

# TAXATION OF FIRMS

## SECTION 184: ASSESSMENT AS A FIRM

A firm shall be assessed as a firm if:

Partnership is evidenced by an instrument

& Individual shares of the partners are specified in the instrument

### OTHER CONDITIONS:

- (a) Copy of the instrument of partnership certified by all partners (other than minor partners) should be furnished with the return of income of the previous year in respect of which assessment as a firm is first sought.
- (b) Where any change in constitution had taken place in the previous year, firm to furnish certified copy of the revised instrument of partnership along with the return of income for the assessment year relevant to such previous year.

## CASES WHERE SALARY AND INTEREST PAID TO PARTNERS BE DISALLOWED EVEN IF CONDITIONS OF 40(b) ARE SATISFIED

1. Failure on part of the firm as referred to in section 144.
2. Non-compliance with the technical requirements of section 184 by the firm.

Such salary and interest shall not be taxable in hands of partner.

## SECTION 187: CHANGE IN CONSTITUTION OF FIRM

Where during the course of assessment under section 143/ 144/ 147, it is found that a **change has occurred in the constitution of a firm, assessment shall be made on the firm as constituted at the time of making the assessment.**

### Note:

**There is a change in the constitution of the firm in the following two cases:**

- (a) - One or more partners cease to be partners/ one or more new partners are admitted; and
- **One or more partners before the change, continue as partner after the change**

(b) All/ some of the partners continue with a change in the respective shares.

However, nothing in clause (a) shall apply where the firm is dissolved on the death of any of its partners.

### SECTION 188: SUCCESSION OF ONE FIRM BY ANOTHER FIRM

Where a firm carrying on a business or profession is succeeded by another firm, and the case is not one covered by section 187, **separate assessment** shall be made on the predecessor firm and the successor firm as under:

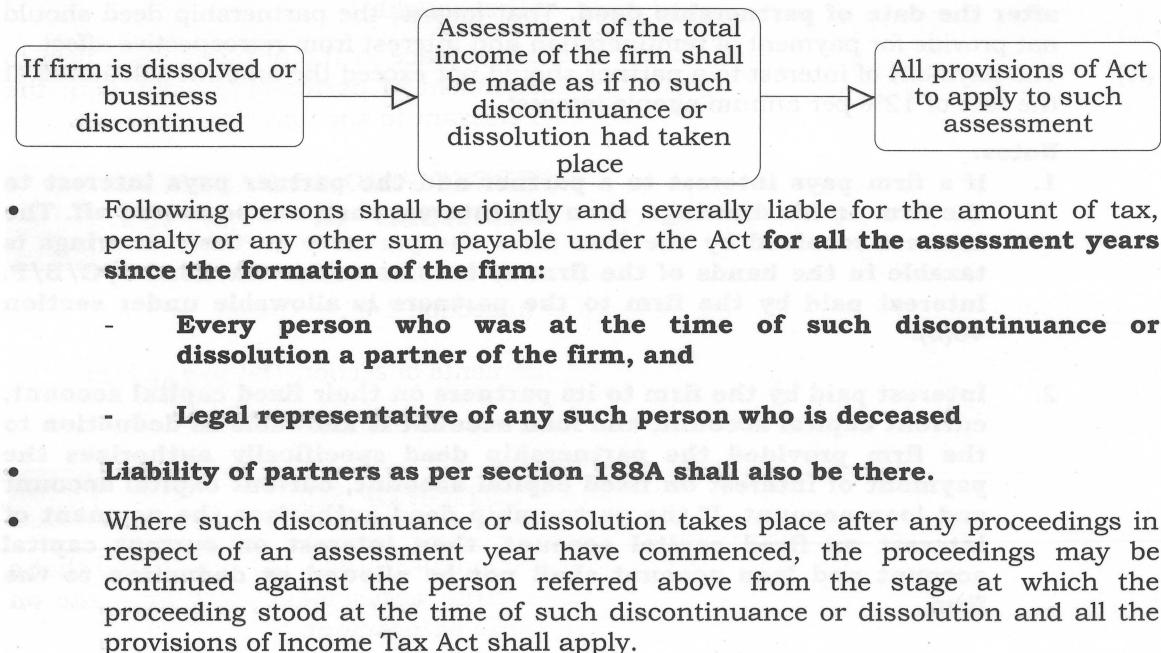
Predecessor firm shall be assessed → Upto the date of succession  
Successor firm shall be assessed → After the date of succession

### SECTION 188A: JOINT & SEVERAL LIABILITY OF PARTNERS FOR TAX PAYABLE BY FIRM

Following persons shall be **jointly and severally liable along with the firm** for the amount of tax, penalty or other sum payable by the firm for any previous year:

- Every partner of the firm **during such previous year**; and
- Legal representative of any deceased partner.

### SECTION 189: FIRM DISSOLVED OR BUSINESS DISCONTINUED



### TAXATION OF FIRMS AND ITS PARTNERS: PROVISIONS IN BRIEF

1. Flat tax rate of 30% plus 12% surcharge where total income exceeds ₹1 crore (+4% health & education cess).  
LTCG taxable under section 112 and STCG taxable under section 111A. LTCG referred in section 112A are taxable as per section 112A.

2. Shares of partners in the total income of the firm is EXEMPT in the hands of partners under section 10(2A).
3. Remuneration and interest paid to the partners is allowed as deduction to the firm subject to the limits and conditions specified in section 40(b).
4. Remuneration and interest received by the partners shall be taxed in their hands as P/G/B/P under section 28(v). However, salaries and interest which have not been allowed under section 40(b) or section 184(5) or section 185 shall not be added to the income of the partners under section 28(v).

**SECTION 40(b): PAYMENT OF INTEREST, SALARY, BONUS,  
COMMISSION OR REMUNERATION MADE BY  
FIRM TO ITS PARTNERS**

Interest and remuneration paid to the partners by a firm are not deductible. **However, the interest and remuneration paid to partners by a firm are deductible if all the following conditions are satisfied:**

- (i) Payment of **salary, bonus, commission or remuneration**, by whatever name called (hereinafter referred as remuneration) **is to a working partner**. If it is paid to a non-working partner, the same shall be disallowed.
- (ii) The remuneration shall be admissible only if the **partnership deed either specifies the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration**.
- (iii) The payment of remuneration and interest should relate to a **period falling after the date of partnership deed**. That means, the partnership deed should not provide for payment of remuneration and interest from retrospective effect.
- (iv) The payment of interest to a partner should not exceed the amount calculated at the rate of 12% per annum simple interest.

**Notes:**

1. If a firm pays interest to a partner and the partner pays interest to the firm on his drawings, then the interest shall not be netted off. The interest received by the firm from the partners on their drawings is taxable in the hands of the firm as income under the head P/G/B/P. Interest paid by the firm to the partners is allowable under section 40(b).
  2. Interest paid by the firm to its partners on their fixed capital account, current capital account, and loan account is allowable as deduction to the firm provided the partnership deed specifically authorizes the payment of interest on fixed capital account, current capital account and loan account. If the partnership deed authorizes the payment of interest on fixed capital account, then interest on current capital account and loan account shall not be allowed as deduction to the firm.
- (v) The payment of remuneration should not exceed the following amounts (Any amount in excess will be disallowed):
    - (a) On the first ₹3,00,000 of book profit or in case of a loss ₹1,50,000 or at the rate of 90% of the book profit, whichever is more
    - (b) On the balance of book profits. at the rate of 60%

**Following adjustment should be made to the Net Profit under P/G/B/P for computation of Book Profits:**

- (i) Only the income under the head **P/G/B/P** is to be taken.
- (ii) Current year and brought forward **depreciation is to be deducted.** (Section 32)
- (iii) Brought Forward **Losses will not be deducted.** (Section 72 )
- (iv) **Chapter VI-A deductions are also not to be deducted.**
- (v) **Remuneration is to be added back** if it is debited to Profit & Loss Account.
- (vi) **Interest paid to the partners** to the extent it is **deductible shall not be added back.**

### **CONDITIONS FOR ALLOWABILITY OF REMUNERATION AND INTEREST PAID BY THE FIRM TO ITS PARTNERS**

<b><u>Allowability of Remuneration</u></b>	<b><u>Allowability of Interest</u></b>
1. To a working partner.	1. To a working/ non-working partner.
2. To an individual only.	2. To any partner.
3. Should be authorised by partnership deed.	3. Should be authorised by partnership deed.
4. In the partnership deed: <ul style="list-style-type: none"><li>- either specify the amount of remuneration payable to each partner, or</li><li>- lay down the manner of quantification of remuneration to each partner.</li></ul>	4. Rate of interest should be specified in the partnership deed.
5. Remuneration should not be retrospective.	5. Interest should not be retrospective.

### **EXPLANATION 1 TO SECTION 40(b)**

**Where an individual is a partner in a firm in a representative capacity, then interest paid by the firm to him in individual capacity, shall not be taken into account for the purposes of section 40(b).**

### **EXPLANATION 2 TO SECTION 40(b)**

**Where an individual is a partner in a firm in his individual capacity, then interest paid by the firm to such individual shall not be taken into account for the purposes of section 40(b), if such interest is received by him on behalf, or for the benefit of any other person.**

**Note:**

Salary paid to partner representing his HUF has to be disallowed; further salary paid to partners in their individual capacity who had joined firm as partners representing their respective HUFs too has to be disallowed.

## SECTION 10(2A): INCOME EXEMPT FROM TAX

**Share in the total income of the firm shall be exempt in the hands of the partner.**

### CBDT Circular

It is clarified that 'total income' of the firm for section 10(2A) of the Act, includes income which is exempt or deductible under various provisions of the Act. It is, therefore, further clarified that the income of a firm is to be taxed in the hands of the firm only and the same can under no circumstances be taxed in the hands of its partners. Accordingly, the entire profit credited to the partners' accounts in the firm would be exempt from tax in the hands of such partners, even if the income chargeable to tax becomes NIL in the hands of the firm on account of any exemption or deduction.

### For example:

Total income for the firm before deduction under Chapter VI-A	100 lakh
<b>Less:</b> Deduction under section 80-IA	100 lakh
Taxable Income	<b>Nil</b>

Let's say profits as per books of account are also ₹100 lakh. There are two partners of the firm sharing profits equally. Now ₹50 lakhs is credited to capital account of each partner. **CBDT has clarified that although total income of the firm is Nil, yet ₹50 lakhs each credited to each partner's capital account is exempt under section 10(2A).**

## SECTION 78: CARRY FORWARD AND SET OFF OF LOSSES

1. The losses and unabsorbed depreciation can be carried forward by a firm only.
2. **Section 78(1)** provides that where a **change in constitution of firm takes place on account of retirement of partner or death of the partner** then, the firm shall not carry forward and set off the following brought forward losses:

Share of the retired/ deceased partner in the brought forward losses of the firm	<b>x</b>
<b>Less:</b> Share of the retired/ deceased partner in the current year profit	<b>y</b>
	<b>x - y</b>

**(x - y) can not be carried forward by the firm or its partners.**

### Notes:

- Section 78(1) does not apply if change in constitution takes place on admission of a new partner or if all partners remain with a change in profit sharing ratio.
- **Section 78(1) does not apply to brought forward depreciation.**

## CAN REMUNERATION PAID TO THE PARTNER BE DISALLOWED UNDER SECTION 40A(2)

**CIT v. Great City Manufacturing Co. (All):** Where conditions prescribed under section 40(b)(v) are satisfied, the A.O. cannot disallow any part of the remuneration under section 40A(2) on the ground that it is unreasonable and excessive.