REDESIGNED TAXATION ON RECONSTITUTION / DISSOLUTION OF THE FIRM – A NEW JEOPARDY?

Under the erstwhile provisions of the Income tax Act, 1961 ("**the Act**"), where the partner withdrew money from capital account with the partnership firm, there was no provision to tax the same, either in the hands of the partnership firm or the partner. On the basis of the jurisprudence that prevailed at that time, it was held that when a partner retires, what the partner receives is his share in the partnership; the consequence of such distribution or division of assets on retirement of a partner was nothing but mutual adjustment of pre-existing rights between the partners and consequently, there was no transfer for the purposes of levy of capital gains tax under the Act [refer *Dewas Cine Corporation: 68 ITR 240 (SC), CIT vs. Mohanbhai Pamabhai: 165 ITR 166 (SC)*].

Though in terms of the earlier provisions of section 45(4), by virtue of the deeming fiction, tax was imposed in the hands of the firm in a situation where capital asset(s) of the firm was distributed to the partner on dissolution or otherwise, the scope of the said section was, however, limited to distribution of capital asset(s) and not to distribution of money on withdrawal of amount in excess of the balance lying in the capital account of the partner.

Apart from the above, there was a debate whether distribution of capital asset in case of re-constitution of firm by way of retirement or change in profit sharing ratio, etc., was covered within the scope of the provisions of section 45(4) of the Act [*Favourable: Dynamic Enterprises: 359 ITR 83 (Kar); CIT vs. G. Seshagiri Rao : 213 ITR 304 (AP); Against : CIT vs. A.N. Naik Associates: 265 ITR 346 (Bom); ACT vs. Gurunath Talkies: 226 CTR 474 (Kar)*].

To put quietus to the above controversy, to tax withdrawal of enhanced capital balance by way of money and to also tax distribution of assets, the Finance Act, 2021 has made substantive amendments by insertion of new section 9B and also substituted existing section 45(4), retrospectively effective from the previous year 2020-21.

The **new section 45(4)** applies when a partner receives "money or any other asset" from the firm in excess of the balance in the capital account at the time of reconstitution of the firm; the same is deemed to be "capital gains" in the hands of the firm. Further, balance in the capital account is to be calculated ignoring increase / credit to the account due to revaluation of any asset or recording of self-generated goodwill or any other self-generated asset.

Further**, new section 9B**, which shall operate in addition to the provisions of section 45(4), has been inserted to deem receipt of capital asset or stock in trade or both by the partner (from the firm / LLP) as 'transfer' by the firm/ Limited Liability Partnership ("**LLP**") in the year of receipt of asset by the partner. Income arising on such transfer shall be chargeable to tax under the head "capital gains" or under the head "profits and gains of business or profession", as the case maybe, in accordance with the provisions of the Act.

Consequential amendment has been made in section 48(iii) to provide that the amount of capital gains offered to tax by the firm under section 45(4) shall be allowed as reduction while computing capital gains on transfer of any remaining capital asset by the firm, in future, in the manner to be prescribed.

The **scope and operation** of **the two new sections, viz,** sections 9B and 45(4) is tabulated as under:

Section 9B	Section 45(4)
It would apply upon receipt of capital asset or **stock-in-trade** or both by a partner from the firm on the **dissolution or reconstitution** of a firm	It would apply upon receipt of capital asset or **cash** or both by a partner from the firm in connection with **reconstitution** of the firm
Allotment of stock-in-trade to partner is covered	Allotment of stock-in-trade to partner is not covered
For the purpose of computation under section 9B, **FMV is deemed to be full value of consideration** and computation would be in accordance with Chapter IV-C or D i.e., “Profits and gains of business or profession” or “Capital Gains”, as the case may be	Computation mechanism is given in the form of straight jacket **formula** under Section 45(4), viz, Aggregate value of the money and the fair market value (“**FMV**”) of capital asset received by the partner less capital balance at that time.
Computation **can result in** business or capital **loss**.	Computation **cannot result in loss.**
No attribution of gains computed.	Gains computed to be attributed to remaining capital assets of the firm as per section 48(iii) [refer: Rule 8AB infra]

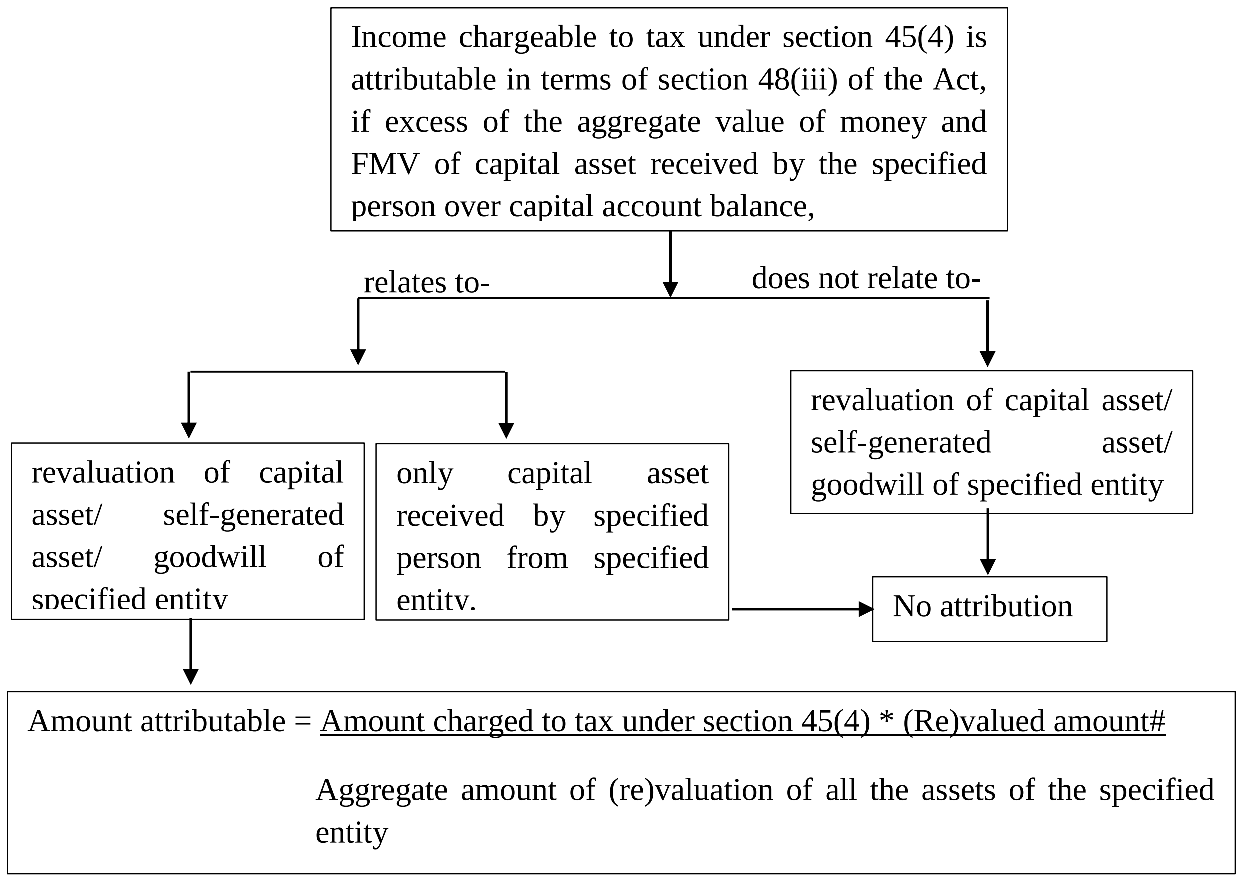
Pursuant to the aforesaid provisions, Income Tax Rules, 1962 (“**IT Rules**”) have been amended/ supplemented vide **Notification No.76 of 2021 dated 2nd July 2021** issued by CBDT, to provide as under:

Nature of capital gains under section 45(4) of the Act

For determination of the nature of capital gains computed under section 45(4) of the Act, viz, whether short-term or long-term capital gains (“**LTCG**”), sub-rule (5) has been inserted in Rule 8AA to provide as under:

- Nature of capital gains or part thereof shall be deemed as -
  - Short term capital gains, if attributed to [clause (i)]-
    - Short term capital asset at the time of taxation
    - Capital asset forming part of block of assets.
    - Self-generated asset or goodwill
  - Long term capital gains, if attributed to [clause (ii)] -
    - Asset not covered by clause (i)
    - Long term capital asset at the time of taxation

New Rule 8AB has been inserted for the purpose of section 48(iii) to provide the manner of attribution of income taxable under section 45(4) of the Act to the remaining capital assets of the specified entity. The same is explained as under:



Please note that –

- Revaluation/valuation certificate must be obtained from a "registered valuer" defined in Rule 11U.
- Details of attribution is required to be electronically submitted by the specified entity in Form No. 5C before due date of filing the income tax return for the assessment year in which the amount is charged to tax under section 45(4) of the Act.
- No depreciation shall be allowable to the specified entity on revaluation of existing assets or valuation of self-generated assets/goodwill.

Guidelines issued vide Notification No. 76 dated 2nd July,2021.

As stated supra, as per the amended section 48(iii), amount taxed under section 45(4) of the Act is required to be attributed to the remaining capital assets of the specified entity and on transfer of such capital assets in the future, the amount so attributed shall be reduced from the full value of the consideration so that the specified entity does not pay tax again on the same amount. However, the said attribution was enacted only for the purposes of section 48 and therefore, does not apply to capital assets which form part of block of assets falling under section 43(6)(c) (WDV of the block of assets) and section 50 (depreciable assets) of the Act.

To remove the said difficulty, Circular 14/2001 dated 2nd July, 2021 has clarified that **Rule 8AB** of the IT Rules notified vide Notification No. 76 dated 02-07-2021 shall also apply to capital assets forming part of block of assets. Accordingly, wherever reference is made for the purposes of section 48, such reference shall be deemed to include reference for the purposes of sub-clause (c) of clause (6) of section 43 and section 50 of the Act.

It is further clarified that in case the capital asset remaining with the specified entity is forming part of a block of asset, the amount attributed to such capital asset under Rule 8AB of the IT Rules shall be reduced from the full value of the consideration received or accruing as a result of subsequent transfer of such asset by the specified entity, and the net value of such consideration shall be considered for reduction from the written down value of such block under sub-clause (c) of clause (6) of section 43 or for calculation of capital gains, as the case may be, under section 50 of the Act.

To put it simply, though in view of amendment in section 48(iii), income on which tax is paid under section 45(4) by the Firm is attributable only to capital assets governed by the former section, to remove difficulty, it has been clarified that the principle of attribution shall also apply to depreciable assets.

For the purposes of understanding and for removing difficulties, the application of section 9B of the Act and sub-section (4) of section 45 of the Act is explained with the help of the following examples:

Illustrations/ Examples

Example-1: Following is the Balance Sheet of Firm "FR" having partners A, B, C with equal profit-sharing ratio.

Liabilities	Amount in Lakh (Book value)	Assets	Amount in Lakh (Book value)
Partners' Capital Balances: A B C	 10 10 10	**Capital Assets- Land:** Land- S (FMV: **70** Lakh) Land- T (FMV: **70** Lakh) Land- U (FMV: **50** Lakh)	 **10** **10** **10**
	30		**30**

All the three lands were acquired by the firm more than 2 years ago, thus, these are long term capital assets. Partner A proposes to retire from the firm. On retirement of A, the lands (all assets) have been revalued and the FMV (as tabulated) is determined on the basis of valuation report issued by registered valuer as per Rule 11U. The firm decides to give him Rs. 11 Lakh of money and land "U" to Partner A to settle his capital balances on retirement.

Assume indexed cost of acquisition of land "U" as Rs. 15 Lakh; and flat tax rate @ 20% on LTCG.

Solution:

As per section 9B of the Act, it shall be deemed that the firm "FR" has transferred land "U" to partner "A" at FMV Rs. 50 Lakh. **Therefore, LTCG computed as per section 9B of the Act in the hands of firm "FR" shall be -**

Particulars	Amount in Lakh
FMV of Land "U" Less: Indexed cost of acquisition (as per section 48)	50 (15)
Long Term Capital Gain on deemed transfer of land "U" [since 'U' is long term capital asset]	**35**
Tax payable on LTCG @ 20% in hands of firm	**7**

Computation of capital gains under section 45(4) of the Act:

At first, capital balance of Partner A is required to be computed after giving effect to aforesaid taxation u/s 9B of the Act.

Net Book Profit on deemed transfer of land "U" to be credited to partner's capital account:

Particulars	Amount in Lakh
FMV of Land "U" Less: Book value of Land "U"	50 (10)
Book Profit before tax **Less: Tax payable on LTCG**	**40** **(7)**
Net Book Profit to be shared in 1:1:1 (profit sharing ratio)	**33**
Thus, capital of each of the partners will be credited with Rs. 11 Lakh for the profit as calculated above in their respective profit sharing ratio.	

Capital Accounts of the partners, as revised, and capital gains u/s 45(4):

Particulars	A	B	C
Capital balances as given	10	10	10
Add: Book Profit on deemed transfer (refer above table)	11	11	11
Total capital balances as per books	**21**	**21**	**21**
Less: Money given to A Less: Land "U" given to A (**FMV**)	(11) (50)		
Excess of settlement money over the capital account balance (taxable u/s 45(4).	**40**		

Please note that –

- The excess money as calculated above **Rs. 40 Lakh** shall be charged to tax under section 45(4) of the Act, **in addition** to an amount of Rs. 35 Lakh charged to tax under section 9B of the Act;

- According to Rule 8AB, Rs. 40 Lakh shall be attributed to remaining assets of the firm "FR" on the basis of increase in their value due to revaluation. In this example, both remaining assets "S" and "T" have their values increased by Rs. 60 Lakh (FMV 70 lakh less Book Value 10 lakh).

  Thus, Rs.40 Lakh will be attributed to both "S" & "T" in the ratio of 60:60 (being upward revaluation of S:T), i.e., Rs. 20 Lakh each. When either of these lands would be sold in future, Rs. 20 Lakh amount attributed shall be reduced from sales consideration under section 48(iii) of the Act; and

- The amount of Rs. 40 Lakh charged to tax under section 45(4) of the Act shall be deemed to be **long-term capital gains** in view of Rule 8AA, considering Rs. 40 Lakh has been attributed to land "S" and "T", both being long term capital assets at the time of taxation under section 45(4) of the Act.

  In simple words, nature of gain u/s 45(4) is determined on the basis of nature of remaining assets to which attribution is required to be made.

Example-2: Suppose all the facts are same as in example-1 above, except that the land "U" is sold at its FMV of Rs. 50 Lakh and thereafter, the final settlement to partner "A" is made in cash Rs. 61 Lakh.

Solution:

LTCG in the hands of firm "FR" on sale of land would be computed as under:

Particulars	Amount in Lakh
Sales consideration of land "U" Less: Indexed cost of acquisition (as per section 48)	50 (15)
Long Term Capital Gain on sale of land "U" [u/s 9B r.w.s 45(1)]	**35**
Tax payable on LTCG @ 20% in hands of firm [since 'S' is long term capital asset]	**7**

Net Book Profit on sale of land "U" to be credited to partner's capital account:

Particulars	Amount in Lakh
Sales consideration of Land "U" Less: Book value of Land "U"	50 (10)
Book Profit before tax **Less: Tax payable on LTCG**	**40** **(7)**
Net Book Profit to be shared in 1:1:1 (profit sharing ratio)	**33**
Thus, capital of each of the partners will be credited with Rs. 11 Lacs for the profit as calculated above.	

Capital accounts of the partners, as revised, and capital gains u/s 45(4):

Particulars	A	B	C
Capital balances as given	10	10	10
Add: Profit on sale of land "U" (refer above table)	11	11	11
Total capital balances	**21**	**21**	**21**
Less: Settlement by way of cash	(61)		
Excess of settlement money as compared to capital balances [taxable u/s 45(4)]	**40**		

Please note that –

- the excess money of Rs. 40 Lakh shall be charged to tax under section 45(4) of the Act in addition to an amount of Rs. 35 Lakh charged to capital gains tax;
- as stated above, Rs. 40 Lakh will be attributed to both "S" & "T" in 60:60, i.e., Rs. 20 Lakh each;
- the amount of Rs. 40 Lakh charged to tax under section 45(4) of the Act shall be deemed to be LTCG.

PS: The final result in both example-1 and 2 is same due to the operation of section 9B of the Act.

Example-3: Following is the Balance Sheet of Firm "FR" having partners A, B, C with equal profit-sharing ratio.

Liabilities	Amount in Lakh	Assets	Amount in Lakh (Book value)
Partners' Capital Balances: A B C	 100 100 100	**Capital Assets-** Land- S (FMV Rs. 45 Lacs) Patent -T (FMV Rs. 60 Lacs) Cash	 30 45 (WDV) 225
	300		**300**

The land was acquired by the firm more than 2 years ago and is, therefore, a long-term capital asset. The patent was acquired/developed/registered only 1 year back. As per the valuation report, there is also a self-generated goodwill of Rs. 30 Lakh. On exit of partner "A", the firm decides to give him Rs. 75 Lakh in cash and land "S" to settle his balances. Indexed cost of land "S" is Rs. 45 Lakh.

The FMV of the assets have been determined as per report of registered valuer on account of revaluation of assets prior to retirement of Partner A.

Solution:

LCG shall be computed in the hands of firm "FR" under section 9B as under:

Particulars	Amount in Lakh
FMV of Land "S" Less: Indexed cost of acquisition	45 (45)
LTCG on deemed transfer of land "S" [u/s 9B r.w.s 45(1)]	**Nil**
Tax payable on LTCG @ 20% in the hands of firm [since 'S' is long term capital asset]	**Nil**

There will be no capital gain tax on application of section 9B of the Act; however, cost of acquisition of land "S" in the hands of Partner "A" shall be taken as Rs. 45 Lakh.

Net Book Profit on deemed transfer of land "S" to be credited to partner's capital account:

Particulars	Amount in Lakh
FMV of Land "S" Less: Book value of Land "S"	45 (30)
Book Profit before tax **Less: Tax payable on LTCG**	**15** **Nil**
Net Book Profit to be shared in 1:1:1 (profit sharing ratio)	**15**
Capital account of each partner will be credited with Rs. 5 Lakh for the profit as calculated above.	

Capital accounts of the partners, as revised:

Particulars	A	B	C
Capital balances (Given)	100	100	100
Add: Profit on deemed transfer of land "S" (refer above table)	5	5	5
Total capital account balances	**105**	**105**	**105**
Less: Settlement by way of cash Less: settlement by way of land "S"	(75) (45)		
Excess of settlement money as compared to capital balances [taxable u/s 45(4)]	**15**		

Please note that –

- Excess money of <u>**Rs. 15 Lakh**</u> shall be charged to tax under section 45(4) of the Act, in addition to any amount charged to tax under section 9B of the Act, which is "Nil" in this example;

- as per Rule 8AB, Rs.15 Lakh shall be attributed to remaining assets of the firm "FR" on the basis of the valuation report of registered valuer.

  In this example, value of patent "T" has to be increased by Rs. 15 Lakhs (FMV of Rs. 45 Lakh less Book Value of Rs. 30 Lakh) and the self-generated goodwill value has been recognised at Rs. 30 Lakhs. Thus, Rs. 15 Lakh will be attributed between patent and the self-generated goodwill in the ratio of 15:30 or 1:2. Thus, Rs. 5 lakhs will be attributed to patent "T" and Rs. 10 Lakh attributed to self-generated goodwill;

- Rs. 15 Lakh charged to tax under section 45(4) of the Act shall be deemed to be short-term capital gains since Rs. 5 Lakh is attributed to the Patent "T" (depreciable asset) and Rs. 10 Lakh has been attributed to self-generated goodwill. In accordance with sub-rule (5) of Rule 8AA of the Rules, both of these are to be characterised as short-term capital gains;

- Rs. 5 lakh attributed to patent "T" shall not be added to the block of the assets and no depreciation shall be available on the same. When patent "T" gets transferred subsequently, Rs. 5 Lakh attributed shall be reduced from the full value of consideration receiving or accruing as a result of transfer of patent "T" by the firm "FR" and the net value shall be considered for reduction from the written down value of the intangible block under section 43(6)(c) of the Act or for calculation of capital gains under section 50 of the Act, as the case may be.

<u>**VA Comments/ Open Issues:**</u>

The release of the above notification/ circular by CBDT is a welcome move towards providing the much-needed clarity to the application of the newly introduced complex scheme of taxation regarding reconstitution of the firm. Having said so, the new provisions, more particularly the concept of attribution of the amount chargeable to tax under section 45(4) to cost of remaining assets still lacks lucidity/ simplicity, which may ultimately end up opening another pandora's box in relation to partnership taxation in future in view of following:

- Although details would be furnished by the taxpayer in Form No. 5C regarding the amount attributed to capital asset(s) remaining with the specified entity; however, in view of the contingency involved regarding sale of the remaining assets of the firm in future (which may happen after considerable period), it would be a complex exercise to reconcile, in future, the cost of acquisition on sale of any of the remaining assets by the specified entity;

- Section 9B provides that FMV of the asset/ stock shall be the full value of consideration; however, no guidelines have been prescribed for computation of FMV as have been prescribed / notified in sections 50C/50CA/56 of the Act. This may lead to litigation on the issue of valuation in each and every case of reconstitution of firm;

- Attribution of cost and it allowability at a future uncertain date, as and when the remaining asset(s) is sold/ transferred, do not take into account the time value of money, which may be considerably lost/ eroded by the time the taxpayer is ultimately able to take benefit thereof. For example, where attributed cost to an asset transferred is allowed, say after 10/ 20 years.

- Where the asset being transferred to the partner on reconstitution of the firm is the only capital asset of the firm, then, Rule 8AB provides for no attribution of the income charged to tax under section 45(4) and consequently, no reduction would be allowable under section 48(iii) subsequently.

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For any details and clarifications, please feel free to write to:

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