

Issues in Taxation of Partnership

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Special Provisions – Quick Look

Main Provisions - Firm

- ▶ Section 40(b)
 - ▶ Disallowance of interest and remuneration
- ▶ Section 45(4)
 - ▶ Capital Gain – transfer of capital asset by firm to partner
- ▶ Section 78(1)
 - ▶ Carry forward and set off of losses in case of change in constitution of firm or on succession

Main Provisions - Partner

- ▶ Section 10(2A)
 - ▶ Exemption to share in the total income of the firm
- ▶ Section 28(v)
 - ▶ Taxability of interest and remuneration as business income
- ▶ Section 45(3)
 - ▶ Capital Gain – transfer of capital asset by partner to firm

Provisions for Restructuring

- ▶ Section 47(xiii)
 - ▶ Succession of the firm by a company
- ▶ Section 47(xiiib)
 - ▶ Conversion of the company into LLP
- ▶ Section 47A(3) & (4)
 - ▶ Consequences of violation of conditions

Other Provisions

- ▶ Section 184
 - ▶ Assessment as a firm
- ▶ Section 185
 - ▶ Assessment when Section 184 not complied with
- ▶ Section 187
 - ▶ Change in constitution of a firm
- ▶ Section 188
 - ▶ Succession of one firm by another firm

Other Provisions

- ▶ Section 188A

- ▶ Joint and several liability of partners for tax payable by firm

- ▶ Section 189

- ▶ Firm dissolved or business discontinued

- ▶ Section 167C

- ▶ Liability of partners of LLP in liquidation

Interest & Remuneration

Manner of Authorisation in Deed

▶ Section 40(b)

Any payment of remuneration to any partner who is a working partner, or of interest to any partner, which, in either case, is not authorised by, or is not in accordance with, the terms of the partnership deed

▶ Circular No. 739

No deduction under section 40(b)(v) will be admissible unless the partnership deed either specifies the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration

Manner of Authorisation in Deed

- ▶ Anil Hardware Store 323 ITR 368 (HP)
 - ▶ Remuneration clause was exact replica of clause (v)
 - ▶ Manner of quantifying has been provided
- ▶ Sood Brij & Associates 203 Taxman 188 (Del)
 - ▶ Remuneration to be decided by the partners mutually
 - ▶ Not deductible
- ▶ Durga Dass Devki Nandan 341 ITR 17 (HP)
 - ▶ Circular 739 goes beyond the provisions of Sec. 40(b)
 - ▶ 'authorised' vs. 'quantified'

Remuneration for Special Services

- ▶ Whether limitation provided in Sec. 40(b) apply to a consideration paid to partner for providing special services?
- ▶ CIT vs. Packwell (Karnataka) Industries 267 ITR 452 (Mad)
 - ▶ Any expertise that the partner may possess is required to be made available to the firm as a partner
 - ▶ Any remuneration paid to him for making his expertise available is subject to Section 40(b)

Remuneration for Special Services

- ▶ CIT vs. Yoganand Textiles 202 ITR 869 (Guj)
 - ▶ When an individual is a partner, his capacity cannot be split up for ascertaining whether particular remuneration is admissible or not
 - ▶ Section 40(b) does not envisage splitting of capacities of a partner in which he can work and does not warrant a distinction between a partner obliged to work and the one not obliged to work under the terms of a contract or the provision of law
 - ▶ Section 40(b) applies whether remuneration is paid for the purpose of earning profit or whether it is paid out of profit

Remuneration for Special Services

- ▶ Other decisions upholding applicability of Sec 40(b)
 - ▶ R. J. Trivedi & Sons vs. CIT 188 ITR 299 (MP)
 - ▶ V. Balachandra & Bros. vs. CIT (Kar)

Remuneration for Special Services

- ▶ Decisions holding that Sec. 40(b) does not apply
 - ▶ CIT vs. Chitra Kalapana 169 ITR 678 (AP)
 - ▶ Film business – one partner was a story writer and another was a director
 - ▶ HC held that they were under no obligation to write story or direct film for the partnership firm
 - ▶ CIT vs. Dharti Films 191 ITR 261 (Bom)
 - ▶ Commission retained for film distribution by the partner
 - ▶ Something unconnected with the partnership business
 - ▶ Payment is not out of the income of the firm
 - ▶ CIT vs. Rajam Ramaswamy & Sons 298 ITR 325 (Mad)
 - ▶ CIT vs. Gemini Productions 110 ITR 847 (Mad)

Book Profits – Section 40(b)

▶ Explanation 3

For the purposes of this clause, "book-profit" means the net profit, as shown in the profit and loss account for the relevant previous year, computed in the manner laid down in Chapter IV-D as increased by the aggregate amount of the remuneration paid or payable to all the partners of the firm if such amount has been deducted while computing the net profit.

- ▶ Income credited to P & L A/c but not taxable under the head PGBP but other heads
 - ▶ Whether it should be excluded?

Book Profits – Section 40(b)

- ▶ Contentions favouring inclusion
 - ▶ Net profit as shown in the profit and loss account and not the profit computed under the head PGBP
 - ▶ Provisions of Section 80HHC or 33AB were very specific which is not the case with 40(b)
 - ▶ No re-writing of Profit & Loss A/c
 - ▶ In any case, it is just another form of appropriation of profits on which partners are supposed to pay the tax

Book Profits – Section 40(b)

- ▶ Contentions favouring exclusion
 - ▶ Reference to Chapter IV-D makes it clear that it is only that net profit which is taxable under the head PGBP which should be considered
 - ▶ Might result into a situation whereunder deduction is allowed which otherwise is not permissible
 - ▶ E.g. Rent income which is taxable under the head income from house property
 - ▶ Firm having a business howsoever insignificant would be entitled to deduction of remuneration against the whole of its income and firm not having any business won't get any deduction

Book Profits – Section 40(b)

▶ Decisions favouring inclusion

- ▶ Md. Serajuddin & Bros. vs. CIT 24 taxmann.com 46 (Cal.)
- ▶ CIT vs. J.J. Industries 358 ITR 531 (Guj.)
- ▶ S.P. Equipment & Services vs. ACIT 36 SOT 325 (Jaipur)
- ▶ ACIT vs. Sheth Brothers 99 TTJ 189 (Rajkot)
- ▶ Suresh A. Shroff & Co. vs. JCIT 27 taxmann.com 291 (Mum)

▶ Decisions favouring exclusion

- ▶ CIT vs. Allen Career Institute 94 taxmann.com 157 (Raj)

Book Profits – Section 40(b)

▶ CBDT Circular No. 12/2019 dt. 19-6-19

While computing 'book profit' for purposes of section 40(b)(v) of the Act, all incomes such as capital gain, interest, rental income, income from other sources etc. which do not fall under the head 'profit or gain of business or profession', should be excluded

Book Profits vis-à-vis B/fd Losses

- ▶ M/s. Shree Yogeshwar Developers vs.. ITO – Ahmedabad ITAT
 - ▶ Brought forward business loss should not be reduced
 - ▶ First deduction for remuneration and then set-off of b/fd business loss
- ▶ Vikas Oil Mills vs. ITO 95 TTJ 1126 (Jaipur)
 - ▶ Unabsorbed depreciation is required to be reduced
- ▶ Rajmal Lakhichand vs JCIT (ITAT Pune)
 - ▶ Even unabsorbed depreciation is not required to be reduced
 - ▶ First business loss is to be set-off and then unabsorbed depreciation

Withdrawals vis-à-vis Interest

- ▶ Whether interest can be paid on the capital balance without considering the withdrawals of the partners?
 - ▶ Can it be said that withdrawal is of profits for the year and not of the capital?
 - ▶ Provided profits of the year is sufficient
- ▶ Yes - Deval Utensils Factory vs. DCIT 98 TTJ (Pune) 501
 - ▶ Profits accrue from day-to-day
- ▶ No - Architectural Associates vs. ACIT 277 ITR [AT] 35 (Hyd)
 - ▶ Partners do not have right to claim profits on day-to-day basis

Depreciation vis-à-vis Interest

- ▶ Whether is it mandatory for a firm to provide for depreciation on its assets in the books?
 - ▶ Depreciation is claimed u/s. 32
 - ▶ But not provided in the books
 - ▶ So, capital of partners does not get reduced to that extent
 - ▶ Whether interest paid on such a capital without reducing it by providing depreciation is eligible for deduction?
- ▶ Yes - Sri Venkateshwara Photo Studio 33 taxmann.com 360 (Madras)
 - ▶ Explanation 3 has restricted applicability for remuneration
 - ▶ No restriction has been placed under Sec. 40(b)(iv)

Revaluation vis-à-vis Interest

- ▶ Whether interest paid on enhanced capital due to the revaluation of asset is eligible for deduction?
- ▶ ACIT vs. Sant Shoe Store (2004) 88 ITD 524 (Chandigarh ITAT)
 - ▶ Interest is allowable even though the entry by which capital is enhanced is notional
 - ▶ For all practical purposes, these notional entries are as good as real
 - ▶ AO has no power to re-write the books of account
 - ▶ Partners have been taxed on the interest allowed

Revaluation vis-à-vis Interest

▶ Other decisions

- ▶ ITO vs. Amar Garage (2004) 1 SOT 331
- ▶ ITO vs. Pattani Optical & Contact Lens Clinic ITA No. 1027/Mum/2004 – Mumbai ITAT

▶ Contrary decision

- ▶ Kali BMH Systems Pvt. Ltd. [TS-496-ITAT-2017(CHNY)]
 - ▶ The borrowings representing only an increase in the valuation by the firm of its capital asset would not be entitled for interest deduction
 - ▶ Credit of the revaluation of the partner's capital account was inconsistent with the partnership law
 - ▶ Not in accordance with AS-10 too

Interest on Balances in Other Accounts

- ▶ Novel Distributing Enterprises vs. DCIT 251 ITR 704 (Kerala)
 - ▶ Partnership deed authorised payment of interest on balance in capital account
 - ▶ Interest was paid on balance in capital as well as current account
 - ▶ Interest paid on balance in current account was held to be disallowable
 - ▶ Not in accordance with the terms of partnership deed

Rejection of Books vis-à-vis 40(b)

- ▶ Indwell Constructions vs. CIT 232 ITR 776 (AP)
 - ▶ Books of account of assessee-firm were rejected and its income was estimated by applying proviso to section 145
 - ▶ No separate addition on account of interest and salary paid to partners could be made to such estimated income

14A to a Firm - Interest to Partners

- ▶ Whether disallowance as per Section 14A applies to interest paid to the partners?
- ▶ Contentions in favour of no disallowance
 - ▶ Interest and Salary are just another method of appropriating profits to the partners
 - ▶ R.M. Chidambaram Pillai 106 ITR 292 (SC)
 - ▶ Partnership firm has no distinct identity – no lender and borrower relationship
 - ▶ Interest payable to partners cannot be regarded as an ‘expenditure’ per se but it is a deduction governed by Section 40(b)
 - ▶ Interest is taxable in the hands of partners – contra effect

14A to a Firm - Interest to Partners

- ▶ Whether disallowance as per Section 14A applies to interest paid to the partners?
- ▶ Contentions in favour of disallowance
 - ▶ Section 40(b) does not grant deduction but limits the deduction – Section 36(1)(iii) grants deduction of interest
 - ▶ Munjal Sales Corporation 298 ITR 298 (SC)
 - ▶ Interest is not a distribution of profits as it is payable even in case of a loss
 - ▶ It is an 'expenditure' which can be subject to disallowance under Section 14A

14A to a Firm - Interest to Partners

- ▶ Decisions upholding applicability of Sec. 14A
 - ▶ Shankar Chemical Works 12 taxmann.com 461 (Ahmedabad - Trib)
 - ▶ Partners are still taxable even if interest is disallowed u/s. 14A
 - ▶ Proviso to Section 28(v) applies only if disallowance is u/s. 40(b)
 - ▶ Pahilajrai Jaikishan 157 66 taxmann.com 30 (Mumbai - Trib.)
- ▶ Decision holding that Sec. 14A does not apply
 - ▶ Quality Industries 73 taxmann.com 363 (Pune - Trib.)
 - ▶ Referring only to R.M. Chidambaram Pillai 106 ITR 292 (SC) and not Munjal Sales Corporation 298 ITR 298 (SC)

14A to a Partner

- ▶ Whether disallowance u/s. 14A applies in view of exemption claimed with respect to share of profit u/s. 10(2A)?
- ▶ Vishnu Anant Mahajan vs. ACIT [2012] 137 ITD 189 (Ahmedabad) (SB)
 - ▶ It will be difficult to hold that the share income is not excluded from the total income of the partner because the firm has already been taxed thereon
 - ▶ Exemption u/s. 10(2A) is independently applicable
 - ▶ Disallowance u/s. 14A should apply
 - ▶ In the ratio of exempt income to total income from the firm

Sec. 40(b) vs. Sec. 40A(2)

- ▶ CIT vs. Great City Manufacturing Co. [2013] 351 ITR 156 (Allahabad)
- ▶ The assessing officer is only required to see –
 - ▶ Whether the partners are the working partners mentioned in the partnership deed
 - ▶ Terms and conditions of the partnership deed provide for payment of remuneration to the working partners
 - ▶ Whether the remuneration provided is within the limits prescribed under Section 40(b)(v) or not
- ▶ If all the aforementioned conditions are fulfilled then he cannot disallow any part of the remuneration on the ground that it is excessive by invoking Section 40A(2)

Impact of Method of Accounting

- ▶ Deduction available in the hands of the firm though not paid but credited as per the terms of the partnership deed
 - ▶ CIT vs. Supreme Builders [2008] 303 ITR 1 (Punjab & Haryana)
- ▶ Partners would be taxable in the year in which interest and remuneration are credited even if they are following cash system of accounting
 - ▶ ACIT vs. Vijay Kumar Patni [2007] 108 ITD 409 (Nagpur)

Presumptive Scheme

- ▶ Deductibility of interest/remuneration to partners
- ▶ Circular No. 684 – 10.6.1994 –
 - ▶ Deduction to the extent allowed u/s. 40(b) will be allowed
- ▶ Circular No. 737 – 23.2.1996 –
 - ▶ Sec. 40(b) is not an enabling section for claiming deduction
 - ▶ First circular was withdrawn
- ▶ Finance Act, 1997
 - ▶ Retrospective Amendment – inserting proviso allowing deduction of interest/remuneration
- ▶ Finance Act, 2016
 - ▶ Removed that Proviso in Sec. 44AD

Presumptive Scheme

- ▶ Finance Act, 2016
 - ▶ Section 40 does not mandate for allowance of any expenditure but puts restriction on deduction of amounts, otherwise allowable under section 30 to 38
 - ▶ Removed that Proviso in Sec. 44AD
- ▶ Whether a partner is taxable u/s. 28(v)?
 - ▶ Deduction is deemed to have been granted

Presumptive Scheme

- ▶ Whether partner can opt for presumptive scheme in respect of interest and remuneration from a firm?
- ▶ A. Anandkumar vs. ACIT (Chennai ITAT)
 - ▶ Remuneration and interest received from a partnership firm cannot be construed as a gross receipt and turnover of a business independently carried on by a partner
 - ▶ Intention behind introducing the provisions of presumptive taxation u/s 44AD is to help small businesses to comply with taxation provisions and intention was not to apply to partner's remuneration or interest
 - ▶ Said income cannot be taxed on the basis of presumptive taxation u/s 44AD

Is it mandatory?

- ▶ Is it mandatory for the firm to provide interest and remuneration to the partners as per the partnership deed?
 - ▶ Whether the deduction can be thrust upon the assessee?
 - ▶ Whether the partners can be taxed on the ground that income accrues since partnership deed provided so?
- ▶ ITO vs. Mala Tandon – Amritsar ITAT
 - ▶ Firm eligible for deduction u/s. 80-IB
 - ▶ Deed provided for interest and remuneration
 - ▶ Firm did not provide in its books
 - ▶ Held to be not taxable in the hands of the partner

Is it mandatory?

- ▶ Sri Balaji Agencies vs. ITO [2007] 107 TTJ 658 (Chennai)
 - ▶ When partnership deed stipulated that salary to working partners was to be decided by mutual understanding in case there was no sufficient profit and when assessee was neither paying nor making provision to extent permissible under partnership deed, it was implied that partners had agreed to take a lower sum as appearing in partnership accounts
- ▶ Circular 12/2019
 - ▶ Provides for invoking sub-section (10) of Sec. 80-IA only in a case where the firm is enjoying a tax holiday

Failure to furnish ITR

- ▶ Failure to furnish ITR under Section 139
 - ▶ Triggers Section 184(5)
 - ▶ No deduction of interest and remuneration
 - ▶ Not taxable in the hands of partners
- ▶ Radha Picture Palace vs. DCIT 196 Taxman 534 (Ker)
 - ▶ ITR not filed under Section 139
 - ▶ Notice issued under Section 148
 - ▶ ITR filed in response to that notice
 - ▶ Failure has already occurred
 - ▶ Not eligible for deduction of interest and remuneration

Netting off

- ▶ Only excess of interest paid to partners over interest received from partners is subject to disallowance
 - ▶ Keshavji Ravji & Co. vs. CIT [1990] 183 ITR 1 (SC)
- ▶ Exemption from TDS u/s. 194A
 - ▶ Only for interest paid or credited by a firm to a partner of the firm
 - ▶ Not to interest paid or credited by a partner to a firm in which he is a partner
 - ▶ Provided partner is liable to deduct tax at source u/s. 194A

When HUF is a Partner

- ▶ **Rashik Lal & Co. vs. 229 ITR 458 (SC)**
 - ▶ Remuneration paid to individual who represented his HUF will also be hit by Section 40(b)
- ▶ **Explanation 1 & 2**
 - ▶ Clarifies but only in respect of interest

Partner in a firm in	Interest received in	40(b) applicability
Individual capacity	Representative capacity	No
Individual Capacity	Individual Capacity	Yes
Representative capacity	Individual Capacity	No
Representative capacity	Representative capacity	Yes

Applicability of TDS

▶ Salary

- ▶ No TDS u/s. 192 as not chargeable under the head salaries

▶ Interest

- ▶ Specifically excluded in Section 194A
- ▶ TDS u/s. 195 applies in case of non-resident partner

▶ Commission

- ▶ Whether Section 194H applies?
- ▶ No specific exclusion
- ▶ ACIT vs. Assam Tea House (Chandigarh ITAT) - not applicable

Admission, Retirement & Dissolution

Capital Contribution by Partner

- ▶ Section 45(3)
 - ▶ transfer of a capital asset
 - ▶ by a person to a firm in which he is or becomes a partner
 - ▶ by way of capital contribution or otherwise
 - ▶ chargeable to tax as his income of the PY in which the said transfer takes place
 - ▶ amount recorded in the books of account of the firm as the value of capital asset shall be deemed to be the full value of consideration
- ▶ Taxability of capital contribution
 - ▶ In cash – not taxable
 - ▶ In kind (capital asset) –taxable as CG in the hands of partner

Sec. 45(3) vs. Sec. 50C

- ▶ Introduction of an immovable property by a partner in a firm – what is the full value of consideration?
 - ▶ Sec. 45(3) – amount recorded in the books of the firm
 - ▶ Sec. 50C – consideration received or accruing or value adopted or assessed or assessable by stamp duty authority whichever is higher
- ▶ Which one of these two will prevail?

Sec. 45(3) vs. Sec. 50C

- ▶ Contentions in favour of non-applicability of Sec. 50C
 - ▶ Specific provision to prevail over general provision
 - ▶ Sec. 45(3) is a specific provision dealing with introduction of immovable property as capital contribution
 - ▶ Sec. 50C refers to 'consideration received or accruing' – but it is indeterminable as per Sunil Siddharthbhai vs. CIT [1985] 156 ITR 509 (SC)
 - ▶ Intention was not to consider the market value when Sec. 45(3) was introduced

Sec. 45(3) vs. Sec. 50C

- ▶ Sec. 45(3) would prevail over Sec. 50C
 - ▶ DCIT vs. Amartara Pvt. Ltd. [2018] TIOL 125 (Mum ITAT)
 - ▶ ACIT vs. Kethireddy Venkata Mohan Reddy (Hyd. ITAT)
 - ▶ ACIT vs. Moti Ramanand Sagar (Mum ITAT)
 - ▶ ITO vs. Sheila Sen (Kol ITAT)
- ▶ Sec. 50C would prevail over Sec. 45(3)
 - ▶ Carlton Hotel (P.) Ltd. vs. ACIT [2010] 35 SOT 26 (Lucknow) (URO)

Sec. 45(3) & LLP

- ▶ Introduction of a capital asset by a partner in LLP
- ▶ Rule 23 of LLP Rules, 2009

The contribution of a partner consisting of tangible, movable or immovable or intangible property or other benefits brought or contribution by way of an agreement or contract for services shall be valued by a practicing Chartered Accountant or by a practicing Cost Accountant or by approved valuer from the panel maintained by the Central Government

- ▶ Compulsorily required to be recorded as per Valuer's Report

Introduction of a Stock-in-trade

- ▶ Partner introduces stock-in-trade of his individual business in the partnership firm
- ▶ Sec. 45(3) applies to 'the transfer of a capital asset' and not to a stock-in-trade
- ▶ DLF Universal Ltd. vs. DCIT [2010] 36 SOT 1 (Delhi Trib.) (SB)
 - ▶ stock-in-trade does not retain its character as stock-in-trade at the point of time of introduction
- ▶ ITO vs. Orchid Griha Nirman (P.) Ltd. [2016] 74 taxmann.com 187 (Kolkata - Trib.)
 - ▶ 45(3) doesn't apply [later on firm had converted it into a fixed asset – after two years]
- ▶ Applicability of Section 43CA – in case of immovable properties

Corresponding cost

- ▶ What is the cost of the assets contributed by the partner in the hands of a firm?
- ▶ Firm is also treating it as a capital asset
 - ▶ No specific provision
- ▶ Firm is treating it as a stock-in-trade
 - ▶ Sec. 40A(2) applies - ACIT vs. Karuna Estate & Developers [2018] 92 taxmann.com 282 (Visakhapatnam - Trib.)
 - ▶ Excessive or unreasonable value recorded in the books can be disallowed
 - ▶ Though the partner has been taxed on that value

Applicability of Sec. 56(2)(x)

- ▶ Partnership Firm receiving specified property from its partner
 - ▶ Value recorded in books is lower than SDV/Rule 11UA value
 - ▶ Whether the difference is taxable u/s. 56(2)(x) in the hands of a firm?
- ▶ Value recorded in books cannot be regarded as a 'consideration'
- ▶ Sunil Siddharthbhai vs. CIT [1985] 156 ITR 509 (SC)
 - ▶ Contributing partner derives consideration which is not measurable in present
 - ▶ It lies within the womb of the future

Applicability of Sec. 56(2)(x)

- ▶ CIT vs. Marudhar Hotel (P) Ltd. [2004] 269 ITR 310 (Rajasthan HC)
 - ▶ Total consideration is incapable of determination (in the context of Gift-Tax Act)
 - ▶ Difference between the value of asset introduced and amount at which it was recorded in the books of the firm was held to be not liable to gift-tax

Applicability of Sec. 56(2)(x)

- ▶ Admitted partner is given share which was disproportionate to the capital introduced by him
 - ▶ Whether he is liable to tax u/s. 56(2)(x)?
 - ▶ Assuming firm is holding specified properties
- ▶ Partner does not receive any of the properties which are specified in Sec. 56(2)(x)
 - ▶ Firm continues to be the owner of those properties
- ▶ He receives right to share profit and get the share in surplus upon dissolution
- ▶ What he contributes is not only capital but also labour, efforts, expertise etc.

Distribution by Firm

- ▶ Section 45(4)
 - ▶ transfer of a capital asset
 - ▶ by way of distribution of capital assets
 - ▶ on the dissolution of a firm or otherwise
 - ▶ chargeable to tax as the income of the firm of the PY in which the said transfer takes place
 - ▶ FMV of the asset as on the date of such transfer shall be deemed to be the full value of consideration
- ▶ Taxability of capital asset distributed
 - ▶ In cash – not taxable
 - ▶ In kind (capital asset) – taxable as CG in the hands of firm

Is there a 'transfer'?

- ▶ Section 45(4) triggers provided there is 'transfer' of a capital asset
- ▶ Malabar Fisheries Co. v. CIT [1979] 120 ITR 49 (SC)
 - ▶ Prior to introduction of Sec. 45(4)
 - ▶ Mutual adjustment of rights and no extinguishment of firm's right in the assets which can be considered as 'transfer' as defined u/s. 2(47)
- ▶ No amendment to Sec. 2(47) though Sec. 45(4) was introduced
- ▶ CIT v. Moped and Machines, 281 ITR 52 (MP) – held that there is no transfer even post insertion of Sec. 45(4)
- ▶ Taxability u/s. 45(4) upheld -
 - ▶ CIT vs. A.N. Naik Associates [2004] 265 ITR 346 (Bombay)
 - ▶ Suvadhan vs. CIT [2006] 156 Taxman 229 (Karnataka)

Distribution upon Retirement

- ▶ CIT vs. A.N. Naik Associates [2004] 265 ITR 346 (Bombay)
 - ▶ The word 'otherwise' takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of a retiring partner
- ▶ Burlingtons' Exports vs. ACIT [1993] 45 ITD 424 (BOM.)
 - ▶ Even withdrawal of asset by the partners covered within the scope of 'otherwise'
 - ▶ But only if it is not for a consideration

Distribution upon Retirement

- ▶ Another angle to the controversy
- ▶ Interpretation of the word 'distribution'
- ▶ ACIT vs. Goyal Dresses [2010] 126 ITD 131 (Chennai)
 - ▶ SC in the case of Punjab Distilling Industries Ltd. v. CIT [1965] 57 ITR 1 expounded that the term 'distribution' necessarily involves the idea of division among several persons which is the same as payment to several persons
 - ▶ In this view of the matter, the expression used in section 45(4) 'distribution of capital assets on the dissolution of a firm or otherwise' cannot be extrapolated to bring retirement of one partner into the ambit of this section.

Distribution upon Retirement

- ▶ Taxability of Firm
 - ▶ Payment in cash to retiring partner
 - ▶ Not taxable
 - ▶ CIT vs. Dynamic Enterprises [2013] 359 ITR 83 (Karnataka) (FB)
 - ▶ Payment in kind (capital asset) to retiring partner
 - ▶ Capital Gain is chargeable to tax u/s. 45(4)
 - ▶ CIT vs. A.N. Naik Associates [2004] 265 ITR 346 (Bombay)

Retirement – Taxability of Partner

- ▶ Settlement amount is equal to the capital balance (without any adjustments)
 - ▶ Not taxable at all
- ▶ Settlement amount is more than the capital balance
 - ▶ Determination may be based on –
 - ▶ Notional sale of assets and settlement of liabilities
 - ▶ Revaluation of assets
 - ▶ Creation of Goodwill
 - ▶ Lumpsum
 - ▶ Either settled in cash or in kind

Retirement – Taxability of Partner

- ▶ Settlement amount is more than the capital balance
 - ▶ Issue of taxability may arise –
 - ▶ Whether taxable as capital gains?
 - ▶ Whether taxable under Section 28?
 - ▶ Whether taxable under Section 56(2)(x)?

Retirement – Taxability of Partner

- ▶ Taxability as capital gain – is there a ‘transfer’ by the retiring partner?
 - ▶ Mohanbhai Pamabhai (Guj) – No
 - ▶ Tribhuvandas G. Patel (Bom) – Yes
 - ▶ H.R. Aslot (Bom) & N.A. Modi (Bom) – followed this view
 - ▶ L. Raghu Kumar (AP)
 - ▶ followed Guj HC’s view and dissented from Bom HC’s view
 - ▶ Supreme Court
 - ▶ Affirmed Gujarat High Court’s view
 - ▶ Reversed Bombay High Court’s view
 - ▶ Affirmed Andhra Pradesh High Court’s view

Retirement – Taxability of Partner

- ▶ CIT vs. Mohanbhai Pamabhai 91 ITR 393 (Guj)
 - ▶ Dispute was on taxability of proportionate share in goodwill received by the retiring partner
 - ▶ Interest of a partner in the partnership is not interest in any specific item of the partnership property
 - ▶ It is a right to obtain his share of profits from time to time during the subsistence of the partnership and on dissolution of the partnership or his retirement from the partnership, to get the value of his share in the net partnership assets which remain after satisfying the debts and liabilities of the partnership
 - ▶ What he receives is his share in the partnership and not any consideration for transfer of his interest in the partnership to the continuing partners

Retirement – Taxability of Partner

- ▶ CIT vs. Mohanbhai Pamabhai 91 ITR 393 (Guj)
 - ▶ There is no element of transfer of interest in the partnership assets by the retiring partner to the continuing partners
 - ▶ Neither relinquishment of the capital asset nor extinguishment of any rights in it
 - ▶ It is not possible to predicate that a particular amount is received by the retiring partner in respect of his share in a particular partnership asset or that a particular amount represents consideration received by the retiring partner for extinguishment of his interest in a particular partnership asset

Retirement – Taxability of Partner

- ▶ CIT vs. Mohanbhai Pamabhai 91 ITR 393 (Guj)
 - ▶ Held to be not taxable as capital gains
 - ▶ SC affirmed the view of Gujarat HC
 - ▶ 165 ITR 166 (SC)

Retirement – Taxability of Partner

- ▶ Tribhuvandas G. Patel (Bom)
 - ▶ Retirement of a partner can take either of two forms
 - ▶ If instead of quantifying his share by taking accounts on the footing of notional sale, parties agree to pay a lump sum in consideration of the retiring partner assigning or relinquishing his share or right in the partnership and its assets in favour of the continuing partners, the transaction would amount to a transfer within the meaning of section 2(47) of the Act
 - ▶ N.A. Modi (Bom) and H.R. Aslot (Bom) followed this view
 - ▶ SC reversed the view of Bom HC - [1999] 236 ITR 515 (SC) relying upon the decision in the case of Mohanbhai Pamabhai

Retirement – Taxability of Partner

- ▶ *Sudhakar M. Shetty vs. ACIT 130 ITD 197 (Mumbai)*
 - ▶ Entered into a partnership with Mr. Rakesh Wadhwan
 - ▶ Later on, wife of the assessee, Hemlata Shetty, was admitted as a partner
 - ▶ Firm purchased a property for setting up a hotel
 - ▶ Hemlata Shetty retired on 27-3-2006
 - ▶ Assessee retired on 22-5-2006
 - ▶ Before their retirement, the property was revalued
 - ▶ Rs.30.87 cr was credited to their capital account as share in revaluation surplus

Retirement – Taxability of Partner

- ▶ Sudhakar M. Shetty vs. ACIT 130 ITD 197 (Mumbai)
 - ▶ AO taxed it as a STCG by treating it as a consideration for relinquishing interest in the firm
 - ▶ Before ITAT, assessee relied upon Mohanbhai Pamabhai (SC)
 - ▶ ITAT followed Tribhuvandas G. Patel (Bom)
 - ▶ Retiring partner assigned or relinquished his share or right in the partnership and its assets in favour of continuing partners
 - ▶ Lump sum consideration was paid in return
 - ▶ Not a case of quantifying share by taking account on the footing of notional sale
 - ▶ It was held to be taxable as capital gains

Retirement – Taxability of Partner

- ▶ Other Decisions taking the view similar to Sudhakar M. Shetty (Mum)
 - ▶ Girija Reddy vs. ITO 52 SOT 113 (Hyderabad)
 - ▶ Shevantibhai C. Mehta vs. ITO 4 SOT 94 (Pune)
 - ▶ Savitir Kadur vs. DCIT [2019] 177 ITD 259 (Bangalore - Trib.)
 - ▶ Latest decision
 - ▶ Excess amount paid over and above credit balance in capital account is taxable
 - ▶ However, value of goodwill should be included in the credit balance of the capital

Retirement – Taxability of Partner

- ▶ Hemlata S. Shetty vs. ACIT (Mumbai ITAT)
 - ▶ Another retiring partner's case
 - ▶ Denied to follow the decision in the case of Sudhakar M. Shetty
 - ▶ Decision of Sudhakar M. Shetty was reversed by a later decision
 - ▶ R.F. Nangrani HUF vs. DCIT – ITA 6124/Mum/2012
 - ▶ Relied upon the decision of Bom HC in the case of Riyaz A. Shaikh (2014) 14 taxmann.com 455

Retirement – Taxability of Partner

- ▶ Hemlata S. Shetty vs. ACIT (Bom HC)
 - ▶ Revenue had filed the appeal before Bombay HC
 - ▶ It was argued that she was paid huge amount only for a short duration for which she remained the partner
 - ▶ Admitted on 6-9-2005
 - ▶ Retired on 27-3-2006
 - ▶ HC held it to be not taxable
 - ▶ Liability is on the firm and not on the partner u/s. 45(4)
 - ▶ Relied upon Prashant Joshi & Riyaz Sheikh

Retirement – Taxability of Partner

- ▶ D. S. Corporation vs. ITO (Mum Third Member)
 - ▶ Case of same partnership firm from which Sudhakar Shetty and Hemlata Shetty had retired
 - ▶ AO taxed the whole revaluation surplus in the hands of the partnership firm u/s. 45(4)
 - ▶ ITAT deleted the addition
 - ▶ Land acquired by the partnership firm continued to be owned by the said firm even after reconstitution without any extinguishment of rights in favour of the retiring partners
 - ▶ Money equivalent to enhanced portion of the assets re-valued does not constitute capital asset within the meaning of section 2(14)
 - ▶ No transfer of capital asset by way of distribution of capital asset

Retirement – Taxability of Partner

- ▶ Conclusion – no capital gain in the hands of retiring partner in the absence of a transfer
- ▶ Supreme Court
 - ▶ CIT vs. Mohanbhai Pamabhai [1987] 165 ITR 166
 - ▶ Tribhuvandas G. Patel vs. CIT [1999] 236 ITR 515
 - ▶ CIT vs. R. Lingmallu Raghukumar [2002] 247 ITR 801
- ▶ Bombay High Court
 - ▶ Prashant S. Joshi vs. ITO [2010] 324 ITR 154
 - ▶ CIT vs. Riyaz A. Sheikh [2014] 41 taxmann.com 455
 - ▶ PCIT vs. R.F. Nangrani HUF [2018] 93 taxmann.com 302 (Bombay)
 - ▶ PCIT vs. Hemlata S. Shetty

Retirement – Taxability of Partner

▶ Andhra Pradesh High Court

▶ Chalasani Venkateswara Rao vs. ITO [2012] 349 ITR 423

▶ CIT vs. P.H. Patel [1988] 171 ITR 128

▶ Madras High Court

▶ CIT vs. Legal Representatives of N. Paliniappa Goundar (Decd.) [1983] 143 ITR 343

▶ Kerala High Court

▶ CIT vs. Kunnamkulam Mill Board [2002] 257 ITR 544

Retirement – Taxability of Partner

▶ Other Issues –

- ▶ Will it make any difference if the retiring partner has been paid by the continuing partners directly?
- ▶ Fresh capital introduced by the continuing partners to pay the settlement amount to the retiring partner – whether interest paid on it is eligible for deduction?
 - ▶ Is it a borrowing for the purpose of business?

Retirement – Taxability of Partner

- ▶ Taxability under Section 28
 - ▶ Capital receipt not chargeable to tax under Section 28 unless specifically covered
 - ▶ Prashant S. Joshi vs. ITO [2010] 324 ITR 154 (Bom)
 - ▶ Section 28(iv) does not apply to benefits which are paid in cash or money
 - ▶ A payment made to a partner in realization of his share in the net value of the assets upon his retirement from a firm does not fall under clause (v) of section 28
 - ▶ CIT vs. P.H. Patel [1988] 171 ITR 128 – not taxable as future profits
 - ▶ James P. D’Silva vs. DCIT [2019] 175 ITD 533 (Mumbai - Trib.)

Retirement – Taxability of Partner

- ▶ Taxability under Section 56(2)(x)
- ▶ Retiring by receiving cash equivalent to his share in the underlying properties on fair value basis
 - ▶ Vasumati Prafullachand Sanghavi vs. DCIT [2018] 168 ITD 585 (Pune - Trib.)
 - ▶ Where assessee received amount at the time of her retirement from partnership firm after surrendering her right, title and interest, same was said to be received for consideration and, thus, same was not taxable in hands of assessee under section 56(2)(vi)
 - ▶ Firm and continuing partners are not taxable as not receiving any property

Retirement – Taxability of Partner

- ▶ Taxability under Section 56(2)(x)
- ▶ Retiring by receiving balance in capital ignoring fair valuation of his share which might be higher
 - ▶ Retiring partner is receiving less than his pre-existing rights
 - ▶ Whether continuing partners are taxable in such case – constructive receipt of specified property?
 - ▶ No – CGT vs. T.M. Louiz [2000] 112 Taxman 622 (SC)
 - ▶ There is no transfer of property by the retiring partner to the continuing partner

Retirement – Taxability of Partner

- ▶ Taxability under Section 56(2)(x)
- ▶ Retiring by receiving specified property
 - ▶ Specified value (SDV/FMV) is higher than the value of share of the retiring partner on a fair value basis
 - ▶ Whether the difference is taxable?
 - ▶ Whether the exclusion will apply if the other partners are the relatives of the retiring partner?

Change in PSR

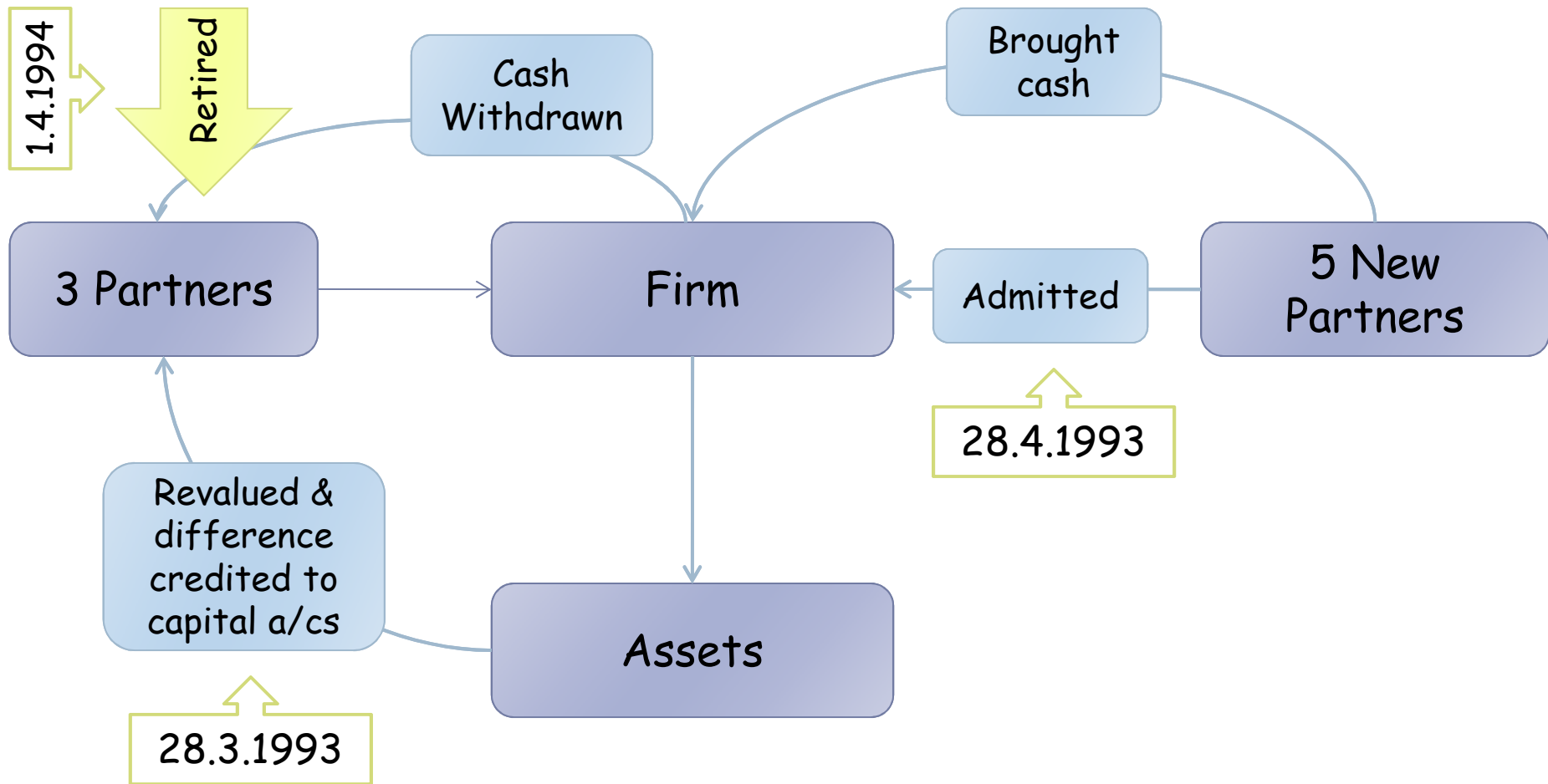
- ▶ CIT vs. P.N. Panjawani [2013] 356 ITR 676 (Karnataka)
 - ▶ Firm consisting of 3 partners sharing $1/3^{\text{rd}}$ each
 - ▶ Owning land
 - ▶ 4 new partners were admitted
 - ▶ Share of each of existing partners was reduced from $1/3^{\text{rd}}$ to $1/6^{\text{th}}$
 - ▶ Land was revalued and correspondingly existing partners withdrew their share of Rs.1.16 crore each
 - ▶ Held that it is not taxable as CG in the hands of old partners u/s. 45(1)

Admission & Retirement

- ▶ Admission of new partners followed by retirement of all existing partners
 - ▶ New partners introduce capital in cash
 - ▶ Retiring partners take away cash in settlement
 - ▶ What is the tax impact?

Admission & Retirement

► CIT vs. Dynamic Enterprises 359 ITR 83 (Kar)(FB)



Admission & Retirement

- ▶ CIT vs. Dynamic Enterprises 359 ITR 83 (Kar)(FB)
 - ▶ S. 45(4) does not apply if the retiring partner takes only money towards the value of his share and there is no distribution of capital assets
 - ▶ Property belongs to the partnership firm and not to the partners
 - ▶ Partners only had a share in the partnership asset when they retired and took their share in cash, they were not relinquishing their interest in the immovable property
 - ▶ It cannot be considered as a device adopted to evade payment of tax

Admission & Retirement

- ▶ Electroplast Engineers [TS-168-HC-2019(BOM)]
 - ▶ 15-1-2010 – 3 new partners were admitted
 - ▶ 16-1-2010 – original 2 partners retired
 - ▶ Goodwill was recognized at Rs.3.75 crore
 - ▶ Retiring partners were paid to that extent
 - ▶ AO taxed it u/s. 45(4) in the hands of the firm
 - ▶ Bombay HC followed Karnataka HC's view in Dynamic Enterprises
 - ▶ No CG u/s. 45(4) in the absence of transfer of capital asset
 - ▶ But, observed that Revenue has not argued that the reconstitution of the firm was a colourable device to avail tax liability.

Admission & Retirement

- ▶ Impact of GAAR in such cases
 - ▶ Main purpose is to obtain tax benefit?
 - ▶ Subject to threshold of 3 crores in aggregate for all parties
 - ▶ Continuation of old partners with a nominal share – would it make any difference?
 - ▶ CIT vs. P.N. Panjawani [2013] 356 ITR 676 (Karnataka) – if existing partners continue it cannot be said that either the firm is a dubious one or the entire transaction is a colourable device and the only object is to avoid payment of tax

Succession & Conversion

Succession of Firm by Company

- ▶ Section 47(xiii)
 - ▶ Conditional exemption
- ▶ CIT vs. Texspin Engineering and Manufacturing Works 263 ITR 345 (Bom)
 - ▶ Not taxable even otherwise
 - ▶ Statutory vesting of properties
- ▶ CIT vs. Ravishankar R. Singh TS-437-HC-2018(Bom)
 - ▶ Followed Texspin's case
 - ▶ SLP dismissed by SC - TS-436-SC-2018
- ▶ CIT vs. Umicore Finance Luxemborg
 - ▶ Non-compliance of condition of Sec. 47(xiii) would not make the company liable

Conversion of Co. into LLP

- ▶ Section 47(xiii b)
 - ▶ Conditional exemption
- ▶ Aravali Polymers LLP v. JCIT [2014] 47 taxmann.com 335 (Kolkata - Trib.)
 - ▶ Non-compliant conversion is taxable
 - ▶ Capital Gain in the hands of company

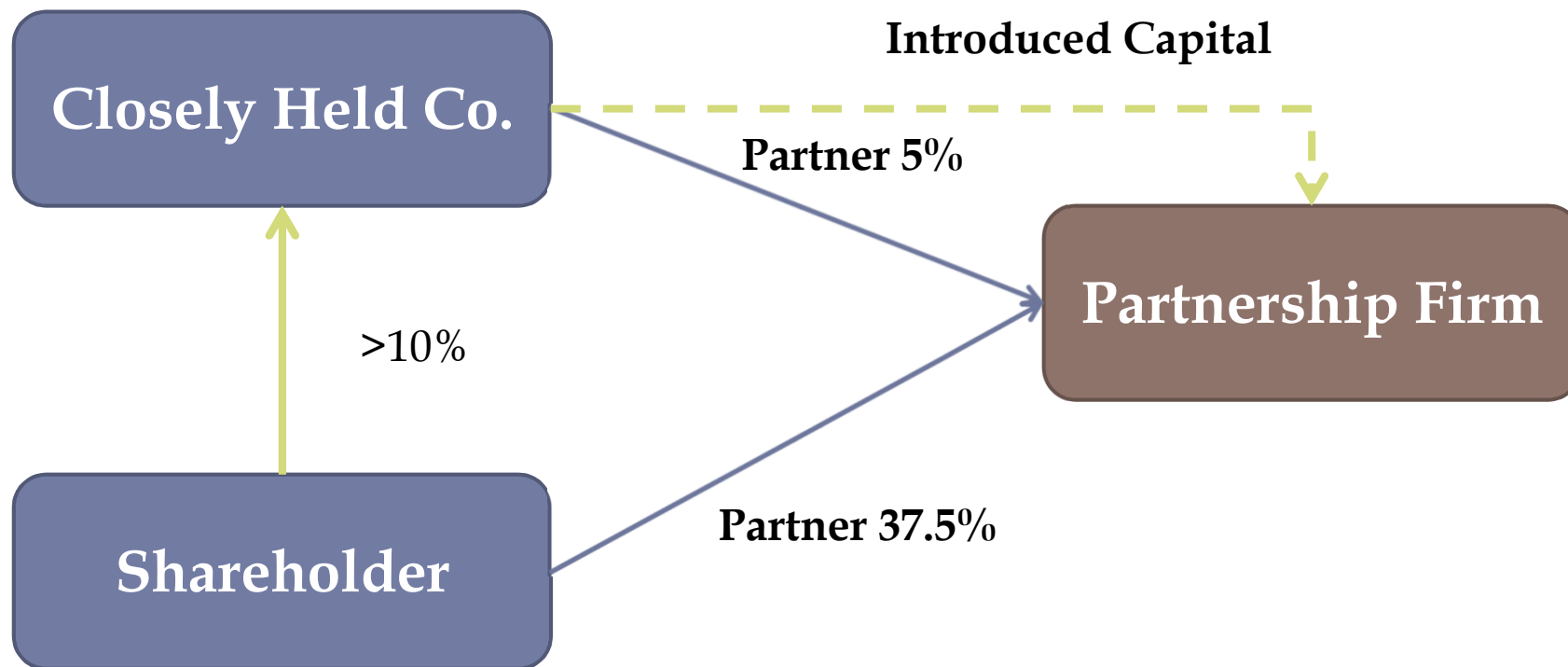
Conversion of Co. into LLP

- ▶ ACIT vs. Celerity Power LLP
 - ▶ [2019] 197 TTJ 45 (Mumbai)
- ▶ Co. was converted into LLP
 - ▶ Conditions of 47(xiiib) were not satisfied
- ▶ Conversion of company into LLP amounts to 'transfer'
- ▶ Computation provision is rendered unworkable and, hence, no capital gains
 - ▶ Book value is the full value of consideration
 - ▶ No difference between transfer value and cost of acquisition

Company as a Partner

Deemed Dividend

- ▶ Lala Mohan Ramchand
- ▶ Mumbai ITAT - BCAJ Sept 17



Deemed Dividend

- ▶ Lala Mohan Ramchand
 - ▶ Mumbai ITAT - BCAJ Sept 17
- ▶ AO: Disproportionate investment of capital as compared profit sharing
- ▶ Capital contribution \neq loan or advance
- ▶ Partnership Act does not contemplate capital contribution to be in proportion of profit sharing ratio
- ▶ Capital was not used for personal benefit of shareholder but for business of firm
- ▶ Held to be not falling u/s. 2(22)(e)

MAT – Loss from Firm

- ▶ CD Equifinance Pvt. Ltd. vs. DCIT
 - ▶ 2018-TIOL-938-ITAT-KOL
- ▶ Assessee co. is a partner in a partnership firm
- ▶ Its share in the loss of partnership firm of Rs.18,91,12,786 was debited to P & L A/c
- ▶ Section 115JB – provides for only reduction of income exempt u/s. 10 if credited to the statement of profit and loss
- ▶ AO & CIT (A) took the view that ‘income’ includes ‘loss’ and added it to the book profits

MAT – Loss from Firm

- ▶ ITAT relied upon
 - ▶ DCIT vs. Metro Exporters Ltd. 10 SOT 647 (Mum)
- ▶ Clause refers not only to ‘income’ but also ‘credited’ to the P & L A/c
- ▶ Deeming provision to be interpreted strictly
- ▶ Adjustment of ‘expenditure’ relating to exempt income also doesn’t apply as ‘loss’ is not an ‘expenditure’

MAT – Loss from Firm

- ▶ DCIT vs. Fixit (P) Ltd.
 - ▶ [2018] 95 taxmann.com 188 (Chennai - Trib.)
- ▶ Share of loss is nothing but share of negative income
- ▶ Loss is nothing but negative profit
- ▶ Held that loss from a partnership firm is required to be added back to the book profits u/s. 115JB

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Miscellaneous

Keyman Insurance Premium

- ▶ PCIT vs. Ramesh Steels [2016] 384 ITR 437 (Punjab & Haryana)
 - ▶ Premium paid on 'Keyman insurance policy' taken on life of partners is allowable as business expenditure
- ▶ Circular No. 38/2016 dated 22-11-2016

It is a settled position that in case of a firm, premium paid by the firm on the Keyman Insurance Policy of a partner, to safeguard the firm against a disruption of the business, is an admissible expenditure under section 37 of the Act

Keyman Insurance Premium

- ▶ Tax treatment upon assignment of policy by firm in favour of the partner
 - ▶ DCIT vs. Manjit Kumar [2014] 65 SOT 117 (Amritsar - Trib.)
 - ▶ Ravi Poddar vs. ACIT [2017] 164 ITD 104 (Jaipur - Trib.)

269SS/269T – Loans from Partners

▶ Not applicable

- ▶ CIT v. Lokhpat Film Exchange (Cinema) [2008] 304 ITR 172 (Raj.)
- ▶ Muthoot Financiers [2015] 371 ITR 408 (Del)
- ▶ CIT vs. V. Sivakumar [2013] 354 ITR 9 (Mad)
- ▶ CIT v. Saini Medical Store. [2005] 277 ITR 420 (P & H)
- ▶ CIT v. Sunil Kumar Goel. [2009] 315 ITR 163

▶ Contrary decision

- ▶ Soundarya Textiles vs. ACIT [2014] 362 ITR 488 (Kerala)

Applicability of Tax Audit to Partners

- ▶ Whether interest and remuneration from firm should be included in 'turnover' or 'gross receipt'?
- ▶ Kolkata ITAT - Yes
 - ▶ Amal Ganguly vs. DCIT
 - ▶ Usha A. Narayanan vs. DCIT
 - ▶ Natarajan Ramesh Rajan vs. DCIT
 - ▶ Sagar Dutta vs. DCIT
- ▶ Mumbai ITAT - Yes
 - ▶ Suhail Amin Nathani vs. ACIT

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