

PARTNERSHIP FIRMS & LIMITED LIABILITY PARTNERSHIPS:
CONTROVERSIAL ISSUES UNDER TAX AND ALLIED LAWS

- Dr. K. Shivaram, Senior Advocate &
Mr. Shashi Ashok Bekal, Advocate

Abstract

*Section 9B and section 45(4) of the Income-tax Act, 1961, (**Act**) were introduced vide Finance Act, 2021, **(2021) 432 ITR (St) 52** albeit there is no reference to the same in the Memorandum explaining the provisions of the Finance Bill, 2021 **(2021) 430 ITR 214 (St)** nor in the Notes on Clauses **(2021) 430 ITR 160 (St)**. Furthermore, they were introduced with a retrospective effect.*

*Though sections 9B and 45(4) of the Act deal with “specified entity” as defined in explanation (ii) to section 9B of the Act which means a firm or other association of persons or body of individuals not being a company or a co-operative society. This article is authored with a special focus on partnership firms (**firms**) and limited liability partnerships(**LLP**).*

*There are several issues revolving around the taxation of firms and LLPs which cannot be covered in this article. At the risk of sounding promotional, We would like to mention that in 2021, the All India Federation of Tax Practitioners (**AIFTP**) released a book titled “Handbook on Taxation of Partnership Firms & Limited Liability Partnerships: Frequently*

Asked Questions” that aims at addressing a lot of queries.

The scope of this article will be restricted to controversial issues for firms and LLPs.

Table of Contents

Abstract

1. Introduction

2. Controversial issues under Tax Laws

- 2.1. The implication of the decision of the Hon’ble Supreme Court in the case of CIT v. Mansukh Dyeing and Printing Mills [2022] 449 ITR 439 (SC)**
- 2.2. Whether the sections 9B and 45(4) of the Act can be introduced with retrospective/retroactive effect?**
- 2.3. Between sections 9B and 45(4) of the Act, which section comes into play first?**
- 2.4. Whether sections 9B and 45(4) of the Act is applicable to payment made to legal heirs of the deceased specified person?**
- 2.5. What are the implications under section 9B of the Act where a partner exists the partnership with raw materials or work in progress?**
- 2.6. Whether deeming sections like section 43CA, section 50C or section 56(2)(x)(b) applicable to transactions covered under section 9B of the Act?**
- 2.7. Whether section 45(4) of the Act is applicable to Slump Sale?**
- 2.8. What is a Limited Partnership?**
- 2.9. What is the due date for filing of return for a Limited Liability Partnership?**
- 2.10. Can a supplementary partnership deed be furnished at the time of assessment with a retrospective effect?**

3. Controversial issues under Allied Laws

- 3.1. Is the Registrar of Firms duty-bound to look into a complaint raised before it?**
- 3.2. Can the partners of an unregistered firm refer its issues for arbitration?**
- 3.3. Can an arbitration clause be enforced by the legal heirs of a deceased partner?**
- 3.4. Can a retired partner be held liable under the Negotiable Instruments Act, 1881? Whether the proceedings can be quashed under section 482 of the Code of Criminal Procedure, 1974? Can criminal proceedings be initiated only against a partner?**
- 3.5. Is an unregistered partnership firm barred from filing a suit on a transaction which is not in course of business?**

4. *Dénouement*

xxx

1. Introduction

As mentioned above, the introduction of sections 9B and 45(4) of the Act has raised a number of issues. In a country like India, the majority of family businesses and businesses are in the form of partnerships. Therefore, it is imperative to understand the implications of the amendments in the Income-tax Act, 1961 and other developments in the jurisprudence governing these entities.

With respect to sections 9B and 45(4) of the Act, the Central Board of Direct Taxes issued a **Circular No. 14 of 2021, dated July 2, 2021 [2021] 436 ITR 25 (St)** which serves as a guide to understanding the computation of Capital Gains and the newly introduced Rule 8AA and Rule 8AB of the Income-tax Rules, 1962

for the purpose of computing the profits/gains arising on account of section 45(4) of the Act.

These amendments still raise a number of issues amongst taxpayers, chartered accountants, lawyers and also Departmental Officers. Although the Indian Partnership Act was enacted in 1932, the jurisprudence governing the law is still developing each day.

In this article, We aim to address a few issues which have come to our notice in the past couple of years.

2. Controversial issues

2.1. The implication of the decision of the Hon'ble Supreme Court in the case of CIT v. Mansukh Dyeing and Printing Mills [2022] 449 ITR 439 (SC)

The Hon'ble Supreme Court in the case of **CIT v. Mansukh Dyeing and Printing Mills [2022] 449 ITR 439 (SC)** where pursuant to the reconstitution of the assessee-partnership firm, assets of assessee were revalued and the revalued amount was credited to partners accounts in their profit sharing ratio, said credit was in effect distribution of the increased value of assets to partners, and as said credits were available to partners for withdrawal, assets so revalued and credited into capital accounts could be said to be 'transfer' which would fall in the category of 'otherwise' under section 45(4) of the Act and said amount would be chargeable to STCG.

The decision of the Hon'ble Supreme Court overrules the decision of the Hon'ble Income-tax Appellate Tribunal – Mumbai Tribunal (Third Member) in the case of **D.S.**

Corporation v. ITO I.T.A. Nos. 3526 & 3527/MUM/2012 dated November 15, 2018 (TM)(Mum)(Trib). It is also contrary to the fundamental principles that one cannot generate income from oneself and that there can be no capital gains without a transfer.

It is pertinent to note that the erstwhile section of section 45(4) of the Act is substituted with a new section 45(4) of the Act by the Finance Act, 2021. The new law doesn't have the term "otherwise" which requires interpretation. The decision of the Hon'ble Supreme Court will definitely provide clarity with respect to all the pending disputes before the lower authorities. However, it has no implications on the new section 45(4) of the Act

2.2. Whether the sections 9B and 45(4) of the Act can be introduced with retrospective/retroactive effect?

Section 9B of the Income-tax Act, 1961 passes the test of Legislative competence, it is not violative of any Fundamental right guaranteed in Part III of the Constitution of India, nor does the provision infringe or is ultra vires any other provision of the Constitution. Therefore, Section 9B of the Income-tax Act, 1961 passes the test of Constitutional validity.

In the case of **Sardar Baldev Singh v. CIT [1960] 40 ITR 605 (SC)** it was held that the legislative competence to enact the section can be clearly upheld on the ground that it was to prevent evasion of income tax and that would be enough to dispose of the argument that the section was an incompetent piece of legislation.

Section 9B of the Income-tax Act, 1961 introduced vide Finance Act, 2021 is effective from Assessment Year 2021-22 onwards i.e., the same is applicable to Finance Year 2020-21.

With respect to the retroactivity of the newly inserted provision, there is no bar on the Legislature to make retroactive amendments. The Hon'ble Supreme Court in the case of **Chhotabhai Jethabhai Patel and Co. v. UOI 1962 SCR Supl. (2)(1)** has held that if a power to impose taxation has been conferred by a constitution, then the legislature could equally make the law retroactive and impose the duties from a date earlier than the date from which it was imposed.

2.3. Between sections 9B and 45(4) of the Act, which section comes into play first?

According to the CBDT **Circular No. 14 of 2021, dated July 2, 2021 [2021] 436 ITR 25 (St)**, section 9B of the Act has to be given effect first and then Capital Gains have to be computed under section 45(4) of the Act.

The Department will have to follow the method prescribed in the Circular. It is a well-settled position in law that the CBDT Circulars and Notifications are binding on the Departmental Officers. The Circulars and Notifications of CBDT explaining the Scheme of the Act has been held to be binding on the Department repeatedly by the Hon'ble Supreme Court in a series of judgments including **UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC), Navnit**

Lal C. Jhaveri v. K.K. Sen IAC [1965] 56 ITR 198 (SC)
and **UCO Bank v. CIT [1999] 237 ITR 889 (SC).**

2.4. What is a Limited Partnership?

A limited partnership is a form of partnership prevalent in the United States of America and some countries in Europe, where some partners have limited liability and one or more partners have unlimited liability. It is frequently used as a vehicle to make investments in India.

An issue arises whether the same would be treated as an LLP or a firm.

A Limited partnership is usually treated as a fiscally transparent entity. Therefore, it would be treated as a firm by the Indian tax Authorities.

The Hon'ble Tax Court of Canada in the case of **Flsmidth Ltd. v. Her Majesty The Queen [2012] 18 taxmann.com 115 (TC - Canada)** has observed that under Canadian tax law, a US limited partnership constituted as per Delaware state laws was treated as a transparent entity. *Albeit*, the Japanese Supreme Court vide order dated July 17, 2015, held the same entity to be a "corporation". Therefore, it becomes important to test the entity with the laws of the Country.

An inference can be drawn to the decision of the Hon'ble Income-tax Appellate Tribunal in the case of **Infosys BPO Ltd. v. DCIT [2021] 131 taxmann.com 293 (Bang) (Trib.)**, **ACIT v. Chiron Behring GmbH & Co. [2009] 314 ITR(T) 59 (Mum)(Trib)** and a decision of the Hon'ble

Authority for Advance Ruling in the case of **Tiger Global International II Holdings, In re [2020] 116 taxmann.com 878 (AAR - New Delhi)** where the view is that a limited partnership is a fiscally transparent entity.

Therefore, it would be advisable to treat a Limited Partnership as a General Partnership to avoid any litigation with Indian tax authorities.

2.5. Whether sections 9B and 45(4) of the Act is applicable to payment made to legal heirs of the deceased specified person?

There is no clarification to this effect.

Assuming a deeming provision has to be strictly, a “legal heir” is not within the definition of a specified person. Therefore, it is a debatable issue. Therefore, it can be argued that provision of section 9B of the Act may not be applicable when payments are made to legal heir. Judicial precedents need to throw light on the subject matter or the CBDT should provide a clarification.

2.6. What are the implications where a partner exists the partnership with raw materials or work in progress?

This is an issue usually arising in the real estate industry where a partner exits with properties which are under construction.

According to Section 9B of the Act, where a partner receives stock in trade from a firm on his retirement, the same would be treated as sales in the hands of the firm.

Stock in trade is usually referred to as inventory for sale in the ordinary course of business.

However, according to Ind AS 2 – Inventory. Inventories are assets: (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Therefore, Stock-in-trade would include raw materials and work-in-progress.

Further, the implications under the Goods and Services tax Act on transfer of Capital assets and/or stock in trade by a Partnership Firm/ Limited Liability Partnership to its partners, remain a debatable issue.

2.7. Whether deeming sections like section 43CA, section 50C or section 56(2)(x)(b) applicable to transactions covered under section 9B of the Act?

Section 9B of the Act is a deeming provision. Section 43CA, section 50C or section 56(2)(x)(b) of the Act are also deeming provisions. Therefore, in our view one deeming fiction cannot be applied to another.

In the case of **Asstt. CIT v. Amartara (P.) Ltd. [2021] 128 taxmann.com 125 (Mum - Trib.)** held that since case of assessee fell under scope of section 45(3) of the Act which itself is a deeming section and provided for deeming consideration to be adopted for computation of capital gains under section 48, section 50C of the Act could not

be extended to compute deemed full value of consideration accruing as a result of such transfer for computation of capital gain.

In the case of **Network Construction Company v. ACIT [2020] 185 ITD 318/119 taxmann.com 186 (Mum. - Trib.)** it was held that provisions of section 50C of the Act will not operate where section 45(3) of the Act is operating.

Further, since the provisions of 9B of the Act invokes the Fair Market Value, the effect of the deeming provisions would be subsumed and there would be no tax leakage.

2.8. Whether section 45(4) of the Act is applicable to Slump Sale?

Section 45(4) of the Act will not be applicable to Slump Sale. Section 45(4) of the Act is attracted when cash or assets are distributed to a specified person by a specified entity on account of reconstitution of the specified entity. In case of a slump sale the entire undertaking is sold lock, stock and barrel. In the case of **Ambo Agro Products Ltd. v. Principal CIT [2017] 81 taxmann.com 305/165 ITD 20 (Kol. - Trib.)** it has been held that section 50B of the Income-tax Act, 1961 is a code in itself and contains both charging and computation provision of capital gains in the case of 'slump sale'.

Therefore, the special provision i.e., section 50B of the Act should apply.

In the case of **Hindustan Electro Graphites Ltd. v. CIT [1998] 96 Taxman 163 (MP) (HC)** it has been held that a special provision will override the general provisions also known as *generalia specialibus non derogant*.

2.9. What is the due date for filing of return for a Limited Liability Partnership? Is an LLP a Company or a Firm?

The reason for addressing the nature of a limited partnership in point 2.3 is because as per explanation (ii)(a) to section 139 of the Act the due date for filing of return for Companies is on October 31 of the assessment year.

On the other hand, a “firm” falls under explanation (ii)(a) to section 139 of the Act i.e., the residuary category.

It is well known that as per section 2(23)(i) of the Act, "firm" shall have the meaning assigned to it in the Indian Partnership Act, 1932, and shall include a limited liability partnership as defined in the Limited Liability Partnership Act, 2008. Therefore, an LLP is a Firm for the purpose of applying the provisions of the Income-tax Act, 1961.

On the other hand, the definition of a company as per section 2(17) of the Act, *inter alia*, includes anybody corporate incorporated by or under the laws of a country outside India. And as per section 3 of the Limited liability Act, 2008, an LLP is a “body corporate”. Therefore, the LLP can also be recognized as a company for the purpose of applying the provisions of the Income-tax Act, 1961.

Clarity is sought on this issue as it can result in a lapse of compliance under the Act.

2.10. Can a supplementary partnership deed be furnished at the time of assessment with a retrospective effect?

In a recent decision of the Hon'ble Income-tax Appellate Tribunal – Mumbai Bench in the case of **Jetkool Exports India v. NFAC ITA No. 2596/Mum/2022 dated March 9, 2023 (Mum)(Trib)** www.itatonline.org where the partnership firm paid a higher remuneration than what was prescribed in the deed but within the limits prescribed by the Act and during scrutiny, the assessee firm furnished a fresh supplementary deed allowing such remuneration with retrospective effect, The Ld. AO disallowed the remuneration paid to partners on the ground that the remuneration was not paid in accordance with the original deed of partnership. The disallowance was affirmed by CIT(A) on the ground that the supplementary deed was only a self-serving document. On appeal, the Tribunal held that the assessee was entitled to modify remuneration as per the amended provision based on the supplementary deed giving effect retrospectively. Accordingly, the disallowance of remuneration affirmed by the Ld. CIT(A) was deleted.

3. Controversial issues under Allied Laws

3.1. Is the Registrar of Firms duty-bound to look into a complaint raised before it?

The Hon'ble High Court of Andhra Pradesh in the case of **Sri Ganesh Sai Granites and Minerals v. Commissioner**

and Inspector General AIR 2023 (NOC) 14 (AP) Where a dispute arose between the partners of a partnership firm claiming that one of the partners forged the signatures of the other partners and created a deed of reconstitution of the Firm. The said deed was registered before the Registrar of the Firms. One of the partners filed a complaint before the Registrar of Firms explaining the details, requesting the registrar not to act on the reconstitution deed filed before it and to rectify the same. There was no enquiry or rectification done by the Registrar of Firms.

On a Writ Petition it was held that As per section 64 of the Indian Contract Act 1932 and State Rules thereof, the partners are entitled to approach the Registrar of Firms to ascertain the correct facts. The Registrar is duty-bound to conduct an enquiry and pass necessary orders. Refusal or inaction by the Registrar is not proper. The Registrar of Firms was directed to conduct an enquiry as per the complaint.

Therefore, it can be said that the Registrar of Firms is duty-bound to look into a complaint raised before it.

3.2. Can the partners of an unregistered firm refer its issues for arbitration?

The Hon'ble High Court of Calcutta in the case of **Md. Wasim & Anr v. Bengal Refrigeration and Company & Ors AIR 2022 CALCUTTA 382** where a dispute arose between the partners of an unregistered firm, after which, one of the partners invoked the arbitration clause. The respondent-partner denied the appointment of an

arbitrator alleging that the allegations raised by the applicants in their initial notice were false. The applicants (partners) filed the application under Section 11 of the Arbitration Act for the appointment of an arbitrator.

It was held that arbitral proceedings shall not come under the expression 'other proceedings' of Section 69(3) of the Partnership Act, 1932 and that the ban imposed under Section 69 of the Act can have no application to arbitration proceedings and as well of the arbitral award under Section 11 of the Arbitration Act.

3.3. Can an arbitration clause be enforced by the legal heirs of a deceased partner?

Section 40 of the Arbitration Act, 1996 clearly provides that arbitration The agreement will not be discharged by the death of the party thereto and will be enforceable by or against the legal representatives of the deceased.

Section 42 of the Partnership Act, 1932 provides for the dissolution of partnership firms by the death of a partner.

In terms of Section 46 of the Partnership Act, 1932 on the dissolution of the firm, every partner or his legal representative is entitled to, as against all the other partners or their representatives, to have the property of the firm applied in payment of the debts and liabilities of the firm and to have the surplus is distributed amongst the partners or their representatives according to their rights.

Therefore, an arbitration clause be enforced by the legal heirs of a deceased partner. [Refer to the case of **Papiya Mukherjee v. Aruna Banerjea and another AIR 2022 Calcutta 201**]

3.4. Can a retired partner be held liable under the Negotiable Instruments Act, 1881? Whether the proceedings can be quashed under section 482 of the Code of Criminal Procedure, 1974? Can criminal proceedings be initiated only against a partner?

A partner cannot be vicariously held liable for the acts of the firm after his retirement.

The accused-retired partner would have to demonstrate that at the time of issuance of the cheque or at the time of the commission of the offence, he was in no manner concerned with the firm or he was not in charge or responsible for the day-to-day affairs of the firm. The same cannot be made on mere bald assertion.

Where a retired partner took recourse under section 482 of the Code of Criminal Procedure, 1974 for quashing the proceedings it was held that the same cannot be done without furnishing some sterling incontrovertible material. [Refer **S.P. Mani and Mohan Dairy v. Dr. Snehalatha Elangovan AIR 2022 SUPREME COURT 4883**]

Further, in such criminal cases, it is imperative to make the Firm as the primary accused as the cheques are issued by the Partner, not in his personal capacity.

The Hon'ble Supreme Court in the case of **Dilip Hariramani v. Bank of Baroda AIR 2022 SUPREME COURT 2258** held that the provisions of Section 141 impose vicarious liability by deeming fiction which presupposes and requires the commission of the offence by the company or firm. Therefore, unless the company or firm has committed the offence as a principal accused, the persons mentioned in sub-section (1) or (2) would not be liable and convicted as vicariously liable. Section 141 of the Act extends vicarious criminal liability to officers associated with the company or firm when one of the twin requirements of Section 141 of the Act has been satisfied, which person(s) then, by deeming fiction, is made vicariously liable and punished. However, such vicarious liability arises only when the company or firm commits the offence as the primary offender. The conviction was set aside.

3.5. Is an unregistered partnership firm barred from filing a suit on a transaction which is not in course of business?

The Hon'ble Supreme Court in the case of **Shiv Developers through its partner Sunil bhai Somabhai Ajmer v. Aksharay Developers & Ors. MANU/ SC/ 0111/ 2022 (SC)** where an unregistered partnership firm instituted a suit seeking a perpetual injunction and declaration of a sale deed as null and void. The Trial Court rejected the application of the defendants stating that the suit was filed by and on behalf of an unregistered partnership firm which was barred by law.

On appeal, the High Court held that the plaintiff, being an unregistered firm, would be barred to enforce a right arising out of the contract in terms of Section 69(2) of the Act of the Partnership Act, 1932.

It was held that to attract the bar of Section 69(2) of the Act, the contract in question must be the one entered into by the unregistered partnership firm with a 3rd party and must also be in the course of its business dealings. Section 69(2) of the Act is not attracted to each and every contract. The sale transaction in question is not arising out of the business of the appellant firm. The subject suit is one where the plaintiff seeks common law remedies with the allegations of fraud and misrepresentation as also as the statutory rights of injunction and declaration in terms of the provisions of the Specific Relief Act, 1963 as also the Transfer of Property Act, 1882 (while alleging want of the sale consideration). Therefore, the bar of Section 69(2) of the Act of 1932 does not apply to the case.

4. *Dénouement*

For a detailed discussion on the subject, refer to the publication of AIFTP titled “*Handbook on Taxation of Partnership Firms & Limited Liability Partnerships: Frequently Asked Questions*” that aims at addressing several queries.