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A STUDY ON THE PROVISIONS OF NOTIONAL RENT IN INDIAN INCOME TAX

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ABSTRACT

This paper is a study on the applicability of the provisions of section 22 of income tax law, to analyse whether the exemption under the provision is applicable to the partner owner of the firm, i.e the individual whose property is occupied by the firm, in which he was a partner, and provide that premises at free of cost. The paper studies the provisions of section 22 of Indian Income Tax law, legal decisions in favour and opposing the decisions of allowing exemptions under above said section, and grounds of final judgement given by Kolkata court in Prodip Kumar Bothra v. CIT (2011) case in this regard.

KEYWORDS

exemption under section 22, owner – partner, deemed rent, notional rent.

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INTRODUCTION

The provisions of Sec.22 of Income Tax Act,1961, provides that, annual value of property occupied by the assessee for his own business and such business income is chargeable to Income tax, then the annual value of that property held for own business shall be exempted from chargeability under Income tax law.

But in the present case, the question is that, whether the above exemption is applicable equally to the partner of a partnership firm who provides his own residential property at free of rent to the partnership firm in which he is a partner.

Lot of discussions were done in different legal case studies on the above question. Different decisions and different views were presented by different legal authorities. But at last in 2011, judgement given in Prodip Kumar Bothra Vs. Commissioner of Income-Tax, Kolkata Income Tax Appeal No. 742 Of 2004 (15-07-2011), it was held that Annual value of the property which was rented even at free of cost to the firm, by the individual who is also a partner in the firm, shall be taxable in the hands of that partner and no exemption U/s 22 is available to him.

The reasons behind the legal decisions of allowing the exemptions of that individual partner was quoted by Mr. Banerjee, who acted as Advocate on behalf of Revenue. And it is advisable to individual partner to receive rent for such property, from the partner firm, even though he is a partner in that firm. Provisions of Income tax law has allowed such rent as deduction for that firm, which is also an indirect financial benefit for the partner who is the owner of the Property occupied.

REVIEW OF LITERATURE

Karnataka vs. K.N. Guruswamy, reported in (1983) 146 ITR 34: If the property or a portion of it, owned by an assessee, is occupied by him for the purpose of his own business or profession, or a property owned by a firm is used for its business, such assessee is entitled to exemption under section 22. In the view that we have taken, the contention urged for the Revenue should prevail, and the Tribunal's finding that the assessee is entitled to exemption under Section 22 should be rejected.

Commissioner of Income-tax vs. K.M. Jagannathan, reported in (1989) 180 ITR 191:.....the tribunal was right in the view it took for the purpose of sec 22. Of the Act, the business carried on by the firm should be regarded as being carried all the partners and therefore, no income from the property should be computed in respect of the portion of the property in respect of the portion under the occupation of the firm in the computation of the income from the property in the hands of the assessee – partner.

Commissioner of Income-tax vs. P.M. Thomas, reported in (1990) 181 ITR 256:.....the assessee is carrying on business in partnership the profits of which are chargeable to income tax. It cannot be stated that the assessee is not occupying the building for the purpose of his business. The business is done in partnership, the other partners are occupying the ground floor along with the assessee and the partnership business is carried on by him along with all the partners. Therefore, we are of the view that the annual letting value of the ground floor of the building belonging to the assessee which is in occupation of a firm in which the assessee is a partner is not includable in the income of the assessee under section 22 of the Act and, consequently, the reopening of the assessment is not suitable.

Commissioner of Income-tax vs. Rabindranath Bhol, reported in (1995) 211 ITR 799 : in the case in hand, we are of the considered opinion that the literal construction put by Karnataka high court to sec 22 of Income tax act works out gross injustice and does not subserve the object of the legislation. In the aforesaid premises, we respectively differ with the views expressed by the Karnataka High court and agree with the conclusion and reasoning's adopted by the Gujarat High court, and hold that the income from a house property owned by the assessee-partner and used in the business carried on by the partnership firm in which the assessee is a partner would qualify for exemption provided in sec 22 of the income tax act 1961.

Prodip Kumar Bothra v. CIT (2011) 62 DTR (Cal) 47:after taking into consideration the overall position of a partnership firm in the light of the Income tax Act, 1961 we are of the view that the exemption under Section 22 of the Act in respect of a property not owned by the partnership firm cannot be availed of by an individual co-owner merely because he happens to be a partner of a firm in occupation of a part of the property.

RESEARCH OBJECTIVES

1. To study the provisions of sec 22 of Indian Income Tax Act, 1961.
2. To study the applicability of exemption under sec. 22 of IT Act, 1961 to Partner – owner.
3. To suggest to the Partner – owner in case of non – applicability of sec. 22 of IT Act, 1961.

RESEARCH METHODOLOGY

The present research study is a blend of secondary data and the major source of data was used from different websites of legal decisions, government portal of Income tax, website of business magazines etc. and it is a descriptive and exploratory research method which has been used to analyses the secondary data collected, in order to conclude whether the provisions of section 22 are applicable to owner partner of a firm.

STUDY ON THE PROVISIONS OF SECTION 22, OF INDIAN INCOME TAX LAW, REGARDING ALLOWANCE OF EXEMPTION ON ANNUAL VALUE OF PROPERTY OF THE PARTNER, WHICH WAS OCCUPIED BY THE FIRM IN WHICH HE IS A PARTNER

As per section 22 of Income Tax Act, 1961, "The annual value of property consisting of any buildings or lands appurtenant thereto of which the assessee is the owner, other than such portions of such property as he may occupy for the purposes of any business or profession carried on by him the profits of which are chargeable to income-tax, shall be chargeable to income-tax under the head "Income from house property".

Here we have to have a look on some vital points, which are as follows;

- 1) What is taxable?
- 2) Who is charged to tax?
- 3) When it will be exempted?

Unlike charging section of other heads of income, the charging section of House property income provides the provisions for both taxability and exemption.

Two peculiar points what we can observe in the above charging section 22 of IT Act, 1961 are, firstly, the income charged to Taxability is Annual value of the property, but not the income or profit as per the provisions of charging sections of other heads of income.

And the second point was that, the owner of the property shall be charged to tax, even though he is not the actual receiver of the income, as provided in the charging section of the head, "Income from House property".

So, as discussed above, what is taxable is the Annual Value of the property after deductions allowed were adjusted. And who is charged to tax, is the owner of the property. The exemption which is available to the owner, only if he carries on business in his own premises, which profit is subject to income tax.

It is clear that exemption can be claimed by the assessee, if he occupies his property for his own business, so the annual value of such property occupied for his business purpose is not charged to tax.

But the key point under the study of the present paper is, the question raises the same exemption is available to the owner of the house property, if that house is occupied by the partnership firm, in which the owner one of the partners.

Legal provisions in favor of applicability of exemption to such owner – partner are,

As per the provisions of section 4 of Partnership act, 1932 - "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. And also, with reference to provisions of Section 5 of Partnership Act, 1932- status of partner, the relation of partnership arises from contract and not from status;

By elaborating the above provisions of partnership act, it was clear that, a Partnership firm is formed by a contract between two or more partners to carry on the same business. And it did not have any separate legal status or legal entity. So, partner and partnership firm both are same and not distinct persons.

As per the provisions of section 25, of Partnership act, 1932 - Every partner is liable jointly with all the other partners and also severally, for all acts of the firm done while he is a partner. And as per the provisions of section 26 of Partnership act, 1932,- Where, by the wrongful act or omission of a partner acting in the ordinary course of the business of a firm or with the authority of his partners, loss or injury is caused to any third party, or any penalty is incurred, the firm is liable therefor to the same extent as the partner.

According to the provisions of section 25 and 26 of the said partnership act, 1932 – Firm is liable for conduct of a partner and at the same time partner is also liable for the conduct of Firm. They both are liable for mis conduct of each other. And in the same way, it seems to be that, they both are not distinct persons. As they both are liable for the misconduct of any of them, either the firm or a partner, the exemption under section 22 cannot be disallowed by showing the partner and firm as distant persons.

The same was held in, Commissioner of Income-tax vs. Rabindranath Bhol, reported in (1995) - in the eye of law, a firm is compendious expression indicate that several persons constituting that firm are carrying on a business. But the compendious expression cannot give to the firm a legal entity or a legal existence.

And as per the provisions of section 28, of partnership act, 1932 - a partner is the agent of the firm for the purposes of the business of the firm.

It was also held in the same case, that – one partner is agent of the other in carrying out that business. Consequently, when a partnership carries on business, each partner therefor must be said to be carrying out that business.

One of the crucial characteristics of Partnership firm is "Unlimited liability", according to which a partner is personally liable for losses of a firm. So, as per just and equity, if the losses of firm have to be borne by individual partner, then the exemption of section 22 which is said to be allowed to partner in individual status only, should also be allowed to the partnership firm, in which he is a partner. And the unlimited liability characteristic also makes the sense that partner and firm are not distinct.

Legal decisions of court of law, against the applicability of exemption to such owner – partner are,

As per the judgement given in Prodig Kumar Bothra v. CIT (2011) case, a partner who is the owner of the property occupied by the firm, in which he was also a partner, exemption under section 22, of the Income Tax Act, 1961 is not allowed.

The following are the grounds under which above legal decision was given.

- 1) To get exemption under section 22, the property should be owned by the partnership firm, but not by the partner.
- 2) The owner and occupier must be same person.
- 3) To claim exemption, the property occupied by the owner for business, and such business profit shall be chargeable under the hands of that owner.

In the legal judgment of, Commissioner of Income-Tax, vs K.N. Guruswamy, the court has followed the decisions of Delhi court in Bhai Sunder Dass & Sons v. CIT and also the decision of Calcutta high court in, Sarvamangala Properties Ltd. v. CIT [1973] 90 ITR 267, that, "property owned by a firm has to be treated as property of the firm and liable to be taxed in respect of income from property in its assessment and not in the assessment of its partners.

Based on the above issues, raised by Mr. Banerjee, Advocate who argued on behalf of Revenue department, Court has issued the judgement, that, the exemption under section 22 of the act in respect of property not owned by the partnership firm cannot be availed, by an individual co-owner merely because he is the partner of the firm, which occupied for its business operations.

A COMPARATIVE ANALYSIS OF PROVISIONS APPLICABLE BETWEEN AN INDIVIDUAL AND SAME INDIVIDUAL AS PARTNER IN A FIRM

Case A: - If an individual Mr. Z is Carrying his business in a portion of his house, and the business is chargeable to income tax, then the provisions of Section 22 of Income Tax Act, 1961 shall be applicable and Mr. Z will get exemption from taxability of Annual value of the property used for carrying his business.

And he shall not be eligible for claiming deduction under section 30, because charging rent for own property is a notional rent and such notional rent is disallowed for claiming deduction by Mr. Z.

Case B: - If the same individual Mr. Z is carrying his business in leased property, there is no question of Section 22 and he can deduct the amount of rent paid to the owner under section 30 of Income Tax Act, 1961.

Case C: - If the individual Mr. Z is a partner in a firm M/S XYZ, and Allowed a portion of his own house property to carry on business of same firm and not charging any amount of rent, then the annual value of that portion shall be taxable as "Deemed income" and he cannot claim exemption under section 22 of Income Tax Act, 1961 as per the judgement given in, Shri Prodig Kumar Bothra v. Commissioner of Income-Tax, Kolkata case.

Here in this case, Mr. Z will not get any rental income, but he shall be chargeable to house property tax as deemed income.

Case D: - If the individual Mr. Z, constitute a firm M/S XYZ in which he is a partner, and allowed a portion of his own property to carry on business of same firm but charged some amount of rent from the firm, then deduction of rent paid under section 30 shall be allowed to the firm and the annual value of the property shall be taxable under House property to Mr. Z as in above case.

Here both the firm and partner will get benefited and can avoid negative effect of the provisions of "deemed rent".

ANALYSIS OF TAX SAVINGS UNDER SEC 22, AVAILABLE TO AN ASSESSEE IN INDIVIDUAL STATUS AND PARTNERSHIP STATUS

On comparing all the above four cases, A, B, C and D, the last one is beneficial to both the individual Mr. Z and the firm M/S XYZ. But when it will be beneficial to both. That means, at what amount of rent if Mr. Z charges from M/S XYZ, both will get benefited. It must be more than the annual value of the property but at what amount.

RECOMMENDATION AND SOLUTION

For a total income more than Rs. 10 lakhs after deduction of notional rent at an amount of more than Rs. 52100, per month, which is allowable as deduction to the firm, then the tax liability of the Partnership firm will be less than the tax liability of the individual owner partner.

Test check of above solution

In case the individual Mr. Z carried on his business in his own premises in individual capacity: -

TABLE 1

Individual Assessee (Mr. Z)	Amount (Rs.)	
Total Income Before deduction of notional rent	15,00,000	(More than Rs. 10,00,000)
Less:- Notional rent (not allowed as deduction)	nil	
Total income After deduction of notional rent	15,00,000	
Tax liability of Individual Assessee Mr. Z	2,62,500	Refer tax calculation, Table: - 2

TABLE 2

Tax calculation;	Amount (Rs.)	
up to Rs. 2,50,000 nil		
Rs. 2,50,000 to Rs. 5,00,000 tax at a rate of 5%	12,500	(5,00,000 – 2,50,000) X 5%
Rs. 5,00,000 to Rs. 10,00,000 tax at a rate of 20%	1,00,000	(10,00,000 – 5,00,000) X 20%
Above Rs. 10,00,000 tax will be at a rate of 30%	1,50,000	(15,00,000-5,00,000) X 30%
Total tax liability	2,62,500	

In case the individual Mr. Z constituted a firm and carry on his business in his own premises charging rent for the premises:

TABLE 3

Assessee as a partnership firm (M/S XYZ)	Amount (Rs.)	
Total Income Before deduction of notional rent	15,00,000	(More than Rs. 10,00,000)
Less: - Notional rent (allowed as deduction)	6,36,000	(monthly rent of Rs.53000 more than Rs.52100)
Total income After deduction of notional rent	8,64,000	
Tax liability of Individual Assessee Mr. Z	2,59,200	(30% of Rs. 8,64,000)

So, here, tax liability of Firm Rs.2,59,200 is less than the tax liability of Individual assessee Rs.2,62,500.

So, it was proved that the suggestion of constituting a firm and leasing the property to that firm is beneficial to individual assessee and firm, rather than continuing the business as individual status.

SUGGESTIONS

It is common in practice of partnership firm, providing some partner's premises as principal place of business, to reduce the rental expenditure to be paid it the same business operations were carried in any other building or it may block more capital in property, if any building was purchased.

Here, according to the layman knowledge, who thinks firm's business as his own business, in ignorance of law, the owner partner will not charge any rent for the building occupied by the firm to carry on its business operations. But as said in the above case law of, Prodip Kumar Bothra v. CIT (2011), the annual value of such rented property shall be charged to house property tax in the hands of that partner-owner as deemed income.

So, to avoid the negative effects of this deemed income provisions, we can adopt the provisions of section 30 of income tax act,1961, under the head " Profit or gains from business or profession". Which allows deductions of rent paid to the partner for occupying his premises for business operations. And such rent should be more than the annual value of the property.

It benefits to the firm for claiming deduction and get tax savings and for the partner owner, as he is getting rent amount, even though it is taxable under the head "House property"

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