

## Part - I

### Law relating to taxation of Partnership Firms

#### 1. Introduction:

Under the income tax law, the total income of the firm will be determined as a separate entity and it will be computed under various heads of income. However while computing taxable profits under head 'profits and gains of business or profession' a deduction is allowable to the firm on account of interest and remuneration payable to the partners.

**2. Firm:** The Income tax Act, 1961, does not define the term 'firm' but Sec.2(23) of the Act which deals with definition simply states as under;

- a. 'Firm' shall have the meaning assigned to it in the Indian Partnership Act, 1932.
- b. 'partner' shall have the meaning assigned to it in the Indian partnership Act, 1932 and shall include –
  - i. Any person who, being a minor, has been admitted to the benefits of partnership ; and
  - ii. A partner of a limited liability partnership as defined in the Limited Liability Partnership Act, 2008;
- c. 'partnership' shall have the meaning assigned to it in the Indian Partnership Act, 1932, and shall include a limited liability partnership as defined in the Limited liability Act, 2008.

**3. Essential Elements of Partnership:** The following three elements are necessary in partnership ;

- a. There must be at least two or more persons who must have entered into agreement.
- b. The agreement must be to carry on business and share profits.
- c. The business must be carried on by all or any of the persons concerned, acting for all.

**4. Assessment of Firm:** If the firm satisfies the conditions laid down u/s 184, the firm shall be eligible for deduction on account of interest, salary, etc. while computing its income under the head business and profession. However, it will be subject to the maximum of the limit specified under Sec.40(b). On the other hand, if such conditions are not satisfied, no deduction shall be allowed to the firm on account of such interest, salary, bonus, etc.

**5. Conditions to be satisfied to be eligible for deduction of interest, Salary, etc. and to be assessee as Partnership firm:**

a. **In the First Assessment year:**

- i. Partnership is evidenced by an instrument i.e. there is a written document giving the terms of partnership.

- ii. The individual share of the partners are specified in that instrument
- iii. A certified copy of the said instrument of partnership shall accompany the return of income in respect of the assessment year.

**b. In the subsequent assessment years:**

The firm shall be assessed in the same capacity for every subsequent year if there is no change in the constitution of the firm or the share of the partners. In case any change had taken place in the previous year, the firm shall furnish a certified copy of the revised instrument of partnership along with the return of income. In failure to do so, the firm shall not be eligible for deduction on account of salary, interest, bonus, etc. Nevertheless, such amount of interest, salary, bonus etc. shall not be charged to tax in the hands of the partner.

Certified copy of the partnership deed can be submitted along with the revised return provided the asst. has not been completed based on the original return filed by the firm. The section speaks of the filing of the certified copy of the partnership deed along with the return. Therefore, return includes the original return as well as the return submitted u/s 139(5). *Kullu velly (77 ITR 124)*, *Balish Singh & Co. vs. CIT (165 ITR 575) (Cal)*, *CIT vs. Shrivastava (170 ITR 556)(M.P.)*. It must however be borne in mind that revised return has to be a valid return in terms of the conditions specified in Sec.139(5). Further according to the decision of the Apex Court in *Kumar Jagdishchandra Sinha vs. CIT (220 ITR 67)*, Sec.139(5) can be invoked only if the original return is filed within the time specified u/s 139(1).

Also filing of certified copy of the partnership deed is procedural / technical requirement and as such the deed can be submitted after the filing of the original return. This view is supported by the Hon'ble Supreme Court in the case of *Manglore Chemicals and Fertilizers Ltd. vs. Dy. Commissioner & Ors. (21 Tax Gazette 193)* Wherein it is held that the stringency and the mandatory nature of a provision for exemption must be justified by the purpose intended to be served. The mere fact that it is a statutory condition does not matter one way or the other. The conditions which belong to the area of procedure have got to be constructed liberally. The Delhi Tribunal has considered the issue after the commencement of the new scheme and held that filing the certified copy of the partnership deed before completion of the asst. is sufficient compliance with the provision of Sec.184 [ITO vs. D. M. Enterprise (67 ITD 123) and Ishardas Sahani (77 ITD 256)].

**6. Interest to Partners :-** (Simple interest) Not exceeding 12% p.a. from 1-6-2002 (18% p.a. up to 31-5-2002).

**7. Remuneration to Partners :**

- a. Payment to a non-working partner will not be allowed as a deduction Partners
- b. A 'working partner' is an individual who is actively engaged in conducting the affairs of the business or profession of the firm.
- c. Quantum of allowance is to be determined with reference to 'book profit' which is defined to mean an amount computed in accordance with the provisions of sections 28 to 44D of the Income-tax Act, as increased by the amount of remuneration to partners if deducted in determining book profit.
- d. Maximum permissible deduction for payment of remuneration to working partners. **Upto A.Y. 2009-10**, the maximum permissible deduction was as under :

<b>Professional firms</b>		<b>Business firms</b>	
<b>Book Profit/Loss</b>	<b>% or amount of deduction</b>	<b>Book Profit/Loss</b>	<b>% or amount of deduction</b>
i. Loss	Rs. 50,000	i. Loss	Rs. 50,000
ii. Profit Rs. 50,000 up to Rs. 50,000	Rs. 50,000	ii. Profit up to Rs. 50,000	Rs. 50,000
up to Rs. 1,00,000*	90%	up to Rs. 75,000*	90%
next Rs. 1,00,000	60%	next Rs. 75,000	60%
Balance profit	40%	Balance profit	40%
*(higher of Rs. 50,000 or prescribed percentage)			
<p><b>From A.Y. 2010-11, deduction for payment of remuneration to working partners for both Business as well as professional firms has changed as under:</b></p>			
<b>Book Profit/Loss</b>	<b>% of amount of deduction</b>		
(i) loss or profit upto Rs. 3,00,000	Rs. 1,50,000/- or 90% of Book Profit whichever is more		
(ii) on the balance	60% of book profit		

**8. Rate of tax :-** Flat rate of 30% on the total income after deduction of interest and remuneration to partners at the specified rates. (No surcharge for Asst.

Yr. 2010-11) to be increased by education cess secondary and higher education cess @ 3% on Income-tax.

**9. Losses of the firm :** Unabsorbed loss including depreciation in respect of A.Y. 1993-94 onwards of the firm will not be apportioned amongst the partners and will be carried forward by the firm only. In case of change in constitution of firm, following treatment will be given;

- a. Calculate the share of profit of the retiring/ deceased partner in the year in which there is a change in the constitution due to such retirement / death.
- b. Compute the share of loss of the retiring/ deceased partner in the brought forward loss of the firm.
- c. Set off the share in the brought forward losses of the retiring/ deceased partner from his share of the profit of the current year.

This set off of share of brought forward loss will be allowed to the extent of share of profit of such partner. The balance loss, if any, will not be allowed to be carried forward either to such partner or to the firm. On the other hand, if in the current year also the share of the partner is a loss, then share of the brought forward loss along with the share of loss of current year will not be allowed to be set off and carried forward. Nevertheless, unabsorbed depreciation of the firm is not covered u/s 78 and therefore, the entire unabsorbed depreciation will be allowed to be carried forward in the hands of the firm, even if there is a change in the constitution of the firm.

**10. Change in constitution (Sec.187) :** Where at the time of making assessment u/s 143 or Sec.144, it is found that a change has occurred in the constitution of a firm, the assessment shall be made on the firm as constituted at the time of making the assessment. In other words, there will not be a separate assessment of firm even when there is a change in the constitution of the firm. There is a change in the constitution when

- a. if one or more of the partner ceases to be partners
- b. one or more new partners are admitted
- c. when there is change in their shares

Dissolution of a firm due to death of any partner will not be considered as change in the constitution of the firm (proviso to Sec. 187)

**11. Succession of one firm by another firm (Sec.188):** Where a firm carrying on a business or profession is succeeded by another firm, and the case is not one covered by Sec.187, separate assessments shall be made on the predecessor firm and the successor firm in accordance with the provisions of Sec.170.

**12. Dissolution of firm or Discontinuance of business :** Where any business or profession carried on by a firm has been discontinued or where a firm is dissolved, the assessing officer shall make an assessment of the total income of the firm as if no such discontinuance or dissolution had taken place, and all the provisions of this Act, including the provisions relating to the levy of a penalty or any other sum chargeable under any provision of this Act, shall apply, so far as may be, to such assessment. Every person who was at the time of such discontinuance or dissolution a partner of the firm, and the legal representative of any such person who is deceased, shall be jointly and severally liable for the amount of tax, penalty or other sum payable, and all the provisions of this Act, so far as may be, shall apply to any such assessment or imposition of penalty or other sum.

**13. Partners' assessments**

1. Once tax is paid by firm, no tax will be payable by the partners on share of income from the firm.
2. Amount of Interest and/or remuneration etc. received by a partner will be taxed in his hands as 'Business or Professional Income', excluding the amount disallowed in the hands of the firm being in excess of limits laid down in S. 40(b) and from A.Y. 2004-05 amount disallowed in the event of any failure as mentioned in S. 144 or non compliance of S. 184.

**14. Admisibility of remuneration and interest vis-a-vis presumptive taxation**

Remuneration and interest will be allowed as deduction from the presumptive income computed at prescribed rate u/ss. 44AD, 44AE & 44AF.

**PART-II**  
**Recent Case-law relating to Taxation of firm**

1. **S.40(b):Amounts not deductible- Limits- Non business income –**

For s. 40(b)(v) limits, P&L A/c profits (including non-business income) have to be taken & not only “profits & gains of business” as computed u/s 28 to 43D.

*Md. Serajuddin & Brothers v. CIT (2012) 210 Taxman 84(Cal.)*

[Allen Career Institution (114 TTJ 492) (Jp)]

[Asst. CIT vs. Bilawala & Co. (133 TTJ 168) (Mum.)]

2. **S.40(b):Remuneration to partner in representative capacity as Karta of HUF-**

Since HUF becomes partner in a firm only through the individual who functions in his capacity qua the firm and hence payment of remuneration by firm to such Karta is allowable as it is an individual who joins the firm as a partner,

*Patel Quarry (90TTJ 215)(Ahd)*

*Smruti Trading Co. (70 TTJ 114)(Mum.)*

*Giriraj Mines (1 SOT 279)(Ahd)*

*National Automobiles ( 93 TTJ 641)(Jd.)*

*Bharat Enterprise ( 101 ITD 353)(Pune)*

*M/S Hemtej Imprint (ITA No: 1520/AHD/2010 dt. 30/07/2010)*

3. **Sec. 40 (b) –Remuneration to partner and terms of partnership deed**

(i) Neither quantum nor manner of computation specified in deed, the same cannot be said to be in accordance with the terms of partnership deed u/s 40(b)(v)-not allowable.

*Sood Brij & Associates v.CIT ( 203 Taxmann 188)(Del)*

*Sood Bhandari & Co. v. CBDT ( 204 Taxmann 340)(PH)*

*Dr. Bidari Ashwini Hospital v. ITO ( 209 Taxmann 303)(Karn.)*

(ii)When the partnership deed provided that remuneration will be as per the provisions of IT Act, it is allowable even if it was not fixed in the deed.

*Durga Dass Devki Nandan v.ITO ( 342 ITR 17)(HP)*

(iii) The presence of a clause in a deed which empowers to modify the terms of remuneration does not disqualify the deduction.

Shabro International ( 42-A BCAJ 25, April 2010-Part-1)

4. **Sec. 40(b) r.w.s. 14A**

When the share of profit is exempt in the hands of the partners u/s 10(2A), s. 14a would apply and any expenditure incurred to earn the share income will have to be disallowed. However it will not include depreciation.

Vishnu Anant Mahajan v. ACIT ( 137 ITD 189)(AHD.)(SB)

Contra: Karan Raghav Export (p) Ltd 196 Taxmann 504)(Del)

5. **Capital Gains- Applicability of sec. 45(4)**

(i) Dissolution by operation of law does not imply that there is a notional transfer of capital assets owned by the firm to other partner/s on that day itself because sec 45(4) does not deem the date of dissolution as the date of transfer. The relevant date is the year in which the property is transferred.

CIT v. Vijayalakshmi Metal Indus. ( 256 ITR 540)(Mad.)

CIT v. Moped & NMachines ( 281 ITR 52)(MP)

(ii) Take over of business of firm by partner on dissolution=Despite amendment to Sec. 2(47), there was transfer of assets to the partner.

Suvadhan v. CIT ( 287 ITR 404)(Ker.)

(iii) Reconstitution vis-a vis dissolution of firm-Two new partners admitted, and on reconstitution original four partners retired. There was transfer attracting 45(4)

CIT v. Gurunath Talkies ( 328 ITR 59)(Karn),

Hotel Luciya Drive-in Restaurant v. CIT (48 DTR 44)(Ker)

CIT v. Kumbazha Tourist Home ( 328 ITR 600)(Ker)

ITO v. International Rubber & Plastics ( 48 DTR 219)(Chen.)

(iv) Conversion of partnership firm into Company under Part IX of the Companies Act.

There was no dissolution of firm when the Co was formed with same partners as its shareholders.

CIT v. Texspin Eng.& Mfg. Works ( 263 ITR 345)(Bom.)

(v) Revaluation of assets before conversion of firm into Company does not attract 45(4)

CIT v. Rita Mechanical Works ( 344 ITR 544)(PH)

ITO v. Gulabdas Printers ( 4 ITR Trib. 264)(Ahd.)

(vi) The closing stock of the firm on conversion of firm to Company should be valued at the cost price and not market value.

CIT v. Hansa Footwear ( 344 ITR 30)(AP)

6. **Sec. 68- credits in capital a/c of partners**

If the explanation about credits in Capital a/c of the partners was not found satisfactory, addition cannot be made in hands of firm.

G.L. Foods v. ITO 134 ITD 159( Luck)

Sarjan Corporation v. ACIT (14 ITR Trib. 140)(Ahd)

Pankaj Dyestuff Indus.(I.T.Reference No.241 of 1993 Guj.)

7. **Sec. 269SS and 269T-Firm & partners**

There was a reasonable cause if the firm was acting under abona fide belief that the payments to the partners did not constitute deposit or advances. No penalty u/s 271D attracted.

Lokhpat Film Exchange ( Cinema) -( 304 ITR 172)(Raj.)

Shrepak Industries v. DCIT ( 64 ITD 300)(Ahd)

Skyline Silk Mills v ACIT ( 101 TTJ 798)(Asr)

8. **S. 54F : Capital gains - Exemption in case of investment in residential house – Deposit in capital gain scheme. [S. 45(3)]**

Where assessee had earned capital gains by virtue of section 45(3) i.e. on account of introducing capital asset in a partnership firm by way of capital contribution, the assessee could not claim benefit of section 54F by constructing a new house if he had not deposited the sale proceeds in capital gains scheme account. Further since the assessee had utilized borrowed amount to construct new property he was debarred from claiming benefit under section 54F. (A. Y. 1995-96)

***CIT v. V. R. Desai (2011) 197 Taxman 52 (Ker.)(High Court)***