Retiring Partner and Partnership Firm – Certain GST Issues

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We all are aware that the settlement of retiring partner from a partnership firm is not an easy task. The journey, the ups and downs, the emotions involved, the timing of retirement and various other factors are evidently enough to create a tense environment between the retiring partner and continuing partners. To add fuel to the fire, the taxation issues also contribute a lot to this uphill task.

On the income tax side, in our previous articles, we have addressed the issues, pre and post insertion of new Section 9B and Section 45(4). The new insertions have provided certain respite but has not taken away the complete strain. May be in coming years, the incidental and ancillary issues surrounding that will also be resolved, paving way to more clarity. On the GST side, the issues started to crop up, mainly due to inadequate legislature. In this article, we will try to raise certain important issues on that front.

Issue #1 – Will the Retiring Partner be called as Service Provider?

Normally, when a partner retires from a firm, there will be a retirement deed in place. The retirement deed inter alia states that the retiring partner is foregoing all the rights in the firm towards the continuing partner. The retiring partner will be entitled for balances lying to credit of his capital and current accounts. However, on many occasions, the retiring partner will be paid more than what is lying in his capital and current accounts. We need to analyse the tax implications in both the scenarios. One, when his capital and current account balance is Rs 100 and he is paid Rs 100 and two, when his capital and current account balance is Rs 100 and he is paid Rs 150. It is important to note that, the income tax implications significantly vary in both the instances. However, our focus is only the probable implications under GST.

In order to answer the above, it is important to understand, what is the relation between the partner and partnership firm qua the GST law? Are they called employee and employer respectively? Are both of them constitute a single entity and cannot be seen as two different persons? This should pretty much lays foundation to our issue. If the retiring partner is called as employee and partnership firm is the employer, then the transactions between the partner and firm may fit under Schedule III to Section 7 of CT Act[1] and hence the same may neither be called as supply of goods nor supply of services. If someone argues that, the retiring partner and firm are one and the same, a sole entity and cannot be separated, then there will be no tax implications, because the basic tenet of 'supply', which pre-requisites two people fails. Let us explore the same.

The first argument that retiring partner is employee and firm is the employer has to be tested under the provisions of the CT Act. Entry 1 of Schedule III provides that services provided by employee to the employer in the course of or in relation to his employment are treated as neither a supply of goods nor a supply of services. From a patient reading, it appears that above entry covers the standard employee and employer transactions and a partner and firm cannot be covered in it. The partner and firm cannot be said to be the employee and employer respectively, for the reason

[1] Central Goods and Services Tax Act, 2017

that partner along with other conceives the firm and not the other way around. Hence, it would be tough to call the partner as employee of the firm, despite of the fact that the firm pays salary, bonus and other similar items to the partner. Accordingly, it can be said that the contract between the partner and firm is not a contract for service but a contract for partnership. It is a settled proposition that any income, salary, bonus and other similar items received by a partner for discharge of obligations as per the partnership deed is nothing but a special share of profits in them. The above was reiterated by Supreme Court in RM Chidambaram Pillai[2]. Hence, the argument that partner is drawing salary from the firm and that makes him the employee and firm as employer, may not stand to the scrutiny of the law.

Let us take, the second argument, whether the partner and firm can be called as single entity and hence, there are no two separate distinct entities. A peep into the service tax law may provide certain thoughts on this aspect. The Gujarat High Court in the matter of Cadila Healthcare Limited[3] has held that services provided by a partner to the firm cannot be called as taxable service, since the firm and partners are one and same. In absence of two distinct entities, which is mandatory for charging service tax, the transactions between the partner and firm cannot be brought to tax, since the firm is no different from the partner. The High Court has reached this conclusion based on the fact that the expression 'person' has not been defined under the service tax law prior to 01.07.2012. In absence of specific definition of 'person', the High Court stated that the partner and firm cannot be seen as distinct. The CESTAT Bangalore in the matter of Gautam Bhattacharya and Yatin Vijaya Patil[4] has also held that the partner and partnership firm cannot be said to be distinct entities and accordingly the salaries received by partners from the firm are not subjected to service tax.

From the above, it appears that the High Court in the matter of Cadila Healthcare Limited (supra) stated that in absence of definition of 'person' to include 'firm' in its ambit, the partner and partnership firm are not different. However, in the matter of Gautam Bhattacharya and others (supra), the CESTAT, though the period is post 01.07.2012, wherein the definition of 'person' exists on the statute book and specifies 'firm' as a person, still went ahead and concluded that partner and partnership firm are same. Hence, the picture is not clear under the old law. Seen under GST law, the expression 'person' has been defined to include 'firm' in its ambit. Now, the question that remains answered is, whether by applying the High Court judgment in Cadila Healthcare Limited (supra), the partner and partnership firm should be seen as distinct persons, because of existence of definition of 'person' or apply the CESTAT judgment in Gautam Bhattacharya and others (supra) and plead that both of them are same and the definition of 'person' does not make any difference. If the rationale of High Court is taken forward, then the partner and partnership firm are different and transactions between them should be brought for scrutiny under the GST laws (let us call this, Arg #1). If the rationale of CESTAT is taken forward, then the partner and partnership firm are same entity and the transactions between them does not exist under the GST laws (let us call this, Arg #2).

Let us not forgot, we have not answered the main issue till now. We are still struggling to understand the nature of relation between the partner and partnership, which would be the base for an appropriate response to the issue framed. The winner of the war between Arg #1 and Arg #2 would show us a direction.

[2] [1977] 106 ITR 292 (SC)
[3] 2022 (5) TMI 800 – Gujarat High Court
[4] 2022 (3) TMI 230 – CESTAT Bangalore

Let us take Arg #1 for analysis. The argument is that partner and partnership firm are different if the definition of 'person' exists. As discussed earlier, the GST laws has a definition of 'person' and includes 'firm' in its ambit. Hence, the Arg #1 gains certain credence. Further, the same is accentuated by the existence of Section 7(1aa) of CT Act. The said sub-section states that the activities or transactions, by a person, other than individual, to its members or its constituents or vice-versa for cash, deferred payment or other valuable consideration is treated as supply. The question that would arise is, whether the partner and partnership firm fit under the ambit of Section 7(1)(aa) and hence, they have to be treated as separate from each other? In our view, the sub-section (aa) does not cover the firm and partnership in its ambit. It is true that the definition of 'person' includes the firm and accordingly there is a possibility to argue that 'firm' falls under the ambit of Section 7(1)(aa). However, can the partner be called as 'members' or 'constituents'. The response would be negative.

We believe that the birth of Section 7(1)(aa) can be attributed to the decision of the Honourable Supreme Court in the matter of Calcutta Club Limited[5], wherein it was held that there would not be any service tax liability for the activities or transactions between the club and its members. Apprehending a similar situation in GST laws, the Government has introduced the current sub-section. This is also evident from the explanation to Section 7(1)(aa) which states that person and its members or constituents would be treated as separate persons notwithstanding anything contrary judgment. Hence, it can be understood that the subject sub-section intends to cover only such transactions between the clubs and its members and not between the partnership firm and partner.

This is also supported from the language of definition of 'business' vide Section 2(17)(e). It includes provision by a club, association, society, or any such body (for subscription or any other consideration) of the facilities or benefits to its members in its ambit and does not include transactions between the partners and firm. If the intention is to cover the firm and its partners, the said part of the definition should have included the firm and partners also in its ambit. Hence, the Arg #1 has a weak case. Let us pause for a moment on Arg #1 and proceed to analyse to Arg #2 and then conclude as to who is the winner?

The Arg #2 stands on premise that, though there exists a definition of 'person' under the GST laws, the partner and partnership firm should be treated as a single entity but not distinct. As discussed earlier, there does not exist a similar provision in case of clubs and associations for the partnership firms to treat the partner distinct from the partnership firm. Under the provisions of Income Tax laws, there is enough infrastructure to tax the transactions between the partner and firm. For example, when a capital asset is brought into the firm by the partner as capital, the same is taxable in the hands of partner [see Section 45(3)], when a capital asset or money is allotted to the partner at the time of reconstitution of firm, the gains arising thereof are taxable in hands of firm [see Section 45(4)] and similarly when stock in trade or capital asset is allotted to the partner at the time of reconstitution or dissolution of firm, the firm is obliged to pay tax [see Section 9B]. However, there does not exist any similar infrastructure under the GST laws. Does this mean, that the legislature thinks for the purposes of GST laws, the partner and partnership firm are one and the same? This is not clear. There can be any surprise from the Government stating that Section 7(1)(aa) is enough to call out the firm and partner are different, though it can be argued that they do not fit there. In our view, Arg #2 has more chance to win.

Further, the rationale of Arg #1 that existence of definition of 'person' does not take the case forward. The inclusion of 'firm' in the ambit of definition of 'person' is to treat the firm as a separate legal entity for the purposes of

[5] 2019 (10) TMI 160 – Supreme Court

assessment and other incidental measures. The decision of Supreme Court in the matter of Jullunder Vegetables Syndicate[6], which was distinguished subtly by the High Court in Cadila Healthcare Limited (supra) stating that in the former case, the sales tax law has included 'firm' as a dealer, whereas in the latter case, the service tax law does not define 'person'. In other words, the High Court communicated that if the service tax law also employs the definition of 'person', the decision of Supreme Court in Jullunder Vegetable Syndicate (supra) would have been applied. But it is to be noted that the Supreme Court was not dealing with the question as to whether the partner and partnership firm are one and the same? The question that was dealt by Supreme Court therein, was whether in absence of specific provision under the sales tax law, can the revenue proceed to tax the dissolved firm with respect to the pre-dissolution turnover? The Supreme Court answered in negative by stating that the definition of 'dealer' includes the firm and since the firm is stated to be a separate legal entity, the revenue cannot proceed to tax the partners for the liability of firm. Further, since the sales tax law does not have provisions dealing with assessment of dissolved firms, there cannot be any assessment, if the firm is dissolved prior to initiation of assessment and definitely not on the partners. Hence, it can be understood that the Supreme Court was dealing with a separate question than what was dealt by High Court in Cadila Healthcare Limited (supra).

Though one may argue that stipulation of 'firm' in the definition of 'person', is good enough to create a veil between the partners and partnership firm, the argument cannot be taken forward to a longer distance, because the other infrastructure, as pointed out earlier, is missing. Hence, just existence of separation is only a step in the entire process and not the entire process. Hence, in our view, the Arg #2 favours much than Arg #1, though tax authorities would argue the contrary.

Though, we have concluded that Arg #2 wins, let us for time being proceed with an assumption that Arg #1 wins. In such a scenario, let us analyse both the instances, where the retiring partner takes the exact amount lying in capital and current accounts and more than said amount. Needless to say, if Arg #2 is adopted, then there is no need to analyse because there are no two persons.

In light of Arg #1 and in situation, where the retiring partner has in his capital and current account, a credit of Rs 100, and takes exactly, the said amount, there should not be any implications under the GST laws. This is for the reason that the partner has invested certain amounts over a period of time, withdrew certain amounts and profits and losses have been allotted him as per his share and the result is balance of capital and current account. Hence, Rs 100 is nothing but the dividend or profit or appreciation including the initial capital amount invested by the partner. In simple words, the partner takes initial capital and profit earned over a period of time. Can the said amount be called as amount paid for services provided by partner to firm? If yes, what is the service involved? Exiting from the partnership firm can be called as a service? Transferring rights in favour of the continuing partners can be brought into the ambit of 'service'? If yes, what is the 'consideration' for such assumed 'service'? Will the balance in capital and current account represents 'consideration' for the purposes of GST laws?

None of the above questions make sense in commercial terms. The retiring partner would argue that he is retiring because he does not want to continue in the business of the firm and how can the same be called as 'service'? The definition of 'services' is laid down in an open ended manner intending to cover all transactions a human mind cannot comprehend. On top of it, the Entry 5(e) of Schedule II states that 'agreeing to the obligation to refrain from any act,

[6] 1966 AIR 1295

or to tolerate an act or a situation, or to do an act' as services. In such expanded breath of 'service', can the retiring partner be said to be providing service to the continuing partners or firm by retiring?

In our view, the same may not be correct. Though the definition of 'service' is wide enough, there cannot be any inference of 'service', when a partner retires from the firm. It also should not fall into the prey to Entry 5(e). Circular 178/10/2022 – GST dated 3rd August 2022 vide Para 4 states that the element of contractual relationship, where one supplies goods or services at the desire or another, is an essential element of supply. The said circular also clarified that Entry 5(e) should be as a result of contractual arrangement. Hence, it cannot be argued that there exists a contractual relationship between the retiring partner and firm. Accordingly, one may conclude that the activity of partner retiring from firm cannot be stated to be 'service'. Assuming that be a service, where is the consideration? Can the capital and current account balance be called as consideration? The answer should be no because, the activity at best can be termed as transaction in money and be out of the definition of 'service'. Even assuming that there is a service, the same fails because there is no consideration for such service.

Now, let us proceed to examine, the implications under the other situation in light of Arg #1. In this situation, the retiring partner takes Rs 150, where his closing capital and current account balance is Rs 100. Whether a service can be inferred now? If not Rs 100, can Rs 50 (150 – 100) be called as consideration for the service? This is tricky. The income tax law specifically taxes this extra Rs 50. Under the GST laws, we cannot infer a service based on the availability of consideration. In other words, the service has to be first identified and later the consideration, but not the way around. Hence, our first job is to identify whether there is a 'service' involved?

The retirement deed states that the retiring partner exhausts all the rights in the firm in favour of the continuing partners and does not have any rights in assets of the firm. Whether this particular activity can be called as 'service'? We have tried to analyse the same in situation, where the partner takes the exact amount from the firm. We have concluded that there cannot be any service inferred. In our view, even in this situation also, the partner cannot be said to providing any service to the firm or continuing partners. However, the tax authorities may infer the service involved because the retiring partner is taking more than what is lying to credit of his capital and current account balances, in this case, Rs 50. Even assuming that there is a service involved and consideration for the same is Rs 50, where is the legislative infrastructure to bring this into tax net? In absence of necessary and clear legislative infrastructure, it would be not easy for the tax authorities to put tax on that Rs 50. Further, before taxing the Rs 50, the nature of such amount need to be analysed. Whether the said Rs 50 is goodwill or profits arising from revaluation of assets or share in future profits or non-compete fee? The tax implications may differ in each particular situation and there cannot be a standardized approach.

To conclude, in our view, the retiring partner cannot be called as service provider, definitely in situation, where the exact amount is withdrawn. In second situation, where the retiring partner takes more than the closing balance, then there is a possibility for he being called as service provider for the amount in excess of his closing balance. The above is in light of Arg #1, on assumption that partner and firm are different. If Arg #2 wins, then in any instance, it can be said that there is no service provider and service receiver.

Issue #2 – If assets were allotted to retiring partner, is the firm obliged to pay tax on the said transaction?

This brings us to the second and last issue. Continuing with the above example and obviously in light of Arg #1, if the retiring partner takes Rs 150 as against his closing balance of Rs 100 and the Rs 150 is settled in form of assets instead of cash, then whether the firm would be obliged to pay tax on such settlement by use of assets?

Our first defence would be there is no supply when the firm allots the assets to the retiring partner instead of cash. The assets cannot be said to be supplied to the retired partner. They are used for settling the retiring partner capital and current account balances. If someone argues that there is a supply, where is the consideration for such supply? Will the retiring partner pay anything? Can the capital and current account balance can be said the consideration for such allocation of assets? The answer would be an emphatic negative. In fact, the retiring partner may be called as service provider but not the firm. Further, assuming there is a service provided by retiring partner, then his consideration is being settled by way of allocation of assets and not the other way around. Hence, there does not arise any instance for the firm to pay tax on the allocation of assets.

However, Entry 4(a) of Schedule II states that where goods forming part of the assets of a business are transferred or disposed of by or under the directions of the person carrying on the business so as no longer to form part of those assets, such transfer or disposal is supply of goods by the person. How do we come out of this? In our view, one should look Entry 4(a) only when there is a supply in first instance. This is also evident from Section 7(1A), where it states that activities or transactions constitute a supply in accordance with provisions of Section 7(1), they shall be treated as supply of goods or services as referred to in Schedule II. Since, in the instant case, there is no supply in the first place, when the firm allots the assets in lieu of cash to the retiring partner, there cannot be any tax by virtue of Entry 4(a).

For now, we end this article with the above two issues. We understand that this is only the beginning of the journey and there would be much more advancement in the legislature to tackle the GST issues that arises between the partners in case of retirement and dissolution.