A S S E S S M E N T O F F I R M S

Definition of Firm, Partner & Partnership

Income-tax Act, 1961

Section 2 (23) (i) :

"Firm" shall have the meaning assigned to it in the Indian Partnership Act, 1932, and shall include a limited liability partnership as defined in the Limited Liability Partnership Act, 2008.

Section 2 (23) (ii) :

"Partner" shall have the meaning assigned to it in the Indian Partnership Act, 1932, and shall include :

(a) any person who, being a minor, has been admitted to the benefits of partnership; and

(b) a partner of a limited liability partnership as defined in the Limited Liability Partnership Act, 2008.

Section 2 (23) (iii) :

"Partnership" shall have the meaning assigned to it in the Indian Partnership Act, 1932, and shall include a limited liability partnership as defined in the Limited Liability Partnership Act, 2008.

Indian Partnership Act, 1932

Section 4 :

"Partnership is a relationship between persons who have agreed to share the profits of business carried on by all or any of them acting for all".

Persons who have entered into 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***.

Limited Liability Partnership Act, 2008

Section 2 (1) (n) :

"Limited Liability Partnership" means a partnership formed and registered under this Act.

Section 2 (1) (q) :

"Partner" means any person who becomes a partner in the Limited Liability Partnership in accordance with limited liability partnership agreement.

Section 184 : Assessment as a firm

A firm shall be assessed ***as a firm*** if it satisfies the 5 basic conditions as mentioned below :

1) Partnership is evidenced by an instrument (i.e. a partnership deed).

2) Individual shares of partners in profits of the firm are specified in the instrument of partnership (i.e. partnership deed).

Note : If only individual shares in ***profits*** are specified in the partnership deed, the same will be applicable while sharing ***losses*** because ***"profits include loss also"***. Where, however, shares of partners are ***unequal*** and a minor is admitted to the benefit of the firm, it will be necessary to specify as to how the loss represented by share of minor will be borne by the major partners.

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3) A certified copy (may be a Xeroxed copy) of above instrument should accompany the ROI of the A.Y. in respect of which assessment as a firm is first sought.

Copy of instrument shall be ***certified in writing*** (i.e. copy of partnership deed should carry the expression ***'Certified to be true copy'*** and below that it should carry the ***signature*** with ***date*** of all the partners not being minor) by :

a) In Normal Circumstances ----------> All partners not being minors. Where a partner expires before filing of the certified copy of the deed with the ROI. Then in such a case a legal representative has to certify the copy of the deed and has to write under the signature indicating as legal representative of the deceased so and so.

b) Where a firm, before filing the certified copy, is dissolved for any other reason ----------> All partners not being minors who were partners just before dissolution and by the legal representative of any such partner who is deceased.

If certified copy is submitted along with the ***Original ROI***, it will not be necessary to submit it again along with the ***Revised ROI***.

4) Once a firm is assessed as a firm it shall be assessed in same capacity if there is no ***change in constitution of the firm*** or the share of the partners.

If change takes place a certified copy of revised instrument shall be filed along with ROI for the A.Y. relevant to such P.Y.

5) Where firm commits any such failure as is mentioned in Section 144 (i.e. Best Judgment Assessment) in respect of any assessment year it shall be assessed **as an AOP** for that assessment year. If the firm has been assessed **as an AOP** for any assessment year, then the <u>firm</u> shall have to comply with all the requirements of Section 184 in order to be assessed **as a Firm** in the subsequent assessment year otherwise it will continue to be assessed **as an AOP** in the subsequent assessment years [Section 184 (5)].

Best Judgment Assessment / Ex-Parte Assessment [Section 144]

If any person :

(a) fails to furnish return under Section 139 (1) and has not furnished a belated return under Section 139 (4), or

(b) fails to comply with all the terms of a notice issued under Section 142 (1), or fails to comply with a direction issued under Section 142 (2A), or

(c) having made a return, fails to comply with all the terms of a notice issued under Section 143 (2),

the Assessing Officer, after taking into account all relevant material which the Assessing Officer has gathered, shall, after giving the assessee an opportunity of being heard, make the assessment of the total income or loss to the best of his judgment and determine the sum payable by the assessee on the basis of such assessment.

Assessment of a firm as an AOP

A <u>firm</u> shall be assessed **as an AOP** if :

a) It commits any such failure as is mentioned in Section 144 [Section 184 (5)].

b) Firm does not comply with the provisions of Section 184 [Section 185].

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If a firm is assessed as an AOP then the following consequences will follow :

a) Salaries and interest to partners will be disallowed.

b) Tax on firm will be levied as per provisions of Section 167B (i.e. Maximum Marginal Rate).

c) The partners' shares will be computed as per the provisions of section 67A and rebate of Income-tax shall be allowable as per Section 86.

d) The B/F losses of firm can't be C/F & S/O by AOP since assessee is changed.

Taxation of firm and its partners

1. Partnership firm is assessed at a flat rate of 30% (plus 2% EC plus 1% SHEC).

2. The ***share of profit*** of the partners in the Total Income of the firm is exempt in the hands of the partners under Section 10 (2A).

3. ***Remuneration*** (may be in form of salary, bonus, commission or any other form) and ***interest*** paid by the firm to its partners is allowed as deduction to the firm subject to certain limits and conditions laid down under Section 40 (b).

4. ***Remuneration*** and ***interest*** received by the partners from the firm shall be taxable in their hands under the head "PGBP".

   Note :

   If remuneration and/or interest has not been allowed under Section 40 (b), then the remuneration and/or interest disallowed under Section 40 (b) shall not be added to the incomes of the partners.

   Example :

   Salary paid to partner A (60% share) Rs. 1,00,000/-

   Salary paid to partner B (40% share) Rs. 4,00,000/-

   If remuneration allowable as per Section 40 (b) is only Rs. 2,00,000/- then :

   - Rs. 2,00,000 shall be allowed as deduction to the firm.
   - Salary taxable in the hands of partners shall be as under :

   Partner A : $\text{Rs. } 2{,}00{,}000 \times \dfrac{\text{Rs. } 1{,}00{,}000}{\text{Rs. } 5{,}00{,}000} = \text{Rs. } 40{,}000/\text{-}$

   Partner B : $\text{Rs. } 2{,}00{,}000 \times \dfrac{\text{Rs. } 4{,}00{,}000}{\text{Rs. } 5{,}00{,}000} = \text{Rs. } 1{,}60{,}000/\text{-}$

5. The losses of the firm shall be carried forward by the firm and shall not be allocated to the partners.

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Section 40 (b)

Remuneration and interest paid by a firm to its partners is allowed as a deduction to the firm if all the following conditions are satisfied :

A. Remuneration can be paid only to a ***Working partner***. Interest can be paid to working as well as non-working partner.

   "***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.

   From the definition of working partner it is clear that remuneration can be paid to a working partner who is an individual. Interest can be paid to any partner (e.g. interest can be paid to a partner which is an HUF).

B. Payment of remuneration and interest should be authorized by the partnership deed and should be in accordance with the terms of the partnership deed. In other words, either ***amount of remuneration*** payable to partners or ***manner of quantification*** of remuneration should be mentioned in the partnership deed. Similarly, rate of interest on capital should be specified in the partnership deed.

C. The payment of ***remuneration*** and ***interest*** should relate to a period falling after the date of partnership deed. That means, the partnership deed should not provide for payment of remuneration and interest from retrospective effect (i.e. any earlier period prior to the date of partnership deed).

   Examples :

   1) The partners entered into a partnership agreement on 1-4-2010 and payment of salary was not mentioned in the deed. On 31-01-2011, the partners entered into an agreement to amend the above deed with retrospective effect from 1-4-2010 to provide a salary of Rs. 2,500/- each per month to each partner. In this case, salary to be allowed under section 40 (b) = Rs. 2,500 x 2 Months x No. of partners.

   2) X & Y enters into partnership on 1-4-2010. The partnership deed provides salary of Rs. 2,500/- per month to X and Rs. 3,000/- per month to Y. On 1-7-2010, the partners entered into an agreement to amend the above deed retrospectively from 1-4-2010 and provide salary of Rs. 5,000/- per month to X and Rs. 6,000/- per month to Y. In this case, salary to be allowed under Section 40 (b) :

      X = Rs. 2,500 x 3 + Rs. 5,000 x 9 = Rs. 52,500/-

      Y = Rs. 3,000 x 3 + Rs. 6,000 x 9 = Rs. 63,000/-

D. The payment of ***interest*** to a partner should not exceed the amount calculated at the rate of 12% per annum simple interest (any amount in excess shall be disallowed).

E. The payment of ***remuneration*** should not exceed the following amounts :

Book Profit	Allowable remuneration
❖ If Book Profit is negative	Rs. 1,50,000
❖ If Book Profit is positive :	
On first Rs. 3 Lakhs of Book Profit	Rs. 1,50,000 or 90% of Book Profit, whichever is more.
On the balance of Book Profit	60% of Book Profit

In other words, amount ***deductible*** on account of remuneration will be lower of the following :

(a) amount calculated as per the above table

(b) amount debited to Profit & Loss Account

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<u>Book Profit</u> :

Computation of book profit is just like computation of income under the head "PGBP". However following shall also be considered :

1) Current year's depreciation and B/F depreciation is to be deducted.

2) B/F business losses are ***not*** to be deducted.

3) Chapter VI-A deductions (i.e. deductions under Section 80C to 80U) are ***not*** to be deducted.

4) Remuneration to partners ***not*** to be deducted. If remuneration has been debited to Profit & Loss Account, it shall be added back.

5) Interest paid to partners to the extent it is deductible (i.e. upto 12%) shall not be added back.

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ASSESSMENT OF FIRMS

PRACTICAL PROBLEMS

Question No. 1 :

A partnership firm submits the following information for the assessment year 2011-12 :

	Rs.
Profit as per P&L Account	60,000
Depreciation as per books of account	20,000
Depreciation as per Income-tax Act	40,000
Brought forward depreciation	2,60,000
Expenditure not allowable as per Income-tax Act debited to P&L Account	30,000
Interest paid to the partners debited in P&L Account :	
Partner A (24%)	10,000
Partner B (16%)	16,000
Remuneration paid to the partners debited to P&L Account :	
Partner A	1,05,000
Partner B	70,000
Other incomes of Partners :	
Partner A	50,000
Partner B	60,000

The partners A and B share profits and losses equally. Compute the taxable income of the firm and its partners.

Question No. 2 :

X, Y and Z are three partners of XYZ & Co., a partnership firm engaged in trading, sharing profits and losses in the ratio of 1 : 2 : 3. The Profit & Loss Account of the firm for the year ended 31.03.2011 is as under :

		Rs.		Rs.
Cost of sales		8,40,000	Sales	18,20,000
Staff salaries		1,18,000	Long-term capital gains	3,80,000
Depreciation		2,10,000	Dividend	50,000
Other expenses		50,000	Other business income	20,000
Remuneration to partners :				
X	2,16,000			
Y	1,08,000			
Z	1,44,000	4,68,000		
Interest on capital to partners :				
X	60,000			
Y	2,00,000			
Z	60,000	3,20,000		
Net Profit :				
X	44,000			
Y	88,000			
Z	1,32,000	2,64,000		
		22,70,000		22,70,000

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Other information :

1. The partnership deed of the firm was amended on 30th June, 2010 with retrospective effect from 1st April, 2010 to provide remuneration and interest to the partners as follows :

	Remuneration	Interest on capital
X (working partner)	Rs. 18,000 per month	Simple interest @ 13.33% per annum
Y (sleeping partner)	Rs. 9,000 per month	Simple interest @ 16% per annum
Z (working partner)	Rs. 12,000 per month	Simple interest @ 13.33% per annum

As per the earlier partnership deed the salary was as under :

X	Rs. 10,000 per month
Y	Rs. 8,000 per month
Z	Rs. 6,000 per month

Interest was provided in the earlier partnership deed at the same rates.

2. Depreciation as per Income-tax Rules amount to Rs. 2,70,000.

3. Expenses of Rs. 35,000 are not allowable under section 43B.

4. The firm has a carried forward loss of Rs. 13,900/-.

5. The other incomes of the partners are :

X	Rs. 40,000
Y	Rs. 1,00,000
Z	Rs. 90,000

Compute the tax payable by the firm and its partners for the Assessment Year 2011-12.

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ASSESSMENT OF FIRMS

SOLUTIONS

Answer to Question No. 1 :

Computation of book profit as per Section 40 (b)

	Rs.	Rs.
Net profit as per Profit & Loss Account		60,000
Add : Expenses debited to Profit & Loss Account but not allowable as deduction	30,000	
Add : Remuneration to partners debited to P&L Account	1,75,000	
Add : Interest paid to partners to the extent not allowed as deduction as per Section 40 (b) [Rs. 10,000 x (24-12)/24 + Rs. 16,000 x (16-12)/16]	9,000	
Add : Depreciation as per books of account	20,000	2,34,000
		2,94,000
Less : Depreciation as per Income-tax rules		40,000
		2,54,000
Less : B/F Depreciation		2,54,000
Book Profit		NIL

Since book profit is Nil, maximum allowable remuneration to partners as per Section 40 (b) = Rs. 1,50,000/-.

As actual amount of remuneration paid to partners (i.e. Rs. 1,75,000/-) is more than the maximum allowable remuneration as per Section 40 (b), the deduction on account of remuneration shall be limited to Rs. 1,50,000/-.

Computation of taxable income of the firm (A.Y. 2011-12)

	Rs.	Rs.
Net profit as per Profit & Loss Account		60,000
Add : Expenses debited to Profit & Loss Account but not allowable as deduction	30,000	
Add : Remuneration to partners to the extent not allowed as deduction as per Section 40 (b) [Rs. 1,75,000 – Rs. 1,50,000]	25,000	
Add : Interest paid to partners to the extent not allowed as deduction as per Section 40 (b) [Rs. 10,000 x (24-12)/24 + Rs. 16,000 x (16-12)/16]	9,000	
Add : Depreciation as per books of account	20,000	84,000
		1,44,000
Less : Depreciation as per Income-tax rules		40,000
		1,04,000
Less : B/F Depreciation		1,04,000
Taxable Income		NIL

Depreciation to be C/F to the next A.Y. = Rs. 2,60,000 – Rs. 1,04,000 = Rs. 1,56,000/-.

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Computation of taxable income of the partners (A.Y. 2011-12)

	A	B
Profits & gains of business or profession :		
Share of profit from firm [Exempt under Section 10 (2A)]	Nil	Nil
Interest from firm	5,000	12,000
Remuneration from firm :		
A (Rs. 1,50,000 x 1,05,000/1,75,000)	90,000	
B (Rs. 1,50,000 x 70,000/1,75,000)		60,000
Profits & gains of business or profession	95,000	72,000
Other incomes	50,000	60,000
Taxable income	1,45,000	1,32,000

Answer to Question No. 2 :

Computation of book profit as per Section 40 (b)

		Rs.	Rs.
Net profit as per Profit & Loss Account			2,64,000
Add :	Expenses debited to Profit & Loss Account but not allowable as deduction u/s 43B	35,000	
Add :	Remuneration to partners debited to P&L Account	4,68,000	
Add :	Interest paid to partners to the extent not allowed as deduction as per Section 40 (b) [Rs. 60,000 x (13.33-12)/13.33 + Rs. 2,00,000 x (16-12)/16 + Rs. 60,000 x (13.33-12)/13.33]	62,000	
Add :	Depreciation as per books of account	2,10,000	7,75,000
			10,39,000
Less :	Incomes credited to Profit & Loss Account but either exempt or taxable under other heads of income :		
	Long-term capital gains	3,80,000	
	Dividend	50,000	4,30,000
			6,09,000
Less :	Depreciation as per Income-tax rules		2,70,000
Book Profit			3,39,000

Maximum allowable remuneration as per Section 40(b) = 90% of Rs. 3,00,000 or Rs. 1,50,000, whichever is more + 60% of Rs. 39,000 = Rs. 2,93,400/-.

Partnership deed was amended on 30th June, 2010 with retrospective effect from 1st April, 2010 to increase remuneration to partners. Section 40 (b) requires that partnership deed should not provide for payment of remuneration and interest from retrospective effect. Again payment of remuneration can be made to a working partner only.

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Therefore, remuneration to be allowed as per Section 40 (b) :

X (working partner)	[Rs. 10,000 x 3 + Rs. 18,000 x 9]	=	Rs. 1,92,000
Y (sleeping partner)		=	Nil
Z (working partner)	[Rs. 6,000 x 3 + Rs. 12,000 x 9]	=	Rs. 1,26,000
			Rs. 3,18,000

Since maximum allowable remuneration as per Section 40 (b) is Rs. 2,93,400/- which is less than Rs. 3,18,000/-, the deduction on account of remuneration shall be limited to Rs. 2,93,400/-.

Computation of taxable income of the firm (A.Y. 2011-12)

	Rs.	Rs.
A. Profits and gains of business or profession :		
Net profit as per Profit & Loss Account		2,64,000
Add : Expenses debited to Profit & Loss Account but not allowable as deduction u/s 43B	35,000	
Add : Remuneration to partners to the extent not allowed as deduction as per Section 40 (b) [Rs. 4,68,000 – Rs. 2,93,400]	1,74,600	
Add : Interest paid to partners to the extent not allowed as deduction as per Section 40 (b) [Rs. 60,000 x (13.33-12)/13.33 + Rs. 2,00,000 x (16-12)/16 + Rs. 60,000 x (13.33-12)/13.33]	62,000	
Add : Depreciation as per books of account	2,10,000	4,81,600
		7,45,600
Less : Incomes credited to Profit & Loss Account but either exempt or taxable under other heads of income :		
Long-term capital gains	3,80,000	
Dividend	50,000	4,30,000
		3,15,600
Less : Depreciation as per Income-tax rules		2,70,000
		45,600
Less : B/F business loss		13,900
Profits and gains of business or profession		31,700
B. Capital Gains :		
Long-term capital gains		3,80,000
C. Income from other sources :		
Dividends	50,000	
Less : Exempt u/s 10 (34)	50,000	Nil
Taxable income		4,11,700

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Computation of tax payable by the firm (A.Y. 2011-12)

	Rs.
Taxable Income	4,11,700
Total income subject to special tax rate (Long-term capital gain)	3,80,000
Total income subject to normal rates	31,700
Tax on Total income subject to special tax rate (i.e. @ 20%)	76,000
Tax on Total income subject to normal rates (i.e. @ 30%)	9,510
Income Tax	85,510
Add : EC @ 2%	1,710
	87,220
Add : SHEC @ 1 %	855
Tax payable (Rounded-off)	88,080

Computation of taxable income of the partners (A.Y. 2011-12)

	X	Y	Z
A. Profits and gains of business or profession :			
Share of profit from firm [Exempt under Section 10 (2A)]	Nil	Nil	Nil
Interest from firm	54,000	1,50,000	54,000
Remuneration from firm :			
X (Rs. 2,93,400 x 2,16,000/3,60,000)	1,76,040		
Y		Nil	
Z (Rs. 2,93,400 x 1,44,000/3,60,000)			1,17,360
Profits & gains of business or profession	2,30,040	1,50,000	1,71,360
Other incomes	40,000	1,00,000	90,000
Taxable income	2,70,040	2,50,000	2,61,360

Computation of tax payable by the partners (A.Y. 2011-12)

	X	Y	Z
Taxable income	2,70,040	2,50,000	2,61,360
Income tax (assuming male individual below 65 years)	11,004	9,000	10,136
Add : EC @ 2%	220	180	203
	11,224	9,180	10,339
Add : SHEC @ 1%	110	90	101
Tax payable (Rounded-off)	11,330	9,270	10,440

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