# Decoding partner's salary taxability u/s 44AD presumptive taxation paradox

**May 24, 2017**

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## 1. Prelude-Presumptive Taxation

A dream of every tax assessee is to have a simpler and fair tax regime. The Tax Reforms Committee led by Dr Raja Chelliah had recommended an Estimated Income Method for small taxpayers in order to facilitate better tax compliance giving a window to convert the said dream into reality. In our country, where small businesses, unorganized sectors and services are hard-to-tax, it is imperative that there exist presumptive schemes for such sectors wherein maintaining books of accounts is a gargantuan task. The outcome of the recommendation led to the birth of presumptive taxation schemes in Direct tax. One of the key provisions in the presumptive taxation is Section 44AD of the Income Tax Act, 1961 ('the Act') - Special Provisions for computing business income on a presumptive basis, which was introduced by virtue of Finance Act 1994, wherein the concept of taxing an assessee by a method of estimating income from its business was introduced especially for small businesses, contractors and goods carriers. The said scheme does not mandate maintaining books of accounts and it is worth recalling here that, the presumptive taxation scheme under Section 44AD is applicable for assessees who are Individuals, HUF and Partnership Firm. Limited Liability Partnership (LLP) and Companies are not entitled to avail benefits under the presumptive taxation scheme.

## 2. Partner's salary deductibility -Pre and Post Finance Act 2016

It is to be noted here that Section 44AD of the Act begins with a non-obstante clause ***(1) Notwithstanding anything to the contrary contained in sections 28 to 43C*** Therefore by virtue of the non-obstante clause, Section 44AD of the Act has a superior position vis vis the other provisions of the Income Tax Act. Nevertheless, Section 44AD(2) of the Act also specifically mentions that any deductions allowable under Section 30 to 38 shall be deemed to have been given full effect. Therefore there are no specific deductions available for the assessee opting for presumptive taxation under Section 44AD of the Act. However there exists an exception by virtue of a proviso to Section 44AD(2), wherein, partner's salary and interest, subject to the threshold limits specified under Section 40(b) **can be deducted** from the amount of eligible income of the assessee which is 8% of the gross turnover of the business of the assessee. Hence in a nutshell, a partnership firm opting for presumptive taxation scheme under Section 44AD of the Act can deduct the partner's salary subject to the threshold limits specified under Section 40(b).

However, Finance Act 2016 has deleted the proviso appearing in Section 44AD (2), consequent to which, deduction of the partner's interest and salary is not further allowed for a partnership firm opting for presumptive scheme under Section 44AD of the Act In this context, we would, in this article specifically, dwell upon the taxability of the Partner's **salary** in the Partner's hand when the Partnership firm is taxed under Section 44AD on presumptive basis, especially in light of the amendment made under the Finance Act 2016.

**3. Taxability of Partner's salary**

Partner's share of profit is exempt from income tax by virtue of Section 10(2A) of the Act. However with regards to salary received by a partner from a partnership firm, the same is taxable under the charging provision Section 28(v) of the Act. It is imperative to note that the proviso[1] to Section 28(v) provides that the amount of salary disallowed in the hands of partnership under Section 40(b) of the Act can be excluded in the hands of the partner to the extent it is disallowed in the hands of the firm. Therefore, the amount of salary to be chargeable to tax under Section 28(v) of the Act for the partner would be contingent to the disallowance under Section 40(b) of the Act.

Hence there could be a possible inference that under the presumptive tax scenario post Finance Act 2016, the entire salary paid to partners may be deemed to have been **disallowed** under Section 40(b) of the Act for the Partnership firm. If the same is deemed to have been disallowed, then a possible view could be taken that the partners are not chargeable to any tax under Section 28(v) of the Act as the proviso to Section 28(v) excludes the amount disallowed under Section 40(b) of the Act for the partnership firm. Therefore any partner receiving salary from a partnership firm which is opting for presumptive scheme under Section 44AD of the Act may not be subject to any tax.

The rationale behind the above view for determining that entire salary paid to partners may be deemed to have been disallowed under Section 40(b) is on the grounds that:

- Section 44AD(1) is a charging section by its own means, wherein as per the said Section, 8% of the gross receipts of the eligible assessee shall be **deemed** to be the profit and gains of such business chargeable to tax under the head Profits and gains of business or profession**.** Therefore Section 44AD (1) determines the taxability by invoking a deeming clause. Further, the section is titled as *Special provision for computing profits and gains of business on presumptive basis*. Hence one may infer that Section 44AD is a self-contained code by its own means devoid of Section 28 to 43C as both chargeability and computation are embedded in it.

- Having inferred that Section 44AD(1) is a separate code by itself wherein it determines the profit computation without referring to Section 29 of the Act, Section 44AD(2) of the Act specifically mentions that the deduction allowable under Section 30 to 38 of the Act are deemed to have been allowed. Such a provision, prima facie appears unnecessary especially considering that Section 44AD (1) begins with a non-obstante clause ***(1) Notwithstanding anything to the contrary contained in sections 28 to 43C*** which on a literal reading specifies that Section 44AD will override all the other provisions relevant for computing profits and gains from business i.e., Sections 28 to 43C of the Act, even if the same are contrary.

- It is to be noted here that the non-obstante clause stresses on the term **contrary.** However, a similar non-obstante clause employed in the newly inserted Section 44ADA of the Act (Special provision for computing profits and gains of profession on presumptive basis), mentions ***Section 44ADA***. ***(1) Notwithstanding anything contained in*** **sections 28** ***to*** **43C.** On a comparison of Section 44AD and Section 44ADA of the Act, the term 'contrary' is absent in the latter section. Given the facts, one may ponder whether the term **'contrary'** used in Section 44AD is superfluous. However it does not appear to be superfluous since the proviso to Section 44AD(2) prior to Finance Act 2016 amendment, specifically mentioned that while determining the income deemed to be profits and gains of business under Section 44AD of the Act, deduction under Section 40(b) shall be allowed subject to the limits specified. Therefore, Section 44AD of the Act which appears to be a separate self-contained code, specifically uses the term contrary in its non-obstante clause so as to enable the eligible assessee to avail the deduction under Section 40(b) of the Act prior to Finance Act 2016. The new Section 44ADA of the Act does not provide for any deduction while determining the presumptive profits and this may be considered the reason for

the absence of the word contrary in the non obstante clause.

- One may contend that pursuant to deletion of proviso to Section 44AD (2) by Finance Act 2016, Section 40(b) which specifies the amounts not deductible has been deemed to have been disallowed. Where Section 44AD(2) specifically mentions that deductions under Section 30 to 38 have been deemed to be allowed, the converse for disallowance under Section 40, 40A, 43B may also be deemed to have been disallowed by Section 44AD.

Based on the above arguments, a view could be taken that the entire salary paid to partners by their partnership firms may be deemed to have been disallowed by virtue of Section 40(b) of the Act. Accordingly the partners may go tax free by taking the benefit available under the proviso to Section 28(v) of the Act.

**4. Epilogue**

A partnership firm opting for presumptive taxation scheme might have felt aggrieved that the deduction which it was claiming under Section 40(b) thus far has been removed by FA 2016, may now actually take the benefit in the Partner's hands by the Partner not offering the salary received to tax. On a macro note, the taxation of salary of partners in their hands under the head PGBP is itself a question of debate. Considering that the partners & the partnership firm are one and the same, they are not two different persons who can contract with each other as per the Indian Contract Act. However by virtue of giving different status under the Income Tax Act, one would wonder whether salary paid to partner's by the partnership firm should at all be taxed under the head PGBP.

While contending the above, the provisions of section 28(v), creates a charging provision on *any interest, salary*, commission or salary, *by whatever name called*, due to or, received by a partner of a firm from such firm shall be subject to tax under the head Profits or Gains from Business or Profession. Even under the contractual principles of a partnership under section 4 of the Indian Partnership Act, 1932, the word 'partnership' ought to be restricted only to nature of relationship between the partners and only as a collective reference to the partners the term 'firm' is used. . It appears that by bringing the partners and firm separately under the tax ambit, there exists a differentiation between them which is contrary to Section 4 of the Indian Partnership Act, which deals that there cannot be an employer and employee relationship between the partners and the firm.

The term employed in the Act is Salary, which presupposes that there is a pre-requisite for an employer-employee relationship. Therefore it would have been appropriate had section 28(v) employed a deeming clause to tax the salary under the head profits and gains of business or profession. In the absence of deeming clause in section 28(v), there exists a valid argument that the partner's salary may be taxed only under the head Salaries (akin to taxing the Director's salary paid by a Company). This may bring parity, equality and arrest various controversies. We will stretch this argument further on a different occasion.

With the focus of the current Government being to promote Ease of Business in India and also to bring lot of small time assesses into the tax bracket for the first time, presumptive taxation scheme is a wonderful tool which caters to the needs of the Government. Where it may be considered that with the introduction of this scheme India has taken leaf from Bolivian tax system, on a similar note, India may also consider the Russian Tax System where a consolidated tax which factors Direct Tax, Indirect Tax and Property Tax has been introduced. With GST round the corner, to encourage assessees in small and unorganized sectors to pay their fair share of taxes, a combined tax system factoring both GST and Direct Tax would be the need of the hour as it will indeed live up to One Nation, One Tax slogan. Alternatively a separate chapter for taxing presumptive incomes may be introduced under the Act, so as to avoid any interpretation issues.

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[1] ***Provided that where any interest, salary, bonus, commission or remuneration, by whatever name called, or any part thereof has not been allowed to be deducted under clause (b) of section 40, the income under this clause shall be adjusted to the extent of the amount not so allowed to be deducted***