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Report of the Comptroller and Auditor General of India

The Report has been laid on the table of the Parliament house on 18-07-2014

Assessment of Firms

Union Government

Department of Revenue - Direct Taxes

Report No. 7 of 2014

Report of the Comptroller and Auditor General of India

for the year ended March 2013

Performance Audit on Assessment of Firms

Union Government
Department of Revenue-Direct Taxes
Report No. 7 of 2014

Laid on the table of Lok Sabha/Rajya Sabha on…………………….

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Preface

The Report for the year ended March 2013 containing the results of the performance audit of Assessment of Firms has been prepared for submission to the President under Article 151(1) of the Constitution of India.

The audit of Revenue Receipts – Direct Taxes of the Union Government is conducted under Section 16 of the Comptroller and Auditor General of India (Duties, Powers and Conditions of Service) Act, 1971.

Our findings are based mainly on test audit conducted from April to July 2013.

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 Firms[1] 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 *percent*[2], however, effective tax rate in their case is only 23.80 *percent*[3] 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

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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.

Chapter I: Introduction

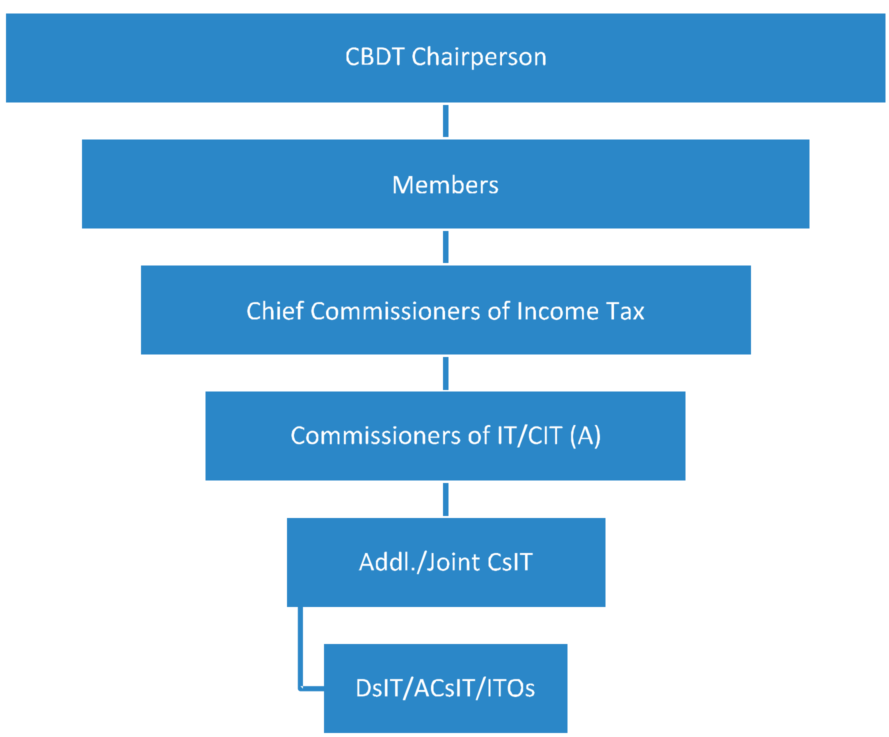
1.1 Introduction

Partnership Firm is one of the forms of business organization and a common vehicle for carrying on business activities in India. Apart from the corporate sector, large business is also organized as partnership Firm. The Income Tax Act, 1961 (Act), does not define the term 'Firm'; however, section 2(23) of the Act states that Firm, Partner and Partnership have the meanings respectively assigned to them in the Indian Partnership Act, 1932. As per the amendment made by Finance Act, 2009, the provisions of taxation applicable to partnership Firm, are applicable to a Firm constituted under Limited Liability Partnership Act, 2008.

1.2 Organizational set-up

Central Board of Direct Taxes (CBDT), as a part of Department of Revenue, Ministry of Finance, is the apex body charged with administration of Direct Taxes. CBDT is headed by the Chairperson and comprises of six Members. In addition to functions and responsibilities, the Chairperson and Members are responsible for exercising supervisory control over field offices of the CBDT, known as Zones. Chief Commissioner of Income Tax (CCIT) heads the field office whose jurisdiction is generally co-terminus with the state. Each CCIT is assisted by CsIT, Additional/Joint CsIT, Deputy CsIT, Assistant CsIT and ITOs.

Graph 1.1: Organogram of CBDT



1.3 Why we chose the topic

There has been steady growth in the Income Tax Return of partnership Firms[1] (Firms) as given below in table 1.1.

Table 1.1: Firms assessees vs Return income

Assessment Years	Firms (in lakh)	Return Income (₹ in crore)
AY 09	7.18	36,942
AY 10	7.60	41,781
AY 11	7.75	45,647
AY 12	6.99	51,482

Firms pay income tax at the rate of 30.90 *per cent* (30 *per cent* plus cess of 3 *per cent*) and contribute maximum to the tax collection made from non-corporate assessees. However, the effective tax rate in their case is only 23.80 *per cent*[2] as number of tax concessions are given to the Firm assessees. Apart from various tax concessions availed by the Firms, their Partners are also getting exemptions on the distributable profits of the Firms.

Every year, in the Compliance Audit Reports of the Comptroller and Auditor General of India, we include draft paragraphs relating to Firms on various compliance issues. In the past, we did not examine the issue of co-relation of Firms and their Partners and its overall impact in the taxation with subsequent gain/loss to the exchequer.

Thus, we undertook the Performance Audit on 'Assessment of Firms' to seek assurance that system and procedures are sufficient within the Income Tax Department (ITD) with respect to assessment of Firms/Partners and there exists a proper machinery to exercise necessary checks/controls in the area of potential misuse of the provisions relating to tax concessions.

[1] As per the database made available by DGIT-Systems, New Delhi.
[2] Source: Receipts Budget, FY 14.

1.4 Legal provisions

Chapter XVI of the Act stipulates special provisions applicable to the Firms. Other provisions of the Act as applicable to other assessees are also applicable to them. Provisions specific to the Firms are summarized below:

Section 184	• A Firm shall be assessed as Firm if the partnership is evidenced by an instrument and individual shares of the Partners are specified in that instrument.
Section 187	• Where at the time of making an assessment, it is found that a change has occured in the constitution of a Firm, the assessment shall be made on the Firm as constituted at the time of making the assessment.
Section 188	• Where a Firm is succeeded by another Firm, separate assessments shall be made on the predecessor Firm and the successor Firm.
Section 189	• Where any business or profession carried on by a Firm has been discontinued or Firm is dissolved, the AO shall make an assessment of the total income of the Firm as if no discontinuance or dissolution had taken place.
Section 40 (b)	• Conditions for claiming deduction of remuneration and interest to the Partners.
Section 45 (3) Section 45 (4)	• The profits and gains arising from the transfer of a capital asset by a Partner of a Firm shall be chargeable to tax as his income. • The profits or gains arising from the transfer of a capital asset by way of distribution of capital assests on the dissolution of a Firm shall be chargeable to tax as income of the Firm.
Section 78	• Where there is a change in the constitution of the Firm, the Firm shall not be entitled to carry forward and set-off of so much of loss proportionate to the share of a retired/deceased Partners.

1.5 Audit Objectives

The objectives of the Performance Audit are to focus on the following:

a. ensuring sufficiency of system, procedures and compliance with the provisions of the Act/Rules;

b. proper application of relevant sections and provisions of the Act;

c. existence of system to co-relate assessment of Firms and their Partners;
d. checking the Internal Control Mechanism of the ITD;
e. highlighting the lacunae or ambiguities in the provisions of the Act and deficiencies, if any, in the administration or policy relating to the assessment of Firm.

1.6 Audit scope

We covered the assessments of Firms completed during financial years (FYs) from FY 11 to FY 13 and up to June 2013.

1.7 Sample size

We filtered and segregated data provided by Director General of Information Tax-Systems (DGIT-System) in respect of Firms, to assess the number of Firms in the respective field units of ITD. On the basis of risk analysis of each unit, we selected 15 *percent* and 20 *percent* of the units (having highest risk factors) for review of metro and non-metro charges respectively. Within the selected unit, we selected all cases of scrutiny assessments, appeal and rectification cases for review. With respect to Internal Control Mechanism, we selected two high risk Commissionerates having Firm as assessee for review. In case of states having just one Commissionerate, we did sampling at the level of Ranges. We requisitioned 27,944 assessment records from the assessment units of the ITD located all over India. However, the ITD produced and we audited 26,328 assessment records.

1.8 Constraints

The Firm assessee and their Partners fall under different jurisdictional charge and are assessed separately by their respective jurisdictional Assessing Officer (AO). The Partners of the Firm are not required to file their respective returns with the same AO who is also in jurisdictional charge of the assessee Firm. In the absence of mechanism to identify the jurisdictional charge of the AO under which the Partners of Firm falls, audit could not co-relate cases of Firm with their Partners in most of the cases.

1.9 Acknowledgment

We held an entry conference with CBDT in May 2013 wherein we explained the audit objectives, scope and the main focus areas of audit examination. The Indian Audit and Accounts Department acknowledges the cooperation of ITD in facilitating the audit.

The exit conference was held (February 2014) with CBDT. We have suitably incorporated CBDT's views in this report.

Chapter II: Systemic issues of the Firms and their Partners

2.1 Introduction

Partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them. Persons who have entered into partnership with one another are called Partners individually and a Firm collectively.

As per the Income Tax Act, 1961 (Act), Firm and their Partners have separate legal status. The assessment of a Firm will not be complete/ accurate unless it is correlated with assessment records of their Partners. In addition to this, the Act has certain inconsistencies regarding exemptions/deductions to the Firm/ Partners and submission of partnership deeds at the time of assessment.

The present Chapter deals with systemic issues arising out of assessment of Firms and their Partners and are described in succeeding paragraphs.

ITD does not have any system of maintaining complete database of Firms and their Partners.

2.2 Registration of Firms

Prior to Finance Act 1992, the Act distinguished between registered and unregistered Firms and provided differential treatment. With effect from 01 April 1993, it is not obligatory for the Firms to get registered for the purpose of income tax. The Firms enjoy benefits of section 40(b) of the Act on the basis of the partnership deed only, irrespective of its registration status, which can be altered as per the convenience of the Firm or its Partner.

Scrutiny of Central Action Plan (CAP) reports of CBDT and information furnished by Tax Recovery Officers (TROs) revealed that no separate mechanism for reporting to CBDT existed in the ITD in respect of Firms. Since registration of the Firm is optional and at the discretion of the Partners, the ITD is not in a position to ascertain as to how many Firms exist in India and out of them, how many file their Income Tax Return (ITR) and discharge their tax liabilities.

Firms also include Limited Liability Partnership (LLPs) and they are required to get registered mandatorily with the Registrar of Companies. Thus, registrations of all the Firms are not streamlined for income tax purpose.

Though the filing of ITR of the Firms is mandatory, in the absence of database of unregistered Firms, there is a possibility of non filing of ITR by such Firms, which may go undetected and may result in loss to exchequer.

ITD is not correlating the assessment records of the Firm and their Partners which resulted in short levy of tax.

2.3 Co-relation of assessment of the Firms and their Partners

The assessee Firm and Partners of the Firm fall under different jurisdictional charge and are assessed separately by their respective jurisdictional AO. Under the present provisions of the Act, the Partners of the Firm are not required to file their respective returns with the same AO, who is in jurisdictional charge of the assessee Firm. Further, the assessee Firms are not bound to declare Permanent Account Number (PAN) of their Partners in the ITR-V as it is not mandatory. There are a number of transactions between a Firm and its Partners that require cross verification such as introduction of capital, charge of interest, remuneration and similar other transactions. As a result, it becomes difficult to co-relate the veracity of capital introduced by the Partners in the Firm and cross check the charging of interest, remuneration and claim of other expenses.

In 183 cases pertaining to Bihar, Andhra Pradesh and Rajasthan, we did not find the ITR of the Partners enclosed with the assessment record of the Firms which prevented cross checking of the remuneration/interest claimed and allowed in the assessment of Firm with that of the Partners.

We cross checked the assessment records of the Partners vis-à-vis the assessment records of the respective assessee Firms and found in 70 cases pertaining to nine states[3] that the AO did not cross verify/co-relate the ITR of Partners with that of the respective assessee Firms which involved a tax impact of ₹ 2.49 crore (see Box 2.1).

Box 2.1: Illustrative cases on co-relation of assessment of the Firms and their Partners

a. In Assam, CIT-II Guwahati charge, the AO completed assessment of the Firm **M/s. Annapurna Foods Products** for the AY 11 after scrutiny in September 2012 at an income of ₹ 25.24 lakh. Schedule A forming part of the balance sheet of the Firm indicated that three Partners introduced fresh capital into the Firm amounting to ₹ 1.03 crore. However, the source of income from which the assessee Partners had introduced the fresh capital was not available on record. Since the assessee Partners had not disclosed the source of income, the amount introduced by the Partners was required to be assessed as undisclosed income in the hands of the Partners. The omission resulted in under assessment of income of ₹ 1.03 crore involving tax effect of ₹ 31.92 lakh.

[3] Gujarat, Rajasthan, Tamil Nadu, Kerala, Maharashtra, Jharkhand, West Bengal, Andhra Pradesh and Haryana.

b. In Karnataka, CIT-IV Bangalore charge, the AO completed assessment of Firm **M/s. Manjrak Marketing** for the AY 09 after scrutiny at NIL income. We noticed that Rakesh Batra, who was a Partner in the above Firm, had introduced capital of ₹ 24 lakh. However, individual record of Rakesh Batra assessed at ITO Ward 8(1), Bangalore, did not reveal any such capital introduced by him. As the source for introduction of capital in the Firm was not established, the receipt of ₹ 24 lakh should have been brought to tax. This omission resulted in short computation of income by ₹ 24 lakh and resultant short levy of tax of ₹ 10.68 lakh.

c. In Rajasthan CIT-II Jaipur charge for the AY 10 in case of **M/s. Alps Corporation**, we observed that assessee Firm paid interest of ₹ 12.43 lakh to its Partner but it was not found to be shown in Partner's computation of income in the ITR which resulted in escapement of income of ₹ 12.43 lakh in the hands of the Partner involving tax effect of ₹ 3.84 lakh.

We also noticed in three cases in West Bengal, that Firms claimed deduction for interest/remuneration to Partners without actually making the payment to the Partners. As these expenditures were not disallowed, it resulted in a revenue impact of ₹ 28.86 lakh (see Box 2.2).

Box 2.2: Illustrative case on deduction for interest/remuneration to Partners

a. In West Bengal CIT-XI Kolkata charge for AY 04, AY 05, AY 07 and AY 09, the assessment was completed in case of **M/s. Fu Leather Industries.** We noticed that in all these AYs, assessee Firm debited interest on Partners' capital and remuneration to the Partners in Profit & Loss Account of respective years but these interest and remuneration were not reflected in Partners' Capital account of respective year. Thus, the assessee Firm claimed deduction for interest on Partners' Capital and remuneration to Partners which was not actually paid. The omission to disallow the same resulted in underassessment of income of ₹ 72.20 lakh with revenue impact of ₹ 24.39 lakh for the respective four AYs.

b. In West Bengal under CIT-XI Kolkata charge for the AY 09, in case of **M/s. SBD Enterprise,** we noticed that the Firm had transferred an amount of ₹ 37.87 lakh from the Profit and Loss Appropriation Account to the Partners' Capital account. However, Partners' Capital accounts reflected that the total amount of profit distributed amongst all Partners stood at ₹ 43.49 lakh. Thus, the Partners' capital account was inflated by an amount of ₹ 5.62 lakh which would result in increase in the amount of interest on Partners' capital in the succeeding year and will have potential tax effect of ₹ 1.74 lakh.

On being pointed out regarding the non-correlation of records, CIT-1 Chennai stated (July 2013) that wherever necessary the Partner's assessment records are being called for. This implies that correlation is being done only at the discretion of the AO and there is no procedure prescribed by the ITD in this regard. The AOs are not giving due importance to correlation/cross verification of information while finalising assessment of the Firm vis-a –vis their Partners.

Further, we observed that there is no mechanism to identify the jurisdictional charge of AO under which the Partner of the Firm is assessed as well as sharing of information available in the Firm's assessment which would be needed for the assessment of any other assessee who has business or other connection with the assessee Firm. Thus, the correctness of the claims made in respect of remuneration and interest by the respective Partners could not be verified/co-related unless the same is specifically called for during the scrutiny assessment. The ITD also could not verify the veracity of capital introduced by the Partner as the Partners are not assessed in the same charge. As there is no provision for deduction of Tax Deducted at Source (TDS) in the Act on payment of remuneration and interest to working Partners under section 40(b)(iv)&(v), it becomes difficult to co-relate the payments made to the Partners.

ITD does not have any system of monitoring the partnership deed of the Firms in order to regulate the claims and collecting information from Registrar of Firms for effective control.

2.4 Inconsistencies in submission of the partnership deed

Under the provisions of section 184(1)(2)(3),(4)&(5) of the Act, any remuneration and interest on capital can be claimed by the working Partners, if the partnership is evidenced by the certified copy of the partnership deed which should accompany the return of income in respect of which the assessment as a Firm is first sought and it shall be assessed in the same capacity if there is no change in the constitution of the Firm.

There is inconsistency in the above provision vis-à-vis Para 6 of Circular No.3/2009 dated 21 May 2009 of CBDT which states that the tax payers should not enclose with the return of income any statement, document, etc., filed either manually or electronically and CCsIT/CsIT must ensure that documents, if any, attached with returns are detached at the time of receiving returns and returned to tax payers immediately.

We noticed that in Karnataka, out of 1,265 cases of assessment test checked, 507 cases were not accompanied by the partnership deed due to which audit could not ensure the correctness of the details of the clauses in the deed such as number of Partners, working Partners, individual profit sharing ratio, remuneration payable to Partners, interest payable to Partners, arbitrator, if any, change in constitution, etc. Further in 30 cases in six states[4] the revised

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[4] Karnataka, Gujarat, Bihar, Andhra Pradesh, Madhya Pradesh, Maharashtra.

partnership deed was not placed on record despite a change in the constitution of Firms/profit sharing ratio having a tax effect of ₹1.39 crore.

Similarly in 10 states[5] in respect of 35 cases, the Firms were allowed to claim deductions in respect of salary and interest without submission/verification/ certification of partnership deed despite there being a change in constitution/profit sharing ratio. This involved a tax effect of ₹ 11.51 crore (see Box 2.3).

Box 2.3: Illustrative cases on inconsistencies in submission of the partnership deed

a. In Haryana CIT-Central-Gurgaon charge for the AY 09 in case of **M/s. Vee Gee Industrial Enterprises**, we noticed that the Firm paid salary to its Partners at ₹ 3.42 crore but neither the partnership deed nor the Income Tax returns of Partners were available on record. Hence, the authenticity/correctness of salary allowed to Partners could not be verified. This involves a tax effect of ₹ 1.16 crore.

b. In West Bengal CIT Central- III Kolkata charge, block assessment of **M/s. Silver Queen Jewellers** was completed for the AY 04 to AY 09 under section 153A/143(3) and for AY 10 under section 143(3). We noticed that the AO allowed a total of ₹ 1.06 crore being the interest on Partner's capital during the said period to the Firm, without verifying partnership deed[6] which involved a tax impact of ₹ 35.85 lakh.

Thus, there exists the contradiction between provisions of the Act and CBDT circulars. The Firms are taking advantage of the CBDT circular and do not submit copy of the partnership deeds subsequently. If there is a change in the partnership deed and is not disclosed by the assessee himself, the ITD is not in a position to know whether the salary, interest, commission, bonus etc. received from the Firm is correct or not. This may result in postponement of demand in case it was selected for scrutiny or loss of revenue in the absence of the scrutiny assessment.

With growing dependence of e-filing and automation of various assessment functions, ITD should make the partnership deed available before AO online at the time of assessment.

[5] West Bengal, Assam, J&K, Haryana, Himachal Pradesh, Uttar Pradesh, Tamil Nadu, Chandigarh, Punjab, Gujarat.

[6] It was not placed in respective assessment folders and proper evidences of calling for by the AO during the assessment proceedings also remained absent.

Partners of Firm avail excess exemption due to ambiguity in the Act.

2.5 Additional exemption claimed by Partners under section 10(2A)

Section 10(2A) of the Act provides that in the case of a person being a Partner of a Firm which is separately assessed as such, his share in the **total income** of the Firm shall not be included in computing the total income of previous year.

Chapter VIA of the Act vide Section 80A stipulates that "in computing the total income of the assessee, there shall be allowed from his gross total income, the deductions specified in section 80C to 80U." Further, Chapter III of the Act deals with 'incomes which do not form part of total income' which inter alia covers Section 10A, 10AA and 10BA of the Act.

Hence, exemptions/deductions under Chapter III and Chapter VIA would not naturally be part of the total income of the Firms and as such Partner would not be eligible to claim exemption under section 10(2A) of the Act on the amount deducted / exempted to the Firm.

We noticed that in 15 cases in six states[7], the Partners have claimed exemption under section 10(2A) in respect of exemptions/deductions claimed by the Firms under section 10A, 10AA, 10BA, 80IB and 80IC resulting in excess exemption under section 10(2A) (see Box 2.4).

Box 2.4: Illustrative cases on lack of clarity in the provisions the Act

a. In Gujarat CIT-V, Ahmadabad charge for AY 10 in case of assessee Firm **M/s. Adani Exports**, AO assessed the total income at ₹ 0.06 lakh after allowing deduction of ₹ 234.39 crore under section 10AA. Scrutiny of the Partners' case revealed that Partners had claimed exemption of above deducted amount under section 10(2A) of the Act thereby leading to excess exemption by an equal amount. This resulted in excess exemption of ₹ 234.39 crore under section 10(2A).

b. In West Bengal CIT-XI, Kolkata charge for AY 09 scrutiny assessment completed in case of an assessee Firm **M/s Sherwood Estate Developers** revealed that AO allowed a deduction of ₹ 15.92 crore under section 80IB and again exempted the amount in the hands of Partners under section 10(2A) of the Act thereby resulting in excess exemption of ₹ 15.92 crore.

c. In Rajasthan CIT-II, Jaipur charge, for AY 10 in case of assessee Firm **M/s. Mangalam Arts**, the AO assessed the total income at ₹ 14.09 crore after allowing deduction of ₹ 20.08 crore under section 10BA. Hence, total income of ₹ 14.09 crore was only to be allowed as exempt under section 10(2A) in the hands

[7] Gujarat, Haryana, Rajasthan, Uttar Pradesh, Uttarakhand and West Bengal.

of the Partners. However, AO allowed exemption to the Partners under section 10(2A) on account of deduction allowed to Firm of ₹ 20.08 crore.

From the above illustrations, due to ambiguity in the definition of 'Total Income' of Firms, the Partners are getting excess exemption under section 10(2A) of the Act.

The Act is not clear about admissibility of non-legal entities such as Firms, Body of Individuals and Association of Persons as Partners in a Firm.

2.6 Composition of partners in a Firm

Section 2(23) of the Act assigns the Firm, Partner and Partnership the same definition as defined in the Indian Partnership Act, 1932, and in the Limited Liability Partnership Act, 2008. Section 4 of the Indian Partnership Act, 1932, states that Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. It has been judicially[8,9] held that the word 'Person' according to the Partnership Act contemplates only natural or artificial persons and therefore, a Firm being not a 'Person' is not entitled to enter into a Partnership with another Firm. Also it has been held[10] that provisions of a Partnership Act should not be ignored the moment a Firm is viewed as an independent taxable entity under the Income Tax law. Hence the Firms, Body of Individuals (BoI) and Association of Persons (AoP) are not legal entities and therefore shall not be a Partner of another Firm.

We noticed in four cases of Maharashtra, Tamil Nadu and West Bengal that Firms were also Partners in another Firm and AO had allowed expenditure on remuneration to Firm-Partners which involved a tax implication of ₹ 20.90 lakh (see Box 2.5).

Box 2.5: Illustrative cases on composition of Partners in a Firm

a. In Tamil Nadu CIT V Chennai charge in case of **M/s. Mega Trends Inc** for AY 11, AO allowed the assessee a deduction of ₹ 11.28 lakh towards interest to the Partners and ₹ 11.80 lakh towards remuneration to the Partners. We noticed that two of the Partners viz. **M/s DCP Trading Co.** and **M/s. Krupa Trading Co.** were Partnership Firms and other Partners were individuals. Therefore, the allowance given to the assessee Firm was incorrect having a tax effect of ₹ 7.13 lakh.

8 Dulichand Laxminarayan v CIT (1956) 29 ITR 535(SC).
9 Malabar Fisheries Co. v CIT(1979) 120 ITR 49(SC).
10 CIT v Standard Maltings & Allied products Corpn. (1997) 226 ITR 1 (Guj.).

b. In Maharashtra CIT-XX Mumbai charge, in scrutiny assessment of **M/s. K.C. Corporation** for AY 10 and AY 11, we observed that M/s K.C. Corporation, the Firm is Partner in another Firm **M/s K.C. Corporation JV**. Since M/s K. C. Corporation is not a legal entity hence, it cannot be a Partner in another Firm. Therefore, the profit of ₹ 8.77 lakh and ₹ 7.43 lakh for AY 10 and AY 11 respectively received by the assessee is not eligible for exemption under section 10(2A). The omission resulted in under assessment of income by an equal amount having a tax effect of ₹ 6.61 lakh including interest.

Thus, ineligible entities have become Partners in a Firm, thereby availing the various benefits applicable to a Firm. The Act provisions have to be made clear for the purpose of Income Tax whether non legal entities such as Firms, Body of Individuals (BoI) and Association of Persons (AoP) can be Partners in a Firm.

The Act is silent on charging interest on negative balance on capital accounts of Firms which suppress income by Partners.

2.7 Non-charging of interest on withdrawals by the Partners

Section 40(b)(iv) of the Act stipulates that any payment of interest to any Partner which is authorized by the terms of partnership deed, shall not exceed 12 *percent* simple interest per annum. It is seen that the Firms are paying interest on positive balance of the capital account whereas they are not charging interest on the negative (debit) balance of the capital account since the Act does not provide for it. If debit/negative balance in Partners' capital account is a result of withdrawal by the Partner, the Firms should charge interest on it as it is equivalent to loan to the Partner.

We noticed 74 cases in eight states[11] where interest was paid on the positive balance in capital accounts of the Partners but no interest was charged on the withdrawals/debit balances in the Partners' capital account which indicated a loss of revenue of ₹ 1.16 crore (see Box 2.6).

Box 2.6: Illustrative cases on non-charging of interest on withdrawals by the Partners

a. In Tamil Nadu CIT-I Coimbatore charge in the case of **M/s. Emerald Bullions and Jewelers**, for the AY 11, we noticed that the assessee Firm had not charged interest of ₹ 31.12 lakh on the debit balance in Partners' current account amounting to ₹ 259.00 lakh having a tax effect of ₹ 9.61 lakh.

[11] Maharashtra, Bihar, West Bengal, Himachal Pradesh, Punjab, Uttar Pradesh, Tamil Nadu, Kerala.

b. In Maharashtra CIT-Central Pune charge, in the case of **M/s. Pride Purple Properties** for AY 08 and AY 09, we observed that the Partner's capital had a debit balance of ₹ 1.42 crore and ₹ 10.88 crore respectively. However, no interest was charged by the Firm. We also noticed that the Firm has paid interest/financial charges of ₹ 90.15 lakh and ₹ 56.96 lakh during the respective AYs on loans/ advances but did not charge any interest from the Partner from overdraw from the capital. ITD rectified (March 2013) the mistake under section 147 of the Act.

c. In Maharashtra CIT-XX Mumbai charge, in the case of **M/s. Nanavati Construction** for AY 10, the partnership deed authorized to charge interest on debit balance of capital account. However, no interest was charged on the debit balance of the Partner capital account of ₹ 6.38 crore. This omission resulted in under assessment of income of ₹ 76.61 lakh and short levy of tax of ₹ 34.63 lakh.

In absence of clarity in provisions, the Firms are not charging interest on withdrawals from the capital account and thereby suppressing income to that extent.

The Ministry replied (February and March 2014) that the Act does not provide for charging of interest by the Partner but only contains the provisions for disallowance if it exceeds certain percentage or is not authorised by the Partnership deed. Charging/not charging of interest on debit balance of the Partner's Capital account is a business decision and the Act cannot mandate a Firm to charge such interest.

AOs are not applying section 14(A) of the Act consistently on Partner's share of profit received from a Firm which is exempted under section 10(2A) of the Act. Also, AOs are unable to apply section 14(A) read with Rule 8D of the Act relating to partnership Firms on the exempted income in the absence of previous year's details of income.

2.8 Disallowances under section 14A

As per section 14A(1) of the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income. Rule 8D of the Act prescribes the method of disallowance of expenditure incurred with respect to the exempt income which is calculated from the income statement of the previous year.

Share of profit received by a Partner from a Firm is exempted under section 10(2A) of the Act as the Firm and its Partners are assessed separately on their total income. Hence, expenditure incurred in earning the share from partnership Firm will have to be disallowed under section 14A of the Act. It has been judicially[12] held that section 14A of the Act applies to Partners' share in profits of the Firm.

We found that AOs are not consistently applying the provisions of section 14A on the exempted income of the Partners which is claimed under section 10(2A) of the Act. In Gujarat, in 13 cases relating to Partners, we noticed that AOs did not apply the provision of section 14A on the Partners' share in profits of the Firm where disallowance under section 14A amounted to ₹ 1.23 crore on total exemptions of ₹ 62.42 crore. Similarly, in Maharashtra, we noticed in five cases that Partners claimed exemption amounting to ₹ 1.77 crore wherein AOs failed to make a disallowance of ₹ 36.39 lakh under section 14A.

We also noticed that the AOs could not apply section 14A read with rule 8D to partnership Firms on the exempted income, in the absence of previous year's details of income since the partnership Firms are not mandatorily required to prepare their accounts in a format similar to that of Companies. For instance, in Maharashtra CIT-XX Mumbai charge, in scrutiny assessment of **M/s K. C. Corporation** for AY 10, disallowances under section 14A read with rule 8D could not be computed due to non-availability of financial statements of previous year.

As per the data furnished by the DGIT (Systems) there has been a steady growth in the income of partnership firms which was more than ₹ 50,000 crore for AY 12. Eventually, profits of the Firms are distributed among the partners who in turn get exemption under section 10(2A). Hence, there is a possibility of loss of revenue to the exchequer due to non-application of provision of section 14A on the partners' shares in profits of the Firm.

[12] Shri Vishnu Anant Mahajan vs. ACIT (ITA no.3002/AHD/2009).

2.9 Recommendations

We recommend that

a. 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.

The Ministry replied (February and March 2014) that they are not mandated to maintain database of registered Firms. However, DGIT (Systems) maintains the database of those Firms who have filed their ITRs and it is growing every year. Apart from this, ITD keeps check on AIR information for high value transactions, PANs and maintain 360 degree profiling of the entity. E-filing also leads to maintenance of a robust database of Firms.

b. 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.

The Ministry replied (February 2014) that in ITR Form meant for Firms & LLPs (ITR-5), it is compulsory for the Firms to declare their partners name, percentage of share and PANs in the ITR. E-filing is now compulsory and declaration of PAN etc is mandatory. PAN helps ITD to track the jurisdictional charge of the Partners.

c. 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.

The Ministry while agreeing with the recommendation of audit, replied (February and March 2014) that the issue is being examined as it would require modification in the ITRs.

d. 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.

e. 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.

The Ministry replied (February 2014) that the issue whether non-legal entities can be partners in a Partnership Firm is governed by the provisions of the Partnership Act.

f. 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.

Chapter III: Special provisions of exemption/deduction to the Firms

3.1 Introduction

The partnership Firms are separate taxable entities under the Act. The Act provides special provisions of exemptions/deductions available to the Firms and their Partners. In computing the income of the Firm, interest and remuneration to the Partners are allowed as deductions subject to certain conditions as prescribed in the Act. The conditions for allowance of deduction of remuneration and interest to the Partners are as follows:

- **a.** Payment should be authorized by the partnership deed.
- **b.** Payment should be in accordance with the terms of the partnership deed.
- **c.** Payment should relate to the period after the date of such partnership deed.
- **d.** Remuneration should be paid to working Partners.
- **e.** Interest should not be in excess than prescribed.
- **f.** Partnership deed should specify the amount of remuneration
- **g.** Remuneration payable is subject to certain defined monetary and percentage limits with reference to 'book profit' of the partnership Firm.

The present Chapter deals with cases where ITD did not comply to the special provisions of the Act applicable to the Firms.

Assessing Officers allowed payment of remuneration to non-working Partners and for period prior to the date of deed which resulted in ineligible deductions to Partners and consequent loss of revenue.

3.2 Remuneration paid to non working partner and for period prior to deed date

As per Section 40(b)(iii) of the Act, any payment of remuneration to any Partner is to be authorised by the partnership deed and such payments should not be made from a date prior to the date of partnership deed unless it is authorised by an earlier deed.

We noticed that the AOs had allowed (i) expenditure on remuneration paid for a period prior to the date of deed and (ii) expenditure on remuneration paid to the Partners who were not actively engaged in the affairs of the Firm. There were nine such cases noticed in respect of Tamil Nadu, Kerala, Punjab and Rajasthan which involved a tax implication of ₹ 2.50 crore (see Box 3.1).

Box 3.1: Illustrative cases on unauthorized deductions on expenditure on remuneration

a. In Kerala CIT-II Kochi for the AY 11 in the scrutiny assessment of **M/s. Blastline India**, AO allowed a deduction of ₹ 1.76 crore towards remuneration to the Partners. Scrutiny of the assessment revealed that the Partners of the Firm were working abroad during the above period and the business of the Firm was run through a CEO (Manager) appointed on their behalf. The Partners, not being actively engaged in conducting the affairs of the Firm, are ineligible for remuneration. The ineligible deduction allowed had a tax effect of ₹ 64.80 lakh. ITD accepted (June 2013) the objection.

b. In Tamil Nadu CIT-V Chennai charge for the AY 11 in the case of **M/s. Price Waterhouse & Co.,** a firm of Chartered Accountants, AO allowed salary of Partners amounting to ₹ 1.25 crore as claimed by the assessee. We noticed that the remuneration was authorized with effect from 01 April 2009 in the deed dated 23 September 2010. As per the provisions of the Act, payment is eligible only for the period after the date of deed i.e. from 23 September 2010 in AY 12 and not in AY 11. This involved a tax effect of ₹ 38.56 lakh.

The above cases imply that AOs have not paid due attention to the partnership deed which resulted in ineligible deductions and consequent loss of revenue.

Assessing Officers allowed unauthorized and excess payment of interests which resulted in ineligible deductions to Partners and consequent loss of revenue.

3.3 Excess payment of interest

Section 40(b)(iv) of the Act provides for payment of simple interest to any Partner at a rate not exceeding 12 *percent* and which needs to be authorized by and in accordance with the terms of the partnership deed.

We noticed that in 13 cases in respect of Maharashtra, Uttar Pradesh, Odisha and Assam, AO allowed deduction for expenditure on payment of interest to the Partners, (i) which was more than the rate prescribed/authorised in the partnership deed, (ii) where the rate prescribed/authorised in the partnership deed was exceeding the limits provided under section 40(b)(iv) of the Act and (iii) which was not authorized in the deed. This had resulted in loss of revenue of ₹ 97.14 lakh (see Box 3.2).

Box 3.2 Illustrative cases on excess payment of interest

a. In Odisha CIT-Bhubaneswar charge for AY 11, we noticed in the case of **M/s. Serajuddin & Co.** that AO allowed deduction towards interest to a Partner which exceeded the limit of twelve *percent* simple interest per annum by ₹ 66 lakh. The mistake resulted in under assessment of income by ₹ 66 lakh and consequent short levy of tax of ₹ 20.26 lakh.

b. In Uttar Pradesh CIT-Allahabad charge for AYs 09 to 11 in the case of **M/s. Chhota Bhai Munna Bhai & Company**, the partnership deed provided interest at the rate of twelve *percent* per annum on the closing balance of the capitals of the Partners. We noticed that AO allowed interest of ₹ 1.76 crore on opening balance of the capital against the allowable interest of ₹ 1.53 crore. This omission resulted in excess allowance of interest of ₹ 22.90 lakh involving tax effect of ₹ 9.83 lakh with interest. ITD accepted (April 2013) the observation.

c. In Maharashtra CIT-XX Mumbai charge, for AYs 09 and 10 in scrutiny assessment of **M/s. Giriraj Conductors,** the partnership deed authorized payment of interest on fixed capital only. However, AO allowed interest payment of ₹ 58.64 lakh on fixed and current capital as against the interest payable of ₹ 17.16 lakh on the fixed capital. The omission resulted in excess payment of interest of ₹ 41.48 lakh and short levy of tax of ₹ 13.47 lakh.

Interest is paid to the Partner on the capital introduced by him. It is increased by the deposits made by him and the share of profits credited to his account and is reduced by the amounts withdrawn by him and the share of losses debited to his account. It is seen from the above illustrations that deduction of interest are allowed to the Firms which is being calculated on the opening as well as closing balance of the Partners' capital. Hence, the Act is not clear regarding the 'base amount' on which the interest to Partners is to be calculated.

3.4 Unauthorised quantum of remuneration

According to section 40(b)(v) of the Act, any payment of remuneration to any working Partner should be authorized and in accordance with the partnership deed not exceeding the amount prescribed. CBDT in its circular No.739 dated 25 March 1996 clarified that '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. Any enhancement in the quantum of remuneration shall have to be effected through a supplementary partnership deed only.

We noticed in 81 cases in thirteen states[13] that AO allowed expenditure on remuneration, which was not authorized or paid in excess of the amount specified in the partnership deed and where supplementary deed enhancing the remuneration was not produced, which involved a tax effect of ₹ 14.64 crore (see Box 3.3).

Box 3.3 Illustrative cases on unauthorized expenditure

a. In Delhi CIT-XIII charge for the AY 09 in the assessment of **M/s. Vaish Associates,** we observed that the partnership deed of assessee Firm did not define the quantum of remuneration or method of computation of remuneration paid to the Partners. Hence, the remuneration of ₹ 4.15 crore paid to the Partners should have been disallowed. The omission resulted in inadmissible allowance of expenditure amounting to ₹ 4.15 crore involving short levy of tax of ₹ 1.88 crore including interest. Further, we noticed that in the case of same assessee, for AY 10, the ITD had itself made addition on similar grounds which on being challenged by the assessee was dismissed by CIT (Appeals).

b. In Uttar Pradesh CIT-I Kanpur charge for AY 09 and AY 10 in case of **M/s. Calico Trends,** we noticed that partnership deed did not quantify the amount of remuneration but for giving reference to the limits specified under section 40(b)(v) of the Act. However, AO allowed deduction towards partners remuneration of ₹ 9.77 crore which was irregular involving a tax effect of ₹ 4.01 crore. In reply (April 2013), AO did not accept the observations stating that the remuneration allowed was within the permissible limits as per the provisions of the Act. The reply is not tenable in view of the CBDT circular which clarifies that deduction towards remuneration was not admissible unless partnership deeds are very specific and quantified.

c. In Maharashtra CIT-XXII Mumbai charge for AY 10 in scrutiny assessment of **M/s. Yash Developers**, the Firm had paid remuneration to the Partner ₹ 47.71 lakh whereas the partnership deed quantified remuneration at ₹ 1.20 lakh only. The omission has resulted in excess payment of remuneration of ₹ 46.51 lakh and short levy of tax of ₹ 20.87 lakh.

d. In West Bengal CIT-Central-III Kolkata charge for AY 09 in the assessment of **Gopal Krishna and Brothers,** we noticed that the partnership deed neither specified the amount of remuneration payable to each individual working Partner nor did it lay down the manner of quantifying such remuneration. It only mentioned "Salary, Commission or other Remuneration may be given to Partners, as may be decided by the parties by mutual consent". Therefore, as per clarification given in CBDT Circular No. 739 dated 25 March 1996*,* amount of remuneration of ₹ 28.62 lakh paid to the Partners of the Firm was not allowable deduction. Mistake in allowing deduction resulted in underassessment of income by an equal amount having a tax effect of ₹ 11.76 lakh.

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[13] Tamil Nadu, Jharkhand, West Bengal, Haryana, Delhi, Karnataka, Kerala, Maharashtra, Chandigarh, Punjab, Andhra Pradesh, Uttar Pradesh, Assam.

From the above illustrations, it is clear that the AOs are not consistent in applying the provisions of section 40(b)(v) read with CBDT circular no. 739. There seems to be contradiction between section 40(b)(v) and CBDT circular 739 dated 25 March 1996 as the section does not lay down any condition that the partnership deed should quantify remuneration whereas the circular states that remuneration has to be quantified or the manner of quantification stated in the deed. It has been judicially[14] held that allowances of remuneration should be made according to the provisions of the Act and not as interpreted by CBDT circular. This may result in common area of conflict between ITD and the assessee Firms.

Assessing Officers incorrectly computed book profit for the purpose of remuneration by including capital gain, interest income/rental income/income for other sources which resulted in excess payment of remuneration and short levy of tax.

3.5 Incorrect computation of book profit for the purpose of remuneration

Section 40(b)(v) of the Act provides the limitation of payment of remuneration to its Partners. As per the Act, any payment of remuneration to any Partner who is a working Partner, which is authorized by, and is in accordance with the partnership deed and relates to any period after the date of such partnership deed, should not exceed the aggregate amount as computed in Table 3.1.

Table 3.1: Limit of deduction on book profit

Assessment Year	Book profit	Maximum allowable deduction
AY 09 and AY 10	On the first ₹ 75,000[15] of the book profit, or in case of loss	₹ 50,000 or at the rate of 90 *per cent* of book profit whichever is more
	On the next ₹ 75,000 of the book-profit	at the rate of 60 *per cent*
	On the balance of the book profit	at the rate of 40 *per cent*
AY 11	On the first ₹ 3,00,000 of the book profit or in case of Loss	₹ 1,50,000 or at the rate of 90 *per cent* of the book profit, whichever is more
	On the balance of the book profit	at the rate of 60 *per cent*

Further explanation of the section states that book profit for the purpose of computation of remuneration is the result of adjustment made as per Chapter IV-D of the Act with the profits shown in the Profit and Loss Account.

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14 Himachal Pradesh High Court in the case of M/s. Durga Dass Devki Nandan vs. ITO (ITA No. 4 of 2005 dated 11 March 2011).

15 ₹ 1,00,000 on the first and next slab for a firm carrying on a profession referred to in section 44AA.

Audit noticed that in 24 cases pertaining to eight states[16], AO calculated book profit for the purpose of remuneration by including capital gain, interest income/rental income/income from other sources which resulted in excess payment of remuneration and short levy of tax of ₹ 1.37 crore (see Box 3.4).

Box 3.4: Illustrative cases on incorrect computation of book profit

a. In Maharashtra CIT-XXII Mumbai charge for AY 10, in scrutiny assessment of **M/s. S. Narendra Kumar and Company**, AO considered interest income also while computing book profit for the purpose of remuneration. Interest income is a part of chapter IV-F of the Act and hence not to be considered as a part of book profit. The omission resulted in excess payment of remuneration of ₹ 82.41 lakh having a tax effect of ₹ 28.01 lakh.

b. In Rajasthan, CIT-I Jodhpur charge for AY 09, AO completed assessment of a Firm **M/s. Ercon Composites.** We observed that AO allowed excess payment of remuneration of ₹ 55.28 lakh due to inclusion of interest income of ₹ 9.99 lakh and non-adjustment of brought forward unabsorbed depreciation of ₹ 70.68 lakh while arriving at the book profit. The omission resulted in short levy of tax of ₹ 22.72 lakh including interest. ITD did not accept (June 2013) the audit observation stating that nowhere in the Act, it is provided that the above mentioned items are to be reduced for calculating book profit and that remuneration to partner has been allowed as per section 40b of the Act. The reply is not tenable as the adjustment of other income and unabsorbed depreciation is to be made while calculating the book profit as the same are covered under Chapter IV-D.

c. In Gujarat, CIT Gandhinagar charge, for AY 06, AO completed the assessment of assessee firm **M/s. Ranjit Construction Company** in December 2007 determining an income ₹ 3.01 crore. We noticed that the assessee Firm had paid remuneration of ₹ 1.95 crore to its Partners on book profit of ₹ 3.65 crore which included other income of ₹ 1.20 crore consisting of interest, insurance claim and rent income. Other income of ₹ 1.20 crore was required to be excluded while calculating the book profit for the purpose of remuneration. The omission resulted in under assessment of income of ₹ 39.93 lakh and consequent short levy of tax of ₹ 19.43 lakh including interest. ITD took (March 2009) remedial action by raising demand under section 143(3) read with section 147 of the Act.

From the above illustrations, we observed that there are inconsistencies in arriving at book profit for the purpose of calculating remuneration. Further the Kolkata High Court, in the case of Md. Serajuddin & Brothers vs. CIT held that Chapter IV-D nowhere provides that method of accounting for the purpose of ascertaining net profit, should be the only income from business alone and not from other sources. Thus, for the purpose of section 40(b)(v)

[16] Maharashtra, Haryana, Himachal Pradesh, Punjab, Uttar Pradesh, Gujarat, Rajasthan and West Bengal.

read with explanation, there cannot be a separate method of accounting for ascertaining net profit and/or book profit.

Hence, the Act is not clear regarding meaning of book profit for the purpose of remuneration of Partner under section 40(b)(v).

3.6 Failure to comply with the provisions of section 184

Section 184 of the Act provides that a Firm shall be assessed as a Firm if the partnership is evidenced by an instrument, the individual shares of the Partners are specified in the instrument and the certified/revised copy of the instrument of partnership shall accompany the return of income of the Firm relevant to the AY.

With effect from AY 07, it is mandatory for a Firm to file return of income irrespective of whether there is taxable income or not. If Firms failed to comply with notice issued under section 142(1) & 143(2), it is a failure mentioned in section 144 and the deduction in respect of remuneration and interest paid is not allowable. Section 185 of the Act provides that, in the event there is a failure on the part of a Firm in complying with the conditions of section 184 or it has committed failures specified in section 144, no deduction by way of any payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by such firm to any Partner of such Firm shall be allowed in computing the income chargeable under the head "profits and gains of business or profession".

We noticed in 33 cases in Kerala, West Bengal and Bihar that though the Firm/Partners did not comply with the provisions of section 184, AO allowed deduction towards remuneration & interest to Partners under section 40(b) which had a tax implication of ₹ 1.09 crore (see Box 3.5).

Box 3.5: Illustrative cases on ineligible deduction claimed towards remuneration & interest to Partners

a. In West Bengal CIT-Central-III Kolkata charge, in the assessment of **M/s. Naresh Kumar & Co.** for AY 05 to AY 11, the assessee failed to comply with the notices issued under section 142(1) & 143(2) and even after the appellate order[17], status of the assessment under section 144 remaining unchanged, the assessee was not entitled for remuneration under section 184(5) of the Act. However, AO allowed the remuneration of ₹ 1.67 crore (for seven *AYs*) in the orders passed under section 251/144/153A resulting in underassessment of income to the extent of that amount with a tax effect of ₹ 55.15 lakh for seven AYs. ITD did not accept (July 2013) the audit observation on the basis of two

[17] Being aggrieved, the assessee filed an appeal to the Learned CIT-Appeal, C-III, Kolkata, WB which was dismissed and it was observed therein that the AO was fully justified in invoking the provisions of Section 144 since the requisite information as requisitioned by the AO was not furnished by the appellant.

judicial decisions[18], however the judicial decisions quoted by ITD were on different grounds and could not be applied to the present case.

b. In Bihar CIT- II Patna charge for AY 11, AO completed assessment of firms **M/s. Vimlesh Prasad Singh and M/s. Trade Wings** under section 144 for non production of books of accounts and their confirmation and hence they were not eligible for deduction towards expenditure on remuneration and interest. The incorrect allowance resulted in under assessment of income by ₹ 12.86 lakh and ₹ 0.54 lakh respectively with consequent short levy of tax aggregating to ₹ 5.63 lakh.

Chapter XVI of the Act deals with the special provisions applicable to the Firms and certain conditions are laid down under section 184 for the assessment of Firms. Even though the sections under the chapter are specific to Firms, AOs are not applying the provisions scrupulously.

3.7 Non-payment of interest/remuneration to Partners resulting in excess deduction

Subsection 10 of section 80IA provides that where it appears to the AO that owing to the close connection between the assessee carrying on the eligible business and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits which might be expected to arise in such eligible business, the AO shall in computing the profits and gains of such eligible business for the purposes of this section, take the amount of profit as may be reasonably deemed to have been derived from the business.

Section 40(b)(v) put ceiling on the maximum amount of remuneration that can be paid but does not make mandatory to pay remuneration to the Partner. We noticed that the Firm, enjoying tax exemption under section 10A/80IB/80IC/80IE of the Act, did not pay remuneration and interest on Partners' capital even though in some cases the partnership deed had a provision for charging of interest. Thus, the Firm earned more net profit than the ordinary profits which might be expected to arise in normal course of business and attracted the provisions of section 10A(7)/80IB(13)/ 80IC(7)/80IE(6) read with section 80IA(10) of the Act resulting in short levy of tax. Further, this resulted in non-inclusion of interest and remuneration in the taxable income of the Partner thereby loss of revenue to exchequer.

[18] 1.43 SOT 11(Asr.)(Uro.)-2011.& 07 SOT 457 (Lucknow) 2006.

Audit noticed 60 cases in five states[19] that the Firms were not paying interest/ remuneration to the Partners although the partnership deed provided for the same thereby increasing their profit eligible for exemption/deduction involving a revenue loss of ₹ 39.79 crore (see Box 3.6).

Box 3.6: Illustrative cases on non-payment of interest/remuneration

a. In Gujarat CIT-V Ahmedabad charge for the AY 09 in the case of **M/s. Adani Exports**, the AO assessed the Firm's income at ₹ 0.74 lakh after allowing deduction of ₹ 179.07 crore under section 10AA of the Act. We observed that the assessee Firm had not provided for the interest of ₹ 23 crore (at the rate of 9 *per cent*) to the Partners although the same was provided in the deed. Thus, the assessee Firm had made more than reasonable profits which would have accrued to the Firm and consequently enabling the Firm to claim higher amount of exemption under section 10AA of the Act. The amount of ₹ 23 crore was required to be disallowed from the business income eligible for deduction under section 10AA of the Act. Omission to do so resulted in short levy of tax of ₹ 9.85 crore including interest.

b. In Gujarat CIT-Valsad charge for AY 11 in the case of **M/s. Alidhara Texspin Engineers**, AO assessed the Firm's income at ₹ 25.11 crore after allowing deduction of ₹ 4.02 crore under section 10B. The assessee Firm was required to pay remuneration to working Partners of ₹ 9.90 crore on the amount of profit of ₹ 24.75 crore as per terms in partnership deed. However, the Firm did not pay any such remuneration to the working Partners. Hence, the amount of ₹ 9.90 crore was required to be disallowed from the business income eligible for deduction under section 10B of the Act in the hands of the Firm. Omission to do so resulted in short levy of tax of ₹ 4.10 crore including interest.

c. In West Bengal CIT-XI, Kolkata charge for the AY 07 and AY 08 in case of **M/s. Modern International,** we noticed that AO allowed the assessee an exemption of ₹ 5.86 crore under section 10A. However, the Firm did not debit interest of ₹ 1.36 crore on Partner's capital in Profit and Loss account even though it was allowable as per the partnership deed. Thus, the Firm earned more net profit than the ordinary profits which might be expected to arise in normal course of business attracting the provisions of section 10A(7) read with section 80IA(10) of the Act resulting in loss of revenue to exchequer due to short levy of tax of ₹ 45.65 lakh. Similarly, the AO did not levy tax of ₹ 25.60 lakh on the Firm in the AY 07.

Audit examination thus revealed that the assessee Firms are availing more exemptions/deduction by inflating profits through non-payment of remuneration/ interest to their Partners. On the other hand, taxable income

[19] West Bengal, Assam, Gujarat, Maharashtra, Madhya Pradesh.

of partners gets reduced owing to non inclusion of said remuneration/interest leading to loss of revenue to the exchequer.

Assessing Officers allowed the share of loss pertaining to the retired/deceased Partner to the subsequent year thereby resulting in excess carry forward of loss and short levy of tax.

3.8 Share of retired or deceased Partner

Section 78(1) of the Act disallows carry forward and set off of loss in proportion to the share of a retired or deceased Partner whenever there is any change in the constitution of the Firm.

Audit noticed that in four cases in respect of Assam, Haryana, Maharashtra, and Rajasthan, AO had allowed the share of loss pertaining to the retired/deceased Partner to the subsequent year thereby resulting in excess carry forward of loss and short levy of tax of ₹ 70.11 lakh (see Box 3.7).

Box 3.7: Illustrative cases on share of retired or deceased partner
In Maharashtra CIT-XX Mumbai charge for AY 10 in scrutiny assessment of **M/s. Rodium Properties**, one of the Partners having share profit ratio of 30.6 *per cent* retired during the FY relevant to AY. We observed that AO allowed the carry forward of total capital loss of ₹ 4.87 crore to the subsequent year which included ₹ 1.49 crore being the share of loss of retired Partner. The mistake resulted in excess carry forward of loss of ₹ 1.49 crore and short levy of tax of ₹ 50.62 lakh. ITD accepted (May 2013) and rectified the mistake under section 154 of the Act (May 2013).

Therefore, ITD has no system in place to keep track of changes in the composition of Firms and are not using their software module in order to prevent incorrect carry forward and set off of losses pertaining to retired/deceased Partners.

3.9 Incorrect deductions u/s 80IB

3.9.a Section 80IB(10) of the Act provides hundred *percent* deduction to profits of an undertaking derived from the developing and building housing projects approved before 31 March 2008 subject to fulfillment of certain conditions which includes that the project should be on the size of plot of land which has a minimum area of one acre.

In Karnataka in respect of two assessees, we noticed incorrect deduction under section 80IB(10) having a short levy of tax aggregating ₹ 4.47 crore (see Box 3.8).

Box 3.8 Illustrative case on incorrect deduction u/s 80IB (10)
In Karnataka CIT-IV Bangalore charge for AY 10 and AY 11 in the case of **M/s. Divyajyothi Earth**, AO allowed deduction under section 80IB of the Act at ₹ 97.48 lakh and ₹ 22.16 lakh respectively for two AYs. We noticed that Firm had undertaken the housing project on a plot of land having area of less than one acre, thus violating the condition for claim of deduction. Omission to disallow the deduction resulted in short levy of tax aggregating ₹ 1.45 crore. The ITD stated (June 2013) that considering the undivided share of land of the Partner in the project land area there was no violation of conditions prescribed in section 80IB of the Act. The reply of the ITD is not tenable as the Firm and its Partner in their individual capacities are distinct taxable entities and their individual holdings in land cannot be clubbed for considering the project area eligible for deduction under section 80IB of the Act.

3.9b. As per provisions of section 80IB(11A), the amount of deduction in the case of an undertaking deriving profit from an "integrated business" of handling, storage and transportation of food grains, shall be hundred *per cent* of the profits and gains derived from such undertaking for five AYs beginning with initial AY.

We noticed one case on the above issue in Madhya Pradesh (see Box 3.9).

Box 3.9 Illustrative case
In Madhya Pradesh CIT-Gwalior charge for AY 10 and AY 11 in the case of **M/s. Agrawal Ware House**, we noticed that the assessee had shown warehouse rental income of ₹ 34.99 lakh and ₹ 37.47 lakh respectively in the Profit & Loss Account against which it had claimed deduction under section 80IB(11A) for ₹ 19.89 lakh and ₹ 24.96 lakh respectively. AO had allowed it in the scrutiny assessment. Further, we noticed that the assessee's main source of income was rental income from ware house and it did not carry out any "integrated business" as defined in section 80-IB(11A) making the assessee ineligible for deduction under section 80IB(11A). The allowance of ineligible deduction of ₹ 44.85 lakh resulted in under assessment of income by an equal amount involving tax effect of ₹ 17.09 lakh.

We also noticed that a number of entities assessed in construction business were registered as Firms and in our previous report[20], we had highlighted similar nature of observation regarding ineligible deduction given to assessee firms under section 80IB of the Act.

[20] Report No. 12 of 2011-12-Performance Audit of Business of Civil Construction.

3.10 Recommendations

We recommend that

a. 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.

The Ministry replied (March 2014) that the issue is being examined as it would require modification in the ITRs to comply with the provisions of the Act.

b. 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.

c. 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.

d. 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.

The Ministry replied (February 2014) that the principles of computation of book profit cannot be applied to Firms as unlike the companies for which the Companies Act provides the detailed mechanism for determination of book profit, the Partnership Act does not provide any mechanism for determination of book profit of the Firm.

Audit is of the view that although the Act provides for the calculation of book profit for the purpose of remuneration of the Firm, it is still not clear whether non-business items such as capital gain, interest income, rental income, interest from other sources etc, are to be excluded or not. The Ministry may therefore issue clarification so that AOs apply it consistently.

The Ministry further replied (March 2014) that the computation of book profit is done under Chapter IV-D of the Act and reiterated that only income under the head "profits and gains of business or profession" is to be considered for calculation of book profit for determination of remuneration to Partners. However, the Ministry stated that the issue is being examined and necessary clarifications would be issued.

e. 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.

The Ministry replied (February 2014) that the Act does not provide for charging of interest by the partner or payment of remuneration by the Firm but only contains the provisions for disallowances if it does not fulfill certain conditions. Charging/Not charging of interest on Partner's Capital account or payment of remuneration is a business decision and the Act cannot mandate a Firm to charge such interest or payment of remuneration. Further, in order to protect the tax base of the Firms claiming these profit linked deductions, the concept of Alternate Minimum Tax has been introduced in the Income Tax Act vide Finance Act, 2012 in section 115 JC, which provides for levy of alternate minimum tax after adding back the deductions under Chapter VI A & section 10AA of the Income Tax Act.

Audit, while agreeing with the Ministry's view, is of the opinion that the Ministry may ensure strict enforcement of payment of remuneration/interest to Partners as per partnership deed by Firms who are availing various tax exemption/deduction as there are instances of non complying to provisions of Partnership deed by AOs.

The Ministry further stated (March 2014) that the issue is under consideration for any further clarification in this regard.

Chapter IV: Assessment of Firms

4.1 Introduction

We noticed mistakes relating to incorrect allowance of exemption/deduction, capital gains, carry forward and set off of losses, computation of income, incorrect allowance of depreciation etc in the assessments of Firms made by the ITD.

Several sections of the Act dealing with generic issues in the context of revenue collection have been incorporated in this chapter. We noticed 287 cases relating to mistakes, where the provisions of the Act were not followed correctly, with a tax effect of ₹ 244.57 crore. Category wise details of mistakes in assessment are shown in Table 4.1.

Table 4.1: Nature of mistakes with its tax effect

Nature of Mistakes	Cases	Tax effect (₹ in crore)
1. Income not assessed	56	44.13
2. Incorrect allowance of exemption/deduction	40	59.60
3. Mistakes in computation of Income	28	19.64
4. Depreciation/Set off of losses	44	25.00
5. Incorrect allowance of expenditure/provision	24	9.19
6. Capital gains	15	27.26
7. Other cases	80	59.75
Total	**287**	**244.57**

Assessing Officers did not assess income of the 56 Firms which resulted in short levy of tax of ₹ 44.13 crore.

4.2 Income not assessed

Section 5 of Act provides that the total income of a person for any previous year shall include all incomes from whatever source derived, actually received or accrued or deemed to be received or accrued.

We found 56 cases in 13 states[21] involving ₹ 44.13 crore where income was not offered to tax (see Box 4.1).

Box 4.1: Illustrative cases on income not assessed

a. In Andhra Pradesh, CIT-III Hyderabad charge, AO completed the assessment of **M/s. Dream Resorts** for AY 09 after scrutiny where the assessee received total amount of ₹ 14.85 crore towards settlement of bank dues. However, the assessee offered only ₹ 5.77 crore as income and hence, balance amount of ₹ 9.08 crore escaped assessment leading to short levy of tax of ₹ 3.90 crore including interest.

[21] Maharashtra, Tamil Nadu, Rajasthan, Punjab, Haryana, Assam, Karnataka, Andhra Pradesh ,Madhya Pradesh, Uttar Pradesh, Bihar, West Bengal and Chhattisgarh.

b. In Tamil Nadu, CIT-I Madurai charge, AO completed the assessment of **M/s. LPL Sons Roadlines** for AY 10 at nil income. We noticed that the assessee had shown total amount of ₹ 9.62 crore received towards lorry freight, hire charges and commission in the Income & Expenditure Accounts although assessee had actually received a total amount of ₹ 20.01 crore for the same during the year. Hence, the amount of ₹ 10.39 crore escaped income which resulted in short levy of tax of ₹ 3.50 crore.

Assessing Officers allowed incorrect exemption/deduction of 40 Firms resulting in short levy of tax of ₹ 59.60 crore.

4.3 Incorrect allowance of exemption/deduction

Chapter VIA and section 10 of the Act provide for certain deduction/ exemptions in computing total income of an assessee subject to fulfillment of conditions specified therein.

We noticed 40 cases of incorrect allowance of exemption/deduction in 13 states[22] involving tax effect of ₹ 59.60 crore (see Box 4.2).

Box 4.2: Illustrative cases on incorrect allowance of exemption/deduction

a. In Tamil Nadu, CIT-I Chennai charge, AO while completing the assessment of **M/s. Plaza Realities** for AY 10 under scrutiny, allowed deduction under section 80IB(10) for a sum of ₹ 13.46 crore. We noticed that the assessee entered into the contract with the land owner for the construction and therefore as per explanation inserted to the Act by Finance (No.2) Act, 2009, the assessee, being a contractor, should not have been allowed deduction under section 80IB of the Act. Mistake in allowing ineligible deduction resulted in short levy of tax of ₹ 6.59 crore.

b. As per section 10B(2)(iii) of the Act, if the new unit is formed by transfer of any plant and machinery previously used for any purposes, the unit is not entitled to claim any deduction under section 10B. In Tamil Nadu, CIT-VIII Chennai charge, AO completed the assessment of **M/s. Indira Industries** for AY 09 under scrutiny and allowed deduction of ₹ 7.86 crore under section 10B of the Act even though the assessee had installed the machinery which had already been previously used. The mistake resulted in under assessment of income by an equal amount involving short levy of tax of ₹ 3.73 crore.

[22] Maharashtra, Tamil Nadu, Gujarat, Rajasthan, Punjab, Haryana, Himachal Pradesh, J&K, Jharkhand, Assam, Karnataka, Andhra Pradesh and Madhya Pradesh.

Assessing Officers committed mistakes in computation of income in 28 cases involving tax effect of ₹ 19.64 crore.

4.4 Mistakes in computation of Income

Section 143(3) of the Act provides that AOs have to determine and assess the income correctly. Different types of claims together with accounts, records and all documents enclosed with the return are required to be examined in detail in scrutiny assessments. CBDT has also issued instructions from time to time in this regard.

We noticed 28 cases of mistakes in computation of Income in eight states[23] involving tax effect of ₹ 19.64 crore (see Box 4.3).

Box 4.3: Illustrative cases on mistakes in computation of income

a. In Andhra Pradesh, CIT-III Hyderabad charge, AO completed the assessment of **M/s. Edelvalue Partners[24]** for AY 11 after scrutiny at a loss of ₹ 26.69 crore as declared by the assessee. Audit noticed that the assessee deducted gross unrealized gain[25] of ₹ 30.17 crore instead of net unrealized gain of ₹ 7.58 crore from the net profit. The mistake resulted in under assessment of income of ₹ 22.59 crore involving potential tax effect of ₹ 6.83 crore. The ITD did not accept (May 2013) the audit observation stating that net unrealized gain was arrived at by adopting Accounting Standard-30 and the same needs to be deducted from the net profit. The reply itself confirms that the net unrealized gain should have been deducted from the net profit.

b. In Karnataka, DGIT (Investigation) Bangalore charge, AO completed the assessment of **M/s Devi Enterprises** for AY 11 under section 153(c)/144 of the Act at an income of ₹ 49.12 crore. We observed that AO had adopted the advance tax at ₹ 450 lakh instead of correct amount of ₹ 460 lakh and levied surcharge on tax which was not applicable for the relevant AY. The mistake resulted in excess levy of tax of ₹ 1.60 crore. The ITD rectified the mistake under section 154 of the Act (June 2013).

c. In Maharashtra, CIT-XV Mumbai charge, AO while completing the assessment of **M/s. Siddhivinayak Developers** for AY 08 after scrutiny in December 2009, considered the value of opening stock in the Profit & Loss Account at ₹ 32.08 lakh instead of correct amount of ₹ 184.08 lakh. The mistake resulted in under assessment of income of ₹ 152 lakh involving short levy of tax of ₹ 68.05 lakh.

23 Maharashtra, Punjab, Karnataka, Andhra Pradesh, Madhya Pradesh, Delhi, Odisha and Uttar Pradesh.
24 Engaged in business of trading in derivatives, securities and commodities.
25 Included under income from treasury operations in Profit & Loss Account.

Assessing Officers committed mistakes in allowance of depreciation/set off of losses in 44 cases involving tax effect of ₹ 25 crore.

4.5 Depreciation/set off of losses

Section 32 of the Act provides for allowance of depreciation at the rates prescribed in the Act subject to fulfillment of certain conditions. Further, section 72 provides for carry forward and set-off of net loss of an AY against profits and gains of the following eight AYs.

We found mistakes in allowance of depreciation/set off of losses in 44 cases in 12 states[26] involving tax effect of ₹ 25 crore (see Box 4.4).

Box 4.4: Illustrative cases on depreciation/set off of losses

a. In Gujarat, CIT I Rajkot charge, AO completed the assessment of **M/s. P. C. Patel & Company** for AY 11 at an income of ₹ 7.88 crore. We observed that AO allowed depreciation on tipper and dumper @ 30 per cent instead of applicable rate of 15 *percent* on the tipper/dumper as the assessee was engaged as a contractor. The mistake resulted in under assessment of income of ₹ 3.27 crore involving short levy of tax of ₹ 1.37 crore including interest. ITD replied (May 2013) that assessee had executed agreement of hiring of heavy earthmoving machinery for excavation work and hence, assessee was eligible for higher depreciation. Reply of the ITD is not tenable as the assessee had used tipper/dumper for the execution of contract work and not for the purpose of routine business activity.

b. In Maharashtra, CIT-XX Mumbai charge, AO completed the assessment of **M/s. Punit Creation** for AY 11 after scrutiny in December 2012 at a loss of ₹ 2.44 crore and allowed brought forward losses of AY 07 and AY 08 amounting to ₹ 3.45 crore which were already adjusted against the income of AY 10. The mistake resulted in excess allowance of carry forward of losses by an equal amount involving potential tax effect of ₹ 1.06 crore.

Assessing Officers committed mistakes in allowance of expenditure/ provisions in 24 cases resulting in short levy of tax of ₹ 9.19 crore.

4.6 Incorrect allowance of expenditure/provision

Provision made in the accounts for an accrued or known liability is an admissible deduction while other provisions do not qualify for deduction. Further, Section 37(1) of the Act stipulates that any expenditure incurred wholly and exclusively for the purpose of business or profession is allowed in computing the business income of the assessee.

[26] Maharashtra, Tamil Nadu, Gujarat, Rajasthan, Punjab, Karnataka, Andhra Pradesh, Kerala, Delhi, West Bengal, Goa and Uttar Pradesh.

We noticed 24 cases in nine states[27] involving short levy of tax of ₹ 9.19 crore having mistakes in allowance of expenditure/ provisions (see Box 4.5).

Box 4.5: Illustrative cases on incorrect allowance of expenditure/provision

a. In Assam, CIT-II Guwahati charge, AO while completing the assessment of **M/s. Brahmaputra Rolling Mills** for AY 10 after scrutiny at a loss of ₹ 4.80 crore, allowed expenses amounting to ₹ 13.45 crore on account of trial operation expenses. Since the amount expended for trial production was incurred before the commencement of commercial production, it should have been disallowed treating it as a capital expenditure. This omission resulted in underassessment of income of ₹ 13.45 crore involving potential tax effect of ₹ 2.05 crore.

b. In Tamil Nadu, CIT-I Chennai charge, AO while completing the assessment of **M/s. Kunnam Granite & Works** for AY 10 allowed an expense of ₹ 5.46 crore towards foreign currency fluctuation loss which was speculative in nature. The mistake in allowing speculative loss as business expenditure resulted in under assessment of income by an equal amount involving tax effect of ₹ 1.86 crore.

Assessing Officers did not consider capital gains for tax in 15 cases resulting in short levy of tax of ₹ 27.26 crore.

4.7 Capital gains

Section 45 of the Act provides that any profit or gain arising from the sale or transfer of a capital asset is chargeable to tax under the head "capital gains" and shall be deemed to be the income of the previous year in which the transfer took place.

We noticed 15 cases in four states[28] involving tax effect of ₹ 27.26 crore where capital gain was not offered to tax (see Box 4.6).

Box 4.6: Illustrative case on capital gains

Section 50C of the Act provides that where the consideration received as a result of the transfer by an assessee of a capital asset, being land or building or both, is less than the value adopted or assessed by stamp valuation authority for the purpose of payment of stamp duty in respect of such transfer, the value so adopted or assessed be deemed to be the full value of the consideration received or accruing as a result of such transfer.

27 Maharashtra, Tamil Nadu, Karnataka, Kerala, West Bengal, Uttar Pradesh, Assam, Odisha and Madhya Pradesh.

28 Maharashtra, Tamil Nadu, Gujarat and Haryana.

In Maharashtra, CIT-XII Mumbai charge, AO completed scrutiny assessment of **M/s. Kohli Associates** for AY 07 at an income of ₹ 123.39 lakh. We observed that assessee had received sale consideration of ₹ 153.60 lakh on sale of old structure and construction of new project, however, the value of constructed project for the purpose of stamp duty was ₹ 255.80 lakh. The incorrect adoption of sale value of asset resulted in under assessment of long term capital gain at ₹ 103.20 lakh involving tax effect of ₹ 23.16 lakh. ITD took remedial action by way of passing order under section 263 of the Act (December 2011).

4.8 Other cases

We also noticed various types of mistakes in 15 states[29] such as short/non levy of interest, incorrect classification of income, failure to comply with TDS/TCS provisions etc. in 80 cases involving tax effect ₹ 59.75 crore (see Box 4.7).

Box: 4.7: Illustrative cases on miscellaneous mistakes

a. In Delhi, DIT (International Taxation)-I, AO while finalizing assessment of **M/s. ESS Distribution (Mauritius)** for AY 08 after scrutiny in October 2011 at and income of US$ 3.12 crore, did not levy interest under section 234B of ₹ 9.56 crore. ITD rectified the mistake under section 154 of the Act (October 2012).

b. In Maharashtra, CIT-XXII Mumbai charge, AO while completing the assessment of **M/s. Rajesh Builders** for AY 08 under section 143(3) read with section 147 in March 2013 levied interest under section 234B for ₹ 2.81 crore instead of correct amount of ₹ 5.59 crore resulting in short levy of interest of ₹ 2.78 crore.

c. Section 234B(3) provides that where, as a result of an order of re-assessment under section 147 of the Act, the amount on which interest is payable is increased, the assessee shall be liable to pay simple interest at the rate of one per cent for every month or part thereof commencing on the day following the regular assessment till the date of re-assessment on the amount by which the tax on the total income determined on the basis of re-assessment exceeds the tax on total income determined in regular assessment. In Karnataka, CIT-III, Bengaluru charge, AO completed the assessment of **M/s Annapurneshwari Investments** for AY 06 after scrutiny at an income of ₹ 61.29 crore. Subsequently, case was reassessed under section 147 of the Act determining income of ₹ 26.63 crore. We observed that interest under section 234B (3) was levied at ₹ 1.87 crore instead of correct amount of ₹ 2.92 crore resulting in short levy of interest of ₹ 1.05 crore. ITD accepted and initiated action under section 154 of the Act (April 2013).

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29 Maharashtra, Tamil Nadu, Gujarat, Rajasthan, Punjab, Haryana, Jharkhand, Karnataka, Andhra Pradesh, Uttar Pradesh, Odisha, Delhi , Chhattisgarh, Madhya Pradesh and Bihar.

4.9 Recommendation

We recommend that 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.

The Ministry in its reply (February 2014) elaborated on the steps taken by CBDT to improve the quality of assessment. CBDT has laid emphasis on improving quality of scrutiny assessment in their Central Action Plan. Post assessment, field offices, from FY 12 onwards, forward analysis of 50 quality assessments for suggesting improvement of assessments which are published annually. CBDT has also instructed supervisory offices to play an effective role and to bring matter of omission/commission on part of AOs to the Competent Authority for administrative action. CBDT also uses the system of review and inspection as an effective tool to monitor the quality of scrutiny assessments. A lot of emphasis is being laid on capacity building of Assessing Officer(s) which is achieved through regular training and interaction with Commissioner (Appeals) and Commissioners posted in Income Tax Appellate Tribunal at regular intervals.

Chapter V: Internal Control

5.1 Introduction

Internal control is necessary to improve policy formulation and implementation. An effective system of internal controls serves as a means to obtain reasonable assurance that the steps and action undertaken by the ITD meet their established goals and objectives. We have tried to highlight the control issues of the ITD by checking records available at the CsIT[30] relating to the Firms.

ITD did not carry out inspections/quarterly reviews of records maintained for the Firms diluting the importance of monitoring.

5.2 Monitoring

Section 119 of the Act provides that CBDT may, from time to time, issue such orders, instructions and directions to other income tax authorities as it may deem fit for proper administration of the Act, and such authorities and all other persons employed in the execution of this Act, shall observe and follow such orders, instructions and directions of CBDT.

It is thus, imperative that all officers employed in the execution of these statutes shall observe and follow any orders, instructions and directions issued by CBDT for proper tax administration. Brief of some of the instructions issued by the CBTD are given in Box 5.1.

Box 5.1: Instructions regarding inspection

a. *Instruction no. 16/2008 dated 04 November 2008*: CsIT are required to carry out inspections of Range Offices & Circle Offices under their control and submit inspection report.

b. *Instruction no. 15/2008 dated 04 November 2008*: Each CIT is required to review the assessment of the DCsIT/ACsIT and make at least three assessments of each DCsIT/ACsIT per quarter. Similarly, Range Officers are required to review the assessment done by ITOs in their range and to make specific comments on at least three assessments of each ITO per quarter.

We found deficiencies in monitoring by ITD which are as follows:

a. In West Bengal, the inspections carried out by CIT-Central-III and CIT-XI, Kolkata for FY 11 did not translate into productivity as the deficiencies pointed out in inspection reports were continued in inspection report of next year also. We also found that CsIT and Range Officers reviewed less number of assessment orders as against the

30 Two CsIT taken for evaluation for each state.

limit prescribed in the instructions, thus diluting the control activities of the ITD.

b. In CIT-Bhubaneswar (for FY 13), CIT-Cuttack (for FY 12 and FY 13) and their Range Offices, the Commissioners as well as Range Officers did not carry out inspection in their subordinate offices.

c. In Tamil Nadu CIT-VIII Chennai and CIT-Coimbatore, there was no monitoring/ controlling mechanism at the level of CIT regarding the issue of notices sent to non filers and stop filers.

d. In Bihar CIT-II Patna charge, assessment records of **M/s. Uma Shankar Singh** for AY 09 revealed that CIT-II Patna had carried out quarterly review and sought compliance report from AO on certain observations. However, the AO did not take any action, neither did he furnish compliance report on the observations made by CIT-II Patna.

Therefore, instructions issued by CBDT from time to time are not being followed by Range Officers and Circle Officers properly.

ITD did not maintain prescribed records properly which resulted in ineffective control mechanism.

5.3 Deficiencies in maintenance of Registers

Documentation of procedure and maintenance of registers for various functions of the ITD and its updation are essential for effective control mechanism (see Box 5.2).

Box 5.2: Instructions regarding maintenance of registers
a. *Instruction no. 1/2009 dated 12 February 2009*: Jurisdictional AOs and designated AOs are required to maintain register of action taken on AIR information in the prescribed format which should be inspected every quarter by Range head and the CIT concerned.
b. *Para 2.4.1 of Chapter 14 of Manual of Office Procedure (MOP)-Vol.-I, 2003*: Each AO has to maintain a Grievance Register in the proforma prescribed in Annexure I.

We found deficiencies in maintenance of registers, which are as follows:

a. In Gujarat, the Grievance Registers were not maintained properly. The columns like ‘Code No.’, ‘Nature of Disposal’ etc. were not included in the Register. Scrutiny of Personal Deposit (PD), Account Cash Book, PD Ledger Account and the correspondence folder revealed that the monthly balance statement from the bank was not obtained and reconciled with the balance in the Cash Book. We also found a discrepancy in the closing balance as per Cash Book and Bank Book records for an amount of ₹ 4.82 lakh. In Gujarat CIT-Valsad charge, the Arrear Demand & Collection register (ADCR) was not updated/rectified resulting in excess credit of ₹ 22 lakh to the assessee.

b. In Uttar Pradesh and Uttarakhand, registers such as Advance Tax Register, Annual Information Return (AIR) and references to Valuation Cell Register were either not maintained or not updated.

c. In Karnataka and West Bengal, Demand & Collection Register were not updated and register of action taken on AIR was not maintained at all.

d. In Himachal Pradesh charge, in eight units, no register to utilize the AIR information were maintained and in one unit, it was not put up to the Addl. CIT for quarterly verification/monitoring.

Non maintenance of prescribed registers to ensure comprehensive recording of the transactions defeated the very objective of the system, hence diluting the internal control mechanism of the ITD.

ITD did not give importance to their internal audit as it was neither conducted nor did it cover the Firms assessment records.

5.4 Internal Audit

The objective of internal audit inter alia includes checking whether procedures and terms prescribed by the ITD are adequate and the instructions issued and procedures prescribed by CBDT are being duly implemented. Role of internal audit is also to exercise vigilance for prevention of mistakes and to improve quality of assessment by reducing the errors and omissions.

The deficiencies in conducting internal audit were as follows:

a. In Uttar Pradesh, the internal audit was not being conducted regularly for FY 11 and FY 12.

b. In Andhra Pradesh, out of 35 units selected for audit, internal audit was not conducted in 7 units and partly completed in 11 units.

c. In Odisha, CIT-Bhubaneswar charge, we found that none of the assessment records had the evidence of audit conducted by Internal Audit Party (IAP).

d. In West Bengal, internal audit did not check the assessments completed relating to the Firms in assessment charges under CIT XI & CIT Central III Kolkata during the period FY 11 to FY 13.

e. In Uttarakhand, CIT-Dehradun charge, we found that IAP did not check any assessment records during FY 13.

The above deficiencies indicate lapses in the internal control mechanism of the ITD.

ITD did not effectively utilize the information available in the Tax Audit Reports issued by Accountants (third party) against the Firms which resulted in income escaping assessment.

5.5 Incorrect/incomplete certification by Chartered Accountants

The Tax Audit Report issued by an accountant is one of the tools in the hands of the ITD for deciding the correctness of the income and deductions claimed by the assessee. CBDT in order to ensure that the assessee, accountant and AO comply with the various provisions of the Act, had issued *Instruction No. 1959 and 1976 in January 1999 and November 1999* respectively. These Instructions contain detailed procedures for effective utilization of information available in the Tax Audit Reports while finalizing the assessments. The instructions issued included that the AO may again examine the Tax Audit Report thoroughly at the time of completion of assessment of the detailed scrutiny u/s 143(3), to ascertain whether any addition to the income is possible on the basis of the same or whether any further investigation is required pursuant to the information submitted therein.

Section 44AA requires compulsory maintenance of books of accounts by different categories of taxpayers and section 44AB requires the audit of accounts of any person carrying out any business or profession, by an accountant if the total turnover/gross receipts of the business or profession for the previous year exceed ₹ 40 lakh or ₹ 10 lakh respectively. The deficiencies in third party reporting are given in Box 5.3.

Box 5.3: Illustrative cases on deficiencies in third party reporting

a. In Odisha, CIT-Bhubaneshwar charge, we noticed that provisions of section 44AA of the Act were not complied with in respect of M/s. S. M. Enterprises. In Karnataka, CIT-Hubli charge, AO completed the assessment of a Firm **M/s. A. A. Logistics** for AY 09 under scrutiny and for AY 10 & AY 11 under summary manner. We noticed that the provisions of section 44AA and section 44AB of the Act were not complied with and no action had been initiated in this regard to levy penalty u/s 271A and 271B of the Act. On being pointed out, the ITD accepted the audit observation for AY 09 and levied the penalty under section 271A of the Act.

b. In Andhra Pradesh, CIT-Tirupati charge, we found in two cases that the 'Third Party' had reported/certified identical details[31] in respect of two assessee Firms indicating incorrect reporting by the Chartered Accountant.

c. In West Bengal, we found in two cases that the 'Third Party' failed to report correctly regarding compliance of TDS provisions and in one case, they did not quantify the 'Telephone & Motor Car Expenses' despite the expenses being debited to Profit & Loss Account.

d. In Maharashtra CIT-Thane charge, in the case of **M/s. Shree Varad Vinayak Developers** for AY 11**,** the assessee had furnished the Tax Audit Report for AY 10 wherein the tax auditor had reported on non-deduction of TDS on ₹ 59 lakh. But the AO failed to reopen and assess the return for the AY 10 by scrutiny to add back the amount of ₹ 59 lakh to income. This resulted in loss of revenue by ₹ 18.23 lakh.

e. In Karnataka, out of 1,265 Firms test checked, we found 250 Firms having 867 Partners did not mention PAN of Partners in form 3CD report.

f. In Punjab, we found that the assessee had not furnished the form 3CD report as per the section 44AB. Further, AO did not levy penalty nor issued notice to the assessee for non-compliance of provisions.

In this connection, a reference is also invited to 'Review on Appreciation of Third Party Reporting/ Certification in Assessment Proceedings'[32] wherein recommendation had been made to ensure that AOs critically examine the Tax Audit Reports along with the connected records and take action in terms of instruction number 1959 in cases where inaccurate information have been furnished by tax auditors. CBDT had accepted the recommendation. However, keeping in view the recurrence of similar instances, the recommendation is reiterated.

5.6 Effectiveness of survey in tax administration

The provisions of the Act empower the AO to scrutinize the returns and the statements filed in order to determine the income and to collect tax. The examination of books of accounts and verification of the facts presented by the assessee are the primary jobs of the AO. In this context, the power of survey serves the following two important purposes viz (i) ITD's determination to reach out and obtain information about the assessee and his income earning activities, and (ii) meaningful selection of cases for scrutiny by collecting information about various trades and trade practices.

[31] For hire charges and labour welfare expense.
[32] Chapter-2 of CAG's report no. PA 7 of 2008.

In Haryana, we found that information obtained during the survey was not utilized in assessment for the computation of total income involving tax effect of ₹ 4.14 lakh.

Thus the AOs are not making effective use of the information collected during the surveys while making assessments.

5.7 Selection for scrutiny

CBDT issues instructions every year which lay down the procedure for selection of assessments for compulsory scrutiny under various categories. As per the CBDT's norms for compulsory scrutiny and Computer Aided Selection for Scrutiny (CASS) norms, the returns of all the builders following project completion method are required to be selected for compulsory scrutiny.
We found two cases in Maharashtra wherein the cases were not considered for assessment under scrutiny manner in spite of a reduction in the income with respect to previous year (see Box 5.4).

Box no.5.4: Illustrative case on non-selection under scrutiny assessment

In Maharashtra in CIT-XXII Mumbai charge for the last three AYs 09, 10 and 11, in case of **M/s. Raja Construction** we noticed that the Firm was assessed under summary despite there being a reduction of income of ₹ 118 lakh in AY 10 compared to AY 09. The Firm has shown taxable income of ₹ 157.41 lakh, ₹ 39.93 lakh and ₹ 70.68 lakh respectively during the above AYs, however, the case was not selected for scrutiny.

ITD did not recover/write off of arrear demands against the defaulting Firms leading to loss of revenue.

5.8 Recovery/Write-off of arrear demand

Under the provision of section 226(5) of the Act, the AO or Tax Recovery Officer (TRO) may, if so authorized by the CCIT or CIT by general or special order, recover any arrears of tax due from an assessee by distraint and sale of his movable/immovable property in the manner laid down in the schedule. Further, Chapter 13 of the Manual of Office Procedure of the ITD specifies that when tax demands remain irrecoverable in spite of exercise of powers of recovery under the Act, the option of "write off of arrears" should be considered. The powers to sanction write off of revenue have been delegated by the Central Government to the Income Tax Authorities. All the CITs have full powers to write off irrecoverable balance of Income Tax, Wealth Tax etc. subject to a report to the next higher authority.

If an assessee fails to pay the amount of tax of demand, within one month from the date of receipt of notice, the AO shall initiate the proceeding of recovery of such demand by distraint warrant and sale of movable/immovable properties of the assessee. He should also report such matters to higher authorities/CsIT and TROs for taking prompt/proper action along with proceedings of initiation of penalty u/s 221(1) for non-payment of such amount of demand notice.

We found cases where provisions for recovery/write off of demands were not followed.

- **a.** In Haryana charge, arrear of tax demand of ₹ 125.81 lakh were outstanding against the defaulting Firms for more than 3 years in eight cases. Further, in Punjab charge, arrear of tax demand outstanding against defaulting Firms amounted to ₹ 282.01 lakh and in Jammu & Kashmir charge, total arrears of ₹ 813.15 lakh were outstanding for more than three years. However, in no case, recourse to proceedings laid down in the Act had been initiated.
- **b.** We also found in Assam CIT-II Guwahati charge for the AY 10 in case of **M/s. GM Coke Holding** that AO raised demand notice of ₹ 257.35 lakh which was also confirmed by the CIT(A) but did not follow up further action for recovery. ITD also did not initiate any requisite penalty proceedings for default in payment of demand tax.
- **c.** In Uttar Pradesh, we noticed that the AO did not partially write off/write-off the arrear demand despite demands amounting to ₹ 25,630 lakh and ₹ 2,961 lakh pertaining to Kanpur and Agra respectively being outstanding for more than three years in respect of FY 11, 12 and 13. We also found in CIT-Allahabad that a demand of ₹ 115.04 lakh created after scrutiny assessment for AY 10 in respect of **M/s. Gajraj Chemicals** was not followed up for recovery.
- **d.** In Kerala CIT-II, Kochi charge, we found that although tax arrears amounting to ₹ 209.11 crore (all assessees) was outstanding at the end of March 2013, the AO did not take any coercive action for recovery of the same.
- **e.** In Gujarat, we found in seven cases that outstanding demand was recovered without charging interest u/s 220(2) of the Act having a tax effect of ₹ 53.85 lakh.

It is evident from the above illustrations that internal control at the level of AO and TRO is weak and not being monitored at appropriate level.

5.9 Others

a. According to CBDT's *Instruction no.7/2002 of August 2002*, refunds determined, where administrative approval is necessary before issue of refund, should be issued within 30 days from the date of determination of refunds. In West Bengal under CIT-XI Kolkata charge, we noticed that Range Offices took considerable time of more than two months in granting administrative approval for refund. In twelve cases, similar approval was accorded after the aforesaid prescribed date.

b. In Uttar Pradesh CIT-Ghaziabad charge, we noticed in two cases that the Online Tax Accounting System had created a fictitious demand without recognizing the credit for tax deposited.

c. In Gujarat, we found that settlement of grievances was pending for more than three years in respect of four cases and for less than three years for eight cases. The ITD accepted (July 2013) the observation and replied that the pendency shown by audit is being attended to.

d. We observed in Gujarat CIT-Valsad charge that in the case of Firm **M/s. J. K. Brothers**, irregular allowances of carry forward of losses amounting to ₹ 17.20 lakh was granted due to non-synchronization of total income shown under ITD system software with the total of various head of income entered by the users.

e. In Andhra Pradesh we noticed that out of 474 stop-filers and 3202 non-filers in respect of Firms the ITD issued notices to only 114 assessees. In Karnataka ITD did not issue any notice nor levied any penalty to the 1748 non-filers.

5.10 Recommendations

We recommend that

a. 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.

b. ITD may ensure that all required registers are maintained by their field units which may be checked for compliance by the Internal Audit Party.

The Ministry replied (March 2014) that DIT (Organisation & Management Services) has prescribed certain set of registers to be maintained and it has been enabled in electronic form in ITD application.

New Delhi **(MANISH KUMAR)**
Dated : **30 May 2014** **Pr. Director (Direct Taxes)**

Countersigned

New Delhi **(SHASHI KANT SHARMA)**
Dated : **30 May 2014** **Comptroller and Auditor General of India**

Abbreviations

ACIT	Assistant Commissioner of Income Tax
ADCR	Arrear Demand & Collection Register
AIR	Annual Information Return
AO	Assessing Officer
AOP	Association of Persons
AY	Assessment Year
BoI	Body of Individuals
CAP	Central Action Plan
CBDT	Central Board of Direct Taxes
CCIT	Chief Commissioner of Income Tax
CEO	Chief Executive Officer
CIT	Commissioner of Income Tax
CIT(A)	Commissioner of Income Tax (Appeal)
DCR	Demand & Collection Register
DGIT	Director General of Income Tax
DIT	Directorate of Income Tax
FY	Financial Year
HUF	Hindu Undivided Family
IAP	Internal Audit Party
ITD	Income Tax Department
ITO	Income Tax Officer
ITR	Income Tax Return
JCIT	Joint Commissioner of Income Tax
LLP	Limited Liability Partnership
PAN	Permanent Account Number
TCS	Tax Collection at Source
TDS	Tax Deducted at Source
TRO	Tax Recovery Officer