KALPESH CLASSES
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BASIC CONDITION FOR THE ASSESSMENT OF FIRMS

Question :
X and Y are equal partners in a firm carrying on some business. The firm failed to comply with the provisions of section 184. The profit and the loss account of the firm is as follows:

	Rs.		Rs.
Selling and administrative expenses (Rs. 30,000 paid in cash)	1,05,000	Gross profit	3,00,000
Interest to partners :		Miscellaneous receipts	10,000
Y	20,000		
Remuneration to partners :			
X 70,000			
Y 70,000	1,40,000		
Net profit			
X 22,500			
Y 22,500	45,000		
TOTAL	3,10,000	TOTAL	3,10,000

Answer
If a partnership firm failed to comply with the provisions of section 184, then remuneration and interest to partners is not deductible.

Computation of total income of the firm	Rs.	Rs.
Net profit as per P & L A/c		45,000
Add:		
Interest to partners [disallowed]	20,000	
Remuneration to partners [disallowed]	1,40,000	
Cash payment to consultant [disallowed u/s 40a(3)] (20% of Rs.30,000)	6,000	1,66,000
Business income		2,11,000

COMPUTATION OF SECTION 40(b)

Question
A partnership firm consisting of two partners, X and Y is engaged in the business of civil construction. The firm had a turn over of Rs.30 lakh. The firm submitted its return of income wherein it had been stated that it wished to be governed by the provision of section 44AD. As authorized by the partnership deed, the firm paid remuneration to the partners within limit of section 40(b). The Assessing Officer declines to allow remuneration in computation of firm’s business income. Discuss.

Answer

Section 44AD provides for a method of estimating income from the business of civil construction or supply of labour for civil construction work whose gross receipts from such business do not exceed Rs.40 lakh, in the present problem, in view of the aforesaid provisions, the Assessing Officer is incorrect in his approach.

Problem

X was a partner in a firm in his capacity as the karta of his HUF. On the amounts deposits by the partners, the firm paid interest. X, in his individual capacity had made deposits in the same firm in which he was a partner. The assessee claimed that the interest paid in his individual capacity should not be disallowed. The Assessing Officer did not agree and disallowed the interest paid to X in his individual capacity. Discuss. [NOVEMBER2000] **KALPESH CLASSES**

Answer

According to explanation 1 to section 40(b), where an individual is a partner in a firm on behalf, or for the benefit, of any other person, interest paid by the firm to such individual, otherwise than as partner in a representative capacity, is not taken in to account, for the purpose of section 40(b). In the present problem, in view of the aforesaid provisions, the action of the Assessing Officer is incorrect.

Question

Venkat & Co. is a partnership concern, which has filed its return of income. The certified copy of the partnership deed shown that two of the partners would receive fixed sums annually and not any specific share in the profits of the firm. The assessing officer is of the opinion that as the individual shares of the partners are not specified in the partnership deed, the partnership concern cannot be assessed as a firm for the purposes of the income tax act, 1961 and proposes to assess it as an AOP. Is the contention of the assessing officer correct?

Answer

About sharing of profits, if may be said that partners can agree to share profit in any way they like. They may agree to share them equally. They may also agree that one partner is to receive a fixed annual or monthly sum in lieu of a sum varying in accordance with the profits actually earned. In that view of the matter, the word 'shares' in section 184(1) cannot be read out to mean stated proportions. Therefore, even where a deed of partnership provided that two of the partners would receive fixed sums annually and not some stated proportion of profits, it cannot be said that the requirements of section 184(1) are not fulfilled. The assessing officer's contention is incorrect. Reference may be made to the decision of the Bombay high court in CIT vs. J. K. Doshi & Co. (1989) 176 ITR 371 (Bom.)

Question :

XYZ is a partnership firm consisting of partners X, Y and Z sharing profits and losses equally. The current account of X shows a credit balance of Rs.5 lakh. The current accounts of Y and Z show debit balances of Rs. 2 lakh each on the said date, representing amounts withdrawn by mutual consent for personal expenses. The Assessing Officer proposes to disallow a part of the interest paid on loans borrowed by the firm for business purposes to the extent of Rs.72,000, being the amount attributable to the money drawn by the partners for non-business purposes. On what grounds would you contest the disallowance of interest by the Assessing Officer ?

Answer

The loans borrowed by the firm and the amounts withdraw by the partners Y and Z do not appear to be related to each other. It cannot be said that the loans taken by the firm have been utilized by partners by withdrawing it for their personal use and the loans may have been used wholly for the purpose of business. The withdrawal by Y and Z resulting in their debit balances in the current account appears to be an independent transaction. Also the credit balance in the current account of X is more than sufficient to cover the amounts withdrawn by Y and Z. Hence, in the absence of any connection between the aforesaid transactions, the disallowance of interest by the Assessing Officer is unjustified.

Question : Section 40(b)

a firm comprising of four Partners A,B,C and D carrying on business in partnership, sharing profits and losses equally shows a profit of Rs.1,00,000 in its books after deduction of the following amounts for the year—

	Rs.
a. Remuneration to partner A, who is not actively engaged in business	48,000
b. Remuneration to partner B and C actively engaged in business	
Partner B	60,000
Partner C	72,000
c. Interest on partner D on loan of Rs. 2,25,000	36,000

The deed of partnership provides for the payment of above remuneration and interest to partners. You are required to work out the taxable income of the firm as well as partners. **KALPESH CLASSES**

Answer

Computation of remuneration and interest deductible u/s 40(b)

	Rs.	Rs.
Net profit as per P & L A/c		1,00,000
Add:		
Remuneration to partners (i.e., Rs.48,000+Rs.60,000+Rs.72,000)	1,80,000	
Interest to partners (to the extent not deductible)	9,000	1,89,000
Book profit		2,89,000

Remuneration deductible is Rs.1,68,100 but subject to actual salary paid to working partners B & C of Rs.1,32,000.

Computation of total income of the firm	Rs.
Book profit	2,89,000
Less:	
Remuneration deductible	1,32,000
Business income	1.57,000

Computation of taxable income from partners

	A. Rs.	B. Rs.	C. Rs.	D. Rs.
Remuneration	Nil	60,000	72,000	---
Interest	--	--	--	27,000
Net income	Nil	60,000	72,000	27,000

Question

The partner of a firm is carrying on business in the same line as the firm, in his proprietary capacity. On sales effected by the firm through the proprietary concern, a commission at the rate of 2 percent was paid to the concern. Is it deductible ? **KALPESH CLASSES**

Answer

Section 40(b) provides that in the case of any firm, the payment of interest, salary, bonus, commission or remuneration paid by the firm to any partner of the firm will not be allowed as a deduction. In the given case the payment of commission to the proprietary firm on sales affected by the firm through the proprietary concern is in reality a payment to the partner. Even though it may be argued that the payment to the proprietary concern is a payment to a separate entity, it is nonetheless a payment to the partner so far as the firm is concerned vide CIT v Angadi Brothers 157 ITR 426, Mysore Bangle Works v CIT 157 ITR 411(Kar.).

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Question

A firm carries on business in a premises belonging to one of the partners. No rent was paid to the partner for use of the premises. The Assessing Officer, however, assessed the partner on the annual value of the properly under the head "Income from Property". Is the assessment correct?

Answer

Section 22 specifically excludes from its scope portions or the entire property:

(i) Which the owner may occupy for the purposes of any business carried on by him.

(ii) The profits of which are chargeable to income tax.

Both the above conditions must be fulfilled and then only the house property is taken out of the scope of Section 22 Addl. CIT v Hindustan Machine Tools Ltd.- (1980) 121 ITR798, 803 (Kar.), The Gujarat High Court in CIT v Rasiklal Balalbhai (1979) 119 ITR 303,beKerala High Court in CIT v P.M. Thomas (1990) 181 ITR 256, the Madras High Court in CIT v K.M. Jugannathan (1989) 180 ITR 191 held that even where the property belongs to one or more of the partners arid is being used for the purposes of the business of the partnership its annual value is to be excluded from the operation of Section 22, if the other condition namely that the income of the painter ship business is chargeable to tax is fulfilled. The reason for such exclusion seems to be that in such case the house property constitutes one of the commercial assets and it is the use of all commercial assets together which pro dukes business income. If such business income computed in accordance with the provisions of Section 28 to 44 D is chargeable to income tax, it would have been unfair to deal with such house property separately and Fix a notional income there for which really does not exist. It is significant to note that in respect of buildings etc. owned by the assessed and used for the purposes of his business, depreciation etc. is allowable under Section 32. No depreciation is allowable in respect of buildings etc. the income whereof is assessable under Section 22.

However, it may be noted that the Karnataka High Court in CIT v K.N. Guru swami (1984) 146 ITR 34 has held that where the house property owned by one of the partners of a firm is used for the Firm's business, the notional income in respect of such property is includible in the total income of the partner concerned. The Supreme Court has dismissed a special leave petition applied for by an assessed against a judgment dated 10.11.83 of the Karnataka High Court in ITRC No. 145 of 1980, whereby the High Court answered the reference against the assess following its judgment in CIT v K.N. Gurus Amy (1984) 146 ITR 34 (Kam.) Therefore, it is possible to take two views in the above matter.

ASSESSMENT AFTER DISSOLUTION

Question :

A partnership consisting of three partners A, B and C was dissolved and for settlement of the accounts of the partners on dissolution the closing stock of goods was taken over by one of the partners at cost. The Assessing officer revalued the stock at market value, which was higher than the cost, in order to arrive at the true profits of the firm. Is his action correct ?

Answer

The terms of the partnership do not bind the department. While during the continuance of a business the valuation of stocks at cost or market price whichever is less may be considered permissible, on dissolution there is a disruption of the business and the settlement of accounts cannot be carried out on a notional basis. Every asset of the partnership must be converted into money and the settlement of accounts made on that basis. In a continuing business it makes no difference to the profits even if the stocks are valued at cost, because profits would accrue on disposal in the following year. However, on dissolution of a firm the same principle will not hold good. **KALPESH CLASSES**

Approving the decision of the Madras High Court to the above effect in ALA Firms (1976) 102 ITR 622 and approving the decision in Ramachari & Co. v CIT (1961) 41 ITR (Madras) the Supreme Court held recently in ALA Finn v CIT (1991) 93 CTR (SC.) l3 that the valuation of stock at the time of dissolution of a Firm has to be taken at the market value and not at cost or market value whichever is lower or on any other basis. There can be no doubt that in taking accounts for the purposes of dissolution, the Firm and the partners being commercial men would value the assets only on a real basis and not at cost or any other value appearing in the books. The real rights of the partners cannot be mutually adjusted on any other basis. In view of this position, the action of the Assessing officer was justified.

Problem

X, traders, a partnership firm consisting of three partners, A, B, and C is assessed to income tax as partnership firm. B and C retired from the partnership with effect from December 31. A took over the business and continued as proprietor. The stock-in-trade as at December 31, was valued at average purchase price for settlement of accounts, which was the system consistently followed. On these facts, you are consulted on the following issues:

1. Under which provisions M/s X traders for the period April 1, to March 31, shall be assessed ? Can the Assessing Officer dispute the stock valuation in the assessment of the firm ?

2. A desires to admit three partners after 3 months of the retirement of B and C, Amongst the partners, it is agreed that two partners, shall be working partners and paid remuneration, your advice is sought as to the requirement to see that the remuneration to the working partners is allowable in the hands of the firms.

Answer

1. As per section 189, where any business or profession carried on by a firm has been discontinued, the Assessing Officer shall make assessment of the firm as if no such discontinuance had taken place, and all the provisions of the act including the provisions relating to the levy of a penalty or any sum chargeable under any provisions of the act, shall be apply, so far as may be, to such assessment. Every person who was at the time of such discontinuance is a partner of the firm, shall be jointly or severally liable for the amount of tax, penalty or other such sum payable, and all the provisions of the act, so far as may be, shall apply to any such assessment or imposition of penalty or other sum. **KALPESH CLASSES**

The Chunnilal Khushaldas Patel v. CIT [1967] 66 ITR (guj), it was held that incase a partnership firm is converted in to a proprietory concern of one of the partners and closing stock is taken over by the partner (who takes over) at cost then no profit is said to accrue to the partnership firm as per section 189 for the period April 1, 2003 to March 31, 2004 since the partnership firm was discontinued on December 31, 2003 and the proprietory concern came in to existence with effect from January 1, 2004. therefore, there was a discontinuance of the firm. The Assessing Officer cannot dispute the stock valuation as per the ruling given in Chunnilal Khushaldas Patel v. CIT (supra). Discontinuance is different from dissolution and, therefore, the principle given in ALA firm v. CIT [1991] 189 ITR 285 (SC) is not applicable.

2. To obtain deduction of remuneration paid to partners certain conditions (as specified by sections 40(b) and 184 should be satisfied.

Question :

A firm dissolved with effect from March 31, the firm filed its return of income for the relevant assessment year and the assessment resulted in demand of tax and penalty. How and from whom the tax and penalty are to be recovered ?

Answer

According to section 189, every person who was at the time of discontinuance or dissolution is a partner of the firm and the legal representative of any such person who is deceased , shall be jointly and severally liable for the amount of tax, penalty or other sum payable, and all provisions of this act, so far as may be, shall apply to any such assessment or imposition of penalty or other sum. Therefore, any assessed tax or penalty against the firm may be realized from any of the partners of the firm at the time of dissolution of the firm.

Problem :

X Agencies, a partnership firm constituted by three partners with equal shares is dissolved on April 1, after a search. The liability finally decided against the firm outstanding to be paid is Rs.15.lakh. Out of three partners, one is declared insolvent by the court. The Assessing Officer, for recovering the demand, attached the bank accounts of other two partners and could recover an amount of Rs.6 lakh from the account of one such partner. You are asked by the partners of dissolved firm

1) about the liability of each of them to pay outstanding demand; and
2) whether the action of the Assessing Officer to attach the bank account of partners against the demand of dissolved firm is justified ?

Answer

As per section 189(3), every person who was at the time of such discontinuance or dissolution a partner of the firm, shall be jointly and severally liable for the amount of tax, penalty or other such sum payable, and all the provisions of the Income-tax-Act, so far as may be, shall apply. In the present problem, in view of the aforesaid provisions, the answer is as under-

1. All the three partners are jointly and severely liable for making payment of outstanding dues of Rs.15 lakh. After insolvency of one of the partners, the other two shall be jointly and severally liable with respect to the outstanding dues.

2. The action of the Assessing Officer to attach the bank account of partner against demand of dissolved firm is justified. (www.kalpeshclasses.com)

Question

Examine the tax consequences of the following issue in the case of a firm. A partnership consisting of three partners A, B and C was dissolved and for settlement of the accounts of the partners on dissolution the closing stock of goods was taken over by one of the partners at cost. The Assessing officer revalued the stock at market value, which was higher than the cost, in order to arrive at the true profits of the firm. Is his action correct ? (www.kalpeshclasses.com)

Answer

The terms of the partnership do not bind the department. While during the continuance of a business the valuation of stocks at cost or market price whichever is less may be considered permissible, on dissolution there is a disruption of the business and the settlement of accounts cannot be carried out on a notional basis. Every asset of the partnership must be converted into money and the settlement of accounts made on that basis. In a continuing business it makes no difference to the profits even if the stocks are valued at cost, because profits would accrue on disposal in the following year. However, on dissolution of a firm the same principle will not hold good.

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FIRMS IN CHIT FUND BUSINESS

Question

X Chits is a partnership firm engaged in chit business. Three of its partners are subscribers in a chit group conducted by the firm. After the auction is over each month, the firm pays to each subscriber his share of dividend. Discuss whether the share of dividend paid by the firm to the three partners participating in the chit group can be treated as commission paid to partners and hence disallowed under section 40(b).

Answer

It is to be examined whether the share of dividend paid by the firm to the three partners amounts to commission. For conduction the chit fund, the partnership firm is entitled to take its commission. However, the amount paid by the firm to the partners is not commission. After the auction was over, the subscribers of the chit are entitled to get their share of dividend income. Merely because partners of the firm also happen to be the subscribers to the fund, it cannot be said that what they receive is commission and not their share of dividend income arising of the chit fund. Hence, section 40(b) has no applicability in this case, as the payment to the three partners is made in their status as contributers to the chit fund and not as partners.

Question :
Malini chits are a partnership firm engaged in chit business. Three of its partner is subscriber in a chit group conducted by the firm. After the action is over each month, the firm pays to each subscriber his share of dividend. Discuss whether the share of dividend paid by the firm to the three partners participating in a chit group can be treated as commission paid to partners and hence disallowed under section 40(b) of the income tax act 1961.

Answer
The assessed is a partnership firm doing business in conducting chit transactions. Three partners of the firm are subscribers in a chit transaction. After the auction was over, the firm has paid the share of dividend to the subscribers who the partners of the firm. The subscribers of the chit are entitled to get their share in the dividend income after the auction of the chit is over. Therefore, what was paid by the partnership firm to the partners was not commission out of the income earned by the partnership firm. For conducting the chit, the partnership firm is entitled to take its commission. The amount paid by the firm to the three partners is not out of the commission earned by the firm. Even if the partnership firm failed to pay the dividend amount to the subscribers, they are entitled to collect the dividend amount to the firm conducting the chit. Under such circumstances, the payment of amount in the present case by the partnership firm to the partners cannot be called commission as stated under section 40(b). In as much as the amounts paid by the partnership firm to the partners were not in the nature of commission as contemplated under section 40(b) the income tax authorities can make no disallowance by applying the provisions of section 40(b). Since the amount paid by the partnership firm is the dividend income arising out of the chit transaction to its subscribers, section 40(b) has no application to the facts arising in this case. Payment to partner was not quo partner but as a contributor to the chit. (www.kalpeshclasses.com)

MISC AREAS OF FIRMS

Problem
X was ousted as a partner from a partnership firm. Subsequently, a new firm was constituted which used the entire assets of the earlier firm without rendering accounts to X. X challenged the action by commencing the legal proceedings and the matter was settled, X being paid Rs.70,000 on accounts of his share in the partnership. Is the amount paid to him deductible as business expenditure ?

Answer
In the present case, a sum of Rs.70,000 is paid to X not for further expansion of the business but in order to discharge the statutory liability of the retiring partner. The amount of Rs.70,000 is to be paid to him for use as his share of the assests and goodwill of the firm. It is in discharge of statutory liability which was redeemed by paying the share of the retiring partner. It cannot be said for the purpose of advancement of the business of the partnership firm, but it was a mere

discharge of the liability of the firm. Therefore, it can be correctly styled as a revenue expenditure—CIT v. Delhi Beedi Sales Agencies [1996] 89 Taxman 613 (MP).

Question

A firm ABC had an immovable property purchased out of the firm's funds for Rs. 6,00,000. On 31.3.1994, the property was divided among the partners equally by making entries in the capital accounts of the partners. The property was subsequently sold during the previous year for Rs. 9,00,000. The Assessing Officer assesses the resultant capital gain in the hands of the firm.

Answer

The capital gain is assessable in the hands of the firm. Although a firm can acquire and own property under sections 14 and 15 of the Partnership Act, during the subsistence of the partnership, no partner can deal with any portion of the property as his own nor even to the extent of his share in the firm. The property remains the property of the firm in which the partners have common interest. A division among the partners of the property cannot be brought about by book entries. Registration under section 17(l)(b) of the Registration Act is necessary, if the property is to be divided, possessed and enjoyed by the partners. Therefore, the property continues to belong to the firm in the absence of registration of the transfer and the capital gain is assessable in the hands of the firm- CIT v. J.M. Mehta and brothers 214 ITR 716. (www.kalpeshclasses.com)