**IN THE INCOME TAX APPELLATE TRIBUNAL**
**MUMBAI BENCHES 'H"**

BEFORE SHRI M.A. BAKSHI, V.P. AND SHRI V.K. GUPTA, AM

ITA No. 7534/Mum/2004
Assessment Year 2001-02

Mr. Dharmasingh M. Popat,
M/s Mulla & Mulla & Cragie Blunt & Caroe,
Mulla House,
51 Mahatma Gandhi Road,
Fort,
Mumbai-400 001.
PAN AAMPP 3239 N
Appellant

Vs.

A.C.I.T. 11(2),
Room No. 442, 4th Floor,
Aayakar Bhawan,
Mumbai. - 20

Respondent

Appellant by Shri S.E. Dastur
Respondent by Shri P.N. Devadasan

ORDER

Date of hearing 6.11.08
Date of pronouncement

PER V.K. GUPTA, A.M.

This appeal, filed by the assessee, is directed against the order of CIT (A) XI, Mumbai dated 16.9.2004 for A. Y. 2001-02.

2. We have heard both the sides and have also perused the materials placed on record and applicable legal position.

3. In this appeal, the assessee is aggrieved by the decision of Id. CIT (A) in confirming the disallowance of Rs. 10,70,864/- u/s. 14A of the Act.

4. The facts, in brief, are that the assessee is a partner in the partnership firm engaged in legal profession. During the year under consideration, the assessee received salary at Rs. 13,26,000/- from the said partnership firm and also received share in profit thereof at Rs. 40,25,600/-. The assessee claimed expenses of Rs. 14,27,819/- against these incomes and arrived at an income of Rs. 39,23,7807- out of which assessee claimed Rs. 40,25,600/- as exempt u/s. 10(2A) of the Act and, hence, finally showed a net loss of Rs. 1,01,819/- under the head profits and gains of business or profession. In respect of A.O.'s query regarding applicability of provisions of Section 14A of the Act in regard to assessee's claim of set off of such expenses, it was contended that the major part of total expenditure of Rs. 14,27,819/- was incurred as conferences, seminars and court sessions abroad which were deductible from business income and since the assessee had business income as aforesaid and salary received from partnership firm was also assessable as a business income u/s. 28(v) of the Act, hence, provisions of Section 14A were not applicable. The assessee also stated that the expenditure incurred had nothing to do with the tax free income in the form of share of profit from the partnership firm and if the assessee would have earned only share

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of profit from the firm, perhaps, only then, provisions of Section 14A applied. The assessee also submitted that it had earned Rs. 15,075/- for sessions of International Court of Arbitration at Paris and which has been offered as income. The A.O., however, held that the explanations given by the assessee were not acceptable and since the assessee did not allocate expenses against the income earned as salary from the firm and income earned as share of profit from the firm, hence, the same was to be done now and for this purpose he analysed the break-up of expenditure of Rs. 14,27,819/- and found that it comprised of following:-

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| (i) | Expenses on study tour | Rs. 10,40,879/- |
| (ii) | Depreciation | Rs. 1,01,0407- |
| (iii) | Legal books, magazine & subscription | Rs. 2,41,243/- |

The A.O. also found that though the assessee spent more than Rs. 10 lacs on study tour and because of that the firm could obtain professional fee of Rs. 1.07 crores as stated by the assessee in his letter dated 22.1.2003 whereas he was given salary of only Rs. 13,26,000/- only. Thereafter, the A.O. drew support from various decisions to hold that the assessee could not be allowed to follow the laws which suited to the assessee and close his eyes to the laws which did not suit him. Finally, he held that assessee 's share of profit at Rs. 40,25,600/- worked out to 75% of total amount received by the assessee from the firm by way of share in profit and salary, hence, 75% of the total expenditure of Rs. 14,27,819/- was allocable towards share in profit and, hence, added a sum of Rs. 10,70,864/- to the total income of the assessee. Aggrieved by this, the assessee carried the matter in appeal before the Id. CIT(A) wherein the assessee contended that in Section 14A the words used were " does not form part of total income under this Act" and not does not form part of total income of the assessee under the Income Tax Act" hence, the A.O. had inserted the words " of the assessee" between the words "income which does not form part of the total income" and "under this Act" which could not be done by the A.O. and since the income had been taxed in the hands of the firm, hence, income by way of salary or share of profit were not incomes which did not form part of the total income under the Income Tax Act. It was also contended that entire expenditure incurred for earning salary as well as share of profit from the firm was allowable to the extent incurred by the firm, in firm's assessment and to the extent incurred by the partner, in the partner's hand. The assessee also contended that the tax on an income of the firm was by the partners as compendium and the firm on its income had paid taxes, hence, it could not be said that share of profit was exempt from tax. For this proposition, the assessee relied on the following judicial decisions-

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| Mafatlal Holdings Ltd. | ITA No. 2935/M/02 Dt.23.4.2003 |
| S.G. Investments & Industries Ltd. | 89 ITD 44 |
| Premier Consolidated Capital Trust (I) Ltd. | 83 TTJ 843 (Mum) |

The assessee also relied on the decision of the Hon'ble Bombay High Court in the case of Phiroze H. Kudianavala as reported in 113 ITR 873. The Id. CIT(A), however, confirmed the action of A.O. The relevant findings of the Ld. CIT(A) are as under-

> I have considered the arguments of appellant and the contentions of the A.O. The fact that appellant has earned the share of profit of Rs. 40,25,600/- which is exempt u/s. 10(2A) of IT. Act is not disputed. It is also not disputed that the salary of Rs. 13,26,000/- earned by the appellant from the firm is taxable as business income in the hands of appellant.
>
> The main argument of the appellant is that to invoke Section 14A of IT. Act, the income in question should not form part of total income. It has been

emphasized that Section 14A of I.T. Act did not specifically mention the total income of the appellant implying that the income in question need not necessarily form part of total income of the firm.

I am not inclined to agree with the appellant on this issue. The provisions of any Section when applied to san assessee are directed towards that assessee only. Simply because the words "of the assessee" are not mentioned in the Section, it cannot be said that the Section shall not apply to the appellant. I would be stretching it too far if the interpretation of the appellant is to be accepted. Obviously, when applied in the case of appellant, Section 14A of I.T. Act meant that the income in question should not form part of the total income of the appellant.

The reliance by the appellant on the decision in the case of P.H. Kudianavala 113 ITR 873 is out of context in as much as that for the period to which the decision relates, the share of profit of the partner from the partnership firm was taxable and was not exempt. The exemption u/s. 10(2A) of the I.T. Act is available w.e.f. 1-4-1993 only.

A perusal of statement of total income indicates that the appellant has claimed entire expenses of Rs. 14,27,819/- against the remuneration of Rs. 13,26,000/- from the firm implying that none of the expenses was allocable against other incomes. Considering these facts, the AO has been reasonable in allocating the expenses against the taxable income by way of salary received by the appellant which is taxable as business income."

Aggrieved by this, the assessee is in appeal before us.

5. The learned counsel for the assessee initiated his arguments by stating that assessee was a partner in a firm of solicitors wherefrom assessee received salary and share in the profits of such firm and further submitted that salary so received was taxed in the hands of the assessee as business income and share profit of firm had been fully taxed in the hands of the firm, hence, both salary and such share in the profits had been taxed and, therefore, it could not be said that these incomes were exempt from tax. The Ld. Counsel placed reliance on the decision of Hon'ble Supreme Court in the case of CIT vs. R.N. Chidambaram Pillai as reported in 106 ITR 292 and contended that in this case the Hon'ble Supreme Court had held that salary paid to partners out of the portion of agricultural income of the firm was to be treated as of the nature of agricultural income as the firm was not a legal person even though it had some attributes of personality and even in Income Tax Law, the firm was a unit of assessment by special provisions but not a full person, hence, partnership firm was not independent from it's partners and also salary received by a partner retained it's character of profit of the firm.. The Ld. Counsel further contended that there was a difference between share holder vis-a-vis company and partner vis-a-vis firm as far as legal personality was concerned, hence, in case of dividend declared by a company, it could said that the dividend distribution tax paid by the company could not be said to have been paid by the share holder whereas in case of partnership firm which was not a separate entity and the profit, being taxed in the hands of the firm was only exempt u/s. 10(2A) of the Act, in the hands of the partner, hence, provisions of Section 14A was not applicable. The Id. Counsel, on this aspect, further contended that from A.Y. 1993-94 a new scheme of taxation/assessment had been introduced but it did not mean that the basic character of partnership firm or profits of such partnership business had been done away i.e. the object of such scheme was to tax the total profit of partnership firm either at the hands of the firm and its partners in respect of interest, salaries paid to the partner which had been allowed deduction in the hands of the firm and, therefore, even after such changes in law, total profits received by the partner in the form of share and salary retained the same character and was not an exempt income. In this regard, he also contended that if a remuneration or interest paid to a partner was disallowed in the hands of the firm, then, such remuneration or interest was not taxable u/s. 28(v) of the Act. The Id. Counsel further contended that it was

a matter of convenience among the partners as to decide the mode of distribution of profits, but the same would not make an income already taxed as exempt income. The Ld. Counsel further contended that apart from these two types of incomes, the assessee also earned sitting fee/arbitration fee in the capacity of Member of International Court of Arbitration which in the year under consideration was Rs. 15,075/- and the same had been offered for taxation in the year under consideration, hence, for this reason also, the provisions of Section 14A were not applicable because u/s. 14A of the Act what an expenditure incurred by an assessee in relation to income which did not form part of the total income under this Act could only be disallowed. The Ld. Counsel also submitted a chart to show that the assessee earned substantial income by way of arbitration fee in subsequent assessment years, which was offered as business income, hence, the impugned expenditure incurred by the assessee in the year under consideration were allowable as deduction. He also contended that in the facts of the case, no disallowance could be made under rule 8D of Income Tax Rules, 1962 and drew our attention to the relevant provisions.

6. The learned DR., on the other hand, contended that partnership firm was a separate entity under the provisions of Section 2(31) of the Act and, hence, tax paid by the firm on the profits could not be said to be an income which was not exempt from tax in the hands of the partner. He also contended that assessee received share in the profit which was exempt in its hands under the provisions of Section 10(2A) of the Act, hence, provisions of Rule 8D was applicable. The Ld. D.R. further contended that the A.O., in the assessment order, had observed that the assessee himself vide it's letter dated 22.1.2003 had stated that because of study tour undertaken by the assessee, the partnership firm had earned a sum of Rs. 1.07 crores , hence, the expenditure which was claimed by the assessee was directly connected with the income earned by the assessee from such firm and the A.O. rightly disallowed the same in the proportion of share of profit to the total income earned by the assessee from the firm.

7. We have considered the submissions made by both parties, material on record and orders of authorities below. The first question which is to be decided by us is whether partnership firm is merely a compendium of partners having no independent legal personality for the purpose of Income Tax Act and, hence, share of profit is not an exempt income in the hands of partner for the reason that the firm has paid tax thereon.

8.1. In this regard, it is to be noted that scheme of assessment/taxation of partnership firm and partners has undergone change on a number of occasions. Initially payment of salary, bonus or commission etc. by the firm to the partners was not allowable as an expenditure and share in the profits of a partnership firm was also taxable in the hands of partners subject to certain relief/rebates. Subsequently, w.e.f. A.Y. 1993-94, the scheme of assessment for partnership firm is treated as an independent entity in a limited sense like a company for the purposes of Income Tax Act, 1961. The expenditure by way of remuneration, interest, commission etc. paid to partners is also allowable in the hands of partnership firm subject to certain ceilings and share in the profit of a partnership firm is not taxable in the hands of partners, however, the interest and salary etc. allowed in the hands of partnership firm is taxable as business income in the hands of partners to that extent. It is also pertinent to note that provisions of Section 40(b) pre-suppose the allowability of such expenditure u/s. 28(1) or 37(1) and further expenditure like rent paid to partner is allowable without any restriction of course subject to provisions of Section 40A(2) of the Act.

8.2. The assessee has placed reliance on the decision of the Hon'ble Supreme Court in the case of CIT vs. R.N. Chidambaram Pillai as reported in 106 ITR 292 wherein the Hon'ble Supreme Court having regard to the earlier scheme of assessment in terms of provisions of Section 10(1), 10(4)(b) and 16(1)(b) of Income Tax Act, 1922 held that salaries paid to the partners were regarded by the Income Tax Act as retaining character of profits and not excludible from the tax net, hence, salary paid to partners out of the portion of agricultural income of the firm was to be treated as of the nature of agricultural income. However, the fact remains that the Hon'ble Supreme Court was dealing with a case where

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the profits of the partnership firm were subject to double taxation i.e. once at the hands of the partnership firm and secondly in the hands of partners.

8.2.1. Now, we would make a humble attempt to find out the judicial opinion on this issue. In this regard, we consider it pertinent to a Three Judge Bench decision of the Hon'ble Supreme Court in the case of CIT vs. A.W. Figgies and Co. & Others as reported in 24 ITR 405. In this case, the issue before the Hon'ble Supreme Court was that whether a firm which had been re-constituted due to change in partners on a number of occasions earlier was entitled to relief u/s. 25(4) of Indian Income Tax Act. The Tribunal, in this case had held that for the purposes of Income Tax Act, the firm was to be regarded as having a separate juristic existence apart from the partners carrying on the business and that the firm could be carried on even if there was a change in its constitution. The Hon'ble Calcutta High Court also confirmed the decision of the Tribunal. The Hon'ble Supreme Court reviewed the provisions of Section 25(4) of the Act and observed that this section did not regard a mere change in the personnel of the partners as amounting to succession and disregarded such a change and, therefore, natural consequence of such provision was that a mere change in constitution of partnership did not necessarily bring into existence a new assessable unit or a distinct assessable unit and in such a case there was no devolution of the business as a whole. Thereafter, the Hon'ble Supreme Court held that as per the law, partnership firm had no legal existence apart from its partners, however, under the Income Tax Act, position was somewhat different, hence, technical view of the nature of a partnership under English law or Indian law could not be taken in applying the law of Income Tax. The relevant findings of the Hon'ble Supreme Court are as under: -

> " *It is true that under the law of partnership a firm has no legal existence apart from its partners and it is merely a compendious name to describe its partners but it is also equally true that under that law there is no dissolution of the firm by the mere incoming or outgoing of partners. A partner can retire with the consent of the other partners and a person can be introduced in the partnership by the consent of the other partners. The reconstituted firm can carry on its business in the same firm's name till dissolution. The law with respect to retiring partners as enacted in the Partnership Act is to a certain extent a compromise between the strict doctrine of English common Law which refuses to see anything in the firm but a collective name for individuals carrying on business in partnership and the mercantile usage which recognizes the firm as* a *distinct person or quasi corporation. But under the Income Tax Act the position is somewhat different. A firm can be charged as a distinct assessable entity as distinct from its partners who can also be assessed individually. Section 3 which is the charging section is in these terms:-*
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> *"Where any Central Act enacts that income tax shall be charged for any year at any rate or rates tat at that rate or those rates shall be charged for that year in accordance with, and subject to the provisions of this act in respect of the total income of the previous year of every individual, Hindu undivided family, company and local authority and of every firm and other association of persons or the partners of the firm or the members of the association individually.*
>
> *The partners of the firm are distinct assessable entities, while the firm as such is a separate and distinct unit for purposes of assessment. Sections 26, 48 and 55 of the Act fully bear out this position. These provisions of the Act go to show that the technical view of the nature of a partnership, under English Law or India law, cannot be taken in applying the law of income tax."*

Thus, in this case, in our humble opinion, the Hon'ble Supreme Court recognized the dichotomy between the general partnership law and Income Tax Act and if a situation was taken care of by specific provisions of Income Tax Act, then, such provisions were to prevail over the provisions of general law.

8.3. Again, in the case of Dulichand Laxminarayan vs. CIT as reported in 29 ITR 535, the Hon'ble Supreme Court (Three Judge Bench) held that a firm was not a person and as such it was not entitled to enter into a partnership with another firm or HUF or individual, hence, a partnership purporting to be one between three firms, an HUF family business and an individual was not entitled for registration u/s. 26A of Indian Income Tax Act, 1922 r.w. Rule 2. The relevant findings are as under-

> *" Some of the mercantile usages relating to a firm have, however, found their way into the law of partnership. Thus in keeping accounts, merchants habitually show a firm as a debtor to each partner for what he brings into the common stock and each partner is shown as a debtor to the firm for all that he takes out of that stock. But under the English common law, a firm, not being a legal entity, could not sue or be sued in the firm name or sue or be sued by its own partner, for one cannot sue oneself. Later on this rigid law of procedure, however, gave way to considerations of commercial convenience and permitted a firm to sue or be sued in the firm name, as if it were a corporate body (see the Code of Civil Procedure, Order XXX, corresponding to Rules of the English Supreme Court Order XL Vlll-A). The law of procedure has gone to the length of allowing a firm to sue or be sued by another firm having some common partners or even to sue or be sued by one or more of its own partners (see order XXX, rule 9, of the Code of Civil procedure), as if the firm is an entity distinct from its partners. Again, in taking partnership accounts and in administering partnership assets, the law has, to some extent, adopted the mercantile view and the liabilities of the firm are regarded as the liabilities of the partners only in case they cannot be met and discharged by the firm out of its assets. The creditors of the firm are, in the first place, paid out of the partnership assets and if there is any surplus then the share of each partner in such surplus is applied in payment of his separate debts, if any, or paid to him. Conversely, separate property of a partner is applied first in the payment of his separate debts and the surplus, if any, is utilized in meeting the debts of the firm (see section 49 of the Indian Partnership Act, 1932). In the Indian Income Tax Act itself a firm is, by section 3, which is the charging section, made a unit of assessment.*
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> *It is clear from the foregoing discussion that the law, English as well as Indian, has, for some specific purposes, some of which are referred to above, relaxed its rigid notions and extended a limited personality to a firm. Nevertheless, the general concept of partnership, firmly established in both systems of law, still is that a firm is not an entity or "person" in law but is merely an association of individuals and a firm name is only a collective name of those individuals who constitute the firm. In other words, a firm name is merely an expression, only a compendious mode of designating the persons who have agreed to carry on business in partnership. Accordingly to the principles of English jurisprudence, which we have adopted, for the purposes of determining legal rights " there is no such thing as a firm known to the law" as was said by james, L.J., in Ex Parte Corbett: In re Shand. In these circumstances to import*

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*the definition of the word "person" occurring in section 3(42) of the General Clauses Act, 1897, into section 4 of the Indian Partnership Act will, according to lawyers, English or India, be totally repugnant to the subject of partnership law as they known and understand it to be. It is in this view of the matter that it has been consistently held in this country that a firm as such is not entitled to enter into partnership with another firm or individuals. It is not necessary to refer in detail to those decisions many of which will be found cited in Jabalpur Ice Manufacturing Association v. Commissioner of Income Tax, Madhya Pradesh , to which a reference has already been made. We need only refer to the case of Bhagwanji Morarji Goculdas v. Alembic chemical Works Co. Ltd. and Others", where it has been laid down by the Privy council that Indian Law has not given legal personality to a firm apart from the partners. This view finds support from and is implicit in the observations made by this Court in Commissioner of Income Tax, West Bengal v. A.W. Figgies & Co. and Others.*

In this case, the Hon'ble Supreme Court found that as per Section 2(6B) of the Income Tax Act, 1922, the term "firm" and "partnership" had same meaning respectively as they had in the Indian Partnership Act, 1932 and, thereafter, the Hon'ble Supreme Court after considering the provisions of Indian Partnership Act, 1932 and the General Clauses Act, 1897, held that the word "persons" in Section 4 of Indian Partnership Ad, 1932 contemplated only natural or artificial i.e. legal persons and since a firm was not a person and as such, it was not entitled to enter into partnership with another firm or HUF or individual. In holding so, the Hon'ble Supreme Court also reviewed the English law as well as provisions of Code of Civil Procedure.

8.4 Thus, it is again noted that, when the provisions of Income Tax itself defined the 'firm' or 'partnership' as contemplated under Indian Partnership Act, 1932 and no other specific provisions existed as regard to the legal status of a partnership firm, the Hon'ble Supreme Court decided the issue on the basis of provisions of General Law and i.e. Indian Partnership Act, 1932 which was also held so by the Hon'ble Supreme Court in the case of ITO vs. A.W. Figgies & Co. and Others (supra).

8.5 Similar view was taken by the Hon'ble Supreme Court in the case of Malabar Fisheries Co. vs. CIT as reported in 120 ITR 49 (supra), wherein the Hon'ble Supreme Court (Three Judge Bench decision) held as under:-

*"Having regard to the above discussion, it seems to us dear that a partnership firm under the Indian Partnership Act, 1932, is not a distinct legal entity apart from the partners constituting it and equally in law the firm as such has no separate rights of its own in the partnership assets and when one talks of the firm's property or firm's assets all that is meant is property or assets in which all partners have a joint or common interest, if that be the position, it is difficult to accept the contention that upon dissolution the firm's rights in the partnership assets are extinguished. The firm as such has no separate rights of its own in the partnership assets but it is the partners who own jointly or in common the assets of the partnership and, therefore, the consequences of the distribution division or allotment of assets to the partners which flows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between the partners and there is no question of any extinguishment of the firm's rights in the partnership assets amounting to a transfer of assets within the meaning of s.2(47) of the Act. In our view, therefore, there is no transfer of assets involved even in the sense of any extinguishment of the firm's rights in the partnership assets when distribution takes place upon dissolution.*

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> *Counsel for the revenue referred us to* a *decision of the Karnataka High Court in Addl. CIT v. M.A.J. Vasanaik [1979] 116 ITR 110 (Kar.), where that court has taken the view that when individual assets are brought in to a partnership firm so as to constitute the partnership property, there is a transfer of interest of the individual to the partnership property, there is a transfer of interest of the individual to the partnership and ss. 34(3)(b) and 155(5) of 1961 Act are attracted. In the first instance that decision dealt with the converse case and it does not necessarily follow on a parity of reasoning that the distribution, division or allotment of partnership assets to the partners of a firm upon its dissolution would amount to a transfer of assets as was sought top be contended by the counsel for the revenue. Secondly, it is unnecessary for us to express any opinion on the correctness or otherwise of the view taken by the Karnataka High Court in that case.*
>
> *There is yet another reason for rejecting the contention of the counsel for the revenue and that is that the second condition required to be satisfied for attracting s. 34(3)(b) cannot be said to have been satisfied in the case. It is necessary that the sale or transfer of assets must be by the assessee to a person. Now every dissolution must in point of time be interior to the actual distribution, division or allotment of the assets that takes place after making up accounts and discharging the debts and liabilities and thereupon distribution, division or allotment of assets takes place inter se between the erstwhile partners by way of mutual adjustment of rights between them. The distribution, division or allotment of assets to the erstwhile partners, is not done by the dissolved firm. In this sense there is no transfer of assets by the assessee (dissolved firm to any person. It is not possible to accept the view of the High Court that the distribution of assets effected by a deed takes place eo instanti with the dissolution or that it is effected by the dissolved firm.*

8.6. Again it is seen that no specific provisions existed under the Income Tax Act, 1961 as regard to the issue whether distribution of assets among partners on dissolution of firm would amount to transfer or not and in that situation, the Hon'ble Supreme Court held that as per the General Law, partnership firm as such had no rights in assets of the firm even before dissolution, hence, how there could be a question of extinguishment of firm's right in the partnership assets amounting to a transfer of assets within the meaning of section 2(47) of the Act.

8.8. Again, in the case of Dy. Commissioner of Sales Tax (Law), Board of Revenue (Taxes), Ernakulam vs. K. Kelukutty, as reported in 155 ITR 158, the Honble Supreme Court observed as under:-

> " As *long ago as Watson and Everitt v. Blunden [1933] 18 TC 402, Rommer L.J. said that for taxing purposes " a partnership firm is treated as an entity distinct from the persons who constituted the firm". This dictum was approved by the House of Lords in Income Tax commissioner for the City of London v. Gibbs [1942] 10 ITR (Suppl) 121, and was accepted as good law in India in respect of a partnership firm under the Indian Income Tax Act, 1922, in AW. Piggies and Co. [1953] 24 ITR 405 (SC). What that implies is that for the purposes of assessment to tax, the income of a partnership firm has to be assessed in the hands of the firm as a single unit, the firm itself being treated as an assessable entity separate and distinct from the partners constituting it. The firm is an assessable unit separate*

*and distinct from the individual partners, who as individuals constitute assessable units separate and distinct from the firm. It is on that basis that the provisions of the tax law are structured into a scheme providing for the assessment of partnership income. We do not think the principle goes beyond the purposes of that scheme. It does not confer a corporate personality on the firm. Beyond the area within which that principle operates, the genera! law, that is to say, the partnership law, holds undisputed domain.*

*Now, in every case when the assessee professes that it is a partnership firm and claims to be taxed in that status, the first duty of the assessing offer is to determine whether it is, in law and in fact, a partnership firm. The definition in the tax law defines an " assessee" or a "dealer" as including a firm. But for determining whether there is a firm, the assessing offer will apply the partnership law, subject of course, to any specific provision in that regard in the tax law modifying the partnership law. If the tax law is silent, it is the partnership law only to which he will refer. Having decided the legal identity of the assessee that it is a partnership firm. he will then turn to the tax law and apply its relevant provisions for assessing the partnership income."*

8.9. Thus, in our humble view, the conclusion which emerges from the above discussion is that though the partnership firm is not a separate entity as per general law, however, for a specific purpose it may be treated as independent of its partners under the provisions of Income Tax Act 1961 To put it differently, the concept of partnership firm, being a compendium of its partners is subject to the tax law modifying such concept of partnership law which means that if there exist no provision in the tax laws for a particular situation, then, the provisions of partnership law would be the guiding factor for adjudication of that issue.

8 10. Now, we consider it pertinent to refer to certain decisions where a view has been expressed that for computing the income of a partnership firm for the purpose of determining its Income Tax liability, it was to be treated as distinct from its partners.

9.11. The Hon'ble Supreme Court [Three Judge Bench] in the case of Bist & Sons vs. CIT as reported in 116 ITR 131 was dealing with the issue where an HUF consisting of father and son carrying on business and the father and son firm which took over the business of HUF including trucks and later on the firm sold such trucks and earned a profit which was sought to be taxed in the hands of the firm as a deemed profit under 2nd proviso to section 10(2){vii) as balancing charge. The Hon'ble Supreme Court held that it could not be done so. Their Lordships' observations, as relevant to the issue on hand, are as under-

*"It is pointed out by the revenue that the partners of the appellant are same two individuals who constituted the HUF, and reliance has been placed on the observation of the High Court that in the constitution of the firm "there was merely a change in the style and nature of the HUF". Now we must remember that we are dealing with a case under the I.T. Act. We are concerned with provisions for the computation of income of an assessee for the purpose of determining its income tax liability. It may be. as is quite often said, that a firm is merely a compendious description of the individuals who carry on the partnership business. But under the I.T. Act, a firm is* a *distinct assessable entity. S. 3 of the Indian I.T. Act, 1922, treats it an such, and the entire process of computation of the income of a firm proceeds on the basis that it is a distinct assessable entity. In that respect it is distinct even from its partners: CIT v. A.W. Figgies and Company [1953] 24 ITR 405 (SC). As an assessable entity it is also*

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> *distinct from a HUF, which in itself is regard as a separate unit of assessment under s.3: Raja Bejoy Singh Dudhuria v. CIT [1933] 1 ITR 135 (PC). For the purposes of the question before us it recks little that the very individuals who constituted the HUF now constitute the appellant-firm. Depreciation allowance was allowed to the HUF in its assessment proceedings, it was a step taken in determining the taxable income of the family. The depreciation allowed to the family cannot be regarded as depreciation allowed to the appellant. We must ignore entirely the circumstance that depreciation has been allowed to the HUF in the past."*

9.12. Further, the Hon'ble Bombay High Court in the case of CIT (Central) vs. Kaluram Puranal as reported in 119 ITR 564 while dealing with the issue of assessability of profit arising from transfer of the shares by the firm to the partners, the Hon'ble Bombay High Court held as under:-

> " It appears to us that it is not proper for us t go into the interesting question raised by Mr. Desai as they do not arise from the order of the Tribunal. It appears that both the AAC and the Tribunal on the facts and circumstances upheld the broad contention advanced on behalf f the assessee that since the firm was indistinguishable from the partners and therefore, in law merely a compendious name for the totality of the partners, the ITO was in error in proceeding on the footing that there was a transaction a commercial transaction of sale of shares between the firm and its seven partners. Before us counsel for the revenue as well as for the assessee have adopted the same extreme positions but it is not possible to agree with either. In Income tax law a partnership firm is a distinct assessable legal entity. From this, it would not follow that all transactions between the firm and its partners, whatever be their nature, whatever be the reasons therefore, are to be regarded as equivalent of ordinary transactions between two separate legal entities. Similarly, from the fact that in general jurisprudence a firm is not invested with legal personality it would not follow that any transaction between the firm and its partners will be required to be considered as an internal partnership arrangement and can not be regarded as giving rise to legal consequences similar to a transaction between two separate entities. In the realities of commercial life one will find a firm borrowing from or lending to its partner, giving premises on lease to or goods and other assets to or from its partner or partners. Merely because a transaction is between a firm and its partner it will not result in the consequence or application of the principle that since the firm is not separate in law from its partners, there can not be any trade or profit as between the two or flowing from the transaction between the two.
>
> Whether it is a distribution of assets, whether such distribution has resulted in a profit, whether the notional profit can be taxed or not, will be required to be decided on other considerations; and unfortunately for us the necessary findings are not on the record. It is not possible for us to uphold the decision of the Tribunal in the rather simplistic manner in which it has been arrived at by holding that such transaction would not attract tax. However, by saying that even such transaction can attract tax, it would not follow that the transaction in the instant case will attract tax on the basis of alleged notional profit as was done by the ITO. We are of opinion that the transaction between the firm and its partners can not be looked at as the Tribunal has done and by itself is no ground for setting aside or striking down

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> the additions made by the ITO. However, merely because shares having a market price higher than the purchase price have been distributed amongst the partners at the average purchase price it will not make the alleged notional or fictional profit automatically taxable in the hands of the assessee. This can only be done if there is necessary factual basis for coming to such conclusions as were urged by the departmental representative before the Tribunal or similar ones; and even then the contentions of the assessee earlier indicated would be required to be considered which we have not done since they do not arise from the order of the Tribunal. The same will be required to be considered by the Tribunal when the case goes back to it.

From the perusal of the above observations, it is noted that the Hon'ble Bombay High Court, in principle, affirmed the position that partnership firm was to be treated independent of its partners and there could be a profit or loss in transactions between them. It is also noted that in this case the Revenue had cited the decision of the Hon'ble Supreme Court in the case of A.W. Figgies and Co., (supra) wherein the Three Judge Bench had also observed that partnership firm was an independent entity than that of its partners for specific purposes under the Income Tax Act.

9.13. Again, the Hon'bte Bombay High Court in the case of CIT vs. Chase Trading Co. as reported in 236 ITR 665 dealing with a case of business loss accruing to the firm on sale of shares to partners held that after following the Hon'ble Bombay High Court earlier decision as mentioned in para 6.4 held that the transfer between the partnership firm and its partners, being a commercial transaction, the assessee must be allowed the loss suffered by it as a business loss. In this process, the Hon'ble Bombay High Court also referred to the decision of the Hon'ble Supreme Court in the case of Malabar Fisheries Co. (supra) and observed as under :-

> "On behalf of the Revenue, reference was made to the decision of the Supreme Court in the case of Malabar Fisheries Co. v. CIT [1979] 120 ITR 49. The reliance placed upon the aforesaid decision is misconceived as the Supreme Court was dealing with the case of distribution of assets between the partners after dissolution of partners. The test applicable to the distribution of assets after a partnership is dissolved will be totally different from the test which willable to transactions between an existing partnership firm and its partners. As the Supreme Court has dealt with the question of distribution of assets to its partners after the partnership is dissolved, the law laid down by the Supreme Court will not be applicable to the facts of the present case."

9.14. Thus, as can be seen from the aforesaid three decisions, in our humble view, the current judicial thought is leaning towards the concept of a separate legal entity of Partnership firm than that of its partners for the purposes of Income Tax Act, 1961. This position leads us to the next path i.e. what is the current legislative thought on this subject as manifested in the prevailing relevant provisions under the Income Tax Act, 1961 which can be summarized as under:

9.15. As noted earlier, there was a judicial opinion that on distribution or division or allotment of assets to partners by the firm on dissolution or otherwise there' resulted no gain exigible to tax, however, by incorporating Section 45(2), 45(3) and 45(4), the legislature has declared its intention in clear terms that partners and the firm are two independent entities not only for the purposes of assessment but also for the purpose of determining the charge of income tax on the transactions entered into between them. Similarly, from A.Y. 1993-94 partnership firms have been given a corporal personality in a limited sense by making necessary amendments in the provisions of Sections 10(2A), 28(V), 40(b) and relevant procedural sections which also conclusively prove that partnership firm as such is

independent from its partners as far as provisions of Income Tax Act, 1961 are concerned. In this regard, we consider it to reproduce the relevant portions of Circular No. 636 dated 31st August, 1992 as reported in 1981 St. 1 wherein the CBDT explained the new procedure of taxation of firm's income:

> *""Taxation of firm's income.- 48. Before the changes made by the Finance Act, the system of levy of tax on firms involved double taxation. The firm as such was taxed in respect of its total income at rates varying from 5% to 18% (the maximum rate being applicable at Rs. 1 lakh and above). After deducting the tax payable by the firm, the balance of income was distributed amongst the partners and they were again taxed at the appropriate rates. Further, the tax liability of a firm and its partners depended upon the question whether the firm was granted registration under the Income Tax Act or not In case of a registered firm, the firm paid tax on its total income according to the rates prescribed in the schedule for registered firms. An unregistered firm was taxed at the rates applicable to individuals, with the share income included in the hands of the partners for rate purposes only. There has been a consistent demand for removal of the double taxation. A new scheme of assessment of firms has been introduced from assessment year 1993-94. the scheme is modeled after the scheme introduced by the Direct Tax Laws (Amendment) Act, 1987, with suitable modifications to take care of the difficulties pointed out in the context of the 1987 scheme. The3 scheme contained in Direct Tax Laws (Amendment) Act, 1987 sought to tax firms at the maximum marginal rate after allowing interest and remuneration to partners. Further there was a rigorous definition of "whole time working partners" to whom alone remuneration was payable. The deduction for remuneration and interest allowable to partners and allowing remuneration to any partner or partners at the discretion of the firm, have been suitably restructured.*
>
> *48.1 a firm will now onwards be taxed as a separate entity (section 184 and 185). There will be no distinction between registered and unregistered firms, and clauses 39 and 48 of section 2 containing the definition of "registered firm" and unregistered firm" have been omitted. After allowing remuneration and interest to the partners, the balance income of the firms will be subject to maximum marginal rate of tax of income tax, which will be 40% of assessment year 1993-94. The surcharge on income tax will be at the rate of 12%, of the total tax, if the income tax exceeds Rs. 1,00,000/-. The earlier distinction between rates of income tax for professional and non-professional firms has been removed. Partners are not liable to tax in respect of the share of income from the firm. However, remuneration and interest allowed to partners will be charged to income tax in their respective hands. The only distinction between professional and non-professional firms will be in respect of slabs for allowing deduction to firms in respect of remuneration.*
>
> *48.2 The share of the partner in the income of the firm will not be included in computing his total income. [Section 19(2A)]. However, interest, salary, bonus, commission or any other remuneration allowed by the firm to a partner will be liable to be taxed as business income in the partners hand. [Section 2(24)(ve) and section 28 (v)]. An explanation has been added to the newly inserted clause (2A) of section 10 to make it clear that the remuneration or interest which is disallowed in the hand of the firm will not suffer taxation in the hands*

> *of the partner. In case any remuneration paid to a partner is disallowed in the hands of the firm or the amount is varied in subsequent proceedings, the partner's assessment can be rectified. [Section 155(1 A).]*
>
> *48.3 The gross total income of the firm is to be determined in the normal way under different heads as in the case of any taxable entity. The gross total income so computed is reduced by salary, bonus, commission, or any remuneration payable or paid to a partner. [Section 40(b)]. Remuneration due to or received by a partner is not to be assessee as income under the head " salaries" [Explanation 2 to section 15]. Any salary, interest, bonus, commission or remuneration to income tax under the head "Profit and gains of business or profession".*

9.16. Thus, specific provisions mentioned hereinabove r.w. the impugned circular go to show that a firm is to be taxed as separate entity and as per para 48.3 the gross total income of the firm is to be determined in the normal way under different heads as in the case of any taxable entity, hence, any expenditure which has been incurred by firm for the purposes of it's business is to be allowed as a deduction in computing the total income of the firm subject to any specific limitation/prohibition provided for the allowance of such expenditure.

9.17. Accordingly, having regard to judicial opinion as elaborated hereinabove and also the legislative changes in the Act, in our opinion, a partnership firm is a separate entity than that of its partners under the Income Tax Act and if there exist any specific provision in the Income Tax Law modifying the partnership law then, such specific provision shall be applied and if the tax law is silent on a specific issue, then a reference will have to be made to the provisions of partnership law for the adjudication of the same and in the present case, provisions of law sufficiently take care of the issue involved herein, hence, the issue is to be decided accordingly. In the present case, there exist specific provisions for computing the income of the partnership firm as well as that of it's partners, hence, total income of both is liable to be computed in accordance with such provisions. We further hold that since partnership firm, for the purpose of Income Tax Act is a separate assessable entity and, therefore, partners vis-a-vis partnership firm would stand on the same footing of shareholders vis-a-vis company. Accordingly, income charged in the hands of partnership firm can not be treated as being a non- exempt income in the hands of a partner of such firm and, therefore, provisions of Section 14-A would be applicable in computing the total income of such partner in respect of his share in the profits of such firm.

9.18. The second contention of the assessee is that salary received by the partner retained the character of profit of the firm although such salary was taxable as income from business in the hands of such partner. Though the nature of salary received by a partner was held by the Hon'ble Supreme Court in the case of P. Chidambaram Pillai (supra) to retain the same character as of the income of partnership firm yet the legislature has treated it differently for the purpose of assessment. This may be explained with reference to the provisions of Section 10(2A) vis-a-vis Section 28(v) of the Act. The salary received by a partner from the firm, which is allowed as deduction in the hands of the firm, has to be taxed as business income of the partner in the hands of the partner. Section 10(2A) of the Act provides for exclusion of share in the profit of a partnership firm from the total income in the hands of the partner but salary received by the partner from the firm is to be assessed as deemed business income in the hands of such partner in view of specific provisions of Section 28(v) and is taxable. Thus, in our view, the nature of salary vis-a-vis share profit is of no significance now, hence, this contention of the assessee does not help the cause of the assessee in any manner.

9.19. The assessee has also pleaded that new scheme as applicable from A.Y. 1993-94 was merely a scheme of assessment and it did not change the various facets of partnership

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firm as per General Law. However, in our view the Scheme of assessment is not merely a procedural aspect but it also includes computation of income under the Act. This view is well supported by the decision of Hon'ble Supreme Court in the case of C.A. Abraham vs. ITO, Kottayam and Another as reported in 43 ITR 425, wherein the Hon'ble Court held that expression "assessment included both the computation as well as declaration and imposition of tax liability and the machinery for enforcement thereof. The relevant findings of the Hon'ble Supreme Court are as under:-

> *"That the business of the firm was discontinued, because of the dissolution of the partnership is not disputed. It is urged, however, that a proceeding for imposition of penalty and a proceeding for assessment of income-tax are matters distinct, and section 44 may be resorted to for assessing tax due and payable by a firm business whereof has been discontinued, but an order imposing penalty under section 28 of the Act cannot by virtue of section 44 be passed. Section 44 sets up machinery for assessing the tax liability of firms which have discontinued their business and provides for three consequences, (1) that on the discontinuance of the business of a firm, every person who was at the time of its discontinuance a partner is liable in respect of income, profits and gains of the firm to be assessed jointly and severally, (2) each partner is liable to pay the amount of tax payable by the firm, and (3) that the provisions of Chapter IV, so far as may be, apply to such assessment The liability declared by section 44 is undoubtedly to assessment under Chapter IV, but the expression " assessment " used therein does not merely mean computation of income. The expression " assessment ", as has often been said, is used in the Income-tax Act with different connotations. In Commissioner of Income-tax v. Khemchand Ramdas the Judicial Committee of the Privy Council observed :*
>
> *" One of the peculiarities of most Income-tax Acts is that the word 'assessment' is used as 'meaning sometimes the computation of income, sometimes the determination of the amount of tax payable and sometimes the whole procedure laid down in the Act for imposing liability upon the taxpayer. The Indian Income-tax Act is no exception in this respect………"*
>
> *A review of the provisions of Chapter IV of the Act sufficiently discloses that the word " assessment " has been used in its widest connotation in that chapter. The title of the chapter is " Deductions and Assessment." The section which deals with assessment merely as computation of income is section 23 ; but several sections deal not with computation of income, but determination of liability, machinery for imposing liability and the procedure in that behalf. Section 18A deals with advance payment of tax and imposition of penalties for failure to carry out the provisions therein. Section 23A deals with power to assess individual members of certain companies on the income deemed to have been distributed as dividend, section 23B deals with assessment in case of departure from taxable territories, section 24B deals with collection of tax out of the estate of deceased persons, section 25 deals with assessment in case of discontinued business, section 25A with assessment after partition of Hindu undivided families and sections 29, 31, 33 and 35 deal with the issue of demand notices and the filing of appeals and for reviewing assessment and section 34 deals with assessment of incomes which have escaped assessment. The expression " assessment " used in these sections is not used merely in the sense of computation of*

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> *income and there is in our judgment no ground for holding that when by section 44, it is declared that the partners or members of the association shall be jointly and severally liable to assessment, it is only intended to declare the liability to computation of income under section 23 and not to the application of the procedure for declaration and imposition of tax liability and the machinery for enforcement thereof. Nor has the expression, " all the provisions of Chapter IV shall so far as may be apply to such assessment " a restricted content : in terms it says that all the provisions of Chapter IV shall apply so far as may be to assessment of firms which have discontinued their business. By section 28, the liability to pay additional tax which is designated penalty is imposed in view of the dishonest contumacious conduct of the assessee. It is true that this liability arises only if the Income-tax Officer is satisfied about the existence of the conditions which give him jurisdiction and the quantum thereof depends upon the circumstances of the case. The penalty is not uniform and its imposition depends upon the exercise of discretion by the taxing authorities ; but it is imposed as a part of the machinery for assessment of tax liability. The use of the expression " so far as may be " in the last clause of section 44 also does not restrict the application of the provisions of Chapter IV only to those which provide for computation of income. By the use of the expression " so far as may be " it is merely intended to enact that the provisions in Chapter IV which from their nature have no application to firms will not apply thereto by virtue of section 44. In effect, the Legislature has enacted by section 44 that the assessment proceedings may be commenced and continued against a firm of which business is discontinued as if discontinuance has not taken place. It is enacted manifestly with a view to ensure continuity in the application of the machinery provided for assessment and imposition of tax liability notwithstanding discontinuance of the business of firms. By a fiction, the firm is deemed to continue after discontinuance for the purpose of assessment under Chapter IV.*

Accordingly, we hold that the scheme of assessment as applicable from AY. 1993-94 is not merely procedural but it also includes computation of the income of partnership firm as well as of it's partners.

9.20. The assessee has also pleaded that it was a matter of convenience between the partners as to how they wish to distribute the profits. We are of the view that there cannot be any dispute in this regard but if a particular course of action is adopted, then, the legal consequences thereof, have to be faced i.e. if no salary is paid, then, whole of the income by way of share in profit is exempt in the hands of the partner and consequently, provisions of Section 14A have to be applied in respect of any expenditure incurred by the assessee in relation to such income and when a partner receives salary, then, expenditure incurred for earning the same can be allowed as deduction as it is the net income which is to be taxed under the head income from profits and gains or profession or when a partner receives both salary as well as share in the profit, the logical course can be adopted by way of proportionate disallowance of expenditure incurred towards the same, if there exist no provision for such allocation.

9.21. The assessee, before us, has taken a new plea which was not before the lower authorities i.e. this expenditure was incurred to earn the fee from International Chamber of Commerce. We find that during the year under consideration, the assessee has received only a sum of Rs. 15,025/- on account of attending ICC Plenary Session and not on account of any professional services rendered as a Member of International Court of Arbitration and this has been offered as an income from other sources and not as a business income and

while computing the income from profession, the impugned expenditure has been claimed as a deduction there-from as evident from statement of computation of income under the head profits and gains of business or profession as enclosed with the return of income, (copy of which is placed at page 15 of the paper book), hence, on the face of it, this contention of the assessee is completely contradictory to the claims made by assessee himself originally, hence, rejected. Even otherwise, as per the provisions of Section 57(iii), this expenditure cannot be allowed as it can not be said to have been incurred for earning such fee.

9.22. Now, coming to the question to the applicability of provisions of Section 14A, we have got no hesitation in holding that, in the facts of the case, the provisions of Section 14A are applicable and, in our view, the impugned expenditure can be considered as incurred by the assessee for earning salary as well as share in profits of the partnership firm. The A.O. has disallowed proportionately with reference to share of profits and salary. However, in our view, the same has to be worked out as per the provisions of Rule 8-D of the Income Tax Rules, 1962 as the said Rule has been held to be retrospective by the Special Bench of the Tribunal in the case of Daga Capital Management Ltd. in ITA 8057/M/03 for A.Y. 2001-02, order dated 20.10.2008, hence, we direct the A.O. to re-work out the quantum of expenditure as per this rule which is to be disallowed. The assessee shall be allowed an opportunity of being heard. Thus, ground No. 1 of the assessee stands partly allowed for statistical purposes.

10. In the result, appeal filed by the assessee is partly allowed for statistical purposes.

Pronounced on 6th January, 2009.

Sd/-
(M.A. BAKSHI)
VICE PRESIDENT

Sd/-
(V.K. GUPTA)
ACCOUNTANT MEMBER

Mumbai, dated, 6th January, 2009

RK

Copy to:

1. The Appellant
2. The Respondent
3. The CIT(A)11(2), Mumbai
4. The CIT, Concerned, Mumbai
5. The DR , Bench 'H'
6. Master File

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