

**Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes**

North Block, New Delhi, the 19th of June, 2019

Subject: 'Assessment of Firms'-some of the important issues to be kept under consideration by the Assessing Officers while framing assessment-reg.-

C&AG had carried out a Performance Audit regarding '*Assessment of Firms*' under the Income-tax Act, 1961 ('Act') and in its Report No. 7 of 2014, has made certain suggestions so that in future, assessments in these cases are handled in a more effective manner by the Assessing Officers (AOs). Various recommendations made by the C&AG in its Report have been duly considered by the Board. In order to improve the quality of assessments being framed in these cases and also to reduce the scope for committing errors, the Board desires that Assessing Officers should duly take into consideration the following issues while making assessments in case of firms:

(i) Expenses in the hands of the firm such as interest on capital paid to the partners, remuneration payable to the working partners etc. are taxable in the hands of respective partners. Therefore, while framing assessment in case of firms, a cross-verification of such amounts with income-tax return of firm's partner will be desirable and any discrepancy between the tax return of a firm and its partners should be dealt with as per provisions of the Act. Further, AOs should invariably call for a copy of the partnership deed during the course of assessment proceedings and examine it carefully so that instances of payment of remuneration to any non-working partner or remuneration payment for period prior to the date of partnership deed but claimed as deductible are identified and cognizance of these are duly taken in assessment.

(ii) Section 40(b)(iv) stipulates following three conditions for allowability of interest to the partners of a firm:

- a) the payment should be in accordance with the terms of the partnership deed; and
- b) it should relate to any period falling after the date of such partnership deed; and
- c) it should not exceed the amount calculated at the rate of twelve percent simple interest per annum.

Instances have been noticed where the interest in the partnership deed was stated to be below twelve percent, yet, the same was allowed at the rate of twelve percent by the AO. Such mistakes should be avoided. Further, in case the rate prescribed in the partnership deed is in excess of twelve percent, the excess should be disallowed in assessment. The AO is also required to

ascertain whether payment of interest is duly authorized by the partnership deed or not. Further, while calculating interest payable to the partners for purposes of section 40(b)(iv) of the Act, AOs are taking different yardsticks for calculating interest viz. opening balance of capital, closing balance of capital, fixed capital or current capital etc. In this regard, section 40(b)(iv) of the Act prescribes that payment of interest to partners should be authorized by and be in accordance with the partnership deed. Therefore, while framing assessment, AOs should refer to the terms of the partnership deed for purpose of computation of interest on capital payable to a partner.

(iii) Clause (ii) and (v) of section 40(b) of the Act lays down that payment of remuneration to a working partner should be authorized by the partnership deed, be in accordance with the terms of the partnership deed, should relate to a period after the partnership deed and should also not exceed the maximum amounts prescribed therein. However, it has been noticed that in some assessments, AOs had allowed expenditure on remuneration to the working partners though the same was either not authorized by the partnership deed or was in excess of the amount specified therein. In order to prevent recurrence of mistakes and allowing the expenditure strictly as per provisions of the Act, the AOs should ensure that claim under section 40(b)(v) of the Act is allowed only after a thorough verification of the partnership deed. Further, while computing remuneration which is allowable to a working partner under section 40(b)(v) of the Act, the term '*in accordance with the terms of the partnership deed*' in clauses (ii) and (v) of section 40(b) of the Act implies that remuneration should not be undetermined or undecided. Hence, in all situations, partnership deed should form the basis for determination of remuneration payable to the working partners. Furthermore, in situations where the remuneration either so specified in the partnership deed or computed as per the method indicated therein falls short of the amount allowable under section 40(b)(v) of the Act, it would be restricted to the figure computed on the basis of the partnership deed.

(iv) While computing remuneration payable to the working partners under section 40(b)(v) of the Act, the remuneration should not exceed a particular aggregate amount which is based upon the figure of 'book profit'. The *Explanation 3* to section 40(b) of the Act contains definition of 'book profit' for the purposes of determination of remuneration of the partners and provides that 'book profit' shall mean the net profit, as shown in the profit & 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 calculating the net profit. Therefore, 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.

(v) AOs are advised to apply the provisions of Chapter XVI of the Act in assessment of firms whenever required. It should be taken into consideration that under section 185 of the Act, any non-compliance by the firm or its partners with provisions of section 184 of the Act may result in denial of

expenses such as remuneration, interest etc. payable to the partners which are otherwise allowable under the provisions of the Act.

(vi) It has also come to notice that some firms try to inflate the profits eligible for deduction under section 80IA of the Act by not claiming expenditure towards remuneration, salary, interest etc. which are payable to the partners. In such situations, Assessing Officers may examine these transactions in light of provisions of sub-section (10) of section 80IA of the Act which empower Assessing Officer to re-compute profit of the eligible business after excluding the profits of the related activity/business which produced the excessive profit.

(vii) While framing assessments in case of firms claiming carry forward and set off of losses, Assessing Officers are requested to verify such claims taking into consideration provisions of section 78 of the Act which disallow such a carry forward and set off in case of change in constitution of the firm or on succession.

(viii) Regarding the issue concerning possible action against the tax auditor for furnishing incomplete information in the Tax-Audit Report and effective utilization of information in the Tax Audit Report by the Assessing Officers, it is reiterated that directions given earlier viz. Instruction No. 09/2008 dated 31.07.2008 of CBDT should be followed scrupulously by the field authorities.

2. It is hereby clarified that this circular would also be applicable to limited scrutiny cases if the assessee is a registered firm.

3. This Circular may be brought to the notice of all concerned.

4. Hindi version to follow.

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(Rajarajeswari R.)
Under-Secretary (ITA.II), CBDT

(F.No. 225/54/2014/ITA.II)

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