

## Chapter II: Systemic issues of the Firms and their Partners

### 2.1 Introduction

Partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them. Persons who have entered into partnership with one another are called Partners individually and a Firm collectively.

As per the Income Tax Act, 1961 (Act), Firm and their Partners have separate legal status. The assessment of a Firm will not be complete/ accurate unless it is correlated with assessment records of their Partners. In addition to this, the Act has certain inconsistencies regarding exemptions/deductions to the Firm/ Partners and submission of partnership deeds at the time of assessment.

The present Chapter deals with systemic issues arising out of assessment of Firms and their Partners and are described in succeeding paragraphs.

**ITD does not have any system of maintaining complete database of Firms and their Partners.**

### 2.2 Registration of Firms

Prior to Finance Act 1992, the Act distinguished between registered and unregistered Firms and provided differential treatment. With effect from 01 April 1993, it is not obligatory for the Firms to get registered for the purpose of income tax. The Firms enjoy benefits of section 40(b) of the Act on the basis of the partnership deed only, irrespective of its registration status, which can be altered as per the convenience of the Firm or its Partner.

Scrutiny of Central Action Plan (CAP) reports of CBDT and information furnished by Tax Recovery Officers (TROs) revealed that no separate mechanism for reporting to CBDT existed in the ITD in respect of Firms. Since registration of the Firm is optional and at the discretion of the Partners, the ITD is not in a position to ascertain as to how many Firms exist in India and out of them, how many file their Income Tax Return (ITR) and discharge their tax liabilities.

Firms also include Limited Liability Partnership (LLPs) and they are required to get registered mandatorily with the Registrar of Companies. Thus, registrations of all the Firms are not streamlined for income tax purpose.

Though the filing of ITR of the Firms is mandatory, in the absence of database of unregistered Firms, there is a possibility of non filing of ITR by such Firms, which may go undetected and may result in loss to exchequer.

**ITD is not correlating the assessment records of the Firm and their Partners which resulted in short levy of tax.**

**2.3 Co-relation of assessment of the Firms and their Partners**

The assessee Firm and Partners of the Firm fall under different jurisdictional charge and are assessed separately by their respective jurisdictional AO. Under the present provisions of the Act, the Partners of the Firm are not required to file their respective returns with the same AO, who is in jurisdictional charge of the assessee Firm. Further, the assessee Firms are not bound to declare Permanent Account Number (PAN) of their Partners in the ITR-V as it is not mandatory. There are a number of transactions between a Firm and its Partners that require cross verification such as introduction of capital, charge of interest, remuneration and similar other transactions. As a result, it becomes difficult to co-relate the veracity of capital introduced by the Partners in the Firm and cross check the charging of interest, remuneration and claim of other expenses.

In 183 cases pertaining to Bihar, Andhra Pradesh and Rajasthan, we did not find the ITR of the Partners enclosed with the assessment record of the Firms which prevented cross checking of the remuneration/interest claimed and allowed in the assessment of Firm with that of the Partners.

We cross checked the assessment records of the Partners vis-à-vis the assessment records of the respective assessee Firms and found in 70 cases pertaining to nine states<sup>3</sup> that the AO did not cross verify/co-relate the ITR of Partners with that of the respective assessee Firms which involved a tax impact of ₹ 2.49 crore (see Box 2.1).

**Box 2.1: Illustrative cases on co-relation of assessment of the Firms and their Partners**

a. In Assam, CIT-II Guwahati charge, the AO completed assessment of the Firm **M/s. Annapurna Foods Products** for the AY 11 after scrutiny in September 2012 at an income of ₹ 25.24 lakh. Schedule A forming part of the balance sheet of the Firm indicated that three Partners introduced fresh capital into the Firm amounting to ₹ 1.03 crore. However, the source of income from which the assessee Partners had introduced the fresh capital was not available on record. Since the assessee Partners had not disclosed the source of income, the amount introduced by the Partners was required to be assessed as undisclosed income in the hands of the Partners. The omission resulted in under assessment of income of ₹ 1.03 crore involving tax effect of ₹ 31.92 lakh.

<sup>3</sup> Gujarat, Rajasthan, Tamil Nadu, Kerala, Maharashtra, Jharkhand, West Bengal, Andhra Pradesh and Haryana.

- b.** In Karnataka, CIT-IV Bangalore charge, the AO completed assessment of Firm **M/s. Manjrak Marketing** for the AY 09 after scrutiny at NIL income. We noticed that Rakesh Batra, who was a Partner in the above Firm, had introduced capital of ₹ 24 lakh. However, individual record of Rakesh Batra assessed at ITO Ward 8(1), Bangalore, did not reveal any such capital introduced by him. As the source for introduction of capital in the Firm was not established, the receipt of ₹ 24 lakh should have been brought to tax. This omission resulted in short computation of income by ₹ 24 lakh and resultant short levy of tax of ₹ 10.68 lakh.
- c.** In Rajasthan CIT-II Jaipur charge for the AY 10 in case of **M/s. Alps Corporation**, we observed that assessee Firm paid interest of ₹ 12.43 lakh to its Partner but it was not found to be shown in Partner's computation of income in the ITR which resulted in escapement of income of ₹ 12.43 lakh in the hands of the Partner involving tax effect of ₹ 3.84 lakh.

We also noticed in three cases in West Bengal, that Firms claimed deduction for interest/remuneration to Partners without actually making the payment to the Partners. As these expenditures were not disallowed, it resulted in a revenue impact of ₹ 28.86 lakh (see Box 2.2).

**Box 2.2: Illustrative case on deduction for interest/remuneration to Partners**

- a.** In West Bengal CIT-XI Kolkata charge for AY 04, AY 05, AY 07 and AY 09, the assessment was completed in case of **M/s. Fu Leather Industries**. We noticed that in all these AYs, assessee Firm debited interest on Partners' capital and remuneration to the Partners in Profit & Loss Account of respective years but these interest and remuneration were not reflected in Partners' Capital account of respective year. Thus, the assessee Firm claimed deduction for interest on Partners' Capital and remuneration to Partners which was not actually paid. The omission to disallow the same resulted in underassessment of income of ₹ 72.20 lakh with revenue impact of ₹ 24.39 lakh for the respective four AYs.
- b.** In West Bengal under CIT-XI Kolkata charge for the AY 09, in case of **M/s. SBD Enterprise**, we noticed that the Firm had transferred an amount of ₹ 37.87 lakh from the Profit and Loss Appropriation Account to the Partners' Capital account. However, Partners' Capital accounts reflected that the total amount of profit distributed amongst all Partners stood at ₹ 43.49 lakh. Thus, the Partners' capital account was inflated by an amount of ₹ 5.62 lakh which would result in increase in the amount of interest on Partners' capital in the succeeding year and will have potential tax effect of ₹ 1.74 lakh.

On being pointed out regarding the non-correlation of records, CIT-1 Chennai stated (July 2013) that wherever necessary the Partner's assessment records are being called for. This implies that correlation is being done only at the discretion of the AO and there is no procedure prescribed by the ITD in this regard. The AOs are not giving due importance to correlation/cross

verification of information while finalising assessment of the Firm vis-a-vis their Partners.

Further, we observed that there is no mechanism to identify the jurisdictional charge of AO under which the Partner of the Firm is assessed as well as sharing of information available in the Firm's assessment which would be needed for the assessment of any other assessee who has business or other connection with the assessee Firm. Thus, the correctness of the claims made in respect of remuneration and interest by the respective Partners could not be verified/co-related unless the same is specifically called for during the scrutiny assessment. The ITD also could not verify the veracity of capital introduced by the Partner as the Partners are not assessed in the same charge. As there is no provision for deduction of Tax Deducted at Source (TDS) in the Act on payment of remuneration and interest to working Partners under section 40(b)(iv)&(v), it becomes difficult to co-relate the payments made to the Partners.

**ITD does not have any system of monitoring the partnership deed of the Firms in order to regulate the claims and collecting information from Registrar of Firms for effective control.**

## **2.4 Inconsistencies in submission of the partnership deed**

Under the provisions of section 184(1)(2)(3),(4)&(5) of the Act, any remuneration and interest on capital can be claimed by the working Partners, if the partnership is evidenced by the certified copy of the partnership deed which should accompany the return of income in respect of which the assessment as a Firm is first sought and it shall be assessed in the same capacity if there is no change in the constitution of the Firm.

There is inconsistency in the above provision vis-à-vis Para 6 of Circular No.3/2009 dated 21 May 2009 of CBDT which states that the tax payers should not enclose with the return of income any statement, document, etc., filed either manually or electronically and CCsIT/CsIT must ensure that documents, if any, attached with returns are detached at the time of receiving returns and returned to tax payers immediately.

We noticed that in Karnataka, out of 1,265 cases of assessment test checked, 507 cases were not accompanied by the partnership deed due to which audit could not ensure the correctness of the details of the clauses in the deed such as number of Partners, working Partners, individual profit sharing ratio, remuneration payable to Partners, interest payable to Partners, arbitrator, if any, change in constitution, etc. Further in 30 cases in six states<sup>4</sup> the revised

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<sup>4</sup> Karnataka, Gujarat, Bihar, Andhra Pradesh, Madhya Pradesh, Maharashtra.

partnership deed was not placed on record despite a change in the constitution of Firms/profit sharing ratio having a tax effect of ₹ 1.39 crore.

Similarly in 10 states<sup>5</sup> in respect of 35 cases, the Firms were allowed to claim deductions in respect of salary and interest without submission/verification/certification of partnership deed despite there being a change in constitution/profit sharing ratio. This involved a tax effect of ₹ 11.51 crore (see Box 2.3).

**Box 2.3: Illustrative cases on inconsistencies in submission of the partnership deed**

**a.** In Haryana CIT-Central-Gurgaon charge for the AY 09 in case of **M/s. Vee Gee Industrial Enterprises**, we noticed that the Firm paid salary to its Partners at ₹ 3.42 crore but neither the partnership deed nor the Income Tax returns of Partners were available on record. Hence, the authenticity/correctness of salary allowed to Partners could not be verified. This involves a tax effect of ₹ 1.16 crore.

**b.** In West Bengal CIT Central- III Kolkata charge, block assessment of **M/s. Silver Queen Jewellers** was completed for the AY 04 to AY 09 under section 153A/143(3) and for AY 10 under section 143(3). We noticed that the AO allowed a total of ₹ 1.06 crore being the interest on Partner's capital during the said period to the Firm, without verifying partnership deed<sup>6</sup> which involved a tax impact of ₹ 35.85 lakh.

Thus, there exists the contradiction between provisions of the Act and CBDT circulars. The Firms are taking advantage of the CBDT circular and do not submit copy of the partnership deeds subsequently. If there is a change in the partnership deed and is not disclosed by the assessee himself, the ITD is not in a position to know whether the salary, interest, commission, bonus etc. received from the Firm is correct or not. This may result in postponement of demand in case it was selected for scrutiny or loss of revenue in the absence of the scrutiny assessment.

With growing dependence of e-filing and automation of various assessment functions, ITD should make the partnership deed available before AO online at the time of assessment.

<sup>5</sup> West Bengal, Assam, J&K, Haryana, Himachal Pradesh, Uttar Pradesh, Tamil Nadu, Chandigarh, Punjab, Gujarat.

<sup>6</sup> It was not placed in respective assessment folders and proper evidences of calling for by the AO during the assessment proceedings also remained absent.

## Partners of Firm avail excess exemption due to ambiguity in the Act.

### 2.5 Additional exemption claimed by Partners under section 10(2A)

Section 10(2A) of the Act provides that in the case of a person being a Partner of a Firm which is separately assessed as such, his share in the **total income** of the Firm shall not be included in computing the total income of previous year.

Chapter VIA of the Act vide Section 80A stipulates that "in computing the total income of the assessee, there shall be allowed from his gross total income, the deductions specified in section 80C to 80U." Further, Chapter III of the Act deals with 'incomes which do not form part of total income' which inter alia covers Section 10A, 10AA and 10BA of the Act.

Hence, exemptions/deductions under Chapter III and Chapter VIA would not naturally be part of the total income of the Firms and as such Partner would not be eligible to claim exemption under section 10(2A) of the Act on the amount deducted / exempted to the Firm.

We noticed that in 15 cases in six states<sup>7</sup>, the Partners have claimed exemption under section 10(2A) in respect of exemptions/deductions claimed by the Firms under section 10A, 10AA, 10BA, 80IB and 80IC resulting in excess exemption under section 10(2A) (see Box 2.4).

#### Box 2.4: Illustrative cases on lack of clarity in the provisions the Act

- a. In Gujarat CIT-V, Ahmadabad charge for AY 10 in case of assessee Firm **M/s. Adani Exports**, AO assessed the total income at ₹ 0.06 lakh after allowing deduction of ₹ 234.39 crore under section 10AA. Scrutiny of the Partners' case revealed that Partners had claimed exemption of above deducted amount under section 10(2A) of the Act thereby leading to excess exemption by an equal amount. This resulted in excess exemption of ₹ 234.39 crore under section 10(2A).
- b. In West Bengal CIT-XI, Kolkata charge for AY 09 scrutiny assessment completed in case of an assessee Firm **M/s Sherwood Estate Developers** revealed that AO allowed a deduction of ₹ 15.92 crore under section 80IB and again exempted the amount in the hands of Partners under section 10(2A) of the Act thereby resulting in excess exemption of ₹ 15.92 crore.
- c. In Rajasthan CIT-II, Jaipur charge, for AY 10 in case of assessee Firm **M/s. Mangalam Arts**, the AO assessed the total income at ₹ 14.09 crore after allowing deduction of ₹ 20.08 crore under section 10BA. Hence, total income of ₹ 14.09 crore was only to be allowed as exempt under section 10(2A) in the hands

<sup>7</sup> Gujarat, Haryana, Rajasthan, Uttar Pradesh, Uttarakhand and West Bengal.

of the Partners. However, AO allowed exemption to the Partners under section 10(2A) on account of deduction allowed to Firm of ₹ 20.08 crore.

From the above illustrations, due to ambiguity in the definition of 'Total Income' of Firms, the Partners are getting excess exemption under section 10(2A) of the Act.

**The Act is not clear about admissibility of non-legal entities such as Firms, Body of Individuals and Association of Persons as Partners in a Firm.**

## 2.6 Composition of partners in a Firm

Section 2(23) of the Act assigns the Firm, Partner and Partnership the same definition as defined in the Indian Partnership Act, 1932, and in the Limited Liability Partnership Act, 2008. Section 4 of the Indian Partnership Act, 1932, states that Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. It has been judicially<sup>8,9</sup> held that the word 'Person' according to the Partnership Act contemplates only natural or artificial persons and therefore, a Firm being not a 'Person' is not entitled to enter into a Partnership with another Firm. Also it has been held<sup>10</sup> that provisions of a Partnership Act should not be ignored the moment a Firm is viewed as an independent taxable entity under the Income Tax law. Hence the Firms, Body of Individuals (BoI) and Association of Persons (AoP) are not legal entities and therefore shall not be a Partner of another Firm.

We noticed in four cases of Maharashtra, Tamil Nadu and West Bengal that Firms were also Partners in another Firm and AO had allowed expenditure on remuneration to Firm-Partners which involved a tax implication of ₹ 20.90 lakh (see Box 2.5).

### Box 2.5: Illustrative cases on composition of Partners in a Firm

a. In Tamil Nadu CIT V Chennai charge in case of **M/s. Mega Trends Inc** for AY 11, AO allowed the assessee a deduction of ₹ 11.28 lakh towards interest to the Partners and ₹ 11.80 lakh towards remuneration to the Partners. We noticed that two of the Partners viz. **M/s DCP Trading Co.** and **M/s. Krupa Trading Co.** were Partnership Firms and other Partners were individuals. Therefore, the allowance given to the assessee Firm was incorrect having a tax effect of ₹ 7.13 lakh.

<sup>8</sup> Dulichand Laxminarayan v CIT (1956) 29 ITR 535(SC).

<sup>9</sup> Malabar Fisheries Co. v CIT(1979) 120 ITR 49(SC).

<sup>10</sup> CIT v Standard Maltings & Allied products Corpn. (1997) 226 ITR 1 (Guj.).



**b.** In Maharashtra CIT-XX Mumbai charge, in scrutiny assessment of **M/s. K.C. Corporation** for AY 10 and AY 11, we observed that M/s K.C. Corporation, the Firm is Partner in another Firm **M/s K.C. Corporation JV**. Since M/s K. C. Corporation is not a legal entity hence, it cannot be a Partner in another Firm. Therefore, the profit of ₹ 8.77 lakh and ₹ 7.43 lakh for AY 10 and AY 11 respectively received by the assessee is not eligible for exemption under section 10(2A). The omission resulted in under assessment of income by an equal amount having a tax effect of ₹ 6.61 lakh including interest.

Thus, ineligible entities have become Partners in a Firm, thereby availing the various benefits applicable to a Firm. The Act provisions have to be made clear for the purpose of Income Tax whether non legal entities such as Firms, Body of Individuals (BoI) and Association of Persons (AoP) can be Partners in a Firm.

**The Act is silent on charging interest on negative balance on capital accounts of Firms which suppress income by Partners.**

## 2.7 Non-charging of interest on withdrawals by the Partners

Section 40(b)(iv) of the Act stipulates that any payment of interest to any Partner which is authorized by the terms of partnership deed, shall not exceed 12 *percent* simple interest per annum. It is seen that the Firms are paying interest on positive balance of the capital account whereas they are not charging interest on the negative (debit) balance of the capital account since the Act does not provide for it. If debit/negative balance in Partners' capital account is a result of withdrawal by the Partner, the Firms should charge interest on it as it is equivalent to loan to the Partner.

We noticed 74 cases in eight states<sup>11</sup> where interest was paid on the positive balance in capital accounts of the Partners but no interest was charged on the withdrawals/debit balances in the Partners' capital account which indicated a loss of revenue of ₹ 1.16 crore (see Box 2.6).

### Box 2.6: Illustrative cases on non-charging of interest on withdrawals by the Partners

**a.** In Tamil Nadu CIT-I Coimbatore charge in the case of **M/s. Emerald Bullions and Jewelers**, for the AY 11, we noticed that the assessee Firm had not charged interest of ₹ 31.12 lakh on the debit balance in Partners' current account amounting to ₹ 259.00 lakh having a tax effect of ₹ 9.61 lakh.

<sup>11</sup> Maharashtra, Bihar, West Bengal, Himachal Pradesh, Punjab, Uttar Pradesh, Tamil Nadu, Kerala.



b. In Maharashtra CIT-Central Pune charge, in the case of **M/s. Pride Purple Properties** for AY 08 and AY 09, we observed that the Partner's capital had a debit balance of ₹ 1.42 crore and ₹ 10.88 crore respectively. However, no interest was charged by the Firm. We also noticed that the Firm has paid interest/financial charges of ₹ 90.15 lakh and ₹ 56.96 lakh during the respective AYs on loans/advances but did not charge any interest from the Partner from overdraw from the capital. ITD rectified (March 2013) the mistake under section 147 of the Act.

c. In Maharashtra CIT-XX Mumbai charge, in the case of **M/s. Nanavati Construction** for AY 10, the partnership deed authorized to charge interest on debit balance of capital account. However, no interest was charged on the debit balance of the Partner capital account of ₹ 6.38 crore. This omission resulted in under assessment of income of ₹ 76.61 lakh and short levy of tax of ₹ 34.63 lakh.

In absence of clarity in provisions, the Firms are not charging interest on withdrawals from the capital account and thereby suppressing income to that extent.

The Ministry replied (February and March 2014) that the Act does not provide for charging of interest by the Partner but only contains the provisions for disallowance if it exceeds certain percentage or is not authorised by the Partnership deed. Charging/not charging of interest on debit balance of the Partner's Capital account is a business decision and the Act cannot mandate a Firm to charge such interest.

**AOs are not applying section 14(A) of the Act consistently on Partner's share of profit received from a Firm which is exempted under section 10(2A) of the Act. Also, AOs are unable to apply section 14(A) read with Rule 8D of the Act relating to partnership Firms on the exempted income in the absence of previous year's details of income.**

## **2.8 Disallowances under section 14A**

As per section 14A(1) of the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income. Rule 8D of the Act prescribes the method of disallowance of expenditure incurred with respect to the exempt income which is calculated from the income statement of the previous year.

Share of profit received by a Partner from a Firm is exempted under section 10(2A) of the Act as the Firm and its Partners are assessed separately on their total income. Hence, expenditure incurred in earning the share from partnership Firm will have to be disallowed under section 14A of the Act. It has been judicially<sup>12</sup> held that section 14A of the Act applies to Partners' share in profits of the Firm.

We found that AOs are not consistently applying the provisions of section 14A on the exempted income of the Partners which is claimed under section 10(2A) of the Act. In Gujarat, in 13 cases relating to Partners, we noticed that AOs did not apply the provision of section 14A on the Partners' share in profits of the Firm where disallowance under section 14A amounted to ₹ 1.23 crore on total exemptions of ₹ 62.42 crore. Similarly, in Maharashtra, we noticed in five cases that Partners claimed exemption amounting to ₹ 1.77 crore wherein AOs failed to make a disallowance of ₹ 36.39 lakh under section 14A.

We also noticed that the AOs could not apply section 14A read with rule 8D to partnership Firms on the exempted income, in the absence of previous year's details of income since the partnership Firms are not mandatorily required to prepare their accounts in a format similar to that of Companies. For instance, in Maharashtra CIT-XX Mumbai charge, in scrutiny assessment of **M/s K. C. Corporation** for AY 10, disallowances under section 14A read with rule 8D could not be computed due to non-availability of financial statements of previous year.

As per the data furnished by the DGIT (Systems) there has been a steady growth in the income of partnership firms which was more than ₹ 50,000 crore for AY 12. Eventually, profits of the Firms are distributed among the partners who in turn get exemption under section 10(2A). Hence, there is a possibility of loss of revenue to the exchequer due to non-application of provision of section 14A on the partners' shares in profits of the Firm.

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<sup>12</sup> Shri Vishnu Anant Mahajan vs. ACIT (ITA no.3002/AHD/2009).

## 2.9 Recommendations

We recommend that

- a. The Ministry may maintain complete database of Firms and devise a suitable mechanism to keep track of unregistered Firms and ensure filing of their ITR.

*The Ministry replied (February and March 2014) that they are not mandated to maintain database of registered Firms. However, DGIT (Systems) maintains the database of those Firms who have filed their ITRs and it is growing every year. Apart from this, ITD keeps check on AIR information for high value transactions, PANs and maintain 360 degree profiling of the entity. E-filing also leads to maintenance of a robust database of Firms.*

- b. The Ministry may consider linking the returns of Partners and their Firm so that AOs are able to verify the transactions. The Ministry may also make it compulsory for the Firms to declare their Partners' name and PAN in the ITR.

*The Ministry replied (February 2014) that in ITR Form meant for Firms & LLPs (ITR-5), it is compulsory for the Firms to declare their partners name, percentage of share and PANs in the ITR. E-filing is now compulsory and declaration of PAN etc is mandatory. PAN helps ITD to track the jurisdictional charge of the Partners.*

- c. The Ministry may devise a software module to monitor receipt of first partnership deed and revised partnership deed in order to regulate the claims in regard to salary/remuneration/profit sharing/ rate of interest on Partners' capital. The Ministry may also collect information regarding any change from the Registrar of Firms (to whom such changes are required to be reported as per the Partnership Act) so as to have effective control over assessment of the Firms.

*The Ministry while agreeing with the recommendation of audit, replied (February and March 2014) that the issue is being examined as it would require modification in the ITRs.*

- d. The Ministry may amplify the explanation to section 10(2A) so as to give proper meaning of total income of the Firm to be divided among the Partners in the cases where the total income is reduced due to deduction/ exemption.
- e. The Ministry may clarify whether non-legal entities viz. Firms, Body of Individuals, Association of Persons can be Partners in a Firm in order to avoid inconsistencies in composition of the Partners.

*The Ministry replied (February 2014) that the issue whether non-legal entities can be partners in a Partnership Firm is governed by the provisions of the Partnership Act.*

- f.** The Ministry may clarify on the consistent and harmonious application of section 14A with reference to exempt income specified under section 10(2A). The Ministry may also consider making it mandatory for the Firm to prepare financial statements incorporating current year as well as previous year's figures so as to facilitate application of provision of section 14A read with rule 8D.