Court in Ellerman Lines Ltd.'s case [1971] 82 ITR 913, were contrary to the provisions of the Act. Even so, the Supreme Court held that the circular was binding on the officials of the Income-tax Department. The following observations of the Supreme Court in Ellerman Lines Ltd.'s case [1971] 82 ITR 913, 921 are relevant :

"Now, coming to the question as to the effect of instructions issued under Section 5(8) of the Act, this court observed in *Navnit Lal C. Javeri v. K. K. Sen, Appellate Assistant Commissioner* :It is clear that a circular of the kind which was issued by the Board would be binding on all officers and persons employed in the execution of the Act under Section 5(8) of the Act. This circular pointed out to all the officers that it was likely that some of the companies might have advanced loans to their shareholders as a result of genuine transactions of loans, and the idea was not to affect such transactions and not to bring them within the mischief of the new provision.' The directions given in that circular clearly deviated from the provisions of the Act, yet this court held that the circular was binding on the Income-tax Officers."

11. The same view was reiterated by the Supreme Court in K.P. Vargkese's case [1981] 131 ITR 597 above referred to. The above-mentioned three decisions of the Supreme Court set at rest any doubt as to the binding nature of the circulars issued by the Central Board of Direct Taxes so far as the officials of the Income-tax Department are concerned. We may also refer to two Bench decisions of this court in R. J. K. Ranga Rao v. *Commissioner of Expenditure Tax and Adml. CIT v. Sarvaray a Textiles Ltd.*⁶ which has taken the same view following the above decisions of the Supreme Court. Having regard to the above decisions, we are unable to accede to the submission of the learned standing counsel for the Revenue that the departmental officials are not bound to implement the instructions of the Central Board of Direct Taxes, if such instructions deviate from the correct legal position. We may point out that the provisions of Section 119 of the Act enjoin that the Officers of the Income-tax Department are bound by the instructions and directions given by the Central Board of Direct Taxes. Wherever the instructions given by the Central Board of Direct Taxes to relieve hardship to an assessee are violated and if such instructions are issued in exercise of the powers vested in the Central Board of Direct Taxes under Section 119 of the Act, it is certainly open to this court to compel the Income-tax Officer to follow the instructions of the Central Board of Direct Taxes. This is not to say that this court is bound by the instructions of the Central Board of Direct Taxes. All that is required to be said is that, so far as the officials of the Income-tax Department are concerned, it is not open to them to say that they would not follow the instructions of the Central Board of Direct Taxes and carry matters in appeals and references. Indeed, we do not know whether the Commissioner of Income-tax, who carried this matter in reference to this court, is aware of the above-mentioned circular and, if so, why he thought it necessary to seek a reference on this point to this court when the matter is clearly governed by the circular of the Central Board of Direct Taxes. We do not wish to say anything more.

12. In any view of the matter, we are satisfied that the Tribunal is justified in holding that, in computing the total income of the assessee-firm, only the net amount of interest paid to its partners can be added back. We accordingly answer the question in the affirmative, that is to say, in favour of the assessee and against the Revenue. There shall be no order as to costs.

Cases Referred.

1[1953] 24 ITR 176
2[1984] 147 ITR 332
3[1965] 56 ITR 198
4[1971] 82 ITR 913
5[1981] 131 ITR 597
6[1982] 137 ITR 369