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CHAPTER THREE

**NEW SCHEME FOR TAXATION OF
FIRMS AND PARTNERS**

CHAPTER - III

NEW SCHEME FOR TAXATION OF FIRMS AND PARTNERS

3.1 Introduction:

As stated in the closing paragraphs of the preceding Chapter, the Finance Act, 1992, has made far reaching changes in the system of assessment of the firms under the Income-tax Act, 1961. In the present Chapter, it is proposed to discuss these changes to some extent with respect to their practical implications and to support these discussions with illustrations.

3.2 Distinction between existing scheme and new scheme as to taxation of firms:

<u>Existing Scheme</u>	<u>New Scheme</u>
1. A firm has an option to register itself under the Income-tax Act.	Registration is not necessary; a firm wanting to be assessed as a firm is only required to file a certified copy of the instrument of partnership along with the first return of income and comply with the conditions as prescribed.
2. A registered firm pays tax at rates especially prescribed for it.	A 'firm assessed as such' (FAS) will pay tax at a flat rate of 44.8% (40% income-tax and 12%

surcharge) without any basic exemption.

3. Interest, salary, remuneration, etc., payable to partners is not allowed as deduction, while computing the total income of the firm. Interest, salary, remuneration, etc., payable to partners will be allowed as deduction while computing the total income of the firm but subject to the conditions and ceiling as prescribed under section 40(b).
4. A registered firm's total income after tax is apportioned among partners. A partner's share in the total income of the firm together with any interest, salary, remuneration, etc., received by him is chargeable in his hands at regular rates prescribed in his case. A partner's share in the total income of the firm after allowing deduction for interest, salary, remuneration, etc., subject to conditions and ceiling as prescribed be exempt in his hands. However, interest, salary, remuneration, etc., paid to him as per the conditions and ceilings will be taxable in his hands as profits and gains of business.
5. An unregistered firm pays tax at the rates prescribed in the case of an individual; however, a partner's A 'firm not assessed as a firm' (a non-FAS firm) will be treated as an association of person (AOP). A non-FAS firm will not be allowed deduction in respect

share in the total of interest, salary, remuneration, income of the firm etc., payable to partners. Tax together with interest, liability of the firms will be salary, remuneration, computed as follows:
 etc., payable to him is (i) If individual share of a partner is not known, tax will be levied at maximum marginal rate or a higher rate;
 included in his total partner is known but total income of any partner exceeds the basic exemption limit, then the firm will pay tax at the maximum marginal rate.
 income for rate be levied at maximum marginal rate or a higher rate;
 purposes only; a rebate rate or a higher rate;
 being allowed to him (ii) If individual share of a partner is known but total income of any partner exceeds the basic exemption limit, then the firm will pay tax at the maximum marginal rate.
 under sec.86 at the average rate; however, if any partner exceeds the basic exemption limit, then the firm will pay tax at the maximum marginal rate.
 the unregistered firm has exemption limit, then the firm will pay tax at the maximum marginal rate.
 not paid tax, a partner's share in the total marginal rate.
 income of the firm will (iii) If individual share of a partner is known and no partner has a total income exceeding the basic exemption limit, the firm will pay tax at the rates applicable to an individual.
 be taxed at regular rates without any rebate.

A partner's share in the total income of a non-FAS firm will be treated as follows:

(i) If the non-FAS firm has paid tax at the maximum marginal rate,

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or a higher rate, the partner's share in the total income of the firm will not be included in his total income.

(ii) If the non-FAS firm has paid tax at regular rates applicable to an individual, a partner's share in the total income of the firm will be included in his total income for rate purposes only, and he will be entitled to rebate in respect of such income at the average rate under sec.86.

(iii) If the non-FAS firm has not paid tax, a partner's share in the total income of the firm will be included in his total income and taxed at regular rates without any rebate.

Deductions:

From the gross total income, a firm will be allowed deductions as under:

Section

Nature of Deduction

80G : Deduction in respect of donations to fund and charitable and religious institutions.

- 80GGA : Deduction in respect of donations for scientific research and rural development.
- 80HH : Deduction in respect of profits and gains from new industrial undertakings or hotels set up in certain backward areas (not to be allowed in the case of an undertaking which begins to produce articles after 31st March 1990).
- 80HHA : Deduction in respect of profits and gains from new small-scale industries set up in certain rural areas (not to be allowed in case of an undertaking which begins to produce articles after 31st March 1990).
- 80HHB : Deduction in respect of profits and gains from projects outside India.
- 80HHC : Deduction in respect of profits and gains from exports.
- 80HHD : Deduction in respect of earnings in convertible foreign exchange.
- 80HHE : Deduction in respect of profits from export of computer software, etc.
- 80-I : Deduction in respect of profits and gains from industrial undertakings after a certain date (deduction to be available upto assessment year 1991-92).
- 80-IA : Deduction in respect of profits from industrial undertakings, ship, business of hotel, from assessment year 1992-93.

- 80JJ : Deduction in respect of profits and gains from business of poultry farming.
- 80-O : Deduction in respect of royalty, commission, etc., from a foreign government or foreign enterprise.
- 80-Q : Deduction in respect of profits from business of publication of books.

Where a deduction from any of these sections has been allowed to a firm, the same deduction will not be available to the partners in respect of their individual shares in the income of the firm.

3.3 Computation of Income:

While computing the total income of the firm, deduction for interest, salary, bonus, commission or remuneration paid to any partners is not allowed at present. Under the proposed amendment to sec.40(b), it will be possible for the firm to claim deduction in respect of the above payments to partners, subject to the following ceiling limits provided in the section:

- (i) Interest on capital or moneys borrowed from partners at the rate of 18% simple interest per annum;
- (ii) Salary, bonus, commission or remuneration (hereafter referred to as remuneration) paid or payable to the working partners will be allowable, provided that the aggregate amount in any accounting year does not

exceed the following limits:

<u>Income</u>	<u>Professional Firms</u>	<u>Other Firms</u>	<u>Ceiling Limits</u>
First	1,00,000	75,000	90%
Next	1,00,000	75,000	60%
	Balance	Balance	40%

- (iii) For the above purposes, the term 'working partner' is not defined. Therefore, if remuneration is paid to a partner who is rendering some service to the firm and attending to some work relating to partnership business or profession, the deduction for remuneration paid to such partner can be claimed; however, if the amount of remuneration paid to all the working partners in a firm exceeds the ceiling limits stated in (ii) above, such excess amount will not be allowed as a deduction in the computation of the income of the firm. The assessing officer has power to determine under section 40A(2) whether the remuneration paid to a partner is excessive or unreasonable. Therefore, the remuneration to be paid should not be excessive. Otherwise, it will be disallowed.
- (iv) The ceiling limit for the above remuneration is fixed with reference to the 'income' of the firm. For this purpose, the expression 'income' is defined to mean the total income computed in accordance with the provisions of the Income-tax Act as increased by the amount of interest and remuneration paid or payable

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to all the partners of the firm, if such amount has been deducted while computing the total income. In other words, if the total income, after deducting interest to partners, of Rs.20,000 and remuneration to working partners of Rs.90,000, is Rs.30,000, the income for working out the above ceiling limits will be Rs.1,40,000.

Thus, the amount which is paid by the firm to the partners in excess of the above limits will suffer double taxation, once in the hands of the firm at 40% and again in the hands of the partner who has received such remuneration or interest. For this reason, it will be necessary to take sufficient care while fixing the amount of remuneration and interest payable to partners under the deed of partnership.

3.4 Procedure for Assessment:

The requirement of making application for registration of firm is being deleted. The new procedure for assessment of the firm as provided in sec.184, which is proposed to be amended will be as under:

- (i) The firm must be constituted under an instrument of partnership. Such partnership will have to be executed on a proper stamp paper.
- (ii) Individual shares of the partners must be specified in the instrument of partnership.
- (iii) Certified copy of the partnership deed, duly certified

by all the partners (other than minors) should be filed with the return of income of the first year when assessment in the status of firm is sought. Therefore, certified copy of the operative partnership deed will have to be filed with the return of income for the assessment year 1993-94 in all cases. The return of income in the first year will have to be signed by all partners (other than minors).

- (iv) If there is any change in the constitution of the firm or in the profit/loss sharing ratio of the partnership, the firm will have to revise its partnership deed. When the return of income for the accounting year in which such a change has taken place is filed, it will be necessary for the firm to file a copy of the revised deed of partnership duly certified by all the partners (other than minors) along with the return of income for the relevant year. Such return of income will also be required to be signed by all the partners (other than minors).
- (v) Return of income for the other years in which there is no change in the constitution or profits/loss sharing ratio can be signed by any one partner of the firm and it will not be necessary to file copy off the partnership deed. It may be noted that if there is any change in the terms relating to payment of interest, salary, bonus, commission or remuneration to partners,

it will be considered as a change in the profit/loss sharing ratio and it will be necessary to follow the procedure stated in (iv) above.

Joint and Several Liability of Partners
for the Tax Payable by the Firm (sec.188A):

Under section 188A, the liability of all the partners in respect of the tax, interest, penalty, etc., payable by the firm for any year is joint and several. The assessing officer can recover from the firm as well as all or any of the partners the amount of tax, etc., due from the firm.

If the above formalities contained in sec.184 are not compiled in respect of any year, the firm will be assessed as an association of persons (AOP). Similarly, if the firm does not file its return of income or does not comply with the statutory notices for production of books, records, etc., issued by the Income-tax Officer and the assessment would be completed ex-party, under sec.144.

It may be noted that when a firm is to be assessed in the status of AOP for the above defaults, the total income will be computed as an AOP. Therefore, under sec.40(ba), any interest, salary, bonus, commission or remuneration paid to any partner (member) will be added back in the computation of total income. Moreover, the provisions of sec.167B, which apply to an AOP for determining the rate of tax will apply to such a defaulting firm.

3.5 Computation of Loss:

Any loss suffered by a registered firm was apportioned amongst the partners and was allowed to be set-off against the other income of the partner. The unabsorbed share of business loss from the firm in the hands of the partner was carried forward to the subsequent years and allowed to be set-off against business income of the subsequent years. This provision is now being deleted with effect from the assessment year 1993-94. The business loss suffered by the firm will not be set-off against other income of the firm in the same year and the unabsorbed business loss will be allowed to be carried forward and set-off against business income in the subsequent year. Unabsorbed depreciation allowance will become depreciation of the subsequent year and will be adjusted against income of the subsequent year. If any partner of the firm has retired or died, his proportionate unabsorbed share of loss for the relevant year or earlier year will not be allowed to be carried forward.

It should be noted that if the firm suffers loss in any year, salary, bonus, commission or remuneration will not be allowed as a deduction, whereas the partners will have to pay the tax on salary, etc. received by him from the firm. This is because the ceiling on remuneration of working partners is provided with reference to the adjusted total income of the firm; however, the position about interest

paid to the partners is that the same can be claimed as deduction in the computation of loss of the firm to the extent of the amount calculated at the rate of 18%.

3.6 Assessment of Partners:

Under the new provisions effective from the assessment year 1993-94, the share of a partner in the firm will not be liable to be included in his total income. This exemption is granted under the proposed new sec.10(2A); however, interest, salary, bonus, commission or remuneration received by the partner from the firm will be treated as income from business or profession in the hands of the partner under sec.28(v). This is taxable in the hands of the partner, irrespective of the fact whether the same is allowed as deduction to the firm or not.

If, in the case of a partner, there is any unabsorbed share of business loss from a partnership firm for the assessment year 1992-93 or earlier years, it can be set off only against the interest, salary, etc., received from the said firm or other business income in the assessment year 1993-94 or subsequent years subject to the limit of eight years. For claiming the benefit of deduction of such unabsorbed share of loss from the firm, it is necessary that the partner should continue his interest in the said firm and if possible, continue to receive interest, salary,

etc. from the said firm in the assessment year 1993-94 and the subsequent years.

3.7 Tax Deduction at Source:

The new section 194DD, which is proposed to be inserted with effect from 1.6.1992, provides that the firm must deduct tax at source from the amount of interest, salary, bonus, commission or remuneration paid to the partners. The liability to deduct tax at source will arise when credit for the same amount of interest, salary, etc., is given, or when the amount is paid, whichever date is earlier. The tax will have to be deducted at source at the average rate applicable to the amount of interest, salary, etc. The partner has an option to give the particulars of his income by way of interest, salary, etc., from another firm or any other income and request the firm to deduct tax on his aggregate income from all sources. If this is done, the firm will have to deduct tax at source on such aggregate amount and deposit the same before the due date in accordance with the Income-tax Rules. The firm is also required to give a certificate of TDS to the concerned partner.

3.8 Clubbing Provisions:

Some important amendments are proposed to be made in the provisions relating to clubbing of income of spouse and minor children. These can be briefly stated as under:

- (i) Share of income of wife from the firm in which her husband is also a partner will not be clubbed with the income of the husband.
- (ii) Similarly, share of income of a minor who is admitted to the benefits of any partnership firm will not be added to the income of the parent.
- (iii) The position about income of the spouse or minor child who is a beneficiary in a trust which is a partner in a firm will be the same and the share of income of trust will not be added to the income of the other spouse or parent of the minor.
- (iv) Salary, commission, fees or remuneration received by a spouse from a firm or any other concern carrying on business in which the other spouse has substantial interest will now be clubbed even if the spouse receiving salary, etc., possesses technical or professional qualifications and experience.
- (v) In the case of a partnership firm engaged in a profession, the above provision will not apply if the spouse receiving salary, etc., possesses technical or professional qualifications, i.e. a degree or diploma of a recognized university. For this purpose, a member of the Institute of Chartered Accountants or of the Institute of Cost and Works Accountants or the Institute of Company Secretaries will not be covered by the above exception because these Institutes are not recognized universities.

- (vi) It is significant to note that in the case of an assessee, other than a firm (i.e. individual, company, etc.), engaged in a profession, the provisions for clubbing the salary, etc., received by the spouse will apply, even if such spouse possesses technical or professional qualifications stated in (v) above.
- (vii) If an assessee has gifted an asset to the spouse or son's wife, the income from such assets is to be clubbed with the income of the donor, if the gifted amount is invested in a partnership-firm, the share from the firm will not be included in the income of the donor. However, interest on capital invested out of the gifted amount in a partnership firm, in which the donee is a partner, will be included in the income of the donor. Similarly, income from business carried on by donee with the help of the gifted amount will also be included in the income of the donor.
- (viii) Under the scheme for clubbing the entire income of a minor with the income of the parent, whose income is higher, now proposed under the new section 64(1A), any income of the minor by way of interest from the firm, in which he/she is admitted to the benefits of partnership will be clubbed with the income of the parent. If the minor is getting any remuneration from the firm, it will also be similarly clubbed. If such remuneration, however, is being paid for any

manual work done by the minor or for any activity involving application of his specialized knowledge or experience (e.g. activity as a musician or an actor), the clubbing provisions will not apply.

3.9 Conclusion:

The Finance Minister has, however, assured that the Board will be asked to issue instructions to the assessing officers so as to ensure that the powers under sec.40A(2) are not used in the cases of small firms and even otherwise, it should be used sparingly. What instructions the Board issues is yet to be seen, but the instructions alone will not serve the purpose, if the instructions are generally not known to the taxpayers and often much is left to the discretion of the assessing officer.

3.10 Illustrations:

EXAMPLE FOR REGISTERED FIRMS FOR ASSESSMENT YEAR 1992-93

Illustration-1:

A & Company is a registered firm. The partners are A, B and C, sharing business profits and losses in the proportion of 40%, 30% and 30%, respectively. As provided in the agreement, partner-A is entitled to interest amounting to Rs.6,000 on his capital and the firm has charged interest of Rs.1,000 on his drawing. The partners B and C are entitled to salary

of Rs.5,000 and Rs.9,000 respectively. The net profit of the firm for the financial year 31.3.1992 (assessment year 1992-93) is Rs.81,000.

Net profit as per books of account	=	Rs 81,000
<u>add:</u> Interest to partner A on capital account	Rs 6,000	
<u>less:</u> Interest paid to firm by partner A on drawings	<u>1,000</u>	5,000*
Salaries to partners B and C	<u>14,000</u>	<u>19,000</u>
Taxable income		<u>1,00,000</u>
Tax payable by the registered firm for Asstt. year 1992-93 on taxable income of Rs.1,00,000		<u>9,072</u>
Taxable income of the firm		1,00,000
<u>less:</u> Tax payable by the firm		<u>9,072</u>
		90,928
<u>less:</u> Net interest and salaries to partners to arrive at divisible income	<u>19,000</u>	<u>19,000</u>
Income for division amongst partners:		<u>71,928</u>

Allocation amongst the partners as under:

<u>Partner (Share)</u>	<u>Share of divisible income</u> Rs	<u>Interest</u> Rs	<u>Salary</u> Rs	<u>Total</u> Rs
A (40%)	28,771	+ 5,000	+ NIL	= 33,771
B (30%)	21,578	+ NIL	+ 5,000	= 26,578
C (30%)	<u>21,579</u>	+ <u>NIL</u>	+ <u>9,000</u>	= <u>30,579</u>
<u>Total:</u>	<u>71,928</u>	+ <u>5,000</u>	+ <u>14,000</u>	= <u>90,928</u>

Assuming that the partners have no other income liable to income-tax except share from the firm, the taxable income of the partner A will be Rs.33,771 for the assessment year 1992-93. Deduction in respect of life insurance premia, etc., under

section 80C is not allowable as section 80C has been deleted w.e.f. 1.4.1991 (assessment year 1991-92 and onwards); however, under section 88, deduction will be allowed at 20% of the amount paid or invested or deposited by way of life insurance premia, etc., from the income-tax payable on taxable income.

Illustration-2:

EXAMPLES FOR FIRM FOR ASSESSMENT
YEAR 1993-94

(A) Messrs.X and Co. is a trading firm consisting of partners Mr.A and Mr.B, sharing profits/losses equally. As per partnership deed, partner Mr.A is entitled to Rs.18,000 as simple interest @18% p.a. on capital, and working partner, Mr.B. (who is actively engaged in conducting the affairs) of the business of the firm) is entitled to Rs.42,000 as remuneration. These payments are within the limits specified under sec.40(b)(iv) and 40(b)(v). The net profit of the firm (after debiting interest and remuneration to partners) for the financial year ending 31.3.1993 is Rs.10,000.

a. Income-tax payable by the firm:

Net profit (after debiting interest and remuneration to partners)	Rs 10,000
<u>add:</u> Interest and remuneration to partners (Rs.18,000+Rs.42,000)	<u>60,000</u>
	<u>70,000</u>
<u>less:</u> Interest and remuneration paid to partners allowable u/sec.40(b)(iv)/40(b)(v)	<u>60,000</u>
Taxable income of the firm	<u>10,000</u>
Income-tax payable by the firm @40% on taxable income of Rs.10,000	<u>Rs 4,000</u>

b. Income-tax payable by the partners	Mr A	Mr B
Business income:		
Share in total income of the firm (Excludible u/s.10(2A))	nil	nil
Interest/remuneration received from the firm chargeable as business income (u/s 28(v))	18,000	42,000
Other sources:		
Interest income on deposits with companies	30,000	10,000
Gross total income	<u>48,000</u>	<u>52,000</u>
<u>less:</u> Deduction u/sec.80D @100% of medical insurance premia paid Rs.5,000	5,000	5,000
Taxable income	<u>43,000</u>	<u>47,000</u>
Income-tax payable on taxable income of Rs.43,000/Rs.47,000	<u>3,000</u>	<u>3,800</u>
Aggregate of income-tax payable by the firm and partners (Rs.4,000+ Rs.3,000+Rs.3,800)		<u>10,800</u>

(B) In the example (1) above if, partner Mr.A. is entitled to Rs.21,000 as simple interest @21% on capital, working partner Mr.B is entitled to Rs.1,08,000 as remuneration and net profit, after debiting the said interest/remuneration is Rs.10,000 then, the tax payable by the firm and partners will be as under:

a. Income-tax payable by the firm-	
Net profit (after debiting interest and remuneration to partners)	Rs 10,000
<u>less:</u> Interest and remuneration paid to partners (Rs.21,000+Rs.1,08,000)	<u>1,29,000</u>
	1,39,000
<u>less:</u> Interest paid to Mr.A Rs.21,000 (allowable @18% p.a. u/s.40(b)(iv)	<u>18,000</u>
Book profit for the purpose of sec.40(b)(v) vide Explanation 3 to sec.40(b)	1,21,000

<u>less:</u> Remuneration paid to Mr.B. Rs.1,08,000. Allowable u/sec. 40(b)(v)(2):		
On first Rs.75,000 of the book profit @90%	Rs 67,500	
On the balance Rs.46,000 of the book profit @60%	<u>27,600</u>	<u>95,100</u>
Taxable income of the firm		<u>25,900</u>
Income-tax payable by the firm @40% on taxable income Rs.25,900		<u>10,360</u>
b. Income-tax payable by partners:		
Business income	nil	nil
Share in total income of the firm (excludible u/sec.10(2A))	nil	nil
Interest/remuneration allowed to firm chargeable as business income u/s.28(v) read with proviso	18,000	95,100
Other sources:		
Interest income on deposits with companies	<u>30,000</u>	<u>10,000</u>
Gross Total Income	48,000	1,05,100
<u>less:</u> Deduction u/s.80D as stated in example (1)	<u>5,000</u>	<u>5,000</u>
Taxable income	<u>43,000</u>	<u>1,00,100</u>
I.T./I.T.& S.C. payable on taxable income of Rs.43,000/Rs.1,00,100	<u>3,000</u>	<u>21,773</u>
Aggregate of tax payable by the firm and partners (Rs.10,360+Rs.3,000+ Rs.21,773)		<u>35,133</u>