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## CHAPTER FOUR

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# TAX REFORMS AND CASELAW

CHAPTER - IV

# TAX REFORMS AND CASELAW

## 4.1 Introduction:

The Chelliah Committee has stressed that double taxation in regard of taxation of partnership firms should be avoided in the following words:

> "...that we should avoid double taxation and propose as a measure of relief to treat that firm as a separate tax entity and do away with the taxation of the same income in hands of the partners.".

## 4.2 Chelliah Committee Report:

Chelliah Committee on Reforms on Taxation was constituted by the Government of India in August 1991, which consisted of:

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| 1. | Dr.Raja J.Chelliah | Chairman |
| 2. | Shri.S.V.Iyer | Member |
| 3. | Shri.V.U.Eradi | Member |
| 4. | Dr.Amaresh Bagachi | Member |
| 5. | Shri.V.Rajaraman | Member |

The terms-of-reference of this committee were as under:

(i) Ways of improving the elasticity of tax revenues, both direct and indirect, and increasing the share of direct taxes as a proportion of total tax revenues and of GDP;

(ii) Making the tax system fairer and broad-based with necessary rate adjustments, particularly with regard to the commodity taxation and personal taxation;

(iii) Rationalization of the system of direct taxes with a view to removing anomalies, improving equity and commodity taxation and personal taxation;

(iv) Identifying new areas for taxation;

(v) Ways of improving compliance of direct taxes and strengthening enforcement;

(vi) Simplification and rationalization of customs tariffs with a view to reducing the multiplicity and dispersion of rates and to eliminate exemption which have become unnecessary;

(vii) Reducing the level of tariff rates, keeping in view the need for mobilizing resources to facilitate fiscal adjustment and the objective of promoting international competitiveness;

(viii) Simplification and rationalization of the structure of excise duties for better tax compliance and administration;

(ix) Scope of extending the MODVAT scheme;

(x) Any other matter related to the above points or incidental thereto.

The approach of the committee has been deliberate on the need for reforms in all important areas in the direct and indirect tax systems, in order to set the trend for

for inaugurating a new era in the development of tax policy, structure and administration. In the interim report, the committee has examined the case for introducing certain fundamental reforms in the direct and indirect tax systems, in line with the aforesaid goal so that the changes that are required to be brought in immediately are conceived as an integral part of the reforms suggested by the committee.

The guiding principles under which the committee is functioning are as under:

(i) The tax system and its burden must be acceptable to the citizens, i.e. the potential taxpayers;

(ii) Given our past experience and the present totality of circumstances affecting the tax system and its operation, it is better to have moderate rates with broad bases;

(iii) While the tax structure should be progressive, it should not be such as to induce the generation of unaccounted income and wealth;

(iv) The tax system must be rational from the economic point of view. For this purpose, the structure once established must remain stable unless and until the economic conditions undergo a radical transformation. Ad hoc changes from year to year will undermine rationality and reintroduce complications;

(v) The tax system and law should be as simple as possible, It should have the strictly limited objectives of raising revenues for the government, in a fair and efficient

manner. Achieving redistribution and discouraging some industries and the use or consumption of some products as well as granting a reasonable degree of protection to domestic industries. A simple system will have only a limited number of rates and exemptions or reductions and give the least possible discretionary power to the tax officials for interpreting the law;

(vi) Methods of tax administration should be modernized and tax enforcement should be visibly improved;

(vii) The tax reforms suggested should be fully, or atleast nearly, revenue neutral in their totality. The system, however, should become more income-elastic.

Pursuant to the recommendations, the committee furnished its interim report, wherein the recommendations touching the Partnerships were as follows:

(1) A 'partnership' as defined in the Indian Partnership Act is the relation between persons who have agreed to share the profits of a business carried on by all or anyone of them, acting for all persons who have entered into partnership with one another who are called 'partners' and collectively called 'firm' and the name under which the business is carried on is called the 'firm-name'. The definition of a partner includes a minor admitted to the benefits of a partnership.

(2) The income-tax law in India has, from its very inception, taken account of this relationship which continues to be the most dominant form of business organization, particularly amongst the trading community, as forming the basis of a separate taxable entity. This is despite the fact that a firm is not a separate judicial person unlike a corporate body.

(3) The existing scheme of taxation of firms as it has evolved over the years is primarily based on the felt-need for countering tax avoidance through this medium. The existing scheme can be characterized as follows:

(a) The method and quantum of taxation differs according to whether the firm is registered under the Income-tax Act or not; however, in order that a firm may get registration, it has to satisfy certain conditions and comply with some formalities.

(b) Amongst the registered firms, a distinction is made between professional and non-professional firms, the rates of tax are lower for the professional than for non-professional firms. In the case of unregistered firms, tax is levied at the rate applicable to an individual, on the firm itself as a distinct taxable entity for purposes of the Act. The firm pays the tax in discharging its own liability and not on behalf of the partners;

however, a partner in an unregistered firm is exempt from income tax in respect of his share in the profits of the firm, provided the tax has already been paid by the firm. Though the partners' share of profits is exempt from income-tax, it has to be included in his toal total income for the purposes of determining the rate of tax applicable to his income, together with income from all other sources.

(c) In computing the taxable income of a firm, any payment of interest, salary, bonus, commission or remuneration by the firm to any partner of the firm is not an allowable deduction.

(d) With a view to counteracting tax avoidance through the mechanism of partnership firms, the tax law provides certain exceptions for aggregating with one spouses' income, the share income of the other spouse from a partnership firm in which both the spouses are partners.

(e) The income of minors admitted to the benefits of any partnership is included in the income of the parent, irrespective of whether or not either parent is a partner in the same firm.

(f) Any loss suffered by a registered firm which cannot be set-off against any other income of the firm is apportioned amongst the partners

for set-off against their income from all other sources. Unabsorbed loss, if any, is allowed to be carried forward for adjustment by the partners in the subsequent assessment year; however, in the case of an unregistered firm, any loss which cannot be set off against any other income of the firm is allowed to be carried forward for adjustment by the firm in the subsequent assessment year.

(g) Tax deducted at source from payments made to a firm are allowed as a credit against total tax payable by the firm on its income.

(h) For purposes of registration, a firm has to satisfy certain conditions, it has to make an application in the prescribed form to the Assessing Officer duly signed by all the partners (not being minors) personally. Such an application is required to be accompanied by the instrument of partnership, specifying the individual shares of the partners in the profits and losses of the firm.

(4) It is well recognized that a good tax system should be neutral to the type of business organization and form of ownership and control. Accordingly, all non-natural persons must be taken to serve only as conduits. Profits ought to be taxed at the appropriate income-tax rates in the hands of the persons who came together to form the entity; hence, both equity and efficiency

considerations require that the profit of a partnership firm should be assessed only in the hands of the partners; however, some compromises may have to be made therein for administrative reasons.

(5) Based on the above principles, various schemes for taxation of firms and their partners could be evolved. One possible scheme is a partnership and also the share of the partners in the post-tax profits of the firm. This is the scheme which is now in operation. But as noted, it results in double taxation. It is also administratively burdensome, as it entails rectification of partners's tax assessments as a consequence of any change in the declared income of the firm. The number of such rectification can be very large. Further,m any laxity on the part of the tax administration in carrying out such rectification can lead to revenue loss. In order to mitigate the full impact of double taxation, the profits of the partnership firms are taxed at proressive but low rates of tax and the post-tax income is compulsorily apportioned amongst the partners in the ratio of their share in the partnership for tax at the appropriate income tax rates in the hands of the partners.

(6) An alternative, and in our view, more equitable scheme could be not to tax the income of a partnership but to tax at the appropriate income-tax rates the partners

in respect of their shares in the profits of the firm. Under this scheme, the income-tax liability will be fully borne by the partners at their respective rates of tax and hence, the scheme would be neutral to the form of organization in which the business is carried on.

Committee's Report on Tax Reforms
<u>Assessment of Partnership Firms:</u>

In case of partnership firms' assessment, the following changes have been suggested:

(a) The scheme of registration of firms for income-tax purpose should be abolished. All firms should be treated like for income-tax.

(b) The existing separate tax on the income of the firm should be abolished. The firm should be required to calculate capital gains and its income other than capital gains separately. The income other than capital gains should be apportioned amongst the partners in the ratio of their share in the profits of the firm, for taxation in their hands at the appropriate income-tax rates. In computing the income of the firm, it should be allowed, as against the present practice to claim as a deduction any payment of interest, salary, bonus, commission or remuneration to any of its partners.

(c) Where new partners are admitted to the benefits of partnership at any time during the accounting year after the end of the first three months, the share of the new partners in the profits of the firm should be ignored and profits should be apportioned amongst the old partners in the revised ratio of their share in the manner indicated in Chapter-6. This should, however, only be in respect of the financial year in which the new partners have been admitted. This, however, will not apply when a firm is reconstituted on the death of a partner.

(d) Where a firm has any income from capital gains, it will be eligible to claim "roll-over" relief wherever permissible. Any capital gain (after allowing for the "roll-over" relief) or loss incurred by the firm should be apportioned amongst the partners in the ratio of their share in the profits of the firm. The partners, however, should be allowed any "roll-over" relief in respect of such share in the capital gains. The relief for "bunching" of gains should be allowed to be claimed by the partners in their personal assessments.

(e) All associations of persons, bodies of individuals should be taxed in the same manner as firms.

(f) Where the shares of partners of a firm or of members in the AOP or BOI are not specified, they should be presumed to be equal amongst them and no partner

should be allowed to claim differently at any time, in the future, in respect of profits of the year for which such presumption is made.6

(g) The firm or AOP or BOI should not be allowed any credit for tax deducted at source from payments received by it. It should, however, be allowed to apportion the same amongst its partners in the ratio of their share in the profits.

(h) The firm should be required to pay advance-tax on behalf of its partners in respect of the income of the partner firm, the firm and income from all other sources along the same lines as the facility available under sub-section (2)(2B) and (3) of section 192 to both the employer and the employees in respect of deduction of tax at source. The advance tax paid by the firm on behalf of the partners should be deposited with the Central Government through a single challan. The firm should, after the end of the previous year, be required to submit separate annual statement regarding advance tax on behalf of the partners.

(i) Every firm should be required to issue a certificate to every partner, indicating the amount of interest, salary, bonus, commission or remuneration paid by it, the share of the partner in profits of the firm. The share of the partners in the tax deducted at source on payment received by the firm and the advance

tax paid by the firm in respect of the income of the partners.

(j) Notwithstanding the fact that there would be no tax liability on the part of the firm AOPs and BOIs, they should be required to file their returns of income, irrespective of their level of income where the firm files the return of income voluntarily but after the due date, they should be required to pay one-half per cent of the computed income of the firm, subject to a minimum of Rs.200/- as a late fee for every month of default. If the return is filed in response to a notice issued after the end of the assessment year and the firm has not deposited the deducted tax at source in the appropriate manner from payments made to the partners, the firm should be assessed to tax at the maximum marginal rate of tax individuals and also be required to pay late-fee as indicated above. In such a case, distribution of income in the partners' hands would not arise.

(k) In case where the returned income of the firm is increased as a result of additions or disallowances, the difference between the assessed income and the income declared should be taxed at the maximum marginal rate in the hands of the firms, but exempt from any additional tax liability in the hands of the partners; however, in case where loss is returned and where

the additions made result in a reduction in the loss or in the computation of positive income, the income or loss computed should be apportioned amongst the partners and consequential rectifications should be carried out in their tax assessments.

(l) The problem of "benamidar" partners should be tackled only by sustained investigation under the Benami (Prohibition) Act, 1988, without causing distortion in the tax structure. Where it is established that a partner in a firm is the benamidar of any other partner of the firm or is an undisclosed benamidar of an outsider and any one or more of the other partners knew or had reasons to believe that it was so, the whole of the income of the firm (including any payment income to the partners) should be taxed at the maximum marginal rate.

These recommendations have been partially accepted by the Finance Minister vide para-65 of part-B of his Budget Speech 1992-93.

**4.3 Caselaw:**

The provisions relating to the assessment of partnership firms have been already discussed in the earlier Chapter. These provisions are at times challenged by the assessee or by the Department. The ultimate interpretation is settled

at the highest forum, i.e. the Supreme Court of India. In fact, major litigations under the Income-tax Law is with reference to the assessment of the firms. Therefore, some of the cases decided by the Supreme Court and reported in the 'Income-tax Report' are presented below:

In the Supreme Court of India. August 30, 1990

Uttam Kumar Pramod Kumar
v.
Commissioner of Income-tax, Kanpur.

Firm - Registration - Preamble reciting that minors admitted to benefits of partnership - But minors treated at par with major partners for rights of management of business and liability for losses also - Firm not entitled to registration - Income-tax Act, 1961, sec.1985.

The appellant firm was constituted under a deed of partnership, the preamble of which provided that two minors were admitted to the benefits of partnership. Under the terms of the deed, however, the minors were treated on par with the major partners; inter alia, they were given rights of participation in the business of the firm and were laos also made liable for the losses of the firm. On a reference, the High Court held that the firm was not entitled to registration under section 185 of the Income-tax Act, 1961. On appeal to the Supreme Court:

Held, affirming the decision of the High Court, that, although the preamble of the deed provided that the minors were admitted to the benefits of partnership, the dominant intention

of the parties, as it appeared from the terms of the deed, was to admit the minors as full-fledged partners and not merely to the benefits of partnership alone; and, therefore, the High Court was right in holding that the firm was not entitled to registration.

In the Supreme Court of India October 24, 1991

Chandrakamal Manilal Shah and another
v.
Commissioner of Income-tax

Firm - Registration - Hindu undivided family - Partnership between Karta and undivided member - Member not contributing any cash asset but contributing only skill and labour - Partnership valid - Firm entitled to registration - Indian Income-tax Act, 1922; s.26A - Hindu Gains of Learning Act, 1930, ss.2,3.

Words and phrases : "Learning", "Skill" and "Labour", meanings of:

C was the karta of a Hindu undivided family which carried on business in cloth. N, one of the sons of C, joined the business on a monthly salary in April, 1959. With effect from November 1, 1959, the business was converted into a partnership between C, the karta of the undivided family, and N. The deed of partnership dated November 12, 1959, indicated that N was a working partner having a 35 per cent share in the profits and losses of the firm and the remaining 65 per cent share was held by C as karta of

the family. N did not contribute any cash assets towards the capital of the firm but was contributing only his skill and labour. The Income-tax Officer rejected the firm's application for registration under section 26A of the Indian Income-tax Act, 1922, on the ground that there was no valid partnership, and the Appellate Assistant Commissioner and the Appellate Tribunal, on appeal, upheld the decision of the Income-tax Officer. The High Court, on a reference, affirmed the decision of the Tribunal, holding that there was no valid partnership. On appeal to the Supreme Court.

Held, reversing the decision of the High Court, that the mere fact that N had neither separated from the family nor brought in any cash asset as his capital contribution to the partnership but was contributing only his skill and labour, could not in law detract from a valid partnership being created. The partnership between C, as the karta, and N was valid and the firm was entitled to registration.

It is not correct to say that, under Hindu law, there can be no contract inter-se between the undivided members of a Hindu undivided family.

By the Court: The aim of business is earning of profit. When an individual contributes cash assets to become a partner of a firm in consideration of a share in its profits, such contribution helps and, at any rate, is calculated to help achievement of the purpose of the firm, namely, to earn profits. The same purpose is undoubtedly achieved

also when an individual in place of cash assets, contributes his skill and labour in consideration of a share inn the profits of the firm. Just like a cash asset, the mental and physical capacity generated by the skill and labour of an individual is possessed by or is a possession of such individual. Indeed, skill and labour are themselves possessions. "Any possession" is one of the dictionary meanings of the word "property". In its wider connotation, therefore, the mental and physical capacity generated by themselves weould be the property of the individual possessing them. They are certainly assets of that individual and there is no reason why they cannot be contributed as a consideration for earning profit in the business of a firm.

In the Supreme Court of India. January 17, 1992

Commissioner of Income-tax
v.
Ashoka Engineering Co.

Commissioner of Income-tax
v.
Grafik India

Commissioner of income-tax
v.
Syed Jaffer and Sons

Firm - Registration - Application for Registration or Declaration for continuance of registration - Filed beyond time - Rejection by assessing officer - Appeal to appellate assistant commissioner - Maintenance - "Not in order", meaning of - Income-tax Act, 1961, secs.(184(4),(7),185(2),(3),246(j).

Appeal - Provision conferring right of appeal - Should be construed in a reasonable, practical and liberal manner.

Rejection of an application for registration of a firm or a declaration for continuance of registration on the ground that there was not sufficient cause preventing its being filed in time can be treated as a case where the declaration or application is "not in order" and is consequently rejected. Even if an application is filed before the Income-tax Officer, which prima-facie, appears to be out of time, the Income-tax Officer cannot straightway reject it or refuse to entertain it. He will have to give an opportunity to the assessee to show cause how it can be entertained. Sometimes, even his impression that there is delay may itself be shown to be wrong. If the assessee satisfies the Income-tax Officer that there was sufficient cause, then the application has to be entertained by the Income-tax Officer. In other words, the defect that the application was beyond time stands remedied and the application is in order. On the other hand, if delay is not condoned, the officer rejects the application as "not in order". The defect neet not be something in the application. It can also be one in the procedure prescribed for making the applications.

Cases where registration is refused for the reasons set out in section 184(4) or 184(7) of the Income-tax Act, 1961, are really cases where there is an order refusing registration to the firm by rejecting its application, within the meaning

of section 185(2) or (3). An appeal is maintenable from an order rejecting an application for registration or declaration for continuance of registration filed beyond time on the ground that there was not sufficient cause preventing its being filed within time.

There is no inherent right of appeal to any assessee; it has too be spelt from the words of the statute, if any, providing for an appeal. But it is an equally well-settled proposition of law that, if there is a provision conferring a right of appeal, it should be read in a reasonabble, practical and liberal manner.

In the Supreme Court of India January 21, 1992

Commissioner of Income-tax
v.
Amritlal Nihalchand

Firm - Succession of change in constitution - Original firm of two partners and two minors admitted to benefits dissolved - New deed executed by three partners - Succession and not mere change in constitution - Income-tax Act, 1961, sec.187,188.

The respondent, a firm dealing in cloth, filed two separate returns for the assessment year 1969-70, one for the period November 3, 1967 to January 22, 1968, and the other for the period January 23, 1968 to November 21, 1968, both periods forming trogether the Samvat year 2024. The original deed was executed on June 24, 1963. In this deed, there were two partners, R and C, and two minors,

A and P, were admitted to the benefits of partnership. With effect from January 22, 1968, that firm was dissolved and the business was taken over by a new firm of the same name along with the debts, liabilities, stock and tenancy rights. The new firm was constituted under a deed of partnership executed on January 24, 1968. There were three adult partners R, C and A in the new firm. it was stated in the deed dated January 24, 1968, that the old firm was dissoved by the partners with effect from the end of January 22, 1968. Intimation that the old firm was dissolved and the new firm had been brought into existence was sent to the Registrar of Firms and to the Income-tax Officer. The Income-tax Officer was of the view that there was surely a change in the constitution of the firm and not a dissolution and made a single assessment clubbing the incomes of the two periods. The tribunal confirmed the assessment. On a reference, the High Court held that there was no change in the constitution as contemplated by section 187 of the Income-tax Act, 1961, but only a succession within the meaning of section 188; and, therefore, the clubbing of the incomes for the two periods were wrong. On appeal, the Supreme Court affirmed the decision of the High Court.

In the Supreme Court of India. January 16, 1992

Commissioner of Income-tax
v.
Ram Laxman Sugar Mills

Firm - Remuneration paid to partner - Dissensions among partners - Sugar factory - Central Government exercising powers under the Essential Supplies Act and appointing two authorized controllers and later four partners as Board of Management - Amount paid to partners in Board of Management - High Court holding amount to be allowable deduction in computing firm's income - Appeal to Supreme Court - Appeal dismissed without question being decided - Indian Income-tax Act, 1922, s.10(4)(b) - Essential Supplies (Temporary Powers) Act, 1946.

From the decision of the Allahabad High Court in CIT v. Ram Laxman Sugar Mills (1973) 90 ITR 73 (FB) to the effect that the sum of Rs.28,422 paid in the previous year relevant to the assesssment year 1957-58 by the respondent-firm to its four partners who were appointed to a board of management by the Central Government exercising its powers under the Essential Supplies (Temporary Powers) Act, 1946, owing to dissensions among the partners, could not be disallowed under section 10(4)(b) of the Indian Income-tax Act, 1922, the Department preferred an appeal to the Supreme Court. The Supreme Court dismissed the appeal without expressing any opinion on the question, having regard to the small sum involved, the huge lapse of time and the fact that the question (which was not of recurring importance) was decided on the special facts of the case.

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