

Chapter I: Introduction

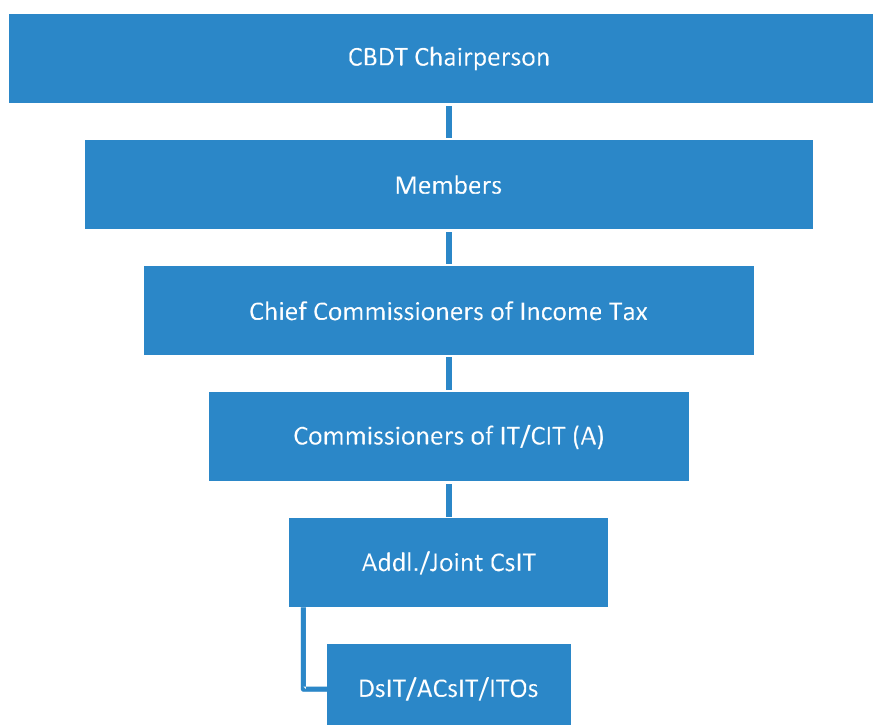
1.1 Introduction

Partnership Firm is one of the forms of business organization and a common vehicle for carrying on business activities in India. Apart from the corporate sector, large business is also organized as partnership Firm. The Income Tax Act, 1961 (Act), does not define the term 'Firm'; however, section 2(23) of the Act states that Firm, Partner and Partnership have the meanings respectively assigned to them in the Indian Partnership Act, 1932. As per the amendment made by Finance Act, 2009, the provisions of taxation applicable to partnership Firm, are applicable to a Firm constituted under Limited Liability Partnership Act, 2008.

1.2 Organizational set-up

Central Board of Direct Taxes (CBDT), as a part of Department of Revenue, Ministry of Finance, is the apex body charged with administration of Direct Taxes. CBDT is headed by the Chairperson and comprises of six Members. In addition to functions and responsibilities, the Chairperson and Members are responsible for exercising supervisory control over field offices of the CBDT, known as Zones. Chief Commissioner of Income Tax (CCIT) heads the field office whose jurisdiction is generally co-terminus with the state. Each CCIT is assisted by CsIT, Additional/Joint CsIT, Deputy CsIT, Assistant CsIT and ITOs.

Graph 1.1: Organogram of CBDT



1.3 Why we chose the topic

There has been steady growth in the Income Tax Return of partnership Firms¹ (Firms) as given below in table 1.1.

Table 1.1: Firms assessees vs Return income

Assessment Years	Firms (in lakh)	Return Income (₹ in crore)
AY 09	7.18	36,942
AY 10	7.60	41,781
AY 11	7.75	45,647
AY 12	6.99	51,482

Firms pay income tax at the rate of 30.90 *per cent* (30 *per cent* plus cess of 3 *per cent*) and contribute maximum to the tax collection made from non-corporate assessees. However, the effective tax rate in their case is only 23.80 *per cent*² as number of tax concessions are given to the Firm assessees. Apart from various tax concessions availed by the Firms, their Partners are also getting exemptions on the distributable profits of the Firms.

Every year, in the Compliance Audit Reports of the Comptroller and Auditor General of India, we include draft paragraphs relating to Firms on various compliance issues. In the past, we did not examine the issue of co-relation of Firms and their Partners and its overall impact in the taxation with subsequent gain/loss to the exchequer.

Thus, we undertook the Performance Audit on 'Assessment of Firms' to seek assurance that system and procedures are sufficient within the Income Tax Department (ITD) with respect to assessment of Firms/Partners and there exists a proper machinery to exercise necessary checks/controls in the area of potential misuse of the provisions relating to tax concessions.

¹ As per the database made available by DGIT-Systems, New Delhi.

² Source: Receipts Budget, FY 14.

1.4 Legal provisions

Chapter XVI of the Act stipulates special provisions applicable to the Firms. Other provisions of the Act as applicable to other assesseees are also applicable to them. Provisions specific to the Firms are summarized below:

Section 184	<ul style="list-style-type: none"> •A Firm shall be assessed as Firm if the partnership is evidenced by an instrument and individual shares of the Partners are specified in that instrument.
Section 187	<ul style="list-style-type: none"> •Where at the time of making an assessment, 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.
Section 188	<ul style="list-style-type: none"> •Where a Firm is succeeded by another Firm, separate assessments shall be made on the predecessor Firm and the successor Firm.
Section 189	<ul style="list-style-type: none"> •Where any business or profession carried on by a Firm has been discontinued or Firm is dissolved, the AO shall make an assessment of the total income of the Firm as if no discontinuance or dissolution had taken place.
Section 40 (b)	<ul style="list-style-type: none"> •Conditions for claiming deduction of remuneration and interest to the Partners.
Section 45 (3) Section 45 (4)	<ul style="list-style-type: none"> •The profits and gains arising from the transfer of a capital asset by a Partner of a Firm shall be chargeable to tax as his income. •The profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a Firm shall be chargeable to tax as income of the Firm.
Section 78	<ul style="list-style-type: none"> •Where there is a change in the constitution of the Firm, the Firm shall not be entitled to carry forward and set-off of so much of loss proportionate to the share of a retired/deceased Partners.

1.5 Audit Objectives

The objectives of the Performance Audit are to focus on the following:

- a. ensuring sufficiency of system, procedures and compliance with the provisions of the Act/Rules;
- b. proper application of relevant sections and provisions of the Act;

- c. existence of system to co-relate assessment of Firms and their Partners;
- d. checking the Internal Control Mechanism of the ITD;
- e. highlighting the lacunae or ambiguities in the provisions of the Act and deficiencies, if any, in the administration or policy relating to the assessment of Firm.

1.6 Audit scope

We covered the assessments of Firms completed during financial years (FYs) from FY 11 to FY 13 and up to June 2013.

1.7 Sample size

We filtered and segregated data provided by Director General of Information Tax-Systems (DGIT-System) in respect of Firms, to assess the number of Firms in the respective field units of ITD. On the basis of risk analysis of each unit, we selected 15 *percent* and 20 *percent* of the units (having highest risk factors) for review of metro and non-metro charges respectively. Within the selected unit, we selected all cases of scrutiny assessments, appeal and rectification cases for review. With respect to Internal Control Mechanism, we selected two high risk Commissionerates having Firm as assessee for review. In case of states having just one Commissionerate, we did sampling at the level of Ranges. We requisitioned 27,944 assessment records from the assessment units of the ITD located all over India. However, the ITD produced and we audited 26,328 assessment records.

1.8 Constraints

The Firm assessee and their Partners fall under different jurisdictional charge and are assessed separately by their respective jurisdictional Assessing Officer (AO). The Partners of the Firm are not required to file their respective returns with the same AO who is also in jurisdictional charge of the assessee Firm. In the absence of mechanism to identify the jurisdictional charge of the AO under which the Partners of Firm falls, audit could not co-relate cases of Firm with their Partners in most of the cases.

1.9 Acknowledgment

We held an entry conference with CBDT in May 2013 wherein we explained the audit objectives, scope and the main focus areas of audit examination. The Indian Audit and Accounts Department acknowledges the cooperation of ITD in facilitating the audit.

The exit conference was held (February 2014) with CBDT. We have suitably incorporated CBDT's views in this report.