

Executive Summary

- Partnership Firms (Firms) along with Association of Persons (AOPs) and Body of Individuals (BOIs) constitute one of the major businesses apart from the corporate sector in India. Firms are governed by India Partnership Act, 1932. The Income Tax Act, 1961 (Act) provides various exemptions and deductions to the Firms. Income Tax Department (ITD) has the responsibility to oversee that the conditions specified in provisions of the Act for availing exemptions/ deductions are fulfilled. The main objective of the present review is to seek an assurance that system and procedures of the ITD are sufficient relating to provisions of the Firms vis-a-vis existence of proper machinery within the ITD to exercise necessary checks/controls in the area of potential misuse of the provisions of the Act.
- The returned income of the Firms¹ has increased from ₹ 36,942 crore in Assessment Year (AY) 09 to ₹ 51,482 crore in AY 12. Firms pay income tax at the rate of 30.90 percent², however, effective tax rate in their case is only 23.80 percent³ as number of tax concessions are given to Firm assessees. This necessitates examination of the veracity of exemptions/ deductions allowed to the partnership Firms vis-à-vis the claims made by the Firms.
- We requisitioned 27,944 assessment records relating to Firms, out of which ITD produced and we audited 26,328 records. We have highlighted 1,497 cases involving a tax effect of ₹ 328.04 crore relating to systemic, compliance and control issues in assessment.
- We have pointed out inconsistencies and lack of clarity in the Act which has resulted in incorrect assessments and short levy of taxes. Besides, we have highlighted lapses in allowance of exemptions/ deductions to the Firms and inadmissible remuneration/interest to their Partners. We have also brought out compliance and internal control issues of ITD indicating deficiencies in quality of assessments and internal control mechanism.
- We noticed in 937 cases having a tax effect of ₹ 16.95 crore wherein Assessing Officers (AOs) did not cross verify/co-relate the return of income of the Partners with that of the respective assessee Firms. AOs allowed deductions to the Firms for salary and interest without

¹ As per data provided by DGIT (Systems).

² 30 per cent plus cess of 3 per cent.

³ Source: Receipts Budget, FY 14.

submission/ verification/ certification of the partnership deed. We also noticed that the Partners of the Firms claimed excess exemption under section 10(2A) of the Act and no interest was charged on the withdrawals/debit balances in the Partners' capital account (paragraphs 2.3 – 2.8)

- We further noticed in 227 cases having a tax effect of ₹ 65.72 crore wherein ITD had allowed (a) expenditure on remuneration paid for a period prior to the date of the deed, (b) expenditure on remuneration paid to the Partners who were not actively engaged in the affairs of the Firm and (c) expenditure on remuneration which was not authorized or paid in excess of the amount specified in the partnership deed. ITD also allowed deduction for expenditure on payment of interest to the Partners (a) which was more than the rate prescribed/authorised in the partnership deed, (b) where the rate prescribed in the partnership deed was exceeding the limits provided under the Act and (c) which was not authorized in the deed. ITD allowed book profit for the purpose of remuneration without excluding capital gain, interest income and income from other sources with the profits shown in the Profit & Loss Account. We also observed that the Firms were availing more exemptions/deduction by inflating profits through non-payment of remuneration/interest to their Partners and ITD allowed carry forward/set-off of losses pertaining to the retired/deceased Partner to the subsequent year (paragraphs 3.2 – 3.9).
- We noticed 287 cases with a tax effect of ₹ 244.57 crore, where the provisions of the Act were not followed during the assessments (paragraphs 4.2 – 4.8).
- With respect to internal audit, we noticed that the Commissioners of Income Tax did not carry out inspections/ reviews of assessment orders. ITD did not give importance to their internal audit as it was neither conducted nor did it cover the Firms assessment records. ITD did not effectively utilize the information available in the Tax Audit Reports and maintain updated registers required for effective control of various functions.
- With the view to streamline the assessment of Firms in India, we have made recommendations relating to systemic issues, inconsistencies in the Act and internal control by the ITD which are placed under 'Summary of Recommendations' and at the end of each Chapter.

Summary of Recommendations

With reference to systemic issues relating to Firms and their Partners

1. The Ministry may maintain complete database of Firms and devise a suitable mechanism to keep track of unregistered Firms and ensure filing of their ITR.
2. The Ministry may consider linking the returns of Partners and their Firm so that AOs are able to verify the transactions. The Ministry may also make it compulsory for the Firms to declare their Partners' name and PAN in the ITR.
3. The Ministry may devise a software module to monitor receipt of first partnership deed and revised partnership deed in order to regulate the claims in regard to salary/remuneration/profit sharing/ rate of interest on Partners' capital. The Ministry may also collect information regarding any change from the Registrar of Firms (to whom such changes are required to be reported as per the Partnership Act) so as to have effective control over assessment of the Firms.
4. The Ministry may amplify the explanation to section 10(2A) so as to give proper meaning of total income of the Firm to be divided among the Partners in the cases where the total income is reduced due to deduction/ exemption.
5. The Ministry may clarify whether non-legal entities viz. Firms, Body of Individuals, Association of Persons can be Partners in a Firm in order to avoid inconsistencies in composition of the Partners.
6. The Ministry may clarify on the consistent and harmonious application of section 14A with reference to exempt income specified under section 10(2A). The Ministry may also consider making it mandatory for the Firm to prepare financial statements incorporating current year as well as previous year's figures so as to facilitate application of provision of section 14A read with rule 8D.

With reference to special provisions of exemption/deduction to the Firms

7. ITD may ensure compliance with the prescribed provisions (i) specific to Firms as laid down in Chapter XVI, (ii) relating to set off/ carry forward of losses of retiring/ deceased Partners and (iii) for deduction in respect of remuneration and interest as claimed by the Firms.

8. The Ministry may clarify the 'base amount' of the Partners' capital on which the interest is to be calculated for allowance of interest under section 40(b)(iv) of the Act.
9. The Ministry may resolve the conflict between provision of section 40(b)(v) of the Act and CBDT circular no. 739 dated 25 March 1996 regarding quantification of remuneration in the partnership deed.
10. The Ministry may clarify the manner of computation of book profit in respect of payment of remuneration of Firms and ensure that AOs apply the uniform approach consistently.
11. The Ministry may consider introducing an enabling provision in the statute for compulsory charging of interest on partner's capital and payment of remuneration by the Firms availing exemption/deduction under sections 10A/10B/80IA/80IB/80IC/80IE of the Act.

With reference to Assessment of Firms

12. CBDT may devise a mechanism to improve the quality of assessments and explore the possibility of capacity building for Assessing Officers for reducing the incidence of mistakes.

With reference to Internal Control

13. ITD may strengthen its internal control and monitoring mechanism to ensure compliance with the instructions, rules, circulars and provisions of the Act. The Ministry may also take appropriate action against the third parties for incorrect certification in Tax Audit Report and may make concerted efforts required for recovery of arrears or write-off of irrecoverable arrears.
14. ITD may ensure that all required registers are maintained by their field units which may be checked for compliance by the Internal Audit Party.