

Section 9B & 45(4) of the Income Tax Act

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Erstwhile scheme of taxation up to AY 2020-21

- S.45(4) provides for capital gains taxation in hands of firm, on transfer of capital asset to partners, by way of distribution, on dissolution or otherwise

Capital gains = FMV of capital asset on the date of distribution (-) cost/WDV

- Further, The Apex court in case of M/s. MansukhDyeing and PrintingMills [2023] 151 taxmann.com 306 (SC) held that –

“Where pursuant to reconstitution of assessee-partnership firm, assets of assessee were revalued and revalued amount was credited to partners accounts in their profit sharing ratio, said credit was in effect distribution of increased value of assets to partners, and as said credits were available to partners for withdrawal, assets so revalued and credited into capital accounts could be said to be 'transfer' which would fall in category of 'otherwise' under section 45(4) and said amount would be chargeable to tax as STCG”.

S. 9B- Income on receipt of capital asset or stock in trade by specified person from specified entity.

- (1) Where **a specified person** receives during the previous year **any capital asset or stock in trade or both from a specified entity** in connection with the **dissolution or reconstitution** of such specified entity, then the specified entity shall be deemed to have transferred such capital asset or stock in trade or both, as the case may be, to the specified person in the year in which such capital asset or stock in trade or both are **received by the specified person**.*
- (2) Any profits and gains arising from such deemed transfer of capital asset or stock in trade or both, as the case may be, by the specified entity shall be—*
 - (i) deemed to be the income of such specified entity of the previous year in which such capital asset or stock in trade or both were received by the specified person; and*
 - (ii) chargeable to income-tax as income of such specified entity under the head "Profits and gains of business or profession" or under the head "Capital gains", in accordance with the provisions of this Act.*
- (3) For the purposes of this section, fair market value of the capital asset or stock in trade or both on the date of its receipt by the specified person shall be deemed to be the full value of the consideration received or accruing as a result of such deemed transfer of the capital asset or stock in trade or both by the specified entity.*

S. 9B- Income on receipt of capital asset or stock in trade by specified person from specified entity.

- (4) If any difficulty arises in giving effect to the provisions of this section and sub-section (4) of section 45, the Board may, with the approval of the Central Government, issue guidelines for the purposes of removing the difficulty.*
- (5) Every guideline issued by the Board under sub-section (4) shall, as soon as may be after it is issued, be laid before each House of Parliament, and shall be binding on the income-tax authorities and on the assessee.*

Explanation Next slide....

S. 9B- Income on receipt of capital asset or stock in trade by specified person from specified entity.

Explanation.—For the purposes of this section,—

(i) "reconstitution of the specified entity" means, where—

(a) one or more of its partners or members, as the case may be, of such specified entity ceases to be partners or members; or

(b) one or more new partners or members, as the case may be, are admitted in such specified entity in such circumstances that one or more of the persons who were partners or members, as the case may be, of the specified entity, before the change, continue as partner or partners or member or members after the change; or

(c) all the partners or members, as the case may be, of such specified entity continue with a change in their respective share or in the shares of some of them;

(ii) "specified entity" means a firm or other association of persons or body of individuals (not being a company or a co-operative society);

(iii) "specified person" means a person, who is a partner of a firm or member of other association of persons or body of individuals (not being a company or a co-operative society) in any previous year.]

- Finance Act, 2021 inserted a new section 9B in the IT Act 1961 (hereinafter referred to as "the Act")
- This section mandates that whenever a specified person receives **any capital asset or stock in trade or both (Cap Asset or SIT or Both)** from a **specified entity**, during the previous year, **in connection with the dissolution or reconstitution of such specified entity**, then it shall be **deemed that the specified entity have transferred such Cap asset or stock in trade or both, as the case may be, to the specified person** (hereinafter referred to as "deemed trf").
- This deemed trf would be in the yr in which such Cap Asset or SIT or both are received by the specified person and any profits and gains arising from such deemed trf is deemed to be the income of such specified entity of the previous year in which such Cap Asset or SIT or both were received by the specified person.
- Further, it shall be chargeable to income-tax as income of such specified entity under the head "PGBP" or under the head "Capital gains", in accordance with the provisions of this Act.
- The **FMV** of the Cap Asset or SIT or both, on the date of its receipt by the specified person, shall be deemed to be the full value of the consideration as a result of such deemed transfer.

Sec 45(4)- Transfer of Cap Asset or Money or both by Specified Entity to Specified Person

(4) Notwithstanding anything contained in sub-section (1), where a specified person receives during the previous year any money or capital asset or both from a specified entity in connection with the reconstitution of such specified entity, then any profits or gains arising from such receipt by the specified person shall be chargeable to income-tax as income of such specified entity under the head "Capital gains" and shall be deemed to be the income of such specified entity of the previous year in which such money or capital asset or both were received by the specified person, and notwithstanding anything to the contrary contained in this Act, such profits or gains shall be determined in accordance with the following formula, namely:—

$$\underline{\mathbf{A = B + C - D}}$$

Where,

A = income chargeable to income-tax under this subsection as income of the specified entity under the head "Capital gains";

B = value of any money received by the specified person from the specified entity on the date of such receipt;

C = the amount of fair market value of the capital asset received by the specified person from the specified entity on the date of such receipt; and

D = the amount of balance in the capital account (represented in any manner) of the specified person in the books of account of the specified entity at the time of its reconstitution:

Sec 45(4)- Transfer of Cap Asset or Money or both by Specified Entity to Specified Person

Provided that if the value of "A" in the above formula is negative, its value shall be deemed to be zero:

Provided further that the balance in the capital account of the specified person in the books of account of the specified entity is to be calculated without taking into account the increase in the capital account of the specified person due to revaluation of any asset or due to self-generated goodwill or any other self-generated asset.

Explanation 1.—For the purposes of this sub-section,—

- (i) the expressions "reconstitution of the specified entity", "specified entity" and "specified person" shall have the meanings respectively assigned to them in section 9B;*
- (ii) "self-generated goodwill" and "self-generated asset" mean goodwill or asset, as the case may be, which has been acquired without incurring any cost for purchase or which has been generated during the course of the business or profession.*

Explanation 2.—For the removal of doubts, it is clarified that when a capital asset is received by a specified person from a specified entity in connection with the reconstitution of such specified entity, the provisions of this sub-section shall operate in addition to the provisions of section 9B and the taxation under the said provisions thereof shall be worked out independently.

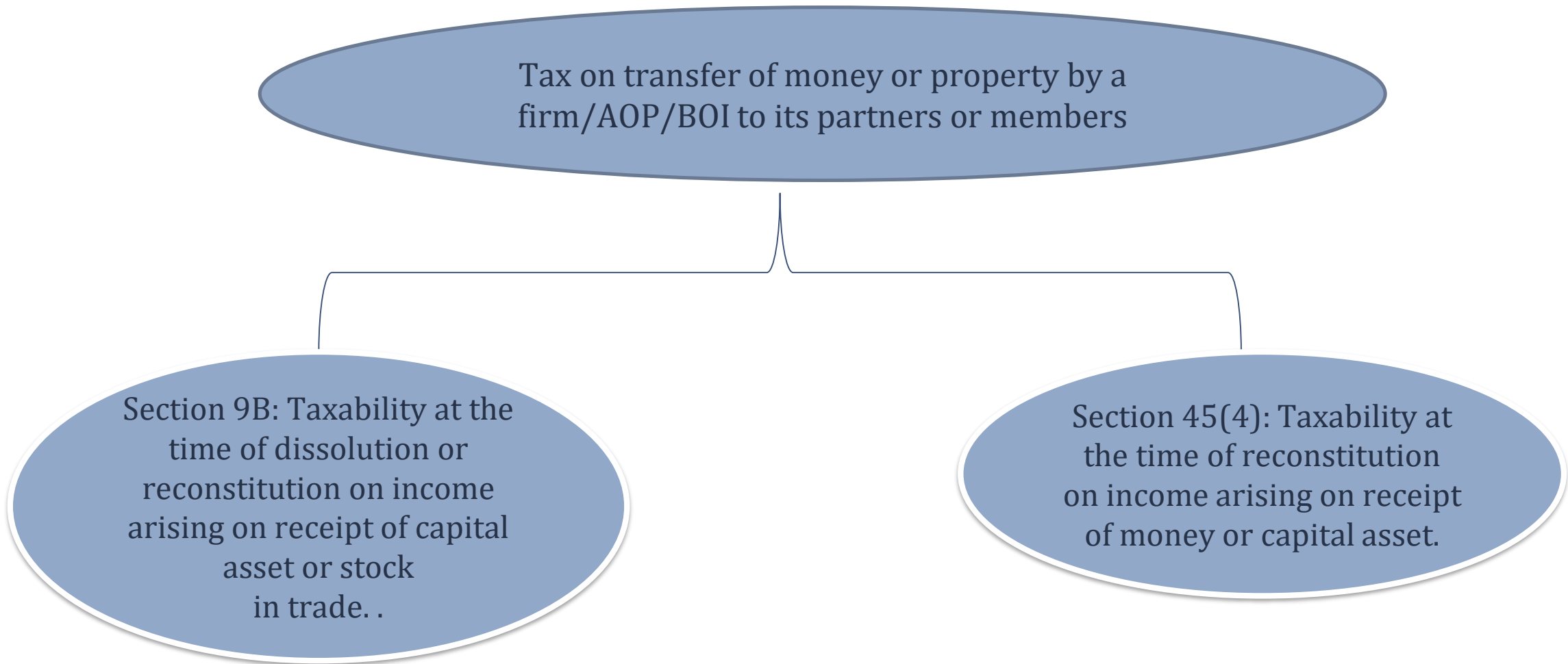
INTRODUCTION -45(4)

- Simultaneously the Finance Act 2021 substituted sub-section (4) of section 45 of the Act
- This newly substituted ss. (4) now provides that where a specified person receives **any money or capital asset or both** from a **specified entity**, during the previous year, **in connection with the reconstitution of such specified entity**, then any profits or gains arising from receipt of such receipt by the specified person shall be chargeable to IT as income of the specified entity under "Capital gains".
- This income shall be the income of the specified entity of the previous year in which such money or capital asset or both were received by the specified person.
- It has been further clarified that when a capital asset is received by a specified person from a specified entity **in connection with the reconstitution** of such specified entity, **the provisions of sub-section (4) of section 45 of the Act shall operate in addition to the provisions of section 9B of the Act and the taxation under the said provisions thereof shall be worked out independently.**
- Both, the new section 9B and substituted sub-section (4) of section 45 are applicable for the assessment year 2021-22 and subsequent assessment years

Sec 45(4)- Transfer of Cap Asset or Money or both by Specified Entity to Specified Person

Particular		Amount
Value of Money on the date of receipts	B	xxx
Add: FMV of Capital Assets on the date of receipts	C	xxx
Total		xxx
Less: Partner Capital Account Balance at the time of reconstitution	D	xxx
Capital Gain	A	xxx

Tax on transfer of money/property by firm/AOP/BOI to its partners or members



To avoid double taxation in case of capital asset at the time of reconstitution, amendment u/s 48 of the Act has been made

Comparative analysis

S No.	Parameter	Erstwhile S.45(4)	New S.9B	New S.45(4)
1	Taxable Entity	Firm / AOP / BOI	Firm / AOP / BOI	Firm / AOP / BOI
2	Event of trigger of taxability	Transfer of capital asset by way of distribution, on dissolution or otherwise of firm	Receipt of capital asset or stock in trade or both by partner/member in connection with dissolution or reconstitution of firm	Receipt of money or capital asset or both by partner/member in connection with reconstitution of firm
3	Year of taxability	Transfer of capital asset	Receipt by partner/member	Receipt by partner/member
4	Head of income	Capital gain	Capital asset :- Capital gains, Stock in trade :- PGBP	Capital gains :- as per formula $A = B + C - D$
5	Quantum of consideration	FMV of capital asset on date of transfer	FMV of capital asset or stock in trade or both on date of receipt by partner/member	Value of money (B) + FMV of capital asset (C) on date of receipt by partner/member

Comparative analysis

6	Cost of acquisition	As per s.48/49 in respect of capital asset transferred	As per s.48/49 in respect of capital asset transferred	Partner's capital account balance (represented in any manner)** at the time of reconstitution
7	Treatment of loss	Loss admissible	Loss admissible	Not admissible
8	Interplay between different provisions	Not applicable	Not specified	S.45(4) shall operate in addition to s.9B and both shall be worked out independently
9	Reduction from sale consideration due to capital gains taxation in hands of firm	Not applicable as capital asset is no longer with firm	Not applicable	S.48 (iii) contemplates reduction from sale consideration on transfer of remaining capital assets, as per prescribed rules (refer later case studies)

***Without taking into account increase (a) due to revaluation of any asset or (b) due to self-generated goodwill/asset*

Comparative analysis

10	Cost of capital asset in hands of recipient partner	FMV based on general principles	FMV based on general principles	FMV based on general principles, also supported by CBDT guidelines
11	Definition of 'reconstitution', 'specified entity' and 'specified person'	Not applicable – Refer back to judicial conflict on whether 'retirement' falls within scope of s.45(4)	Includes retirement, admission or change in profit sharing ratio	Borrowed from s.9B
12	CBDT's power to issue guidelines to remove difficulties	Not applicable	Exists – Binding on both tax authority and taxpayers on placing before both Houses of Parliament	Exists – Provided in s.9B

Applicability of Section 9B Vs 45(4)			
Type of Transaction	Settlement by way of	Section 9B Applicability	Section 45(4) Applicability
<u>Retirement</u> of partner	Nil	No	No
Retirement of partner	Money	No	Yes
Retirement of partner	Capital Asset	Yes	Yes
Retirement of partner	Stock-in-trade	Yes	No
<u>Admission</u> of partner with creation of goodwill before admission	Nil	No	No
Admission of partner with creation of goodwill before admission	Money	No	Yes
Admission of partner with creation of goodwill before admission	Capital Asset	Yes	Yes
Admission of partner with creation of goodwill before admission	Stock-in-trade	Yes	No

Applicability of Section 9B Vs 45(4)			
Type of Transaction	Settlement by way of	Section 9B Applicability	Section 45(4) Applicability
<u>Change in profit sharing ratio</u>	Nil	No	No
Change in profit sharing ratio	Money	No	Yes
Change in profit sharing ratio	Capital Asset	Yes	Yes
Change in profit sharing ratio	Stock-in-trade	Yes	No
<u>Dissolution</u> of Firm	Nil	No	No
Dissolution of Firm	Money	No	No
Dissolution of Firm	Capital Asset	Yes	No
Dissolution of Firm	Stock-in-trade	Yes	No

C.1 – In-specie distribution on dissolution

- APF has two equal partners A1 and A2
- Capital of A1 and A2 is 5,000 each and is represented by land acquired by firm in past by investing capital of 10,000 contributed by partners
- Land is held as a long-term capital asset
- Firm is to be dissolved as its purpose is frustrated
- On dissolution, land is distributed equally between A1 and A2
- FMV of land as on the date of receipt is 1 L

Indicative balance sheet of APF			
<u>Capital</u>		Land (FMV 1L)	10,000
A1	5,000		
A2	5,000		
Total	10,000	Total	10,000

Case Studies to understand operation of s.9B and s.45(4)

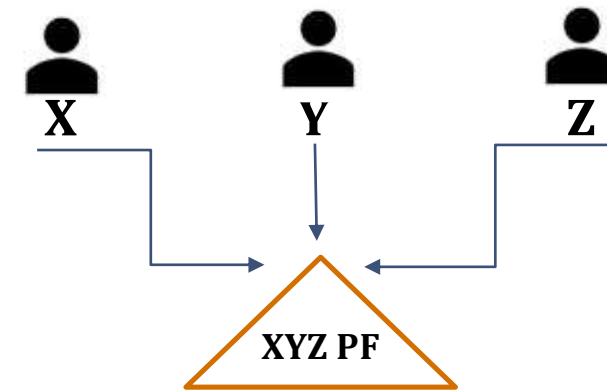
Particulars	S.9B	S.45(4)
FMV of land	1,00,000	N.A
Less:- Cost of acquisition (ignoring indexation)	10,000	N.A
LTCG in hands of firm	90,000	N.A

- S.45(4) not applicable to **dissolution**

Case Studies to understand operation of s.9B and s.45(4)

C.2 – Cash pay out on retirement

- XYZ PF has 3 partners having equal PSR and equal capital contribution
- XYZ PF has land acquired at cost of 1,500 whose FMV is 2,100
- Land is held as a long-term capital asset
- X retires from the firm and his account is settled in cash after taking into account FMV of land
- In order to settle X's share, continuing partners Y and Z bring in cash
- X is paid 700 against his capital balance of 500 (ignoring revaluation)
- 700 is represented by capital of 500 plus 1/3rd share in value appreciation of 600
- Refer next slide for tax implications



Indicative balance sheet			
X Capital	500	Land (FMV 2,100)	1,500
Y Capital	500		
Z Capital	500		
Total	1,500	Total	1,500

C.2 – Cash pay out on retirement

- S.9B does not trigger **as no Capital asset/SIT** is distributed to partner.
- Amount of 200 is attributed to revaluation of land
 - i. S.48(iii) - Reduce 200 from sale consideration on transfer of land in future by firm
 - ii. Say, if firm sells land for 2,100, cost of acquisition (ignoring indexation) is 1,500 and amount attributed is 200, net CG = 400

Particulars	S.9B	S.45(4)
Money Received (B)	N.A	700
FMV of capital asset received	N.A	N.A
Capital balance (D)	N.A	(500)
Capital gains in hands of firm (A)	N.A	200

C.3 - Distribution of capital asset on retirement

- Facts are same as C.2, however, X's account is settled by distribution of one-third land against his capital balance of 500
- FMV of one-third land is 700 ($2,100 \times 1/3$), which is represented by capital of 500 plus 1/3rd share in value appreciation of 600

**Notes- Next slide*

Particulars	S.9B	S.45(4)
Money received	-	- [B]
FMV of capital asset received	700	700 [C]
Cost of one-third land	500	-
Partner's capital balance	-	566* [D]
Capital gains in hands of firm	200	134 [A = B + C - D]

Case Studies to understand operation of s.9B and s.45(4)

X's capital account			
Particulars	Debit	Particulars	Credit
Distribution of one-third land to X	700	Opening balance	500
Closing balance	-	X's share on revaluation of land $[(2,100 - 1,500) \times 1/3]$	200
Total	700	Total	700

Realised profit - 66
 $[(700 - 500) \times 1/3]$

Unrealised profit - 134
 $[(1,400 - 1,000) \times 1/3]$

Notes

- As per CBDT's guidelines, retiring partner's share of value appreciation in capital asset distributed to him (viz. 66) is includible in his capital account balance [D]
- S.48(iii) - Reduce 134 from sale consideration on transfer of two-third land in future by firm
- Say, if firm sells two-third land for 1,400, cost of acquisition (ignoring indexation) is 1,000 and amount attributed is 134, net CG = 266
- Thus, there is no double taxation; taxation u/s. 45(4) merely represents timing difference

C.4 – Distribution of stock in trade on retirement

- XYZ PF has 3 partners having equal PSR and equal capital contribution
- XYZ PF has land acquired at cost of 1,500 whose FMV is 2,100
- Land is held as a stock-in-trade
- X retires from the firm and his account is settled by distribution of one-third land as against his capital balance of 500
- FMV of one-third land is 700 ($2,100 \times \frac{1}{3}$), which is represented by capital of 500 plus 1/3rd share (200) in value appreciation of 600
- S.45(4) is inapplicable to case of distribution of SIT as its applicability is restricted to distribution of any money or capital asset.
- Consequently, s. 48(iii) will also not apply

Particulars	S.9B
FMV of SIT	700
Cost of land	(500)
Business income in hands of XYZ PF	200

Some illustrative issues

- Is tax u/s. 45(4) triggered upon partner retiring from the firm, or upon actual receipt from firm?
- Whether s.45(4) is prospective or retrospective?
- Whether s.9B is prospective or retrospective?
- Impact of retirement of partner at book value
- Impact of partner's capital account turning negative by ignoring revaluation
- Waiver of debit balance in partner's capital account on retirement
- Is s.45(4) applicable on receipt by legal representative of deceased partner?
- Impact of conversion u/s. 47(xiii) or Chapter XXI post retirement
- Withdrawal of firm's property by partners in their PSR
- Some illustrative issues

Some illustrative issues

Issue 1: Is tax u/s. 45(4) triggered upon partner retiring from the firm, or upon actual receipt from firm?

A partner retires in March 2021 whose account is settled in March 2022 by cash payment. Whether s.45(4) triggers in FY 2020-21 or FY 2021-22?

➤ **View 1:- Once a partner retires and entitlement is determinate as a creditor, charge u/s. 45(4) is triggered:-**

- a. As per Indian Partnership Act, immediately upon retirement, a debt (viz. right to receive) is perfected in favour of retiring partner [Pamuru Vishnu Vinodh Reddy v. Chillakuru Chandrasekhara Reddy & Ors. C. A. No. 6519 of 1994, 17 February 2003]
- b. Perfection of a debt in lieu of partnership interest is a constructive receipt by partner from firm
- c. Word 'receipt' extends to credit to the account of the concerned person - Standard Triumph Motor Co. Ltd. v. CIT (1993)(67 Taxman 160)(SC)
- d. Partner may enjoy interest on such debt, partner may monetize such debt by assignment in favour of bank
- e. In many instances such as in the context of s.32AB(3)(ii)/(iii), the legislature itself uses the words "paid" and "payable" interchangeably
- f. Specific references in ITL have been made to 'actual receipt' wherever the legislature intended the point of taxation to be as such, for instance, in s.43B and s.43D - S.45(4) refers to "received" and not "actually received"

Issue 1: Is tax u/s. 45(4) triggered upon partner retiring from the firm, or upon actual receipt from firm?

- View 2:- Word 'receives' refers to actual receipt by the partner from the firm; acknowledgement of debt in favour of retiring partner is insufficient:-
- a. Clear reference is to 'received' in s.45(4) which is different than 'receivable'
 - b. S.45(4) uses a phraseology which is aligned to other receipt-based taxation provisions like s.45(1A) or s.46(2) or s.45(5) - Delhi ITAT Syndicate Printers Ltd (27 SOT 404) held that taxation u/s. 45(1A) is in year of actual receipt
 - c. SC in Moon Mills Ltd. (1966) (59 ITR 574) drew clear distinction between 'received' and 'receivable' and upheld taxation in year of actual receipt in the context of balancing charge provision in 1922 Act which provided for taxation of insurance money "received"
 - d. SC decision in Standard Triumph is distinguishable on facts, as in that case, debtor was holding the money in India on behalf of creditor – In present case, amount is not at disposal of partner, his ability to assign such debt to a bank is not reflective of receipt from firm
 - e. SC in Toshoku Ltd. [1980] 125 ITR 525 (SC) held that mere credit entry would not suffice to answer to the requirement of receipt

Issue 2: Whether s.45(4) is prospective or retrospective?

Partner retires in March 2020, but his account is settled in April 2020 by cash payment – Is s.45(4) triggered, which is effective from AY 2021-22?

➤ **View 1:- S.45(4) applies**

- a. It is deeming fiction of receipt-based taxation, like ss.45(1A) and 46(2) – Since receipt by partner from firm is post 1 April 2020, s.45(4) applies
- b. No grandfathering of past reconstitution unlike s.2(22)(e) which applied to payments post 31 May 1987, s.43C applied only to sale of asset post 29 February 1988
- c. S.46(2) was applied in respect of distributions by liquidator post 1 April 1961, while earlier distributions were exempt-
 - i. Capital gains computed by deducting full cost of acquisition of shares against distributions post 1 April 1961- CIT v. Inland Agencies (P.) Ltd. [1982] 11 Taxman 218 (Madras HC)
- d. Merely because determination of cost [viz. component D] is to relate back to pre-2020 date is not a good defence - even under a normal case, determination of cost is linked to FMV as on 1 April 2001

Issue 2: Whether s.45(4) is prospective or retrospective?

➤ **View 2:- S.45(4) does not apply**

- a. 'Reconstitution' is defined as where a person "ceases" to be a partner of firm – where such cessation took place before introduction of law, it is not 'reconstitution'
- b. S.45(4) only shifts timing of taxation to actual receipt – basis of taxation continues to be accrual – which, in the present case, happened in March 2020
- c. Receipt as also its connection with reconstitution are twin requirements for satisfaction of charge, which is triggered only when both these events occur after April 2020
- d. Very clear provisions (along the lines of Explanations 5 to 7 to s.9(1)(i) for indirect transfer) are needed to trigger charge in respect of past non-taxable events
- e. Analogy of s.46(2) cannot be applied as liquidation of a company is a continuing event while the retirement / reconstitution is a snapshot event

Issue 3: Whether s.9B is prospective or retrospective?

Partner retires in March 2020, but his account is settled in April 2020 by distribution of capital asset – Is s.9B triggered, which is effective from AY 2021-22?

➤ **View 1:- S.9B applies**

- a. S.9B concerns taxability on the part of the firm w. r. t. parting of CA or SIT
- b. If retirement in March 2020 resulted into creation of a debt against firm, settlement of such debt by transfer of CA or SIT represents consideration accruing to firm
- c. Distribution of CA or SIT is in lieu of sale in open market and payment of cash
- d. There is repetitive emphasis in s.9B for treating event of receipt as “deemed transfer”; such deemed transfer occurs in year in which CA or SIT is received by partner from the firm
- e. View 2 results in frustrating charge which already got created under old s.45(4) - legislative intent of s.9B is to expand the scope rather than to sacrifice the charge

Some illustrative issues

➤ View 2:- S.9B does not apply

- a. Retirement in March 2020 could not have resulted into creation of a debt against firm – legally, a partner can never be creditor of the firm; he is creditor of other partners
- b. In absence of saving clause for past reconstitution, lacuna in legislation cannot justify the trigger of charge
- c. View 1 may result in s.9B being applied even to dissolution pre 1 April 1987 (which was tax neutral) and create double whammy in absence of cost step-up to partner u/s. 49(1)(iii)(b)

Issue 4: Impact of retirement of partner at book value

- Settlement at an amount equivalent to partner's capital balance may not attract capital gains tax implications u/s. 45(4)
 - a. If such settlement is as per long standing terms of partnership deed, such settlement merely reflects working out of pre-existing rights
- In a different scenario, suppose, there is retirement and partner retires by withdrawing only capital balance at book value - despite there being higher entitlement basis partnership deed
 - a. Actual receipt by partner from firm is relevant - S.45(4) does not have any deeming fiction for taxation w.r.t. fair value of partnership interest
 - b. S.56(2)(x) implications in hands of continuing partners?
 - i. No transfer of specified property is effected by retired partner in favor of continuing partners
 - ii. Settlement of retired partner without taking into account value of goodwill does not result in any transfer or settlement by such retired partner in favor of continuing partners under Gift-tax Act - assets and goodwill of firm continue to remain those of firm [CGT v T M Louiz [2000] 245 ITR 831 (SC)]
 - iii. During subsistence of firm, no partner has any specific interest in any property of firm – while partners have certain rights on dissolution/retirement, properties remain that of firm and not of partners

Issue 5: Impact of partner's cap a/c turning negative by ignoring revaluation

- XYZ LLP has 3 partners having equal PSR and equal capital contribution
- In year 1, partner X desires to withdraw cash from his capital account for personal purposes-
 - a. In year 1, land is revalued by firm and revaluation profit of 6,000 is credited in equal proportion to capital account of all three partners
 - b. Out of total credit balance in partner's capital account of 3,000 (viz. 1,000 capital contribution and 2,000 revaluation), partner X withdraws cash of 2,500 in year 1
- In year 2, partner X retires from LLP
- Amount payable to X on retirement is determined at 500, which is payable in cash in year 2
- Since retiring partner's account is settled in cash, **s.9B does not trigger**
- Refer next slide for s.45(4) implications

Indicative balance sheet			
X Cap	1,000	Land (FMV 9,000)	3,000
Y Cap	1,000		
Z Cap	1,000		
Total	3,000	Total	3,000

Some illustrative issues

Issue 5: Impact of partner's cap a/c turning negative by ignoring revaluation

Particulars	If no withdrawal in year 1	Post withdrawal in year 1
Money received in connection with reconstitution	3,000 [B]	500 [B]
FMV of capital asset received	- [C]	- [C]
Partner's capital balance at the time of reconstitution	(1,000) [D]	(- 1,500*) [D]
Capital gains u/s. 45(4) in hands of firm	2,000 [A = B + C - D]	2,000 [A = B + C - D]

**Compute without taking into account increase due to revaluation of any asset*

Some illustrative issues

Issue 5: Impact of partner’s cap a/c turning negative by ignoring revaluation

X’s capital account per books (post revaluation)			
Particulars	Debit	Particulars	Credit
Year 1			
To Withdrawal in year 1	2,500	By Opening b/f	1,000
To Closing c/f	500	By X’s share on revaluation of land	2,000
Total	3,000	Total	3,000
Year 2			
		By Opening b/f	500

Memorandum capital a/c (ignoring revaluation)			
Particulars	Debit	Particulars	Credit
Year 1			
To Withdrawal in year 1	2,500	By Opening b/f	1,000
		By X’s share on revaluation of land	Ignored
		By closing c/f	1,500
Total	2,500	Total	2,500
Year 2			
To Opening b/f	1,500		

Issue 6: Waiver of debit balance in partner's cap a/c on retirement

- In earlier case study, assume that partner X withdraws cash of 3,500 in year 1 for personal purposes, against his capital balance of 3,000(post revaluation)
- Firm waives of 500 due from partner X and also, nothing further is paid to partner
 - a. CIT v. Mahindra And Mahindra Ltd.[2018] 93taxmann.com32 (SC):“waiver of loan by the creditor results in the debtor having extra cash in his hand. It is receipt in the hands of the debtor.”
- Hence, waiver of 500 by firm results in receipt of extra cash in hands of partner from firm

Particulars	Amount
Money received in connection with reconstitution	500 [B]
Partner's capital balance at the time of reconstitution	(2,000) [D]
Capital gains u/s. 45(4) in hands of firm	2,500 [A = B + C - D]

Some illustrative issues

Issue 6: Waiver of debit balance in partner's cap a/c on retirement

Memorandum Capital Account of Partner X (ignoring revaluation) is as under:-

Memorandum capital a/c			
Particulars	Debit	Particulars	Credit
Year 1			
To Withdrawal in year 1	3,500	By Opening b/f	1,000
		By X's share on revaluation of land	Ignored
		By closing c/f	2,500
Total	3,500	Total	3,500
Year 2			
By Opening b/f	2,500	By P&L account (waiver in year 2)	500
		By Closing c/f	2,000

Issue 7: Is s.45(4) applicable on receipt by legal representative of deceased partner?

- XYZ PF has 3 partners having equal PSR and equal capital contribution
- Partner X expires
- As per partnership deed, account of deceased partner X is to be settled at fair value in favor of his legal heir without admitting him as partner Continuing partners Y and Z bring in cash for payment to legal heir of X
- While there is no dispute that death of partner gives rise to reconstitution of the firm; limited issue is whether s.45(4) gets triggered when the legal heir receives settlement of deceased partner's capital account.
- S.45(4) states 'where **a specified person receives money.....from specified entity...**'
- 'Specified person' is defined to mean **a person who is partner of a firm....**

Indicative balance sheet			
X Capital	1,000	Land (FMV 9,000)	3,000
Y Capital	1,000		
Z Capital	1,000		
Total	3,000	Total	3,000

Issue 7: Is s.45(4) applicable on receipt by legal representative of deceased partner?

➤ **View 1:- S.45(4) applies**

- a. Legal heir steps into shoes of deceased partner - payment is made to legal heir pursuant to right conferred on deceased partner in terms of partnership deed
- b. Concept of 'substituted assessee' enshrined in s.49(1) of ITL – to also be read into s.45(4)
- c. C.V. Ramanathan v. CIT [1980] 125 ITR 191 (Madras) – exemption u/s. 54 allowed to deceased taxpayer even where the investment in new house was made by son of deceased taxpayer

Issue 7: Is s.45(4) applicable on receipt by legal representative of deceased partner?

➤ **View 2:- S.45(4) does not apply**

- a. Legal heir was never admitted into partnership – hence, is not a ‘specified person’ – charge fails in absence of receipt by a ‘specified person’ –
- b. Being a charging provision, strict interpretation required
- c. S.159/168 provide taxing deceased person’s income in hands of legal representatives/executor – such provisions are inapplicable to present case as taxation u/s. 45(4) is in hands of firm
- d. A specific provision along the lines of Explanation (iii) to s.45(5) is needed for taxing receipt by legal heir
- e. Interest paid by firm to estate of deceased partner administered by trustee, is not hit by s.40(b) as such trustee was never admitted as a partner in firm [Colombo Stores (1984)(17 Taxman 183)(Madras HC)]

Where firm having 2 partners is dissolved due to death of one partner, and business is continued by legal heir with surviving partner, there may be emergence of AOP/BOI

Issue 8: Impact of corporatisation of firm u/s. 47(xiii) or Chapter XXI post retirement

- XYZ LLP has 3 partners having equal PSR and equal capital contribution
- Partner X retires w. e. f. 1 January 2021
- Value of X's interest is determined at 3,000, which is payable in cash by LLP to X at the end of three years, i.e. on 31 December 2023
- X is recognized in books of LLP as a creditor
- Post retirement, remaining partners decide to carry on business in the form of a corporate structure
- On 31 March 2021, Y and Z form a company 'I Co.', infuse capital therein, and I Co. purchases business from LLP for a lump sum consideration – such conversion is exempt u/s. 47(xiii)
- On 31 December 2023, I Co. discharges the debt in favor of X by payment of cash
- Assuming charge u/s. 45(4) is triggered on actual receipt, can such charge trigger even where debt is repaid by I Co. and not by LLP?

Indicative balance sheet			
X Capital	1,000	Land (FMV 9,000)	3,000
Y Capital	1,000		
Z Capital	1,000		
Total	3,000	Total	3,000

Issue 8: Impact of corporatisation of firm u/s. 47(xiii) or Chapter XXI post retirement

- S, 45(4) triggers charge “where specified person receives moneyfrom a specified entity.....”
- At the stage of conversion in year 1, retired partner receives debt owed by I Co. in lieu of debt owed by firm/LLP – retired partner does not receive any money from the firm/LLP
- At the stage of discharge of debt by I Co. in year 3, retired partner receives money from I Co. which is not a ‘specified entity’
- Charging provisions require strict construction – absence of receipt by partner from ‘specified person’ may frustrate the charge?

Additionally, corporatisation u/s. 47(xiii) involves novation of debt as inter-vivos transfer

- Novation involves discharge of original debt due by LLP and substitution by fresh debt due by ICo.
- Such discharge is not by way of repayment but by way of a mutual agreement

Issue 9: Withdrawal of firm's property by partners in their PSR

- XYZ PF has 3 partners having equal PSR
- XYZ PF has two assets, one being business with book value of 2,000 (whose FMV is 6,000) and another being land with book value of 1,000 (whose FMV is 3,000)
- For diverse commercial and social considerations and for bona fide reasons of long-term sustenance of partnership relations, a decision is taken to distribute certain firm's properties
- Accordingly, Land B (having FMV of 3,000) is distributed to X against his entitlement of 3,000
- Firm debits book value of Land B against X's capital account balance
- In absence of any dissolution/reconstitution, s.45(4)/s.9B may not trigger in hands of PF
- Whether s.45(1) triggers in hands of firm? If yes, whether consideration is debit to partner's capital account? Whether s.50C applies?

Indicative balance sheet			
X Capital	1,000	Business (FMV 6,000)	2,000
Y Capital	1,000	Land (FMV 3,000)	1,000
Z Capital	1,000		
Total	3,000	Total	3,000

Issue 9: Withdrawal of firm's property by partners in their PSR

➤ **View 1:- S.45(1) may not trigger in hands of firm:-**

- a) Despite s.14 and s.15 of Indian Partnership Act, firm is not a separate legal entity but a compendium of partners, firm cannot function without partners, and as a result, real owners of firm's property are partners who are effective co-owners in their profit sharing ratio
 - Upon distribution, co-owned property is converted into exclusive property
 - For determining whether an asset withdrawn from firm is long-term or short-term in hands of partner post such withdrawal, holding period of firm was considered [CIT v. Kamala Devi [1997] 227 ITR 701 (Madras HC) and Ratansi Narayan Patel v. CIT [1988] 173 ITR 547 (MP HC)]
- b) During subsistence of firm, there can be 'distribution' of property in profit sharing ratio, as contradistinguished from 'sale' of property for a specified consideration - [Burlingtons' Exports v. ACIT [1993] 45 ITD 424 (Mumbai ITAT)]

Issue 9: Withdrawal of firm's property by partners in their PSR

- **View 2:- Capital gains u/s. 45(1) r. w. s. 50C are attracted:-**
 - S.14 and s.15 of Indian Partnership Act provides that firm can acquire and own assets.
 - No partner has any specific or exclusive interest in any property of firm, even to the extent of his profit share; while partners have certain rights on dissolution/retirement, properties remain that of firm and not of partners
 - Once partner acquires exclusive rights in any property of firm, there is effective transfer or extinguishment of firm's interest in such property hitherto owned by firm**
 - Transfer of property to partners during subsistence of firm is different from distribution of property to partners on dissolution or retirement – also, in former case, debit to partner's capital balance may be regarded as consideration in hands of firm [B.T. Patil & Sons v. CGT [2001] 114 Taxman 301 (SC)]
- Partner can also face consequences u/s. 56(2)(x) if specified property such as land is withdrawn where debit to his capital account is less than stamp duty value

In case of withdrawal from LLP, View 2 becomes stronger as LLP Act regards LLP as a body corporate, capable of acquiring, owning, holding disposing of property

Certain Additional points

- S.9B and s.45(4) are independent charging provisions; absence of back up amendment to definition of 'transfer' u/s. 2(47) or 'income' u/s. 2(24) may not frustrate the charge
- S.9B(3) deems FMV of capital asset or SIT as full value of consideration received or accruing as a result of deemed transfer - where stamp duty value is > FMV, whether the same substitutes FMV?
 - Arguably, no - S.9B(3) begins with the words "for the purposes of this section" – such a specific provision for ascertaining sale consideration shall prevail over all other general provisions such as s.43CA or s.50C
- As per s.45(4), partner's capital account can be "represented in any manner" in the books of the firm
 - In the context, both fixed capital and fluctuating capital account will be considered for s.45(4)
 - However, an account created due to loan is, strictly speaking, not a "capital account"

Certain Additional points

- If retiring partner is from a jurisdiction that has favorable capital gains article in tax treaty with India, can firm suggest that s.45(4) charge is not attracted as firm and partners are alternative taxpayers and if partner is treaty protected, there can be no taxation on firm?
 - For example, Article 13(5) of India-Netherlands treaty provides that “Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 shall be taxable only in the State of which the alienator is a resident”
- Firm may convert CA into SIT before distribution to partner upon reconstitution – such conversion may avoid duplicated taxation u/s. s.45(4) subject to GAAR
 - Upon distribution to partner, firm attracts taxation u/s. 45(2) w. r. t. FMV on date of conversion
 - S.9B impact is confined to appreciation beyond aforesaid FMV
 - Since receipt by partner is SIT which is neither money nor capital asset, s. 45(4) will not trigger.

General principles for attribution of s.45(4) capital gains

- S.45(4) taxes realisation in excess of partner's capital account balance, which represents such partner's share in value appreciation of remaining capital assets of firm
- Since such value appreciation is already taxed u/s. 45(4) at the time of reconstitution, s.48(iii) provides for attributing s.45(4) capital gains to remaining capital assets of firm
- Amount so attributed is reduced from sale consideration as and when such remaining capital assets are transferred by firm
- Aforesaid principle is equally applicable to capital asset forming part of block of assets
 - At the time of transfer, amount so attributed to depreciable capital asset is reduced from moneys payable (or sale consideration, if s.50 applies) and only net amount is reduced from WDV (or charged as short-term capital gains, if s.50 applies)
- However, 'actual cost' remains intact - no depreciation or indexation benefit is available on amount so attributed

Rules prescribed for capital gains chargeable u/s. 45(4) – Rule 8AA(5) and 8AB

Manner of attribution of s.45(4) capital gains – Rule 8AB

Where s.45(4) capital gains relates to	Basis of attribution:	
Capital asset received by partner from firm	No attribution	
Revaluation of any capital asset of firm (other than above)	S.45(4) capital gains x	A
		C
Valuation of self-generated goodwill/asset of firm	S.45(4) capital gains x	B
		C
Does not relate to any of the above	No attribution	

- A = Increase in value of such remaining capital asset because of revaluation
- B = Recognition of value of such self-generated goodwill/asset because of valuation
- C = Aggregate of increase in value of all capital assets because of revaluation, or recognition of value of all self-generated goodwill/assets because of valuation
- **Conditions :**
 - Revaluation should be based on a valuation report obtained from a valuer who is eligible to be appointed as a registered valuer under Wealth Tax Act, 1957
 - Firm to furnish details in prescribed form on or before the due date of filing ROI

Rules prescribed for capital gains chargeable u/s. 45(4) – Rule 8AA(5) and 8AB*

Whether s.45(4) capital gains are short-term or long-term – Rule 8AA(5)

S.N.	Where s.45(4) CG are attributed, in whole or in part, to	Nature of CG chargeable u/s. 45(4)
1	Capital asset which is short-term under ITL, at the time of taxation of s.45(4) capital gains (identify asset by tenure)	STCG*
2	Capital asset forming a part of block of assets (by class of asset)	
3	Self-generated goodwill/asset (by class of asset)	
4	Any other capital asset not covered above and, which is long term capital asset under ITL, at the time of taxation of s.45(4) capital gains (identify asset by tenure)	LTCG

**shall be deemed to be from transfer of short term capital asset*

Illustrative example – Cash pay out on retirement

- XYZ PF has 3 partners having equal PSR & equal capital contribution
- XYZ PF has land acquired at cost of 1,500 whose FMV is 2,100
- Land is held as a long-term capital asset
- Firm also has self-generated goodwill of 3,000
- X retires from the firm and his account is settled in cash after taking into account FMV of land and self generated goodwill
- In order to settle X's share, continuing partners Y and Z bring in cash
- X is paid 1,700 against his capital balance of 500 (ignoring revaluation)
- 1,700 is represented by capital of 500 plus 1/3rd share in value appreciation of 3,600 (600+3000)
- Refer next slide for tax implications

Indicative balance sheet			
X Capital	500	Land (FMV 2,100)	1500
Y Capital	500	Goodwill (FMV 3,000)	-
Z Capital	500		
Total	1,500	Total	1,500

Rules prescribed for capital gains chargeable u/s. 45(4) – Rule 8AA(5) and 8AB*

Illustrative example – Cash pay out on retirement

Particulars	S.9B	S.45(4)
Money received	Not applicable as no capital asset or SIT is distributed	1,700 [B]
FMV of capital asset received		- [C]
Partner’s capital balance		500* [D]
Capital gains in hands of firm		1,200 [A = B + C – D]

Where s.45(4) capital gains relates to	Basis of attribution		Calculation	Nature of s.45(4) CG	CG on future trf
Revaluation of land	S.45(4) CG x	A	1,200 x <u>600</u> 3,600	200 LTCG	400 LTCG (2,100-1,500-200)
		C			
Valuation of self-generated goodwill	S.45(4) CG x	B	1,200 x <u>3,000</u> 3,600	1,000 STCG	2,000 LTCG (3,000-1,000)
		C			

Rules prescribed for capital gains chargeable u/s. 45(4) – Rule 8AA(5) and 8AB*

Illustrative example – Cash pay out on retirement

Where s.45(4) capital gains relates to	Basis of attribution		Calculation	Nature of s.45(4) CG	CG on future trf
Revaluation of land	S.45(4) CG x	A	$1,200 \times \frac{600}{3,600}$	200 LTCG	400 LTCG (2,100-1,500-200)
		C			
Valuation of self-generated goodwill	S.45(4) CG x	B	$1,200 \times \frac{3,000}{3,600}$	1,000 STCG	2,000 LTCG (3,000-1,000)
		C			

- A= Increase in value of such remaining capital asset because of revaluation
- B= Recognition of value of such self-generated goodwill/asset because of valuation
- C= Aggregate of increase in value of all capital assets because of revaluation, or recognition of value of all self-generated goodwill/assets because of valuation

In case of decline in value of assets, rules do not offer any guidance – however, if assets are impaired in books under accounting standards, no controversy arises



Questions

**THANK YOU
CA PIYUSH .S. CHHAJED**



