

IN THE HIGH COURT OF KARNATAKA AT BANGALORE

DATED THIS THE 17<sup>TH</sup> DAY OF NOVEMBER, 2014

:PRESENT:

**THE HON'BLE MR. JUSTICE N.KUMAR**

**AND**

**THE HON'BLE MR. JUSTICE B.MANO HAR**

**ITA NO.1132/2008**

**BETWEEN:**

M/S. HOTEL ROOPA,  
BALMATT A ROAD,  
MANGALORE,  
REPRESENTED BY  
ITS PARTNER,  
SRI VINAY CHANDRA SUVARNA.

**...APPELLANT**

(BY SRI S.P.BHAT &  
SRI C.BASAVAI AH, ADVS.)

**AND:**

1. COMMISSIONER OF INCOME TAX,  
C.R.BUILDING, ATTAVR,  
MANGALORE.
2. ASST. COMMISSIONER,  
OF INCOME TAX CIRCLE-1(1)  
MANGALORE.

**...RESPONDENTS**

(BY SRI JEEVAN.J.NEERALGI, STANDING COUNSEL)

THIS ITA IS FILED UNDER SECTION 260-A OF THE  
INCOME TAX ACT, 1961, ARISING OUT OF ORDER DATED  
08.08.2008 PASSED IN ITA NO.1176/BNG/2007, FOR THE  
ASSESSMENT YEAR 2002-2003, PRAYING TO (I)  
FORMULATE THE SUBSTANTIAL QUESTIONS OF LAW  
STATED THEREIN (II) ALLOW THE APPEAL AND SET ASIDE  
THE ORDER PASSED BY THE ITAT, BANGALORE IN ITA

NO.1176/BNG/2007, DATED 08.08.2008 CONFIRM THE ORDER OF CIT(A) AND THE ASSESSING AUTHORITY.

THIS ITA COMING ON FOR FINAL HEARING THIS DAY, **N.KUMAR J.**, DELIVERED THE FOLLOWING:

### **J U D G M E N T**

Assessee has preferred this appeal challenging the concurrent findings recorded by three Authorities that the interest paid on the borrowing is not for the purpose of business and therefore same is not deductible under Section 36(1)(iii) of the Income Tax Act, 1961.

2. The assessee is a partnership firm which is running boarding and lodging by name Hotel Roopa in Mangalore. Originally it consisted four partners and on 06.10.2000, one more partner was inducted as a partner. On 20.10.2001, three partners retired from the partnership firm and the business was continued only with the remaining two partners. The assessee firm borrowed a sum of Rs.75,00,000/- from the Bank for the purpose of settling the account to the retiring partners and the claim deducted of Rs.5,04,803/- under Section 36(1)(iii) towards interest on the borrowal made to be Bank. The Assessing Officer rejected the

claim of the assessee on the ground that the borrowal has been made for the purpose of discharging the personal liability for the continuing partners of the firm and the payment made to the retiring partners has nothing to do with the business of the firm. Therefore, borrowing cannot be considered as having been made for the purpose of business of the firm. Aggrieved by the said order, the assessee preferred this appeal to the Commissioner of Income-Tax (Appeals) who dismissed the appeal. In second appeal before the Tribunal, arguments of the assessee did not find favour. Therefore, appeal came to be dismissed. Aggrieved by these three orders, the assessee is before this Court.

2. This appeal came to be admitted on considering the following substantial questions of law on 09.03.2009, which reads as under:

- “1. Whether, on the facts and circumstances of the case, the tribunal is justified in rejecting the assessee’s claim of interest of Rs.5,04,803/- on the borrowed funds of Rs.75,00,000/- from the Bank under*

*Section 36(1)(iii) of the Income Tax Act, 1961?*

2. *Whether on the facts and circumstances of the case, the tribunal is justified in holding that borrowing was not made for the purpose of the business and therefore the interest claimed as deduction under Section 36(1)(iii) of the Act is not an allowable deduction?*
3. *Whether on the facts and circumstances of the case, the conclusion of the tribunal that the payments to the retiring partners by the continuing partners had been made only because of increase in their shares is based on any materials?*
4. *Whether the order passed by the tribunal is vitiated on account of non-consideration of the various contentions raised by the petitioner firm in its submission made before it?*
5. *Whether the tribunal in coming to its conclusion has acted judicially in accordance with the principles laid down by the Supreme Court in 66 ITR 714?"*

4. Learned Counsel for the assessee assailing the impugned order contends that the borrowal of the funds for the firm is for the purpose of discharging the liability of the firm to the retiring partners and therefore, it falls under Section 37 of the Partnership Act. Borrowal is only for the purpose of business. If the said amount has not been paid in terms of partnership deed, out going partners had right to proceed against the firm to recover the said amount, and in order to avoid such litigation and to protect the interest of the firm, the aforesaid borrowal was undertaken and payment was promptly made. The increase of the shares of the continuing partners is not relevant in deciding whether the borrowal is for the purpose of business or not. The liability is that of the firm and not of an individual partner. Therefore, he submits that, the assessment order is contrary to law and since both the appellate authorities have affirmed the impugned order, he is before this Court seeking for setting aside of the impugned order.

5. Per contra, learned Counsel for the revenue supports the impugned order passed and places reliance to the Judgment of the Apex Court in the case of ***Madhav Prasad Jatia v. Commissioner of Income Tax U.P.*** reported in (**118 ITR 200**). The Apex Court while interpreting the provisions of Sections 10(2)(iii) and under Section 12(2) of the Income Tax Act, 1961 which deals with Section 36(1)(iii) of the Act has held that:

*“Proceeding to consider the claim for deduction made by the assessee under s. 10(2)(iii) or s.10(2)(xv), we may point out that under s.10(2) (iii), three conditions are required to be satisfied in order to enable the assessee to claim a deduction in respect of interest on borrowed capital, namely, (a) that money (capital) must have been borrowed by the assessee, (b) that it must have been borrowed for the purpose of business, and (c) that the assessee must have paid interest on the said amount and claimed it as a deduction. As regards the claim for deduction in respect of expenditure under s.10(2)(xv), the assessee must also satisfy three conditions, namely, (a) it (the expenditure)*

must not be an allowance of the nature described in clauses (i) to (xiv), (b) it must not be in the nature of capital expenditure or personal expenses of the assessee, and (c) it must have been laid out or expended wholly and exclusively for the purpose of his business. It cannot be disputed that the expression "for the purpose of business" occurring in s.10(2) (iii) as also in s.10(2) (xv) is wider in scope than the expression "for the purpose of earning income, profits or gains" occurring in s.12(2) of the Act and, therefore, the scope for allowing a deduction under s. 10(2) (iii) or 10(2) (xv) would be much wider than the one available under s.12(2) of the Act. This Court in the case of CIT v. Malayalam Plantations Ltd. [1964] 53 ITR 140 (SC)] has explained that the former expression occurring in s.10(2)(iii) and 10(2)(xv), its range being wide, may take in not only the day-to-day running of a business but also the rationalisation of its administration and modernisation of its machinery; it may include measures for the preservation of the business and for the protection of its assets and property from expropriation, coercive process or assertion of hostile title; it may also comprehend payment

*of statutory dues and taxes imposed as a pre-condition to commence or for the carrying on of a business; it may comprehend many other acts incidental to the carrying on of the business but, however wide the meaning of the expression may be, its limits are implicit in it; the purpose shall be for the purposes of business, that is to say, the expenditure incurred shall be for the carrying on of the business and the assessee shall incur it in his capacity as a person carrying on the business”..*

6. From the aforesaid Judgment, it is clear that, the claim for deduction in respect of interest on borrowed capital the assessee has to satisfy three conditions: (i) that money must have been borrowed by the assessee; (ii) that it must have been borrowed for the purpose of business; (iii) that the assessee must have paid interest on the said amount and claimed it as a deduction. Similarly, from the aforesaid Judgment, it is also clear that for claiming the deduction in respect of expenditure under Section 10(2)(xv), the assessee has to satisfy three conditions: (a) the expenditure must not be an allowance in the nature described in clauses (i) to

(xiv); (b) it must not be in the nature of capital expenditure or personal expenses of the assessee; (c) it must have been laid out or expended wholly and exclusively for the purpose of business.

7. In the instant case, reconstituted partnership deed is produced which is dated 19.10.2011 which provides that in consideration of a sum of Rs.1,30,00,000/- payable to the retiring partners, a sum of Rs.55,00,000./- has already been paid by the continuing partners to the retiring partners. The balance amount of Rs.75,00,000/- shall be paid by the State Bank of India, Commercial Branch, out of the loan amount sanctioned to the firm. The continuing partner shall pay the same within 15 days to the retiring partners from the date of the reconstitution, failing which the retiring partner shall recover the same with an interest at 24% p.a. In consideration of the said payment of Rs.1,30,00,000/- retiring partners relinquish all their right, title and interest in the assets and liabilities of the firm and by virtue of the same, the retiring partners shall have no right of whatsoever

nature against the firm or its assets thereafter. The share of the partners for such retirement is 75% and 25%.

8. From a reading of the aforesaid recitals in the reconstituted deed, it is clear that it is continuing partners who are paying a sum of Rs.1,30,00,000/- to the retiring partners. On the date of the reconstituted deed, they had already been paid a sum of Rs.55,00,000/-. The said amount is not out of partnership firm. The balance of Rs.75,00,000/- was also liable to be paid by the continuing partners to the retiring partners. Probably, as on such date, they did not had requisite funds, they have borrowed a sum of Rs.75,00,000/- from the State Bank of India. The recital made in the reconstituted deed that the said amount of Rs.75,00,000/- shall be paid by the Bank, out of the loan amount sanctioned to the firm. Further it casts an obligation on the continuing partners to make payment within 15 days. The amount is borrowed from the Bank. This recital that the balance amount of Rs.75,00,000/- shall be paid by State Bank of India, out of the loan

account sanctioned to the firm to the retiring partners discloses the real intention of the transactions between the parties. Because the continuing partners agreed to pay a sum of Rs.1,30,00,000/- as consideration for the retiring partners to relinquish all their right title and interest with the partnership firm and though they had already paid a sum of Rs.55,00,000/, on the date of reconstituted deed and the balance amount payable is out of the loan sanctioned by the State Bank of India, the said amount of Rs.75,00,000/- has nothing to do with business of the firm. But the said amount was directly made over to the retiring partners as full payment of the balance consideration agreed to be paid by the continuing partners to the retiring partners for their relinquishment to the share which the retiring partners had in the firm. The said amount do not represents the amount borrowed for the purpose of business. It is because of the payment of the said amount, share of the continuing partner becomes 75% and 25%. This amount of Rs.1,30,00,000/- represents

consideration paid for the share of the retiring partners.

It is not a liability of the partnership firm.

9. Section 37 of the Partnership Act on which reliance is placed reads thus:

**“RIGHT OF OUTGOING PARTNER IN CERTAIN CASES TO SHARE SUBSEQUENT PROFITS.**

*Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent. per annum on the amount of his share in the property of the firm : Provided that where by contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or*

*outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner of his estate, as the case may be, is not entitled to any further or other share of profits, but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section”.*

Thus, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property.

10. The amount of Rs.1,30,00,000/- paid is not a share of the profit of the retiring partner in the partnership firm. Therefore, applying the law laid down by the Apex Court in the aforesaid Judgment, when the aforesaid amount of Rs.75,00,000/- is not borrowed by the assessee for the purpose of business and does not laid out expenditure wholly and exclusively for the purpose of business of the firm, claim for deduction

under Section 36(1)(iii) was not justified. The Authorities have rightly disallowed deductions and therefore, we do not see any merit in this appeal.

11. Accordingly, the substantial questions of law are answered in favour of the revenue and against the assessee. No merit in this appeal and it is dismissed.

**Sd/-  
JUDGE**

**Sd/-  
JUDGE**

KSR