www.taxguru.in

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

\+ **Income Tax Appeal No. 1154 of 2011**

Reserved on: 17th October, 2011
% Date of Decision: 4th November, 2011

Sood Brij & Associates ....Appellant
Through Mr. Ajay Vohra, Mr. Amit Sachdeva and Mr. Somnath Shukla, Advocates.

Versus

The Commissioner of Income-tax-XIII, New Delhi …Respondents
Through Mr. N P Sahni and Mr. Ruchesh Sinha, Advocates.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE R. V. EASWAR

1. Whether Reporters of local papers may be allowed to see the judgment?
2. To be referred to the Reporter or not ? Yes.
3. Whether the judgment should be reported in the Digest ? Yes.

SANJIV KHANNA, J.

The present appeal under Section 260A of the Income Tax Act, 1961 (Act, for short) has been preferred by Sood Brij & Associates, a partnership firm, consisting of two partners namely A.K. Sood and B.M. Gupta, who are practicing Chartered Accountants. In their return for the assessment year 2007-08, Rs.21,40,000/- was claimed as a deduction towards salary/remuneration paid to the partners. This was disallowed by the Assessing Officer on the ground of violation of Section 40(b)(v). The appellant-assessee has been unsuccessful in

www.taxguru.in

appeals before the Commissioner of Income Tax (Appeals) and the Income Tax Appellate Tribunal, Delhi (tribunal, for short). The impugned order of the tribunal is dated 29th October, 2010.

2. After hearing the counsel, the following substantial question of law is framed:-

> " Whether on reading of clause 7 of the partnership deed dated 1st May,1976 and clauses 1 and 2 of the supplementary partnership deed dated 1st April,1992, the tribunal was right in holding that remuneration of Rs.21,40,000/- paid to the two partners cannot allowed as a deduction under Section 40(b)(v) of the Act?"

3. Relevant part of Section 40 of the Act reads as under:-

> "40. Amounts not deductible.--Notwithstanding anything to the contrary in sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession",--
>
> X X X
>
> (b) in the case of any firm assessable as such,--
>
> (i) any payment of salary, bonus, commission or remuneration, by whatever name called (hereinafter referred to as remuneration) to any partner who is not a working partner; or
>
> (ii) any payment of remuneration to any partner who is a working partner, or of interest to any partner, which, in either case, is not authorised by, or is not in accordance with, the terms of the partnership deed; or
>
> (iii) any payment of remuneration to any partner who is a working partner, or of interest to any partner, which, in either case, is authorised by, and is in accordance with, the terms of the partnership deed, but which relates to any period (falling prior to the date of such partnership deed) for which such payment was not authorised by, or is not in accordance with, any earlier partnership deed, so, however, that the period of authorisation for such payment by any earlier partnership deed does not cover any period prior to the date of such earlier partnership deed; or

www.taxguru.in

(iv) any payment of interest to any partner which is authorised by, and is in accordance with, the terms of the partnership deed and relates to any period falling after the date of such partnership deed in so far as such amount exceeds the amount calculated at the rate of *twelve per cent. simple interest per annum; or

(v) any payment of remuneration to any partner who is a working partner, which is authorised by, and is in accordance with, the terms of the partnership deed and relates to any period falling after the date of such partnership deed in so far as the amount of such payment to all the partners during the previous year exceeds the aggregate amount computed as hereunder:--

(1) in the case of a firm carrying on a profession referred to in section 44AA or which is notified for the purpose of that section--

(a) on the first Rs. 1,00,000 of the book-profit or in case of a loss Rs. 50,000 or at the rate of 90 per cent. of the book-profit, whichever is more;

(b) on the next Rs. 1,00,000 of the book-profit at the rate of 60 per cent.;

(c) on the balance of the book-profit at the rate of 40 per cent.;

(2) in the case of any other firm--

(a) on the first Rs. 75,000 of the book-profit or in case of a loss Rs. 50,000 or at the rate of 90 per cent. of the book-profit, whichever is more;

(b) on the next Rs. 75,000 of the book-profit at the rate of 60 per cent.;

(c) on the balance of the book-profit at the rate of 40 per cent.;

Provided that in relation to any payment under this clause to the partner during the previous year relevant to the assessment year commencing on the 1st day of April, 1993, the terms of the partnership deed may, at any time during the said previous year, provide for such payment.

Explanation 1.--Where an individual is a partner in a firm on behalf, or for the benefit, of any other person (such partner and the other person being hereinafter referred to as "partner in a representative capacity" and "person so represented", respectively),--

www.taxguru.in

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

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

Explanation 2.--Where an individual is a partner in a firm otherwise than as partner in a representative capacity, interest paid by the firm to such individual shall not be taken into account for the purposes of this clause, if such interest is received by him on behalf, or for the benefit, of any other person.

Explanation 3.--For the purposes of this clause, "book-profit" means the net profit, as shown in the profit and loss account for the relevant previous year computed in the manner laid down in Chapter IV-D as increased by the aggregate amount of the remuneration paid or payable to all the partners of the firm if such amount has been deducted while computing the net profit.

Explanation 4.-For the purposes of this clause, "working partner" means an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner."

4. Section 40(b) relates to firms and the clauses (i) to (v) are interconnected and have to be read harmoniously. The aforesaid clauses prescribe the conditions, when and in what circumstances remuneration paid to a partner are deductable as an expense from income of the partnership firm. One of the prescribed requirements is that payment of remuneration should be made to a working partner and authorized by, and in accordance with the terms of the partnership deed. The remuneration paid to the said partners must relate to the period falling after the date of such partnership deed. Clause (iii) to Section 40(b) specifically stipulates that remuneration paid in the

www.taxguru.in

period pre and posts the partnership deed, are treated differently. Former cannot be deducted from the income of the firm but payment of remuneration to working partners post the partnership deed, authorized by and in accordance with the terms of the deed can be allowed as a deduction. The requirement for allowing deduction is that the remuneration paid should be authorized and in terms of the existing partnership deed. Both conditions must be satisfied. The Section 40(b)(v) also fixes the upper limit of the deduction, which can be claimed as a deduction by the partnership firm.

5. Clause (iii) and other clauses in Section 40(b) specifically use the expression “in accordance with the terms of the partnership deed”. This clearly indicates and manifests the legislative mandate that the quantum of remuneration or the manner of computing the quantum of remuneration should be stipulated in the partnership deed. The expression “in accordance with the terms of the partnership deed” read with clause (iii) of section 40(b), requires and mandates that the quantum of remuneration or the manner of computation of quantum of remuneration should be stated in the partnership deed and should not be left undetermined, undecided or to be determined or decided on a future date.

www.taxguru.in

6. The question raised is whether the conditions stipulated in the aforesaid Section are satisfied in the present case or not. This requires examination of the relevant clauses of the partnership deed dated 1st May, 1976 and the supplementary partnership deed dated 1st April, 1992.

7. Clauses 7 of the partnership deed dated 1st May, 1976 reads as under:-

> "7. That the profits or losses of the partnership, as the case may be, shall be divided amongst and borne by the partners equally."

8. Clauses 1 and 2 of the supplementary partnership deed dated 1st April, 1992 read:

> "1. That subject to mutual consent of the partners, and subject to the provisions of the Income Tax Act, 1961, the working partner or partners shall be paid such remuneration as may be mutually agreed between themselves, from time to time, and such remuneration shall be deductible expense before arriving at the share of the partners as allocable from the net profits.
>
> 2. That both the partners (hereinafter referred as working partners), shall devote their time and attention in the conduct of the affairs of the partnership firm, as the circumstances and need of the firms business may require. The total remuneration payable to the working partners shall be an amount permissible as remuneration to the working partners under the Income Tax Act, 1961 and as applicable from time to time."

9. The partnership as noticed above is between two partners and under clause 7 of the partnership deed dated 1st May, 1976 profits and

www.taxguru.in

losses of the partnership, as the case may be, are to be divided and borne by the partners equally. Clause 1 of the supplementary partnership deed dated 1st April, 1992, authorizes payment of remuneration to the partners but does not quantify the same. It does not prescribe any method or manner to calculate and compute the remuneration. It states that the remuneration payable is to be mutually agreed between the partners from time to time. Clause 1, therefore, requires a mutual agreement in future. The aforesaid clause, therefore, does not satisfy the requirement that the payment of remuneration should be in accordance with the terms of the partnership deed and that the remuneration should relate to payments made in the period after the date of said partnership deed. The tribunal is, therefore, right in their conclusion that clause 1 of the supplementary partnership deed dated 1st April, 1992, does not satisfy the requirements of Section 40(b)(v). From the said clause it is not possible to ascertain the quantum or the amount of remuneration which is payable in terms of the supplementary partnership deed.

10. This brings us to clause 2 of the supplementary deed dated 1st April, 1992. The first sentence in clause 2 states that the two partners will be the working partners. The second sentence in clause 2 stipulates that the total remuneration payable to the working partners shall be

www.taxguru.in

the amount permissible as remuneration to the working partners under the Act, as applicable from time to time. The question is whether the second sentence of clause 2 of the supplementary partnership deed read with clause 7 of the partnership deed, which states that the profits and losses will be equally divided and borne by the partners, satisfies the requirements of Section 40(b)(v). In other words, whether the two clauses read together quantify or stipulate the manner of quantifying the remuneration that is payable to the partners? Having examined the said clauses, we feel that on conjoint reading of clause 7 of the partnership deed dated 1st May, 1976 and clauses 1 and 2 of the supplementary partnership deed dated 1st April, 1992, conditions of Section 40(b)(v) are not satisfied.

11. Clause 2 of the supplementary deed has to be read along with clause 1 of the same deed. These two clauses have to be read harmoniously and reasonably to understand the two covenants and give effect to their true meaning. The second sentence of clause 2 neither quantifies nor lays down the manner of quantifying the total remuneration payable to the partners. Clause 2 stipulates the maximum amount that can be paid as remuneration to the two partners but does not quantify the remuneration payable in a particular year. Quantum or the amount of remuneration and the manner of computing is not

www.taxguru.in

specified or stipulated but as noticed under clause 1 has been left to be decided by a mutual agreement in future.

12. The appellant in actual practice has not read and understood clause 2 as stipulating that the two partners are entitled to remuneration equal to the maximum amount stipulated in Section 40(b)(v) of the Act. As per the return of income filed on 23rd August, 2007, the appellant firm had declared income of Rs.1,44,59,522/-. It is prudent to note that as per the books and the Act Rs. 98,81,165/- would be the maximum remuneration payable to the two partners but the remuneration actually paid was Rs.21,40,000/-. This is admitted by the appellant and further in grounds of appeal it is stated that Rs.98,81,165/- represents the maximum amount payable under Section 40(b)(v) but not the amount that has been mutually agreed to be paid as remuneration. In other words, the appellant has accepted that clause 2 does not quantify or provide the manner of computing remuneration payable to the partners but stipulates the maximum amount payable. Thus, the limits specified under Section 40(b)(v) are incorporated and have become part and parcel of the partnership deed but not the amount or the quantum of remuneration. This is left undecided, unstipulated and left to the discretion of the two partners to be decided at a future point in time. Therefore, payment of Rs.21,40,000/- was not

www.taxguru.in

in accordance with the terms of the supplementary partnership deed dated 1st April, 1992 though authorized by the said deed. The remuneration was paid in terms of a subsequent understanding between the two partners regarding the quantum and the amount to be paid. The said understanding has not been brought on record and probably was an oral understanding. The appellant has not relied on or referred to any such "partnership deed" before the authorities, tribunal or before us.

13. Ratio of the decision of the Himachal Pradesh High Court in ***Commissioner of Income tax vs. Anil Hardware Store,*** [2010] 323 ITR 368 (HP), does not assist the stand and contention of the appellant. On examining the partnership deed, it was held that the two partners were entitled to 50% or equal amount as remuneration. The contention of the Revenue that the partnership deed did not exactly determine the remuneration payable to the partners, was rejected holding that the requirement of the Section was that the partnership deed should specify the amount payable or that the manner of quantifying the remuneration should be specified. In the said case, the High Court held that the manner of fixing the remuneration was specified in the partnership deed.

www.taxguru.in

14. On reading the supplementary partnership deed, in the present case, it is clear that the remuneration is not specified. The manner of computing the remuneration is not specified. On the other hand, the remuneration payable is left to future mutual agreement between the partners who are entitled to decide and quantify the quantum. Remuneration can be any amount or figure but not more than the maximum amount stated in Section 40(b)(v) of the Act. Therefore, the requirements of Section 40(b)(v) are not satisfied.

15. The question of law is answered in favour of the Revenue and against the assessee. The appeal is dismissed. However, there will be no orders as to costs.

(SANJIV KHANNA)
JUDGE

(R. V. EASWAR)
JUDGE

November 4th, 2011
kkb