CBDT clarifies that the partner’s share of profit in the firm’s total income is exempt in the hands of partner even if the income is exempt in the hands of the firm

8 April 2014

Under the Income-tax Act, 1961 (the Act)\(^1\), the share of a partner in the total income of a partnership firm is not chargeable to tax in the hands of such partner. The total income of the taxpayer is the net income after allowing various exemptions and deduction as per the provision of the Act. However, some of the assessing officers levied taxes on partners’ share of profits where partnership firm was having an exempt income on the ground that exemption to partners is applicable only when the firm has earned taxable income. Various representations were made in this behalf to the Central Board of Direct Taxes (CBDT) as to what should be the amount exempt in the hands of partners when firm has claimed exemptions.

Recently, the CBDT has issued a Circular\(^2\) which has been summarised as follows:

- The ‘total income’ of the firm for the purpose of interpretation of Section 10(2A) of the Act, includes income which is exempt or deductible under various provisions of the Act.

- Accordingly, the income of the firm is to be taxed only in the hands of the firm and under no circumstances it can be taxed in the hands of its partners.

- Accordingly, the entire profit credited to the partners’ accounts in the firm would be exempt from tax in the hands of such partners, even if the income chargeable to tax becomes nil in the hands of the firm on account of any exemption\(^3\).

Our comments

Recently, the Karnataka High Court in the case of Vidya Investment and Trading Company Pvt. Ltd.\(^4\) held that the share of a partner in the profits of the firm is exempt under Section 10(2A) of the Act and

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\(^1\) Section 10(2A) of the Act
\(^2\) Circular 8 of 2014, dated 31 March 2014
\(^3\) Exemption under Chapter III of the Act or deduction under Chapter VIA of the Act
\(^4\) Vidya Investment and Trading Company Pvt. Ltd. v. UOI [2014] 43 taxmann.com 1 (Kar)
such exemption is not restricted to amounts which is taxable in partnership firm's hands but includes exempt income in the hands of the firm. The objective to grant exemption to partner under Section 10(2A) of the Act is to avoid double taxation.

In line with this ruling, the CBDT has now issued a welcome clarification that the share of profit of a partner in the firm's income shall be exempt in his hands, even if the firm's income was eligible for the exemption or deduction under the Act. Similarly, the share of profit of a partner in a Limited Liability Partnership's income will also be exempt in the hands of partners.