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Income Tax Liability of a Partnership

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1. Chargeability of Income Tax

As per the Section 195 of the IRD Act No.24 of 2017, Partnership means an association of two or more individuals or corporations carrying on business jointly for the purpose of making profit, irrespective of whether the association is recorded in writing.

However, Partnerships where twenty or more of the partners have limited liability for the debts of the partnership are included in to the definition of a company.

When looking at **section 195**, it covers the definition of,

- **Person** - means an individual or entity and includes a body of persons corporate or unincorporated, an executor, non-governmental organization and charitable institution;
- **Entity** - means a company, partnership or trust, but excludes an individual;

Therefore, under the definition of Entity, Partnership is liable for income tax and it is person under Inland Revenue Act.

2. Income Tax Liability of Partnerships

- A partnership shall not be liable to pay income tax with respect to its taxable income and shall not be entitled to any tax credit with respect to that income, but shall be liable to pay income tax with respect to withholding payments.

- However, the above provision shall not apply to a partnership to the extent that the partnership's taxable income includes a gain from the realization of an investment asset.

- Accordingly, the income tax liability of the Partnership consisting of following two categories.
  a. Withholding payments – Section 84 (a) (ii)
  b. Gains from Realization of an Investment Asset – Capital Gain Tax shall be payable by the Partnership at the rate of 10% as per the 1st Schedule to Act.

- Partnership income of a partnership for a year of assessment shall be the partnership's income from its business or investment for that year of assessment.

- A loss incurred by a partnership for a year of assessment shall be the partnership's loss from its business or investment for the year.

- Allocation of Partnership Income or Loss
  Partnership income or a partnership loss of a partnership shall be allocated to the partners in accordance with this Division.

- Basis of Allocation of Income or Loss
  Partnership income or a partnership loss allocated to partners,
  a. Shall retain its character as to type and source;
  b. Shall be treated as an amount derived or expenditure incurred, respectively, by a partner at the end of the partnership's year of assessment; and
  c. Shall be allocated to the partners proportionately to each partner's share, unless the Commissioner General, by notice in writing and for good cause, directs otherwise.

- Income Derived and Expenditure incurred in common by Partners
  Amounts derived and expenditure incurred in common by partners shall be treated as amounts derived or expenditure incurred by the partnership and not by the partners.

- Assets Owned And Liabilities Owned in Common by Partners
  Assets owned and liabilities owed in common by partners shall be treated as assets owned or liabilities owed by the partnership and not by the partners and shall be treated as,
  a. In the case of assets, acquired when they begin to owe such assets in that way;
  b. In the case of liabilities, incurred when they begin to owe such liabilities in that way; and
  c. Realized when they cease to be so owned or owed in that way.

- Arrangements Between Partnership and its Partners
  Arrangements between a partnership and its partners shall be recognized in instances other than the following, which shall be taken into account in determining a partner's share.
  a. Loans made by a partner to a partnership and any interest paid with respect thereto; and
  b. Services provided by a partner to a partnership (including by way of employment) and any service fee or income from employment payable with respect thereto.

- Change of partners in a partnership
  Where there is a change of partners in a partnership at least two existing partners continue with the partnership, the partnership shall be treated as the same entity both before and after the change.

- Withholding Tax on allocation of partnership income
  As per section 84 (1) (a) (ii) and first schedule to Act, the relevant withholding tax rate is 8% on partners' share of any partnership income.

- Allocation of tax credits
  Tax paid under the provisions of this Act and foreign income tax paid or treated as paid by the partnership with respect to the partnership income shall be allocated to the partners, proportionately to each partner's share, and shall be treated as paid by them. A "partner's share" shall be equal to the partner's percentage interest in any income of the partnership as set out in the partnership arrangement.

Past Paper Questions

2020 JANUARY (Q5)

D & Sons is a partnership formed in 2017 by Dayarathna and his elder son Dilum to act as a bakery products manufacturer. As per the partnership agreement it was agreed to share the profits and losses in the ratio of 2:1 between Dayarathna and Dilum respectively. As per the financial statements for the year ended 31st March 2019, turnover and net profit of the partnership were Rs.46,550,000/- and Rs.9,638,000/- respectively.

1. The following expenses have been deducted when arriving at the net profit: Rs. Salary paid to partners 2,880,000 Rent 960,000 Depreciation 80,000
2. Dayarathna and Dilum draw monthly salary of Rs.110,000/- and Rs.130,000/- respectively for their involvement in the business.
3. Rent has been paid to Dayarathna for the use of first floor of his residence as office of the partnership.
4. Capital allowance on assets for the tax purposes for the year of assessment 2018/19 was Rs.90,000 /-

You are required to: Calculate the following for the year of assessment 2018/19:

(a) The partnership income for tax purpose. (03 marks)

(b) The withholding tax payable by the partnership on partnership income. (02 marks)

(c) The share of partnership income of each partner. (03 marks)

(d) The withholding tax credit available to each partner. (02 marks) (Total 10 marks)

2019 JULY (Q5)

PN Brothers is a partnership formed by two brothers, Praveen and Nissan. It engages in the business of wholesale and retail sale of stationery items. As per the partnership agreement, it was agreed to share profits and losses equally between Praveen and Nissan. As per the financial statement for the year ended 31st March 2019, turnover and net profit of the partnership were Rs.54,350,000 /- and Rs.12,100,000/- respectively.

(1) The following expenses have been deducted when arriving at the net profit: Rs. Salaries paid to partners 2,640,000 Salaries to office staff 3,950,000 Depreciation on assets 190,000
(2) Praveen and Nissan draw monthly salary of Rs.120,000 /- and Rs.100,000/- respectively for their involvement in the business.
(3) Capital allowance on assets for tax purposes for the year of assessment 2018/19 was Rs.175,000 /-.

You are required to: Calculate the following:

(a) The partnership income for tax purpose for the year of assessment 2018/19. (03 marks)

(b) The withholding tax payable by the partnership for the year of assessment 2018/19. (02 marks)

(c) The share of partnership income of each partner for the year of assessment 2018/19. (03 marks)

(d) The withholding tax credit available to each partner for the year of assessment 2018/19. (02 marks) (Total 10 marks)