



Taxation

Taxation of Partnership Firms

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Scope

1. Provisions from 1993 to 2021- an overview
2. Amendments by Finance Act 2021 to section 9B & 45(4) Revisited
3. Amendments by Finance Act 2024 an analysis

Definition of Partnership

Section 2(23) of Income Tax Act, 1961

Firm will include a Limited Liability Partnership formed under The Limited Partnership Act(LLP) and partner will include partner of an LLP

Section 4 of The Indian Partnership Act, 1932

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

Who can be a partner

All the three elements are essential

1. Firm cannot be a partner

Dulichand Laxminarayan v. CIT (1956) 29 ITR 535 (SC)

2. Charitable Trust can be a partner

J.K. Hosiery Factory v. CIT (1971) 81 ITR 557 (All.)

3. Wakf Cannot be partner

Hoosen Kasam Dada (a firm) v. CIT (1937) 5 ITR 182 (Cal.)

Who can be a partner

4. Karta & Member can form partnership

Chandrakant Manilal Shah v. CIT (1992) 193 ITR 1 (SC)

5. Firm is not a distinct legal entity from its partners

Malabar Fisheries Co. v. CIT (1979) 120 ITR 49 (SC)

6. Karta a member of an HUF is partner . The firm recognises the individual. The Karta is responsible to the HUF

Rashik Lal & Co 96 Taxman 16 (SC)

Taxation of Firm & Partner

- Firm taxed on its income after deduction of remuneration to working partners and interest to partners
- Remuneration & interest disallowable u/s 40(b)- disallowance restricted to amounts in excess of limits set out in the section
- Circular no.739 dated 25-3-1996
- Remuneration & interest taxable as business income Section 28(v)
- To the extent not permissible as a deduction in terms of section 40(b)- not taxable proviso to section 28(v)

Remuneration (Section 40(b))

- Should not be disallowable in terms of 37(1) or 40A(2)
- Should be paid only to a working Partner
- Such remuneration is authorised by and is in accordance with partnership deed
- Circular no. 12/2019 dated 19-6-2019
- It is related to period falling on or after the date of such partnership deed
- It should be within the limits specified in subclause (v) of clause (b) of section 40

Remuneration (Book Profit)

- Book Profit means
- Net profit as per Profit & Loss Account after all adjustments u/s 28 to 44D
- Aggregate remuneration paid or payable to all working partners if it has been deducted while computing net profit.

Remuneration {Section 40(b)}

- Should not be disallowed u/s 36(1)(iii), 40(a)(i) or 40A(2)
- Such interest is authorised by and is in accordance with partnership deed
- It is related to period falling on or after the date of such partnership deed
- It should be within the limits specified in clause (iv) of section 40 (b) (12% p.a. Simple Interest)

Taxability of Partners

- Salary, bonus, interest, commission, etc received by partners taxable u/s 28(v) under the head 'Profits and Gains of Business or Profession'
- Share of Profit / Loss is exempt u/s 10(2A)

Issues prior to 2021

1. In computing book profit is carry forward business loss of the past years to be deducted ?
2. Is partners remuneration allowable from presumptive income u/s 44AD/ 44ADA
3. Is a partner of firm which is carrying on a profession, entitled to adopt presumptive taxation u/s 44ADA for the remuneration he/she earns

Issues prior to 2021(contd)

4. What is the tax status of remuneration paid to a person who is a partner as Karta of a HUF in the firm
5. How is allowability of remuneration to be determined in the case of a firm which follows cash method of accounting.

Issues prior to 2021(contd)

6. In computing Book Profit are the following to be included

- Capital Gain
- Section 50 income
- Interest on Fixed Deposit

7. If the remuneration of a partner crosses the threshold u/s 44AB, is he/she liable to tax audit?

8. In regard to the deductibility of expenditure from remuneration / interest earned by a partner what is the impact of section 14A.?



Amendments by Finance Act 2021 w.e.f. AY 2021-22

Objective

Memorandum

In this regard, it has been noticed that there is uncertainty regarding applicability of provisions of aforesaid sub-section to a situation where assets are revalued or self-generated assets are recorded in the books of accounts and payment is made to partner or member which is in excess of his capital contribution.

Provisions - Introduced

Section 9B - inserted

- Refined version of old section 45(4)

Section 45(4)- replaced

- New provision to tax gain of partners

Section 48

- Clause (iii) - benefit of step-up cost

Definitions - Section 9B Explanation

Specified person

- A person who is -
 - Partner of a firm
 - Member of other AOP or BOI
- in any previous year

Definitions - Section 9B Explanation

contd.

Reconstitution of the specified entity

- a) One or more of its partners ceases to be partners
- b) One or more new partners are admitted in such specified entity
- At least one person who was a partner before the change should continue as a partner even after the change
- a) All the partners continue with a change in their respective share or in the shares of some of them

Definitions Explanation I to section 45(4)

Self-generated goodwill / self-generated asset

Goodwill or asset, as the case may be

- which has been acquired without incurring any cost for purchase or
- which has been generated during the course of the business or profession

Section 9B

Income on receipt of capital asset or stock in trade by specified person from specified entity

Section 9B

Sub-section (1)- Point of Taxation

- Where a Specified Person receives during the previous year
- any capital asset or stock in trade or both
- from a Specified Person
- in connection with
- the dissolution or reconstitution of such Specified Person

Section 9B

Sub-section (1)- Result

- Deemed transfer of such
- capital asset or stock in trade or both
- by the Specified Entity
- to the Specified Person

The year of transfer is the year of receipt of the capital asset or stock in trade by the specified person

Section 9B

Sub-section (2)- Charging Provision

- Profits or gains arising from such deemed transfer shall be
- deemed to be income of such Specified Entity
- of the Previous Year in which such Capital Asset or Stock In Trade were received by the Specified Person
- chargeable to income-tax as income of the Specified Entity under the head Profits or Gains at Business Profession or Capital Gains
- in accordance with the provisions of this Act

Section 9B

Sub-section (3)- Computational Provision

- FMV of the Capital Asset or Stock In Trade on the date of its receipt by the Specified Person
- Deemed to be the full value of consideration received or accruing as a result of deemed transfer

Section 9B

Sub-section(4)

- Guidelines for the purposes of removing the difficulty can be issued by the CBDT with the approval of the Central Government
- Circular No. 14 of 2021 dated 2-7-2021
- Sub-section(5)
- Guideline shall be binding on the IT Authorities and the assesseees

Section 45(4)

Main Provision -

- Any profits or gains arising from such receipt by the Specified Person
- shall be chargeable to income-tax
- as income of such Specified Entity
- under the head Capital Gains
- shall be deemed to be the income of such Specified Entity of the Previous Year in which such money or Capital Asset or both were received by the Specified Person

Section 45(4)

- Computational Provision
- Non-obstante clause
- Notwithstanding anything to the contrary contained in this Act
- Profits or gains shall be determined in accordance with the formula
- $A = B + C - D$

A → Capital Gain

B → Value of Money Received

C → Fair Market Value of Capital Asset on Date of receipt

D → Balance in the Capital Account of the Specified Person at the time of reconstitution

Section 45(4)

- "A" can't be negative
- It shall be deemed to be zero if it is negative
- Loss can't be claimed by the Specified Entity
- Balance in capital account
- Represented in any manner
- Without taking into account the increase due to revaluation of any asset or due to self-generated goodwill or any other self-generated asset

Section 45(4)

- Explanation 2
- Receipt of a Capital Asset by a Specified Person from a Specified Entity in connection with its reconstitution
- Section 9B & 45(4) shall operate simultaneously
- taxation under section 9B shall be worked out independently

Section 9B

Taxing gain of a firm
If assets are
transferred Capital
Gain & Business
Income $FMV - Cost$

Section 45(4)

Taxing gain of a
partner
If money or assets
are received
Only Capital Gains
 $Money + FMV -$
Capital

Both taxable in the hands of a firm

Section 48(iii)

- Clause (iii) - deductible amount while computing Capital Gain
- In case of money or capital asset received by a Specified Person from a Specified Entity referred to in sec. 45(4)
- Amount chargeable to income-tax as income of such Specified Entity under sec. 45(4)
- which is attributable to the capital asset being transferred by the Specified Entity
- calculated in the prescribed manner(Rule 8AB)

Rationale of Section 48(iii)

Memorandum

This is to mitigate the double taxation which may have happened but for this provision in a situation where an asset which was revalued and for which income under the proposed sub-section (44) of section 45 of the Act was brought to tax is transferred subsequently by the specified entity.

The impact of section 9B, 45(4), 48(iii) and Rules 8AA, 8AB

Sec. 9B

- Taxes realised gain of the firm

Sec. 45(4)

- Appreciation in value of the firm's assets - unrealised gain of the firm
- Share of partner - realised by him at the time of reconstitution, if any
- Taxable to that extent - preponement of taxation

Sec. 48(iii)

- Neutralizes taxation which was preponed
- Deduction of unrealised gain already taxed while taxing realised gain subsequently

Rule 8AA Determines Nature of Capital Gains

Rule 8AB Prescribes manner of attribution

Some issues in section 9B and 45(4)

- a) What will be the impact if the specified person received consideration from the other partners and not the specified entity?
- b) If the retiring partner's debit balance in his capital account is waived, will it be considered as a receipt in his hands?
- c) What is the impact if the receipt is spread over more than one year?
- d) Whether 9B or 45(4) will apply when money or assets are given to legal heir of deceased partner?
- e) Will the provisions apply if the reconstitution has taken place prior to 01/04/2020 as the provisions are effective from AY 2021-22?

Amendments by Finance Act No. (2) of 2024

- Amendment of 40(b)(v)
- Insertion of section 194T

Provision Impacting Firms

- Section 40(b)(v),

Present Provision -

The remuneration to any working partner of a firm assessable as such, is allowable as expenditure in hands of such firm as under :

(a) On first Rs. 3,00,000 of the book-profit or in case of a loss	Rs. 1,50,000 or at the rate of 90 percent of the book-profit, whichever is more
(b) On the balance of the book-profit	At the rate of 60 percent

Amendment -

(a) On first Rs. 6,00,000 of the book-profit or in case of a loss	Rs. 3,00,000 or at the rate of 90 percent of the book-profit, whichever is more
(b) On the balance of the book-profit	At the rate of 60 percent

Firm may have to consider amending partnership deed both in regard to quantum of remuneration and re-organisation of capital.

Provision Impacting Firms (Contd)

Insertion of new Section 194T

w.e.f. 01st April 2025 –

- (1) Any person, being a firm, responsible for paying any sum in the nature of salary, remuneration, commission, bonus or interest to a partner of the firm, shall, at the **time of credit** of such sum to the account of the partner (including the capital account) or at the **time of payment** thereof, whichever is earlier shall, deduct income-tax thereon **at the rate of 10%**.
- (2) No deduction shall be made under sub-section (1) where such sum or the aggregate of such sums credited or paid or likely to be credited or paid to the partner of the firm does not **exceed twenty thousand rupees** during the financial year.

Provision Impacting Firms (Contd)

Insertion of new Section 194T (Contd.)

Issue involved –

- When the actual payment of remuneration is different from the remuneration allowable what would be the consequence
- Methodology of determining the nature of payment
- Tax Implication if firm follows cash basis accounting

A blue ballpoint pen is shown in the process of writing the words "Thank you!" in a cursive script on a white, slightly crumpled piece of paper. The pen is positioned at the end of the word "you!".

Thank you!