

IN THE INCOME TAX APPELLATE TRIBUNAL
"SMC" BENCH, MUMBAI

BEFORE SHRI SANDEEP SINGH KARHAIL, JUDICIAL MEMBER AND
SHRI GAGAN GOYAL, ACCOUNTANT MEMBER

ITA No.5276/Mum./2019
(Assessment Year : 2015-16)

M/s. Ratilal & Sons
29/31, Khadak Street
Behind Satkar Hotel
Masjid Bunder Road (West)
Mumbai 400 009 PAN – AADFR3904M

..... Appellant

v/s

Income Tax Officer
Circle-17(3)(1), Mumbai

..... Respondent

Assessee by : Shri Jitendra singh
Revenue by : Shri Chandra Vijay, CIT-DR

Date of Hearing – 17.02.2022

Date of Order – 21/04/2022

ORDER

PER SANDEEP SINGH KARHAIL, J.M.

The present appeal has been filed by the assessee against the impugned order dated 03.05.2019, passed under section 250 of the Income Tax Act, 1961 (*"the Act"*) by the learned Commissioner of Income Tax (Appeals)-28, [*"the learned CIT(A)"*] for the assessment year 2015-16.

2. In this appeal, the assessee has raised the following grounds:-

"1. *The Ld. Commissioner of Income Tax (Appeals) - 28, Mumbai [hereinafter referred to as the "Ld. CIT(A)"] erred in passing the order*

03.05.20 19 upholding the assessment order dated 31.10.2017 passed under section 143(3) of the Income Tax Act, 1961 [hereinafter, referred to as "the Act"] without appreciating the facts and circumstances of the case. The Appellant strongly objects to the addition made in the assessment order.

2. Addition made under section 40A(3) of the Act unjustified - Rs.3,60,000/-

i. The Ld. CIT(A) erred in upholding the action of the Ld. A.O in treating the remuneration paid to the working partner of the firm as alleged violation of provisions of section 40A(3) of the Act. The Appellant prays that the addition of Rs.3,60,000/- under section 40A(3) of the Act is unjustified and the same may be deleted.

ii. The Ld. CIT(A) failed to appreciate that remuneration paid to the working partner of the firm is not hit by the provisions of Rule 6DD as there is no employer- employee relation. The Appellant, therefore, prays that the addition of Rs.3,60,000/- under section 40A(3) of the Act is unjustified and the same may be deleted."

3. The only issue arising in the present appeal is with regard to the disallowance of remuneration paid by the assessee to its Working Partner under section 40A(3) of the Act.

4. The brief facts pertaining to this issue, as emanating from the records are: The assessee is a partnership firm and is engaged in the business of wholesale of Canvas Tarpoulins. For the year under consideration, the assessee e-filed its return of income on 26.09.2015 declaring total income of Rs. 9,40,320.

5. During the course of assessment proceedings, upon verification of Ledger account filed by the assessee, the Assessing Officer found that assessee has paid remuneration of Rs. 30,000 to Mr. Prakash Desai (i.e. one of its Working Partners) in cash. Accordingly, the assessee was asked to show cause as to why said payment be not disallowed under section 40A(3)

of the Act. In reply, assessee submitted that remuneration paid to Partner within the limit of section 40(b) of the Act is fully allowable expense. The Assessing Officer, vide order dated 31.10.2017, passed under section 143(3) of the Act held that remuneration paid to Shri Prakash Desai, in cash, is above the limit fixed by the provisions of section 40A(3) of the Act, which restricts deduction of cash expenditure above Rs.20,000. Accordingly, the Assessing Officer added a sum of Rs.3,60,000 under section 40A(3) of the Act, to the total income of the assessee.

6. The learned CIT(A) vide impugned order dated 03.05.2019 dismissed the appeal filed by the assessee. Being aggrieved, the assessee is in appeal before us.

7. During the course of hearing, Shri Jitendra Singh, learned Authorised Representative ("*learned A.R.*") appearing for the assessee submitted that the amount in question is the remuneration paid to the Working Partners and same is not covered under the provisions of section 40A(3) of the Act. In support of its submissions, the learned A.R. placed reliance on the judicial precedents.

8. On the other hand, Shri Chandra Vijay, learned Departmental Representative ("*learned D.R.*"), vehemently relied upon the orders passed by the lower authorities.

9. We have considered the rival submissions and perused the material available on record. It is trite that the partnership firm is not a juristic

person and there is no separate identity for the firm and its partners. The partnership is only a collective of separate persons and not a legal person in itself. For the purpose of the Act, a firm is considered as a unit of assessment by special provisions. The Hon'ble Supreme Court in the case of CIT v. R.M. Chdambaram Pillai: (1977) 106 ITR 292, while holding that payment of salary to a partner represents a special share of the profits and the salary paid to the partner retains the same character of the income, observed as under:

“there cannot be a contract of service, in strict law, between a firm and one of its partners. So that any agreement for remuneration of a partner for taking part in the conduct of the business must be regarded as portion of the profits being made over as a reward for the human capital brought in.”

Thus, remuneration paid to the partner is share of profits of the partnership firm and same cannot be treated to be in the nature of salary paid to the employee.

10. Before dealing with the issue at hand, it is pertinent to note following relevant facts of the present case, which have also not been disputed by the Revenue: (i) remuneration was paid to the Working Partner; and (ii) same was declared under the head “Profits and gains from business or profession” by the Working Partner. Further, it is also not the case of Revenue that the transaction of payment of remuneration to the Working Partner was of colourable nature. In light of above facts, we will analyse the relevant provisions of the Act. Section 40(b) of the Act lays down certain conditions under which payment to the partner shall not be allowed as a deduction while computing the income of the firm under the head “Profits and gains of

business or profession". Thus, if the payment to partner is not covered under any provision of section 40(b) of the Act, the firm can claim deduction of same from its taxable income and the amount shall be taxed in the hands of the partner. However, if the provisions of section 40(b) of the Act are applicable, the firm cannot claim the payment as a deduction and shall be liable to pay tax on same. On the other hand, it will be allowable in the hands of the partner receiving such remuneration. It is pertinent to note that it is not a case of the Revenue that assessee has violated any of the provisions of section 40(b) of the Act. In the present case, the Assessing Officer denied the deduction to assessee only on the basis that the remuneration was paid to the Working Partner, in cash, over and above the limit prescribed under section 40A(3) of the Act.

11. Section 40A(3) of the Act, as applicable during the relevant assessment year, provides as under:

"(3) Where the assessee incurs any expenditure in respect of which a payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, or use of electronic clearing system through a bank account, exceeds twenty thousand rupees, no deduction shall be allowed in respect of such expenditure."

Thus, for invoking provisions of section 40A(3) of the Act, following conditions need to be cumulatively satisfied:- (i) there should be an expenditure; (ii) expenditure should be in mode other than prescribed by the section; and (iii) amount of expenditure should be more than Rs. 20,000. As stated in the earlier portion of this order, the remuneration paid to partner is share of profit of the firm and it retains the same character in the hands of

the partner and taxable as such. It is not in the nature of salary paid by the employer to an employee, deduction of which can be claimed as an expenditure by the employer. The Hon'ble Jurisdictional High Court in S. Magnus v/s CIT: [1958] 33 ITR 538 observed as under:

"Lindley in his famous treatise on the Law of Partnership, 11th edition, at page 154, states: "In point of law, a partner cannot be employed by his firm for a man cannot be his own employer."

Thus, we are of the view that being a share of profit, remuneration paid to partner will not fall within the category of 'expenditure' as normally considered and accordingly even if paid in cash above the threshold under section 40A(3) of the Act, provided the conditions of section 40(b) of the Act are not applicable, shall be allowed as deduction while computing the income under the head 'Profits and gains of business or profession'.

12. Our aforesaid conclusion is also supported by accounting treatment of remuneration paid to the partner by the firm. As the salaries paid to partners is an appropriation of profit rather than charge, so it is debited to 'profit and loss appropriation account' and shall be credited to respective partners' capital / current accounts.

13. We find that the Hon'ble Supreme Court in Attar Singh Gurmukh Singh v/s ITO: [1991] 191 ITR 667 (SC), while interpreting the term "expenditure" in section 40A(3) of the Act, observed as under:

"...the word 'expenditure' has not been defined in the Act. It is a word of wide import. Section 40A(3) refers to the expenditure incurred by the assessee in respect of which payment is made. It means all outgoings are brought under the word 'expenditure' for the purpose of the section. The expenditure for purchasing the stock-in-trade is one of such outgoings."

14. However, remuneration to Working Partner is nothing but a share of profit of the partnership firm and same is not in the nature of an outgoing or any payment made for any expenditure. Thus, same is not covered even under the wider definition of term "expenditure".

15. Further, in Attar Singh Gurmukh Singh (supra), the Hon'ble Supreme Court noted the objective of provisions of section 40A(3) of the Act and observed as under:

"Section 40A(3) only empowers the Assessing Officer to disallow the deduction claimed as expenditure in respect of which payment is not made by crossed cheque or crossed bank draft. The payment by crossed cheque or crossed bank draft is insisted on to enable the assessing authority to ascertain whether the payment was genuine or whether it was out of the income from disclosed sources. The terms of section 40A(3) are not absolute. Consideration of business expediency and other relevant factors are not excluded. The genuine and bona fide transactions are not taken out of the sweep of the section. It is open to the assessee to furnish to the satisfaction of the Assessing Officer the circumstances under which the payment in the manner prescribed in section 40A(3) was not practicable or would have caused genuine difficulty to the payee. It is also open to the assessee to identify the person who has received the cash payment. Rule 6DD provides that an assessee can be exempted from the requirement of payment by a crossed cheque or crossed bank draft in the circumstances specified under the rule. It will be clear from the provisions of section 40A(3) and rule 6DD that they are intended to regulate the business transactions and to prevent the use of unaccounted money or reduce the chances to use black-money for business transactions. - Mudiam Oil Co. v. ITO [1973] 92 ITR 519 (AP). If the payment is made by a crossed cheque drawn on a bank or a crossed bank draft, then it will be easier to ascertain, when deduction is claimed, whether the payment was genuine and whether it was out of the income from disclosed sources. In interpreting a taxing statute the Court cannot be oblivious of the proliferation of black-money which is under circulation in our country. Any restraint intended to curb the chances and opportunities to use or create black-money should not be regarded as curtailing the freedom of trade or business." (emphasis supplied)

16. As stated earlier, it is not the case of Revenue that the transaction of payment of remuneration to the Working Partner was of colourable nature. As the remuneration is from the firm to the Working Partner, which is

nothing but sharing of profits, the identity of the payer and payee is also not doubted by the Revenue. Further, the genuineness of remuneration and source is also not in dispute. Thus, even in view of the above, the applicability of section 40A(3) of the Act, in the present case, is not justified.

17. In addition to above, we find that the Co-ordinate Bench of the Tribunal in Chhaged Steel Corpn. v/s ACIT: [2001] 77 ITD 419 (Ahmedabad - ITAT) while deleting the disallowance of remuneration to the partner under section 40A(2) of the Act, observed as under:

"...we hold that provision of section 40A had no application to a case governed by section 40(b) of the I.T. Act. This intention is more clearly manifested after amendment of above provision with effect from 1st April, 1993. Even otherwise, section 40(b) is applicable only to the payment made by a firm to its partner whereas provision of section 40A(2) is of general nature applicable to several situations. It is settled law that a special provision governing a special situation has to be applied when that situation arises and not a general provision which governs several fields."

18. Further, the Hon'ble Allahabad High Court in CIT v. Great City Manufacturing Co: [2013] 351 ITR 156 (Allahabad), while dismissing Revenue's appeal, observed as under:

"The assessing officer is only required to see as to whether the partners are the working partners mentioned in the partnership deed, the terms and conditions of the partnership deed provide for payment of remuneration to the working partners and whether the remuneration provided is within the limits prescribed under Section 40(b)(v) or not. If all the aforementioned conditions are fulfilled then he cannot disallow any part of the remuneration on the ground that it is excessive. Since in the present case, all the conditions required has been fulfilled the question of disallowance does not arise."

19. In *N.M. Anniah & Co. v/s CIT*: [1975] 101 ITR 348 (Kar.), Hon'ble Karnataka High Court held that the overriding effect given to section 40A is only in respect of matters not covered by section 40(b) of the Act.

20. Though the above decisions primarily dealt with facts where section 40(b) and section 40A(2) were involved, however, these decisions clearly held that section 40A is a general provision and section 40(b) is a special provision and only in situation which are not covered by section 40(b), section 40A shall be applicable. In the present case, assessee being a partnership firm and section 40(b) being the special provision dealing with computation of income of firm, same shall be applicable for determining the amount of deduction available to the assessee.

21. Further, in the present case, there is no dispute that the remuneration was paid to the Working Partner. Also, there is no allegation that conditions of section 40(b) of the Act are not complied with. Thus, in view of the aforesaid judicial pronouncements also, we are of the view that section 40A(3) was wrongly invoked by the Revenue for disallowing remuneration paid to the Working Partner, which is within the permissible limits as per section 40(b) of the Act.

22. Therefore, in view of our aforesaid findings, the order passed by the learned CIT(A), affirming the disallowance made under section 40A(3) of the Act, is set aside and the grounds raised by the assessee in present appeal are allowed.

23. In the result, appeal by the assessee is allowed.

Order pronounced in the open court on 21/04/2022

**SD/-
GAGAN GOYAL
ACCOUNTANT MEMBER**

**SD/-
SANDEEP SINGH KARHAIL
JUDICIAL MEMBER**

MUMBAI, DATED: 21/04/2022

Copy of the order forwarded to:

- (1) *The Assessee;*
- (2) *The Revenue;*
- (3) *The CIT(A);*
- (4) *The CIT, Mumbai City concerned;*
- (5) *The DR, ITAT, Mumbai;*
- (6) *Guard file.*

*Pradeep J. Chowdhury
Sr. Private Secretary*

By Order

Assistant Registrar
ITAT, Mumbai