

Update
on
CBDT Circular No. 12/2019 dated 19.6.2019

Assessment of Firms
Some of the important issues to be kept under
consideration by the Assessing Officers while framing assessment

1. As per **CBDT Circular No. 12/2019 dated 19.6.2020**, C&AG had carried out a Performance Audit regarding '*Assessment of Firms*' under the Income-tax Act, 1961 (Act) and in its Report No.7 of 2014, had made certain suggestions so that in future, assessments in these cases are handled in a more effective manner by the Assessing Officers (AOs).
2. The Circular further states that various recommendations made by the C&AG in its Report have been duly considered by the Central Board of Direct Taxes (Board).
3. Therefore, in order to **improve the quality of assessments** being framed in the cases of firms **and** also to **reduce the scope for committing errors** in such assessment, the Board desired that AOs should duly take into consideration certain significant issues, which have been enlisted by the Board in its **Circular No. 12 of 2019 dated 19.6.2019**, which are being discussed hereunder.

Applicability of the Circular

{Circular No. 12 of 2019 dated 19.6.2019}

4. The Circular clarifies that it would also be applicable to limited scrutiny cases if the assessee is a registered firm.

Allowance of expenses in the hands of firm

5. **Expenses** in the hands of the firm such as **interest** on capital paid to the partners, **remuneration** payable to the working partners *etc.* are taxable in the hands of respective partners. Therefore, while framing assessment in case of firms, a cross-verification of such amounts with income-tax return of firm's partner will be desirable and any discrepancy between the tax return of a firm and its partners should be dealt with as per provisions of the Act.

Instrument of Partnership

6. Further, AOs should invariably **call for a copy of the partnership deed** during the course of assessment proceedings **and examine it carefully** so that instances of payment of remuneration to any non-working partner **or** remuneration payment for period prior to the date of partnership deed but claimed as deductible are identified and cognizance of these are duly taken in assessment.

Interest to partners

7. In respect of *interest to partners*, the Circular states that section 40(b)(iv) stipulates following three conditions for allowability of **interest** to the partners of a firm:
- (a) the payment should be **in accordance with the terms of the partnership deed; and**
 - (b) it should **relate to any period falling after the date of such partnership deed; and**
 - (c) it **should not exceed** the amount calculated at the **rate of 12%** simple interest per annum.
8. In respect of the *interest* the Circular further states that instances have been noticed where the interest in the partnership deed was stated to be below 12%, yet, the same was allowed at the rate of 12% by the AO. Therefore, the Circular desires that such mistakes should be avoided. In case the rate prescribed in the partnership deed is in excess of 12%, the excess should be disallowed in assessment.
9. The Circular further requires the “Assessing Officer” AO to ascertain whether payment of the *interest* is **duly authorized by the partnership deed or not**.
10. The Circular further states that while calculating interest payable to the partners for purposes of section 40(b)(iv) of the Act, **AOs are taking different yardsticks** for calculating interest *viz.*
- (a) opening balance of capital,
 - (b) closing balance of capital,
 - (c) fixed capital **or**
 - (d) current capital *etc.*
11. Therefore, in this regard the Circular states that section 40(b)(iv) of the Act prescribes that payment of interest to partners should be authorized by and be in accordance with the partnership deed. Therefore, while framing assessment, **AOs should refer to the terms of the partnership deed for purpose of computation of interest** on capital payable to a partner.

Remuneration to partners

12. In respect of **remuneration** to partners the Circulars states that Clause *(ii)* and *(v)* *{it should be read as sub-clause (ii) and (v)}* of section 40(b) of the Act lays down that payment of remuneration to a working partner
 - (a) should be authorized by the partnership deed,
 - (b) should be in accordance with the terms of the partnership deed,
 - (c) should relate to a period after the partnership deed **and**
 - (d) should also not exceed the maximum amounts prescribed therein.
13. In this regards the Circular further states that however, it has been noticed that in some assessments, **AOs had allowed expenditure on remuneration** to the working partners though the same was **either not** authorized by the partnership deed **or** was in excess of the amount specified therein.
14. Therefore, the Circular requires that in order to prevent recurrence of mistakes and allowing the expenditure strictly as per provisions of the Act, the AOs should ensure that claim under section 40(b)(v) of the Act is allowed only after a **thorough verification of the partnership deed**.
15. In respect of computation of remuneration, the Circular further clarifies that while computing remuneration which is allowable to a working partner under section 40(b)(v) of the Act, the term '*in accordance with the terms of the partnership deed*' in clauses *(ii)* and *(v)* of section 40(b) of the Act implies that **remuneration should not be** undetermined **or** undecided.
16. Hence, in all situations, **partnership deed should form the basis for determination** of remuneration payable to the working partners.
17. The Circular further provides that furthermore, in situations where the remuneration either so specified in the partnership deed **or** computed as per the method indicated therein **falls short of** the amount allowable under section 40(b)(v) of the Act, **it would be restricted to the figure computed on the basis of the partnership deed**.
18. While computing remuneration payable to the working partners u/s 40(b)(v) of the Act, the **remuneration should not exceed a particular aggregate amount which is based upon the figure of 'book profit'**.
19. With regards to **'book profit'** the Circular draws attention to The *Explanation 3* to section 40(b) of the Act, which contains definition of **'book profit'** for the purposes of determination of remuneration of the partners. It provides that **'book profit'** shall mean the net profit, as shown in the profit & loss account for the relevant previous year, **computed in the manner laid down in Chapter IV-D as increased** by the aggregate amount of the remuneration paid or payable to all the partners of the firm if such amount has been deducted while calculating the net profit. Therefore, while computing **'book profit'** for purposes of section 40(b)(v) of the Act, all incomes such

as capital gain, interest, rental income, income from other sources *etc.* which do not fall under the head 'profit or gain of business or profession', *should be excluded*.

Chapter XVI of the Act

20. The Circular further states that the AOs are advised to apply the **provisions of Chapter XVI** of the Act in assessment of firms whenever required.
21. Chapter XVI of the Act provides special provisions applicable to firms. It contains following sections:
- | | | |
|------------------|---|---|
| (a) Section 182 | - | Since omitted by the Finance Act, 1992 |
| (b) Section 183 | - | Since omitted by the Finance Act, 1992 |
| (c) Section 184 | - | Assessment as a firm |
| (d) Section 185 | - | Assessment when section 184 not complied with |
| (e) Section 186 | - | Since omitted by the Finance Act, 1992 |
| (f) Section 187 | - | Change in constitution of firm |
| (g) Section 188 | - | Succession of one firm by another firm |
| (h) Section 188A | - | Joint and several of partners for tax payable by firm |
| (i) Section 189 | - | Firm dissolved or business discontinued |
| (j) Section 189A | - | Provisions applicable to past assessments of firms |
22. In this regard the Circular states that it should be taken into consideration that under **section 185** of the Act, any **non-compliance** by the firm **or** its partners with provisions of **section 184** of the Act **may result in denial of expenses** such as remuneration, interest *etc.* payable to the partners which are otherwise allowable under the provisions of the Act.

Section 80IA of the Act

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

Section 78 of the Act

24. In this regard the Circular states that while framing assessments in case of firms claiming carry forward **and** set *off* of losses, Assessing Officers are requested to verify such claims taking into consideration provisions of section 78 of the Act which disallow such a carry forward and set *off* in case of change in constitution of the firm or on succession.

Tax Audit of firms

{Instruction No. 09/2008 dated 31.07.2008}

25. In this regards the Circular states regarding the issue concerning possible action against the tax auditor for furnishing incomplete information in the Tax-Audit Report **and** effective utilization of information in the Tax Audit Report by the Assessing Officers, it is reiterated that directions given earlier *viz.* **Instruction No. 09/2008 dated 31.07.2008 of CBDT** should be followed scrupulously by the field authorities.
26. The **instruction No. 09/2008 dated 31.7.2008**, *inter alia* states that the information available in tax audit reports not being properly analysed during assessment proceeding. Tax audit reports and other statutory audit reports should be critically examined along with connected records and other available evidence. Information available in reports should be effectively utilised while finalising assessment. AOs should not merely rely on certificate re. payments / loans otherwise than by account payee cheque /draft, but test check and keep results of test check on record. In cases of factual misrepresentation by CAs, suitable action u/s. 288 should be taken – disciplinary action through ICAI

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