

## Chapter III: Special provisions of exemption/deduction to the Firms

### 3.1 Introduction

The partnership Firms are separate taxable entities under the Act. The Act provides special provisions of exemptions/deductions available to the Firms and their Partners. In computing the income of the Firm, interest and remuneration to the Partners are allowed as deductions subject to certain conditions as prescribed in the Act. The conditions for allowance of deduction of remuneration and interest to the Partners are as follows:

- a. Payment should be authorized by the partnership deed.
- b. Payment should be in accordance with the terms of the partnership deed.
- c. Payment should relate to the period after the date of such partnership deed.
- d. Remuneration should be paid to working Partners.
- e. Interest should not be in excess than prescribed.
- f. Partnership deed should specify the amount of remuneration
- g. Remuneration payable is subject to certain defined monetary and percentage limits with reference to 'book profit' of the partnership Firm.

The present Chapter deals with cases where ITD did not comply to the special provisions of the Act applicable to the Firms.

**Assessing Officers allowed payment of remuneration to non-working Partners and for period prior to the date of deed which resulted in ineligible deductions to Partners and consequent loss of revenue.**

### 3.2 Remuneration paid to non working partner and for period prior to deed date

As per Section 40(b)(iii) of the Act, any payment of remuneration to any Partner is to be authorised by the partnership deed and such payments should not be made from a date prior to the date of partnership deed unless it is authorised by an earlier deed.

We noticed that the AOs had allowed (i) expenditure on remuneration paid for a period prior to the date of deed and (ii) expenditure on remuneration paid to the Partners who were not actively engaged in the affairs of the Firm. There were nine such cases noticed in respect of Tamil Nadu, Kerala, Punjab and Rajasthan which involved a tax implication of ₹ 2.50 crore (see Box 3.1).

**Box 3.1: Illustrative cases on unauthorized deductions on expenditure on remuneration**

a. In Kerala CIT-II Kochi for the AY 11 in the scrutiny assessment of **M/s. Blastline India**, AO allowed a deduction of ₹ 1.76 crore towards remuneration to the Partners. Scrutiny of the assessment revealed that the Partners of the Firm were working abroad during the above period and the business of the Firm was run through a CEO (Manager) appointed on their behalf. The Partners, not being actively engaged in conducting the affairs of the Firm, are ineligible for remuneration. The ineligible deduction allowed had a tax effect of ₹ 64.80 lakh. ITD accepted (June 2013) the objection.

b. In Tamil Nadu CIT-V Chennai charge for the AY 11 in the case of **M/s. Price Waterhouse & Co.**, a firm of Chartered Accountants, AO allowed salary of Partners amounting to ₹ 1.25 crore as claimed by the assessee. We noticed that the remuneration was authorized with effect from 01 April 2009 in the deed dated 23 September 2010. As per the provisions of the Act, payment is eligible only for the period after the date of deed i.e. from 23 September 2010 in AY 12 and not in AY 11. This involved a tax effect of ₹ 38.56 lakh.

The above cases imply that AOs have not paid due attention to the partnership deed which resulted in ineligible deductions and consequent loss of revenue.

**Assessing Officers allowed unauthorized and excess payment of interests which resulted in ineligible deductions to Partners and consequent loss of revenue.**

**3.3 Excess payment of interest**

Section 40(b)(iv) of the Act provides for payment of simple interest to any Partner at a rate not exceeding 12 *percent* and which needs to be authorized by and in accordance with the terms of the partnership deed.

We noticed that in 13 cases in respect of Maharashtra, Uttar Pradesh, Odisha and Assam, AO allowed deduction for expenditure on payment of interest to the Partners, (i) which was more than the rate prescribed/authorised in the partnership deed, (ii) where the rate prescribed/authorised in the partnership deed was exceeding the limits provided under section 40(b)(iv) of the Act and (iii) which was not authorized in the deed. This had resulted in loss of revenue of ₹ 97.14 lakh (see Box 3.2).

**Box 3.2 Illustrative cases on excess payment of interest**

- a. In Odisha CIT-Bhubaneswar charge for AY 11, we noticed in the case of **M/s. Serajuddin & Co.** that AO allowed deduction towards interest to a Partner which exceeded the limit of twelve *percent* simple interest per annum by ₹ 66 lakh. The mistake resulted in under assessment of income by ₹ 66 lakh and consequent short levy of tax of ₹ 20.26 lakh.
- b. In Uttar Pradesh CIT-Allahabad charge for AYs 09 to 11 in the case of **M/s. Chhota Bhai Munna Bhai & Company**, the partnership deed provided interest at the rate of twelve *percent* per annum on the closing balance of the capitals of the Partners. We noticed that AO allowed interest of ₹ 1.76 crore on opening balance of the capital against the allowable interest of ₹ 1.53 crore. This omission resulted in excess allowance of interest of ₹ 22.90 lakh involving tax effect of ₹ 9.83 lakh with interest. ITD accepted (April 2013) the observation.
- c. In Maharashtra CIT-XX Mumbai charge, for AYs 09 and 10 in scrutiny assessment of **M/s. Giriraj Conductors**, the partnership deed authorized payment of interest on fixed capital only. However, AO allowed interest payment of ₹ 58.64 lakh on fixed and current capital as against the interest payable of ₹ 17.16 lakh on the fixed capital. The omission resulted in excess payment of interest of ₹ 41.48 lakh and short levy of tax of ₹ 13.47 lakh.

Interest is paid to the Partner on the capital introduced by him. It is increased by the deposits made by him and the share of profits credited to his account and is reduced by the amounts withdrawn by him and the share of losses debited to his account. It is seen from the above illustrations that deduction of interest are allowed to the Firms which is being calculated on the opening as well as closing balance of the Partners' capital. Hence, the Act is not clear regarding the 'base amount' on which the interest to Partners is to be calculated.

### 3.4 Unauthorised quantum of remuneration

According to section 40(b)(v) of the Act, any payment of remuneration to any working Partner should be authorized and in accordance with the partnership deed not exceeding the amount prescribed. CBDT in its circular No.739 dated 25 March 1996 clarified that 'no deduction under section 40 (b)(v) will be admissible unless the partnership deed either specifies the amount of remuneration payable to each individual working Partner or lays down the manner of quantifying such remuneration. Any enhancement in the quantum of remuneration shall have to be effected through a supplementary partnership deed only.

We noticed in 81 cases in thirteen states<sup>13</sup> that AO allowed expenditure on remuneration, which was not authorized or paid in excess of the amount specified in the partnership deed and where supplementary deed enhancing the remuneration was not produced, which involved a tax effect of ₹ 14.64 crore (see Box 3.3).

**Box 3.3 Illustrative cases on unauthorized expenditure**

- a. In Delhi CIT-XIII charge for the AY 09 in the assessment of **M/s. Vaish Associates**, we observed that the partnership deed of assessee Firm did not define the quantum of remuneration or method of computation of remuneration paid to the Partners. Hence, the remuneration of ₹ 4.15 crore paid to the Partners should have been disallowed. The omission resulted in inadmissible allowance of expenditure amounting to ₹ 4.15 crore involving short levy of tax of ₹ 1.88 crore including interest. Further, we noticed that in the case of same assessee, for AY 10, the ITD had itself made addition on similar grounds which on being challenged by the assessee was dismissed by CIT (Appeals).
- b. In Uttar Pradesh CIT-I Kanpur charge for AY 09 and AY 10 in case of **M/s. Calico Trends**, we noticed that partnership deed did not quantify the amount of remuneration but for giving reference to the limits specified under section 40(b)(v) of the Act. However, AO allowed deduction towards partners remuneration of ₹ 9.77 crore which was irregular involving a tax effect of ₹ 4.01 crore. In reply (April 2013), AO did not accept the observations stating that the remuneration allowed was within the permissible limits as per the provisions of the Act. The reply is not tenable in view of the CBDT circular which clarifies that deduction towards remuneration was not admissible unless partnership deeds are very specific and quantified.
- c. In Maharashtra CIT-XXII Mumbai charge for AY 10 in scrutiny assessment of **M/s. Yash Developers**, the Firm had paid remuneration to the Partner ₹ 47.71 lakh whereas the partnership deed quantified remuneration at ₹ 1.20 lakh only. The omission has resulted in excess payment of remuneration of ₹ 46.51 lakh and short levy of tax of ₹ 20.87 lakh.
- d. In West Bengal CIT-Central-III Kolkata charge for AY 09 in the assessment of **Gopal Krishna and Brothers**, we noticed that the partnership deed neither specified the amount of remuneration payable to each individual working Partner nor did it lay down the manner of quantifying such remuneration. It only mentioned "Salary, Commission or other Remuneration may be given to Partners, as may be decided by the parties by mutual consent". Therefore, as per clarification given in CBDT Circular No. 739 dated 25 March 1996, amount of remuneration of ₹ 28.62 lakh paid to the Partners of the Firm was not allowable deduction. Mistake in allowing deduction resulted in underassessment of income by an equal amount having a tax effect of ₹ 11.76 lakh.

<sup>13</sup> Tamil Nadu, Jharkhand, West Bengal, Haryana, Delhi, Karnataka, Kerala, Maharashtra, Chandigarh, Punjab, Andhra Pradesh, Uttar Pradesh, Assam.

From the above illustrations, it is clear that the AOs are not consistent in applying the provisions of section 40(b)(v) read with CBDT circular no. 739. There seems to be contradiction between section 40(b)(v) and CBDT circular 739 dated 25 March 1996 as the section does not lay down any condition that the partnership deed should quantify remuneration whereas the circular states that remuneration has to be quantified or the manner of quantification stated in the deed. It has been judicially<sup>14</sup> held that allowances of remuneration should be made according to the provisions of the Act and not as interpreted by CBDT circular. This may result in common area of conflict between ITD and the assessee Firms.

**Assessing Officers incorrectly computed book profit for the purpose of remuneration by including capital gain, interest income/rental income/income for other sources which resulted in excess payment of remuneration and short levy of tax.**

### 3.5 Incorrect computation of book profit for the purpose of remuneration

Section 40(b)(v) of the Act provides the limitation of payment of remuneration to its Partners. As per the Act, any payment of remuneration to any Partner who is a working Partner, which is authorized by, and is in accordance with the partnership deed and relates to any period after the date of such partnership deed, should not exceed the aggregate amount as computed in Table 3.1.

**Table 3.1: Limit of deduction on book profit**

Assessment Year	Book profit	Maximum allowable deduction
AY 09 and AY 10	On the first ₹ 75,000 <sup>15</sup> of the book profit, or in case of loss	₹ 50,000 or at the rate of 90 <i>per cent</i> of book profit whichever is more
	On the next ₹ 75,000 of the book-profit	at the rate of 60 <i>per cent</i>
	On the balance of the book profit	at the rate of 40 <i>per cent</i>
AY 11	On the first ₹ 3,00,000 of the book profit or in case of Loss	₹ 1,50,000 or at the rate of 90 <i>per cent</i> of the book profit, whichever is more
	On the balance of the book profit	at the rate of 60 <i>per cent</i>

Further explanation of the section states that book profit for the purpose of computation of remuneration is the result of adjustment made as per Chapter IV-D of the Act with the profits shown in the Profit and Loss Account.

<sup>14</sup> Himachal Pradesh High Court in the case of M/s. Durga Dass Devki Nandan vs. ITO (ITA No. 4 of 2005 dated 11 March 2011).

<sup>15</sup> ₹ 1,00,000 on the first and next slab for a firm carrying on a profession referred to in section 44AA.

Audit noticed that in 24 cases pertaining to eight states<sup>16</sup>, AO calculated book profit for the purpose of remuneration by including capital gain, interest income/rental income/income from other sources which resulted in excess payment of remuneration and short levy of tax of ₹ 1.37 crore (see Box 3.4).

**Box 3.4: Illustrative cases on incorrect computation of book profit**

- a. In Maharashtra CIT-XXII Mumbai charge for AY 10, in scrutiny assessment of **M/s. S. Narendra Kumar and Company**, AO considered interest income also while computing book profit for the purpose of remuneration. Interest income is a part of chapter IV-F of the Act and hence not to be considered as a part of book profit. The omission resulted in excess payment of remuneration of ₹ 82.41 lakh having a tax effect of ₹ 28.01 lakh.
- b. In Rajasthan, CIT-I Jodhpur charge for AY 09, AO completed assessment of a Firm **M/s. Ercon Composites**. We observed that AO allowed excess payment of remuneration of ₹ 55.28 lakh due to inclusion of interest income of ₹ 9.99 lakh and non-adjustment of brought forward unabsorbed depreciation of ₹ 70.68 lakh while arriving at the book profit. The omission resulted in short levy of tax of ₹ 22.72 lakh including interest. ITD did not accept (June 2013) the audit observation stating that nowhere in the Act, it is provided that the above mentioned items are to be reduced for calculating book profit and that remuneration to partner has been allowed as per section 40b of the Act. The reply is not tenable as the adjustment of other income and unabsorbed depreciation is to be made while calculating the book profit as the same are covered under Chapter IV-D.
- c. In Gujarat, CIT Gandhinagar charge, for AY 06, AO completed the assessment of assessee firm **M/s. Ranjit Construction Company** in December 2007 determining an income ₹ 3.01 crore. We noticed that the assessee Firm had paid remuneration of ₹ 1.95 crore to its Partners on book profit of ₹ 3.65 crore which included other income of ₹ 1.20 crore consisting of interest, insurance claim and rent income. Other income of ₹ 1.20 crore was required to be excluded while calculating the book profit for the purpose of remuneration. The omission resulted in under assessment of income of ₹ 39.93 lakh and consequent short levy of tax of ₹ 19.43 lakh including interest. ITD took (March 2009) remedial action by raising demand under section 143(3) read with section 147 of the Act.

From the above illustrations, we observed that there are inconsistencies in arriving at book profit for the purpose of calculating remuneration. Further the Kolkata High Court, in the case of *Md. Serajuddin & Brothers vs. CIT* held that Chapter IV-D nowhere provides that method of accounting for the purpose of ascertaining net profit, should be the only income from business alone and not from other sources. Thus, for the purpose of section 40(b)(v)

<sup>16</sup> Maharashtra, Haryana, Himachal Pradesh, Punjab, Uttar Pradesh, Gujarat, Rajasthan and West Bengal.

read with explanation, there cannot be a separate method of accounting for ascertaining net profit and/or book profit.

Hence, the Act is not clear regarding meaning of book profit for the purpose of remuneration of Partner under section 40(b)(v).

### 3.6 Failure to comply with the provisions of section 184

Section 184 of the Act provides that a Firm shall be assessed as a Firm if the partnership is evidenced by an instrument, the individual shares of the Partners are specified in the instrument and the certified/revised copy of the instrument of partnership shall accompany the return of income of the Firm relevant to the AY.

With effect from AY 07, it is mandatory for a Firm to file return of income irrespective of whether there is taxable income or not. If Firms failed to comply with notice issued under section 142(1) & 143(2), it is a failure mentioned in section 144 and the deduction in respect of remuneration and interest paid is not allowable. Section 185 of the Act provides that, in the event there is a failure on the part of a Firm in complying with the conditions of section 184 or it has committed failures specified in section 144, no deduction by way of any payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by such firm to any Partner of such Firm shall be allowed in computing the income chargeable under the head “profits and gains of business or profession”.

We noticed in 33 cases in Kerala, West Bengal and Bihar that though the Firm/Partners did not comply with the provisions of section 184, AO allowed deduction towards remuneration & interest to Partners under section 40(b) which had a tax implication of ₹ 1.09 crore (see Box 3.5).

#### **Box 3.5: Illustrative cases on ineligible deduction claimed towards remuneration & interest to Partners**

- a. In West Bengal CIT-Central-III Kolkata charge, in the assessment of **M/s. Naresh Kumar & Co.** for AY 05 to AY 11, the assessee failed to comply with the notices issued under section 142(1) & 143(2) and even after the appellate order<sup>17</sup>, status of the assessment under section 144 remaining unchanged, the assessee was not entitled for remuneration under section 184(5) of the Act. However, AO allowed the remuneration of ₹ 1.67 crore (for seven AYs) in the orders passed under section 251/144/153A resulting in underassessment of income to the extent of that amount with a tax effect of ₹ 55.15 lakh for seven AYs. ITD did not accept (July 2013) the audit observation on the basis of two

<sup>17</sup> Being aggrieved, the assessee filed an appeal to the Learned CIT-Appeal, C-III, Kolkata, WB which was dismissed and it was observed therein that the AO was fully justified in invoking the provisions of Section 144 since the requisite information as requisitioned by the AO was not furnished by the appellant.



judicial decisions<sup>18</sup>, however the judicial decisions quoted by ITD were on different grounds and could not be applied to the present case.

**b.** In Bihar CIT- II Patna charge for AY 11, AO completed assessment of firms **M/s. Vimlesh Prasad Singh and M/s. Trade Wings** under section 144 for non production of books of accounts and their confirmation and hence they were not eligible for deduction towards expenditure on remuneration and interest. The incorrect allowance resulted in under assessment of income by ₹ 12.86 lakh and ₹ 0.54 lakh respectively with consequent short levy of tax aggregating to ₹ 5.63 lakh.

Chapter XVI of the Act deals with the special provisions applicable to the Firms and certain conditions are laid down under section 184 for the assessment of Firms. Even though the sections under the chapter are specific to Firms, AOs are not applying the provisions scrupulously.

### **3.7 Non-payment of interest/remuneration to Partners resulting in excess deduction**

Subsection 10 of section 80IA provides that where it appears to the AO that owing to the close connection between the assessee carrying on the eligible business and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits which might be expected to arise in such eligible business, the AO shall in computing the profits and gains of such eligible business for the purposes of this section, take the amount of profit as may be reasonably deemed to have been derived from the business.

Section 40(b)(v) put ceiling on the maximum amount of remuneration that can be paid but does not make mandatory to pay remuneration to the Partner. We noticed that the Firm, enjoying tax exemption under section 10A/80IB/80IC/80IE of the Act, did not pay remuneration and interest on Partners' capital even though in some cases the partnership deed had a provision for charging of interest. Thus, the Firm earned more net profit than the ordinary profits which might be expected to arise in normal course of business and attracted the provisions of section 10A(7)/80IB(13)/80IC(7)/80IE(6) read with section 80IA(10) of the Act resulting in short levy of tax. Further, this resulted in non-inclusion of interest and remuneration in the taxable income of the Partner thereby loss of revenue to exchequer.

<sup>18</sup> 1.43 SOT 11(Asr.)(Uro.)-2011.& 07 SOT 457 (Lucknow) 2006.



Audit noticed 60 cases in five states<sup>19</sup> that the Firms were not paying interest/ remuneration to the Partners although the partnership deed provided for the same thereby increasing their profit eligible for exemption/deduction involving a revenue loss of ₹ 39.79 crore (see Box 3.6).

**Box 3.6: Illustrative cases on non-payment of interest/remuneration**

**a.** In Gujarat CIT-V Ahmedabad charge for the AY 09 in the case of **M/s. Adani Exports**, the AO assessed the Firm's income at ₹ 0.74 lakh after allowing deduction of ₹ 179.07 crore under section 10AA of the Act. We observed that the assessee Firm had not provided for the interest of ₹ 23 crore (at the rate of 9 per cent) to the Partners although the same was provided in the deed. Thus, the assessee Firm had made more than reasonable profits which would have accrued to the Firm and consequently enabling the Firm to claim higher amount of exemption under section 10AA of the Act. The amount of ₹ 23 crore was required to be disallowed from the business income eligible for deduction under section 10AA of the Act. Omission to do so resulted in short levy of tax of ₹ 9.85 crore including interest.

**b.** In Gujarat CIT-Valsad charge for AY 11 in the case of **M/s. Alidhara Texspin Engineers**, AO assessed the Firm's income at ₹ 25.11 crore after allowing deduction of ₹ 4.02 crore under section 10B. The assessee Firm was required to pay remuneration to working Partners of ₹ 9.90 crore on the amount of profit of ₹ 24.75 crore as per terms in partnership deed. However, the Firm did not pay any such remuneration to the working Partners. Hence, the amount of ₹ 9.90 crore was required to be disallowed from the business income eligible for deduction under section 10B of the Act in the hands of the Firm. Omission to do so resulted in short levy of tax of ₹ 4.10 crore including interest.

**c.** In West Bengal CIT-XI, Kolkata charge for the AY 07 and AY 08 in case of **M/s. Modern International**, we noticed that AO allowed the assessee an exemption of ₹ 5.86 crore under section 10A. However, the Firm did not debit interest of ₹ 1.36 crore on Partner's capital in Profit and Loss account even though it was allowable as per the partnership deed. Thus, the Firm earned more net profit than the ordinary profits which might be expected to arise in normal course of business attracting the provisions of section 10A(7) read with section 80IA(10) of the Act resulting in loss of revenue to exchequer due to short levy of tax of ₹ 45.65 lakh. Similarly, the AO did not levy tax of ₹ 25.60 lakh on the Firm in the AY 07.

Audit examination thus revealed that the assessee Firms are availing more exemptions/deduction by inflating profits through non-payment of remuneration/ interest to their Partners. On the other hand, taxable income

<sup>19</sup> West Bengal, Assam, Gujarat, Maharashtra, Madhya Pradesh.

of partners gets reduced owing to non inclusion of said remuneration/interest leading to loss of revenue to the exchequer.

**Assessing Officers allowed the share of loss pertaining to the retired/deceased Partner to the subsequent year thereby resulting in excess carry forward of loss and short levy of tax.**

### **3.8 Share of retired or deceased Partner**

Section 78(1) of the Act disallows carry forward and set off of loss in proportion to the share of a retired or deceased Partner whenever there is any change in the constitution of the Firm.

Audit noticed that in four cases in respect of Assam, Haryana, Maharashtra, and Rajasthan, AO had allowed the share of loss pertaining to the retired/deceased Partner to the subsequent year thereby resulting in excess carry forward of loss and short levy of tax of ₹ 70.11 lakh (see Box 3.7).

#### **Box 3.7: Illustrative cases on share of retired or deceased partner**

In Maharashtra CIT-XX Mumbai charge for AY 10 in scrutiny assessment of **M/s. Rodium Properties**, one of the Partners having share profit ratio of 30.6 *per cent* retired during the FY relevant to AY. We observed that AO allowed the carry forward of total capital loss of ₹ 4.87 crore to the subsequent year which included ₹ 1.49 crore being the share of loss of retired Partner. The mistake resulted in excess carry forward of loss of ₹ 1.49 crore and short levy of tax of ₹ 50.62 lakh. ITD accepted (May 2013) and rectified the mistake under section 154 of the Act (May 2013).

Therefore, ITD has no system in place to keep track of changes in the composition of Firms and are not using their software module in order to prevent incorrect carry forward and set off of losses pertaining to retired/deceased Partners.

### **3.9 Incorrect deductions u/s 80IB**

3.9.a Section 80IB(10) of the Act provides hundred *percent* deduction to profits of an undertaking derived from the developing and building housing projects approved before 31 March 2008 subject to fulfillment of certain conditions which includes that the project should be on the size of plot of land which has a minimum area of one acre.

In Karnataka in respect of two assesseees, we noticed incorrect deduction under section 80IB(10) having a short levy of tax aggregating ₹ 4.47 crore (see Box 3.8 ).

**Box 3.8 Illustrative case on incorrect deduction u/s 80IB (10)**

In Karnataka CIT-IV Bangalore charge for AY 10 and AY 11 in the case of **M/s. Divyajyothi Earth**, AO allowed deduction under section 80IB of the Act at ₹ 97.48 lakh and ₹ 22.16 lakh respectively for two AYs. We noticed that Firm had undertaken the housing project on a plot of land having area of less than one acre, thus violating the condition for claim of deduction. Omission to disallow the deduction resulted in short levy of tax aggregating ₹ 1.45 crore. The ITD stated (June 2013) that considering the undivided share of land of the Partner in the project land area there was no violation of conditions prescribed in section 80IB of the Act. The reply of the ITD is not tenable as the Firm and its Partner in their individual capacities are distinct taxable entities and their individual holdings in land cannot be clubbed for considering the project area eligible for deduction under section 80IB of the Act.

3.9b. As per provisions of section 80IB(11A), the amount of deduction in the case of an undertaking deriving profit from an “integrated business” of handling, storage and transportation of food grains, shall be hundred *per cent* of the profits and gains derived from such undertaking for five AYs beginning with initial AY.

We noticed one case on the above issue in Madhya Pradesh (see Box 3.9).

**Box 3.9 Illustrative case**

In Madhya Pradesh CIT-Gwalior charge for AY 10 and AY 11 in the case of **M/s. Agrawal Ware House**, we noticed that the assessee had shown warehouse rental income of ₹ 34.99 lakh and ₹ 37.47 lakh respectively in the Profit & Loss Account against which it had claimed deduction under section 80IB(11A) for ₹ 19.89 lakh and ₹ 24.96 lakh respectively. AO had allowed it in the scrutiny assessment. Further, we noticed that the assessee’s main source of income was rental income from ware house and it did not carry out any “integrated business” as defined in section 80-IB(11A) making the assessee ineligible for deduction under section 80IB(11A). The allowance of ineligible deduction of ₹ 44.85 lakh resulted in under assessment of income by an equal amount involving tax effect of ₹ 17.09 lakh.

We also noticed that a number of entities assessed in construction business were registered as Firms and in our previous report<sup>20</sup>, we had highlighted similar nature of observation regarding ineligible deduction given to assessee firms under section 80IB of the Act.

<sup>20</sup> Report No. 12 of 2011-12-Performance Audit of Business of Civil Construction.

### 3.10 Recommendations

We recommend that

- a. ITD may ensure compliance with the prescribed provisions (i) specific to Firms as laid down in Chapter XVI, (ii) relating to set off/ carry forward of losses of retiring/ deceased Partners and (iii) for deduction in respect of remuneration and interest as claimed by the Firms.

*The Ministry replied (March 2014) that the issue is being examined as it would require modification in the ITRs to comply with the provisions of the Act.*

- b. The Ministry may clarify the 'base amount' of the Partners' capital on which the interest is to be calculated for allowance of interest under section 40(b)(iv) of the Act.
- c. The Ministry may resolve the conflict between provision of section 40(b)(v) of the Act and CBDT circular no. 739 dated 25 March 1996 regarding quantification of remuneration in the partnership deed.
- d. The Ministry may clarify the manner of computation of book profit in respect of payment of remuneration of Firms and ensure that AOs apply the uniform approach consistently.

*The Ministry replied (February 2014) that the principles of computation of book profit cannot be applied to Firms as unlike the companies for which the Companies Act provides the detailed mechanism for determination of book profit, the Partnership Act does not provide any mechanism for determination of book profit of the Firm.*

*Audit is of the view that although the Act provides for the calculation of book profit for the purpose of remuneration of the Firm, it is still not clear whether non-business items such as capital gain, interest income, rental income, interest from other sources etc, are to be excluded or not. The Ministry may therefore issue clarification so that AOs apply it consistently.*

*The Ministry further replied (March 2014) that the computation of book profit is done under Chapter IV-D of the Act and reiterated that only income under the head "profits and gains of business or profession" is to be considered for calculation of book profit for determination of remuneration to Partners. However, the Ministry stated that the issue is being examined and necessary clarifications would be issued.*

- e. The Ministry may consider introducing an enabling provision in the statute for compulsory charging of interest on partner's capital and payment of remuneration by the Firms availing exemption/deduction under sections 10A/10B/80IA/80IB/80IC/80IE of the Act.

*The Ministry replied (February 2014) that the Act does not provide for charging of interest by the partner or payment of remuneration by the Firm but only contains the provisions for disallowances if it does not fulfill certain conditions. Charging/Not charging of interest on Partner's Capital account or payment of remuneration is a business decision and the Act cannot mandate a Firm to charge such interest or payment of remuneration. Further, in order to protect the tax base of the Firms claiming these profit linked deductions, the concept of Alternate Minimum Tax has been introduced in the Income Tax Act vide Finance Act, 2012 in section 115 JC, which provides for levy of alternate minimum tax after adding back the deductions under Chapter VI A & section 10AA of the Income Tax Act.*

*Audit, while agreeing with the Ministry's view, is of the opinion that the Ministry may ensure strict enforcement of payment of remuneration/interest to Partners as per partnership deed by Firms who are availing various tax exemption/deduction as there are instances of non complying to provisions of Partnership deed by AOs.*

*The Ministry further stated (March 2014) that the issue is under consideration for any further clarification in this regard.*