TAX ISSUES IN CASE OF PATNERSHIP FIRM / LLP

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Introduction

In India, the partnership firms are dealt with under the Partnership Act, 1932. Unlike the Companies Act, 2013 (or, its earlier versions) which has a specific provision declaring a company to be a separate legal person independent of its shareholders / members, there is no such provision in the Partnership Act to declare a partnership firm to be a separate legal entity or a juristic person.

It is also declared that persons who have entered into a partnership with one another are called **individually "partners"** and **collectively "a firm"** and the name under which their business is carried on is called the **"firm name".** A firm is conglomeration of its partners. Firm name is only a compendious name given to the partnership and the partners are the real owners of its assets. There is no legal provision to declare the partnership firm to be a separate legal entity apart from its partners.

However, for the purpose of the application of the provisions of the Income Tax Act, 1961, a firm and its partner must be treated differently as a partner of a firm may have income other than his share of profits from the firm.For the purposes of assessment to tax, the income of the partnership firm shall be assessed in the hands ofthe firm as a single unit, the firm itself being treated as an assessable entity separate and distinct from the partners constituting it. The firm is an assessable unit separate and distinct from the individual partners whoas individuals constitute assessable units separate and distinct from the firm.

The same is held by various Supreme Court decisions:

Tanna& Modi v. CIT, (2007) 7 SCC 434

DCIT v. K. Kelukutty(1985) 22 Taxman 25

N. Khadervali Saheb v. N. Gudu Sahib, (2003) 3 SCC 229

V. Subramaniam v. Rajesh Raghuvandra Rao, (2009) 5 SCC 608

In this article, I have tried to analyse the tax issues prevailing over Partnership firms / LLP.

❖ **Taxation of Partnership Firm/LLP**

The partnership firm is taxed as a separate entity, with no distinction as registered and unregistered firms whereas an LLP is mandatorily to be registered with Registrar of Companies to have a legal status in the eyes of law. In the eyes of Income Tax vide Sec 2(23), there is no distinction between a partnership firm and an LLP. In computing the total income of the firm, any salary, bonus, commission or remuneration, to a partner, shall be deductible subject to certain restrictions as provided under Sec 40(b) of the Income Tax Act, 1961.In general, partnership firms enjoy a single layer of taxation (@30% + SC + EC/SHEC or HEC), i.e., once a firm pays tax on its profits; distribution of such profits to Partners is exempt.

❖ **Computation of Book Profit**

As per Sec 40(b) of the Act, the book profits for the partnership firm is to be calculated as follows:

Book Profit = Net Profit as Per Profit & Loss A/c – b/f Depreciation + Remuneration to partners if debited + Interest in excess of 12% if debited

A. ***What is included in the income? – Capital Gains, FD Interest, Sec 50 Income, Business Income not credited to P&L A/c***

The provisions of section 40focuses on the calculation of book profits to derive at an income chargeable under "Profits and Gains of Business or Profession". Hence income chargeable under the heads **other than** "Profits and Gains of Business or Profession" shall be excluded from the calculation of Book Profits.

Accordingly, Business Income not credited to P&L A/c shall be included in the Book Profits.

Capital gains arising from the sale of any asset by the partnership firm are taxable under section 112 or 112A, if it is short-term capital gain - tax rate as per normal tax slab, if it is long-term capital gain - tax rate is 20%, in case of sale of listed shares and mutual funds the tax rate for short-term gain is 15%, for long-term income is 10% over Rs. 1,00,000.

B. ***Are brought forward losses and unabsorbed depreciation required to be reduced from the net profit?***

Unabsorbed loss including depreciation of the firm will not be apportioned amongst the partners and will be carried forward by the firm only. Hence, firm can carry forward the loss excluding the loss proportionate to the retiring partners as per the provisions of Sec 78 of the Act.

❖ **Remuneration to Partners**

The allowance of remuneration expenses is based on following conditions:

- It shall be given to Working Partner only
- It shall be authorised by the Partnership deed

No deduction u/s. 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 — *Circular No. 739 dt. 25-3-1996*

Remuneration to partners, even if authorised by the partnership deed but relating to prior period, shall not be allowed as a deduction. Hence, the deduction of remuneration to partners cannot be claimed with a retrospective date.

A. ***Allowability of Remuneration in case of Cash System of Accounting***

As per Sec 145 of the Act, cash system of accounting is allowed to be opted by any person having Income under "Profits and Gains under Business or Profession" or "Income from Other Sources". Hence, the method of accounting followed by the assessee has no relevance while computing income charged to tax under the heads "Salaries", "House property" and "Capital gains". In this method of accounting, revenue and expenses are recorded at the time of its realisation and payment respectively. Accordingly, remuneration paid to partners shall be allowed as an expense in the year of actual payment.

B. *Excessive or Unreasonable remuneration - Sec 40(b)(v) v/s Sec 40A(2)*

Sec 40(b)(v) states conditions for the allowability of remuneration paid to partners being authorised by the partnership deed, paid to working partners and within the limits of the said provisions. If remuneration paid is within the ceiling limit provided under Section 40(b)(v), then provisions of Section 40A(2)(a) cannot be invoked. Section 40A has no application to the matters contained in Section 40(b) and the overriding effect given to Section 40A is only in respect of matters not covered by Section 40(b). The same was also held by High Court of Allahabad in the case of *CIT Vs. Great City Manufacturing Co.(2013) 351 ITR156*.

Applicability of Sec 40A(3) – Cash Payment in excess of Rs. 10,000

The provisions of the section states disallowance of the "expenditure" if the payment of the same is done in cash beyond the threshold limits prescribed. In normal parlance, the remuneration paid to the partners is an expenditure claimed by the partnership firm and hence provisions of Sec 40 are applicable. Accordingly, remuneration expense paid by way of cash shall be disallowed, if made in excess of Rs. 10,000, in a day.

A contrary view to be taken is that remuneration paid to partner is the share of profit of firm and it retains same character in hands of partner and therefore taxable in the books of firm. It is not in the nature of salary paid by the employer to an employee, deduction of which can be claimed as an expenditure by the employer.

Thus, remuneration paid to partner will not fall within the category of 'expenditure' as normally considered and accordingly even if paid in cash above the threshold under section 40A(3) of the Act, provided the conditions of section 40(b) of the Act are not applicable, shall be allowed as deduction while computing the income under the head 'Profits and gains of business or profession'. This is held by Supreme Court in case of *CIT vs. R.M. Chidambaram Pillai [1977] 106 ITR 292* and Mum. Tribunal in case of *Ratilal& Sons vs. ITO [2019] 105 taxmann.com 366* states

C. *Sec 28(v) w.r.t Sec 40(b)*

Sec 28(v) states income to be chargeable under Profits and Gains of Business or Profession only to the extent allowable u/s 40(b)(v). The remuneration allowable u/s 40(b)(v) shall only be taxed in the hands of the partner.

❖ Interest to Partners

The allowance of interest expenses is based on following conditions:

- It shall be authorised by the Partnership deed
- It shall be given at the rate of not exceeding 12%

A. *Charge of Interest on Partner's debit balance*

Interest on capital by the firm to its partner shall be authorised by the deed and hence if the deed specifies the clause to charge interest on the partner's debit balance of capital, then the same shall be credited to firm's account and borne by the partner.

B. *Interest received in a representative or individual capacity*

A partner in a representative capacity is an individual who is a partner in a firm on behalf of, or for the benefit of, any other person.

E.g. A partner representing his HUF shall be called a partner in a representative capacity. The taxability of interest received by them shall depend on whether it is received in a representative capacity or their individual capacity. The tax positions are summarised as under:

<table>
<tr><td>Partner in a representative capacity</td><td>Interest received in an individual capacity</td><td rowspan="2">The limit of section 40(b) is not applicable, i.e. interest more than 12% is allowed, but it should be reasonable.</td></tr>
<tr><td>Partner in an individual capacity</td><td>Interest received in a representative capacity</td></tr>
</table>

❖ Assessment of Firm – Sec 184 & Sec 185

Prior to introduction of the provisions of Sec 184 which came into force w.e.f. 1.4.1993, a firm could be assessed either as a registered firm on complying with the formalities or otherwise only as AOP. However, w.e.f. AY 1993-94 onwards, the firm has to fulfil the conditions in order to get assessed as a firm:

The firm should have a partnership deed containing terms of partnership

Share of each partner shall be specified in the deed

Certified copy of the deed should be attached with the first return of income of firm

Other cases where certified copy of deed is required

If the partnership firm has not complied with the requirements of forming a partnership deed and specifying the relevant clauses of share of partners, then deduction u/s 40(b) shall not be allowed to the firm on its assessment and the same not be chargeable to tax u/s 28(v).

The said provisions seems not be applicable to the LLP since an LLP shall not be incorporated without a registered instrument and hence the LLP shall be deemed to be assessed as firm as per Sec 184.

❖ Set off of losses of the firm

A. *Sec 78(1) - Reduction of brought forwarded losses to the extent retiring/deceased partners*

The change due to retirement or demise of a partner will affect the carry forward loss of the firm since the loss to the extent of the retired or deceased partner has to be reduced for carrying forward to the subsequent year.

Eg. A partnership firm, having 3 partners in equal profit-sharing ratio, earns a profit of Rs. 3,30,000/- in FY 2021-22. It has C/F loss of Rs. 3,00,000/- (PSR =1:1:1), one of them retired in the current year on 31/12/2021, his share of profit for the current year becomes Rs. 82,500/-. Now, loss of the retired partner can't be carried forward but can the excess loss of retired partner of Rs. 17,500/- (1,00,000 – 82,500) be set off against profit of other remaining partners in the current year??

Opinion

Where a change in constitution of firm takes place on account of retirement of partner or death of the partner then, the firm shall not carry forward and set off the following brought forward losses:

Share of the retired/ deceased partner in the brought forward losses of the firm	XXX
Less: Share of the retired/ deceased partner in the current year profit	(XX)

Accordingly, the share loss of the retired partner comes to Rs. 1,00,000/- of which only Rs. 82,500/- will be allowed to be set off and remaining loss of Rs. 17,500 will go lapse.

The provisions of section deal with Change in constitution due to retirement or death of partner. Change in constitution due to admission of partner or change in PSR are not covered by Sec 78.

B. Applicability of Sec 78(1) to unabsorbed depreciation

Provisions of Sec 78(1) deals with the unabsorbed business losses. The same excludes unabsorbed depreciation from its purview and hence carry forward of unabsorbed depreciation is allowed even in case of retirement or death of a partner.

C. Carry forward of Loss of firm on succession – Sec 78(2)

Where any person carrying on any business or profession has been succeeded in such capacity by:

- Any person other than by way of inheritance – loss of predecessor cannot be carried forward
- Any person by way of Inheritance - loss of predecessor can be carried forward

Eg. Mr. M, sole proprietor carrying on the business of garments earned losses in FY 21-22. On his death, his legal heirs viz. wife, son and daughter started a partnership carrying on the same business of the deceased person under the same trade name.

Can the loss of the Mr. M be carried forward by the partnership firm?

Opinion

The nature of business carried on by the partnership firm was same as that of the deceased person under the same trade name. The constituents of the assessee's business were the same as those of the business of the deceased. The intention of the partners / legal heirs of the deceased person were to continue and carry on the business. Hence, succession by way of inheritance within the meaning of Sec 78(2) was occurred. Therefore, the loss incurred by Mr. M before his death shall be carried forward by the partnership firm held by his legal heirs.

** Where there are only two partners, dissolution of Firm by death of one partner, cannot involve succession by inheritance.

❖ **Presumptive Income**

As per Income tax Act, a firm includes LLP whereas as per explanation to Sec 44AD, defines eligible assessee as an individual, Hindu undivided family or a firm who is a resident but not a limited liability partnership firm.

A. ***Deduction of Interest & Remuneration***

Resident Partnership Firms are eligible to opt for presumptive taxation u/s 44AD or 44ADA or 44AE. Sec 44AD and 44AE were amended in 1997 w.e.f 01/04/1994 to allow remuneration and interest to partners (subject to conditions and limits specified in section 40(b)) after determination of profits as per sec 44AD or 44AE. However, by Finance Act, 2016, second proviso to Section 44AD(2) has been omitted which provided for deduction under section 40(b) with regard to the salary and interest to partners. However, sec 44AE has not been amended.

Hence, remuneration and interest to partners will not be allowed in sec 44AD and 44ADA.

B. ***Issue of disallowance u/s 40***

Section 40 is clothed in a negative language and it says that certain amounts shall not be deducted while computing income under thehead "Profits & Gains of Business or Profession". Whereas section 44AD begins with— Not with standing anything to the contrary contained in sec 28 to 43C. On analysis ofboth the sections, the amplitude of non-obstante clause of section 44AD is higher than the non-obstante clause of section 40. Section 40 relates to disallowance of certain expenses due to non-deduction of TDS or non-deduction/non-payment of equalisation levy, remuneration/interest by firm to partners in excess of allowed etc.

Therefore, these expenses would not be disallowed even if TDS has not been deducted. However, the assessee may be deemed as assessee in default as persection 201 as sec 44AD override provisions of section 28 to 43C but not the provisions of TDS.

C. ***Applicability of Section 44ADA to a partner of firm receiving remuneration and/or interest from the firm***

The eligible remuneration is deductible in the hands of firm and taxable in hands of partners, the remainder (profit) is taxable in hands of the firm and exempted in the hands of partners u/s 10(2A). Hence, in the hands of the partner, the following will be the impact:

1. Remuneration which was allowed as deduction in firm will be taxable
2. Profit which was taxed in the hands of the firm will be exempt.

I am of the opinion that the provisions of Section 44ADA is applicable either for an individual or partner in a professional firm. This is also supported by certain judicial pronouncements (though not directly on the said issue) in the case of *Sagar Dutta vs DCIT (ITAT Kolkata)* and *Usha A Narayanan vs DCIT (ITAT Kolkata)*. The following is evident from the above judgments:

In both the judgments,

1. The tax payers were chartered accountants in partner capacity in a firm and contended they were not carrying any profession in individual capacity but they were acting as partner and hence tax audit requirements do not attract.
2. Both of them have received remuneration, salary, interest on capital and others more than the threshold limit specified under Section 44AB.
3. The department is of the view that since the gross receipts (remuneration, salary, interest on capital and others) were in excess of threshold limits specified under Section 44AB, the tax payers would have got their books of accounts and audited.

Based on the above judgements, the salary, remuneration, profit, interest on capital and others received by partner from a partnership firm are treated as gross receipts falling under the ambit of Sec 44AB and hence, the benefit of 50% of gross receipts offering to income tax is possible.

D. *Set off of Brought Forward Loss against Presumptive Income*

The income calculated under Presumptive Scheme shall be aggregated with income from any other business under the provisions of the Income-tax Act. Hence, the brought forward business losses shall be set off against the Presumptive Income.

❖ Corporatisation & Part IX Conversion

A. *Succession of firm by company – Section 47 (xiii)*

Conversion of a Firm to a Company shall not be regarded as a transfer, if all the conditions u/s 47(xiii) are complied with. The provisions of section states capital gains on transfer of capital asset on violation of any of the conditions given. What if there are no capital assets in the firm?

In absence of any capital assets in the firm, the conversion into a Company shall not be bound to the conditions prevailed in sec 47(xiii) of the Act.

At the outset, the High Court of Bombay in the case of *CIT v. Texspin Engg. & Mfg. Works [2003] 129 Taxman 1 (Bombay)* in context of conversion of a firm into a company held that transfer of assets, etc. was pursuance to the statutory vesting under the Companies Act, 1956 and that same did not tantamount to transfer under the IT Act. Further, while coming to the said conclusion, the High Court stated that for a transfer to take place there shall be a transfer or as well as a transferee, both existing at the same point in time simultaneously.

However, in the case of conversion, the transferor and the transferee do not exist together and at the same point in time. It is a case of conversion of the transferor into transferee. In other words, only when the transferor ceases to exist that the transferee comes into existence. Thus, the fundamental test of having the transferor and transferee for the purposes of transfer is not achieved under the conversion framework. Thus, it was held that the statutory vesting of assets on conversion was not to be regarded as transfer and consequently no capital gain arose on such conversion.

Note: Views expressed in this article can be subjective and that of the readers on the same topic may differ.