

ASSESSMENT OF FIRMS

Meaning of Partnership, Firm and Partner

Partnership is a "relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all." These persons are called partners and collectively they are called 'firm'. In Income Tax Act, the term 'partner' also includes (i) a minor admitted to the benefits of partnership, and (ii) a partner of a limited liability partnership.

The above definitions of Partnership Act also hold good for the Income Tax Act. However, it also includes a limited liability partnership. [Sec. 2(23)]

A. Broadly partnership firms can be divided in two categories :

1. **Limited liability partnerships** : In such a case the liability of the partners is limited to the extent of capital contributed by them to the firm.

2. **Unlimited liability partnerships** : In such a case the liability of the partners is unlimited. It means the creditors and money lenders of the firm can recover their dues from the assets of the firm as well as from the personal assets of the partners.

B. Further, the limited liability partnerships and unlimited liability partnerships can be divided in two categories :

1. **Firm fulfils the conditions of Section 184 of the Income Tax Act** : In such a case, in computing the income chargeable under the head 'Profits and gains of business or profession' the interest and remuneration payable to partners are deductible subject to the provisions of section 40 (b).

2. **Firm does not fulfil the conditions of Section 184 of the Income Tax Act** : In such a case provisions of section 185 apply and in computing the income chargeable under the head 'Profits and gains of business or profession' the interest and remuneration payable to partners are not deductible.

For assessment of above mentioned firms (A and B) the income-tax provisions are almost the same.

Note : For provisions of Section 184 and Section 185 See Post.

Who can be a partner?

Individual. Individuals who are major and of sound mind can be the partners of a firm. There is no doubt that a minor can be admitted to the benefits of the partnership but there must be at least two adults to form a legal partnership.

Hindu undivided family. A Hindu undivided family cannot be a partner in a partnership firm. Similarly, the manager of the family cannot enter into partnership with the family in his individual capacity. However, the manager of the family, or any other member of the family (male or female), can become a partner for and on behalf of the family with a stranger. [CIT vs. Seth Govindram Sugar Mills (1965) 57 ITR 510 (SC)] The members of the family do not *ipso facto* become partners in that firm. But the creditors of the firm would be entitled to proceed against the joint family assets including the shares of non-partner coparceners for realisation of their debts.

[Firm Bhagat Ram Mohan Lal vs. CEPT (1956) 29 ITR 521 (SC)]

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ADJUSTMENT OF PROFIT & LOSS ACCOUNT

If a Profit and Loss Account is given for the purpose of computing the total income of the firm, the profit or loss as per Profit and Loss Account shall be adjusted in the same manner as is done in the computation of income under the head 'Profits and Gains of Business or Profession'. Thereafter, the income of the firm from sources other than business is added up in the income from business computed as aforesaid and the resultant amount is the gross total income of the firm.

From the gross total income deductions permissible under *sections* 80C to 80U shall be deducted and the balance shall be the total income of the firm. It is important to note that out of *sections* 80C to 80U, only the following *sections* are applicable to a firm :

Secs. 80G, 80GGA, 80GGC, 80IA, 80IAB, 80IB, 80IC, 80ID, 80IE and 80JJA.

However, the deductions under the aforesaid *sections* will not be allowed against short-term capital gains (specified in *Sec.* 111A) and long-term capital gains (u/s 112).

Computation of Income of a Partner from the Firm

In computing the income of a partner from the firm the following points are worth noting :

(a) **Remuneration.** Wherever any salary, bonus, commission or other remuneration is received by a partner as per the provisions of the partnership deed [but not exceeding as provided in *section* 40(b)], it is not taxable under the head 'Salaries' because a partner of the firm is not an employee of the firm. Hence, this amount is taxable under the head 'Profits and Gains of Business or Profession'.

(b) **Interest.** When any interest is received by a partner as per the provisions of the partnership deed [but not exceeding 12% p.a.], such income is also treated as a part of the business income and included under the head 'Profits and Gains of Business or Profession'.

(c) **Rent.** If a partner lets out his buildings to the firm, the rent received by him will be taxed under the 'Income from House Property'.

(d) If a firm provides rent-free accommodation with free electricity to a partner, such expenses are disallowed in the hands of the firm, hence the amount is not assessable in the hands of the partner, otherwise it would amount to double taxation.

(e) **Share of Profit.** The share of profit of a partner in the firm is exempt under *section* 10(2A). Hence, it will not be included in his income.

(f) **Deductions.** While computing the income of a partner chargeable under the head 'Profits and Gains of Business or Profession', the following deductions may be claimed :

- (i) Any interest paid by him on capital borrowed by him for the purposes of investment in the firm.
- (ii) Any interest paid by him to the firm on his deficit capital. Sometimes the partners are required to maintain a minimum balance in their Capital Accounts. If a partner fails to maintain it, he may be required to pay the interest to the firm at the stipulated rate. Hence interest paid or payable to the firm is deductible.

However, interest paid to the firm on amount withdrawn for the payment of personal advance tax and personal expenses, is not deductible from the interest income from the firm.

- (iii) Any other expense incurred by the partner to earn the remuneration from the firm. For instance, expenses for maintenance and depreciation of car, travelling expenses expended by him for earning the remuneration from the firm.

Treatment of Firm's Losses

Losses brought forward by the firm shall be dealt with as under :

- (1) Speculative business losses can be set-off against the *speculative business income* of the firm in subsequent 4 years.

(2) Non-speculative business losses can be set-off against *any business profit* of the firm in subsequent 8 years.

(3) Long-term Capital losses can be set-off against *Long-term Capital gains* of the firm in the period specified in (2).

(4) Short-term capital losses can be set-off against long-term as well as short-term capital gains of the firm in the period specified in (2).

(5) Unabsorbed depreciation can be set-off against *business income or any other income* of the firm.

Note : The 4-years/8-years period shall be counted w.e.f. the year in which the loss was incurred.

Computation of Book Profit

While computing firm's income book profit has to be determined to comply with the provisions of *section 40(b)*. Hence, a proforma for this purpose is being given below to facilitate as to how book profit is to be determined :

Proforma of Computation of Book Profit

Net Profit as per P. & L. Account	₹	₹
Add :		.. ✓
(i) Inadmissible items (not covered u/ss 30 to 44D)	.....
(ii) Remuneration to partners, if debited to P. & L. A/c	.....
(iii) Disallowance of interest in excess of 12% p.a.	.....	.....
Less :		.....
(iv) Admissible items which are disallowed in (i) above	.....
(v) Income from all other sources credited to P. & L. A/c	.....	.....
Book Profit		<u>.....</u>

Proforma of Computation of Total Income of the Firm

Book Profit of the Firm	₹	₹
Less : Remuneration paid to working partners :		.....
Least of the following two :		
(a) Actual Remuneration	.....
(b) Statutory Limit u/s 40(b)	✓.....	.....
Profits & Gains of Business or Profession of the firm	✓.....	.....
Add : Income from all other sources		.....
Gross Total Income		<u>.....</u>
Less : Deductions u/ss 80C to 80U		.....
Total Income		.....
Less : Tax payable by the firm		.....
Distributable Income to be distributed among the partners according to their profit sharing ratio		<u>.....</u>

Important Notes regarding Computation of Book Profit

- (1) Brought forward Unabsorbed Business Loss is not deductible to arrive at the Book Profit.
- (2) Non-business incomes and their concerned non-business expenses are not included in computing Book Profit.

Computation of tax. For the assessment year 2016-17 income tax will be levied at the following rates :

- (i) Short-term capital gains 15% (u/s 111A);
- (ii) Long-term capital gains 10%/20% (u/s 112);
- (iii) Winnings from lotteries, card games, crossword puzzles, horse race, etc. 30%;
- (iv) Other income 30%.

Firm. A firm cannot enter into a partnership with any other firm or an individual. [*Duli Chand Laxmi Narayan vs. CIT* (1965) 29 ITR 535 (SC)] However, the partner of a firm can become partner of another firm, or all the partners of two firms can join together and form a bigger partnership firm.

Company. Under the Companies Act, a company is a separate entity and possesses a legal personality, hence, two or more companies can become partners in a firm. Similarly, a company can form a partnership with an individual.

Trust. A Trust can be a partner of a firm.

Assessment as a Firm

(Sec. 184)

1. A firm shall be assessed as a firm, if :

- (i) the partnership is evidenced by an instrument; and
- (ii) the individual shares of the partners are specified in that instrument.

2. A certified copy of the instrument of partnership deed shall accompany the return of income of the firm for the previous year relevant to the assessment year in respect of which assessment as a firm is first sought.

3. If once a firm is assessed as a firm for any assessment year, it shall continue to be assessed as a firm for every subsequent year if there is no change in the constitution of the firm.

4. If any change occurs in the previous year, the firm shall furnish a certified copy of the revised partnership deed along with the return of income for the relevant previous year.

5. If there is, on the part of the firm, any failure to comply with the provisions of section 144 [viz., failure to file the return of income, failure to comply with the terms of a notice issued under section 142(1) or 143(2)], the firm shall be assessed as a firm. In such a case the following provisions shall apply :

- (a) No deduction by way of payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by the firm to its partners shall be allowed in computing the income chargeable under the head 'Profits and gains of business or profession'.
- (b) Such interest, salary, bonus, commission or remuneration shall not be chargeable to tax in the hands of partners under the head 'Profits and gains of business or profession' u/s 28(v).

Assessment when Section 184 not complied with

(Sec. 185)

- (1) Where a firm does not comply with the provision of section 184 for any assessment year, the firm shall be assessed for the assessment year as a firm.
- (2) No deduction by way of payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by the firm to its partners shall be allowed in computing the income chargeable under the head 'Profits and Gains of Business or Profession'.
- (3) Such interest, salary, bonus, commission or remuneration shall not be chargeable to tax in the hands of partners under the head 'Profits and Gains of Business or Profession' [u/s 28(v)].

Computation of Firm's Income

In computing firm's income from business or profession, any interest, salary, bonus, commission or remuneration due to or received by a partner of a firm from such firm to the extent of the amount inadmissible u/s 40(b), shall be included under the head business or profession. Remuneration includes salary, bonus, commission, etc. The provisions of section 40(b) provide that the following expenses shall not be allowed :

Items disallowed :

- (i) Salary, bonus, commission or other remuneration paid or payable to any partner of the firm, who is not a working partner is disallowed.
- (ii) Payment of remuneration, which is neither authorised nor in accordance with the terms of the partnership deed, to any partner being working partner is disallowed.
- (iii) Payment of interest, which is neither authorised nor in accordance with the terms of the partnership deed, to any partner is disallowed.
- (iv) Payment of remuneration authorised by and in accordance with the terms of partnership deed relating to any period falling prior to the date of partnership deed for which such payment was neither authorised by nor in accordance with any earlier partnership deed to any working partner is disallowed. In other words, payment of remuneration authorised by and in accordance with the terms of earlier partnership deed to any working partner for any subsequent period is allowed as deduction. Thus, it should be payable after the date of partnership deed.
- (v) Payment of interest in the above circumstances to any partner is disallowed. However, any payment of interest authorised by or in accordance with the terms of the earlier partnership deed to any partner for any subsequent period is allowed as deduction. Thus, it should be payable after the date of partnership deed.
- (vi) Payment of interest authorised by and in accordance with the partnership deed relating to any period falling after the date of the partnership deed to any partner exceeding 12% p.a. is disallowed.
- (vii) Payment of remuneration authorised by and in accordance with the partnership deed relating to any period falling after the date of partnership deed to any working partner exceeding the specified limit is disallowed. The specified limit is as follows :

On the first ₹ 3,00,000 of book profit or in case of loss	₹ 1,50,000 or 90% of book profits, whichever is more.
On the balance of the book profit	@ 60%

Explanations to Section 40(b)

(1) An individual, who is a partner in a firm, on behalf, or for the benefit, of any other person is called a partner in representative capacity. Interest paid by the firm to such individual otherwise than as 'Partner in a Representative Capacity' shall not be taken into account for the purpose of this section.

(2) 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 purpose of this section.

(3) 'Book Profit' means the net profit as per profit and loss account for the relevant previous year computed in accordance with the provisions contained in sections 30 to 44D 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.

(4) '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. A non-working partner may be financing partner, dormant or sleeping partner.

Sometimes, the amount of remuneration payable to each working partner is not specifically stated in the partnership deed. It contains only the fact that the "Working partners shall be paid the remuneration permissible u/s 40(b)." Similarly, in some cases it is mentioned in the deed that the remuneration payable to working partners "shall be decided at the end of the accounting year."

In this connection the Board has clarified that the partnership deed must specifically state the amount of remuneration payable to each working partner or how the remuneration will be computed otherwise no deduction will be allowed u/s 40(b) regarding remuneration to working partners.