Technical Guide on Income Tax on Reconstitution of Firm

Direct Taxes Committee

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi

First Edition	:	August, 2021
Committee/Department	:	Direct Taxes Committee
Email	:	dtc@icai.in
Website	:	www.icai.org
Typeset by	:	Elite Art, New Delhi-110 002
Published by	:	Direct Taxes Committee on behalf of the Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi - 110 002.
Printed by	:	Sahitya Bhawan Publications, Hospital Road, Agra - 282 003.

Foreword to the First Edition

Professionals are engaged in understanding, interpreting, and explaining the intricacies and dynamics of ever evolving tax laws to the relevant stakeholders. The changing scenario of taxation in India in recent years has made the understanding of the law even more challenging and complex. Plethora of amendments that have been incorporated in the taxation laws rendered it necessary for the members to update themselves with the new updated provisions. Recently, the Finance Act, 2021 has made amendments in the provisions pertaining to taxation incidence on dissolution or reconstitution by the partnership firms, AOP and BOI.

Among others, one of the popular forms of conducting business affairs by MSMEs is partnership firm. Even a lot of our practicing members operate by way of partnership form of business. LLP form of partnership has provided better vehicle for doing partnership business. The income-tax law has separate set of provisions for dealing with issues arising from taxation of partnership firms' affairs, *inter-se*. Transfer of capital asset and stock in trade from/to firm, AOP or BOI to/by partners or member on reconstitution or dissolution of firm is quite common. In this regard, certain new provisions have been inserted in the Income-tax Act, 1961 vide the Finance Act, 2021 that substitute the earlier provisions for taxation of such incidences.

The Institute of Chartered Accountants of India (ICAI) has always been proactive in disseminating the knowledge and honing the skills of its members. I am happy to note that yet another step in this direction has been taken by the Direct Taxes Committee of ICAI and they have come out with this publication namely ***"Technical Guide on Income Tax on Reconstitution of Firms"*** to assist the members in meeting their professional commitments in an effective manner.

I appreciate the efforts of CA. Chandrashekhar V. Chitale, Chairman, Direct Taxes Committee and CA. Satish K. Gupta, Vice-Chairman, Direct Taxes Committee who have worked selflessly for bringing out this publication for the benefit of all the stakeholders.

I am sure that this publication will help the members in discharging their professional commitments in an effective manner.

Date: 31.08.2021 — **CA. Nihar N Jambusaria**

Place: New Delhi — **President, ICAI**

Preface to the First Edition

Dynamics of the income-tax law, compel sharpening of skill sets in the arena for effective performance. Addressing counselling and compliance responsibilities of clients and the other stakeholders, importance of updating professional knowledge, need not be overemphasized. ICAI publications afford professionals, worthwhile insight and guidance in this behalf.

As the readers are well aware that the Finance Act 2021 has inserted a new section 9B and also substituted new provisions for section 45(4) and added a clause in section 48 of the Income tax Act, 1961. New Rule 8AB has been inserted to address procedural aspects. This set of provisions deal with taxation of transfer of stock, capital asset and payment of money to partner on dissolution or reconstitution of partnership, Association of Persons (AOP) or Body of Individuals (BOI). The aforesaid provisions aimed at providing clarity on incidence of taxation on transactions emanating from such reconstitution of partnership firm, AOP or BOI bring in completely new concepts and methodology therefor.

These changes in law requires thorough understanding of the provisions and related aspects. The law governing the field unless gathered well by the stakeholders involved in the process, can lend in substantial tax liability and double taxation.

Being professionals, we have to raise the bar of our performances continuously. Professionals execute assignment and discharge responsibility undertaken and provide satisfactory service services on the foundation of knowledge and experience. The process of development of law as also of learning is ever evolving. I am sure that this new publication would provide an excellent companion guiding members' professional practice in this arena.

To elaborate the nitty-gritties of these changes in taxation regime on reconstitution of firms, BOIs and AOPs, and to provide guidance to the members, this publication shall be very useful. It covers the law and procedures relating to taxation of reconstitution of partnership firms, application of latest provisions pertaining to transfer of capital assets, payment of money and / or stock in trade to partners etc. It will be appreciated that this new publication would enable the members to better understand the aforesaid new provisions.

Under the aforesaid circumstances, we at the Direct Taxes Committee thought it fit to bring out this publication namely ***"Technical Guide on Income tax on Reconstitution of Firms"*** as a handy tool to assist the fraternity to make proper compliance of the new provisions and procedures in more objective manner and with consciousness towards related documentations. Of course, readers are expected to update themselves continuously.

We are sincerely thankful to CA. Nihar Niranjan Jambusaria, President, ICAI and CA. (Dr.) Debashis Mitra, Vice-President, ICAI for being guiding force behind all initiatives being taken by the Committee.

We are pleased to place on record my sincere gratitude for the involvements and contributions by all the Committee members and our dear Council Colleagues of ICAI. We are sure that this effort of DTC of ICAI would go a long way in assisting our members in making utmost compliance of the new provisions.

We are extremely thankful to our Members of the Study Group formed under the convenorship of Chairman, DTC, who worked selflessly and dedicatedly to prepare the draft of this publication after taking all inputs from the said group members formed in this regard. We especially appreciate the efforts of our following study group members who provided valuable inputs for this publication CA. Bhide Bilvamangal Dinkar, CA. Bhuvanesh Kankani, CA. Krishna Gujarathi, CA. Navin Podar, CA. Sabne Durgesh Pandurang, CA. Vishwas Mehendale, CA. Jinesh Joshi, CA. Sarvesh Khandelwal and CA. Jayant Adhyapak.

Last but not the least, I appreciate the dedicated efforts of the CA. Shrutika Oberoi, Secretary and whole team of Direct Taxes Committee for their technical and administrative assistance in bringing out this first edition of the said publication in such a short span of time.

CA. Satish K. Gupta
Vice-Chairman,
Direct Tax Committee, ICAI

CA. Chandrashekhar V. Chitale
Chairman,
Direct Tax Committee, ICAI

Date: August 31, 2021

Place: New Delhi

Acknowledgement

The Direct Taxes Committee of ICAI acknowledge the contribution made by the following members of the study group constituted for the purpose of developing the publication namely ***Technical Guide on Reconstitution of Firms*****.** We place on record our gratitude for their contribution in enrichment of knowledge of the members:

- **CA. Chandrashekhar V. Chitale, CCM – Convenor**
- **CA. Bhide Bilvamangal Dinkar**
- **CA. Bhuvanesh Kankani**
- **CA. Krishna Gujarathi**
- **CA. Navin Podar**
- **CA. Sabne Durgesh Pandurang**
- **CA. Vishwas Mehendale**
- **CA. Jinesh Joshi**
- **CA. Sarvesh Khandelwal**
- **CA. Jayant Adhyapak**

Contents

Chapter 1
Introductory: Taxation of Partnership Firms

1. Short title, extent and commencement:

The Indian Partnership Act, 1932 (hereinafter referred to as the Act.) applies to the whole of India. The Act has come into force w.e.f. 1st day of October 1932 with the assent of the Governor General of India on 8th April 1932. ***The Act is applicable to the whole of India including the state of Jammu & Kashmir w.e.f. 09th August 2019 vide The Jammu and Kashmir Reorganization Act, 2019.***

2. What is Partnership:

a) Partnership is the relation between persons who have agreed to share a profit of a business carried on by all or any of them acting for all.

b) A Partner is the agent of the firm for the purposes of the business of the firm.

c) The authority of a partner to bind the firm in ordinary course of business, conferred by section 19 of the said Act is called "implied authority" of a partner.

d) Every partner is liable jointly with other partners and also severally for all acts done for the firm while he was a partner.

e) When duration of partnership is not defined, the partnership is "*partnership at will*".

f) When persons become partner for a particular venture, it is called a "particular partnership".

3. Relations of Partners to one another:

a) Relationship between the partners is defined by the Deed of Partnership.

b) Partnership Deed is required to be executed under section 58(1) of the Act at the time of registration of any firm. The Deed of admission and /or retirement or dissolution of firm, is required to be executed to place on record the subsequent changes to the Registrar of Firms.

c) Even after the dissolution of the firm, the partners are liable to third parties for acts done regarding firm's business after dissolution until public notice to that effect has been given.

4. Dissolution of a firm:

A firm may be dissolved

a) by mutual consent

b) on expiry of the term if it is for a fixed term

c) on death of a partner and

d) by adjudication of a partner as an insolvent

The firm may also be dissolved by the Order of the Court for any of the reasons stated in clause (a) to (g) u/s 44 of the Indian Partnership Act.

On dissolution of a firm, the business of the firm is stopped and the profit and loss account is drawn till the date of dissolution which results in either profit or loss on dissolution. The assets of the firm are liquidated, liabilities are paid off and the balance is distributed among the partners to close their capital accounts. In this particular case, the firm books a business income which is a revenue receipt taxable at normal slab rates. The firm also books a capital gains income/ loss on sale of capital assets which is taxable at the rate of tax applicable to capital gains.

5. Reconstitution of the Firm:

On Admission of a partner, Retirement of a partner, Death of a partner, Change in profit sharing ratios among the partners, Admission of a minor for the benefits of the firm, the firm is said to have been reconstituted. There have been amendments in the Income tax Act 1961 under section 45(4) and that under Section 9B of the Act which are applicable on reconstitution of the firm and also on dissolution of the firm.

6. The Rate of Income tax:

The profits of the firm are taxed at 30% for every rupee of income earned. The firm also pays surcharge on income tax in applicable cases plus the educational cess at 4% as applicable to other entities.

7. Amendments Proposed:

(a) Section 45(4) – Substituted by new Section 45(4) -

Statement of Objects and Reasons forming part of Finance Bill 2021 clarifies the object behind substituting section 45 (4) of the Income-tax Act relating to Capital gains. Section 45(4), till 31st March 2021 provided that the profits or gains arising from the distribution of capital assets on the dissolution of a firm or AOP or BOI (not being a company or a cooperative society) or otherwise, shall be chargeable to tax as the income of the firm, AOP or BOI, of the previous year in which the said transfer takes place. For the purposes of Section 48, the fair market value of the asset on the date of such transfer shall be deemed to be the full value of consideration received or accruing as a result of the transfer.

It was proposed to substitute sub-section (4) under section 45 so as to provide that where a specified person receives during the previous year any money or capital asset or both at the time of dissolution or reconstitution of the specified entity, which represents the balance in his capital account in the books of accounts of such specified entity at the time of dissolution or reconstitution, then any profits or gains arising from receipt of such money and / or capital asset 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 capital asset was received by the specified person.

It was also proposed to amend the section to provide that fair market value of the capital asset on the date of such receipt shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of such capital asset.

It was also proposed to amend the section to provide 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 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.

It was also proposed to amend the section to define the expressions "reconstitution of specified entity, specified entity and specified person". It was further proposed that the said expressions shall have the same meaning assigned to them in Section 9B of the Act. It was also proposed to amend the section to provide that for the purpose of this subsection, the expressions "self-generated goodwill and self-generated asset" shall mean the goodwill or assets acquired without incurring any cost for purchase or generated during the course of business.

The new section 45(4) which we see in the statute book is the replica of all the said proposals. In addition to above, one formula has been provided which clarifies that:

A= B+C-D where,

A - Income chargeable to tax under the head Capital Gains of the specified entity.

B - Value of money received by the specified person from specified entity.

C- Fair market value of the capital asset received by the specified person from specified entity.

D – The amount of balance in capital account of the specified person in the books of account of the specified entity on the date of its reconstitution.

The sum and substance of the provision is the amount paid to the specified person (retiring partner) in excess of balance in his capital account (without taking into account 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) shall be taxable in the hands of specified entity (reconstituted firm) under the head, Income from Capital Gains.

In the above formula, if (A) i.e. - Income chargeable to tax under the head Capital Gains of the specified entity is negative, then its value shall be deemed to be zero. It means, under such situation; section 45(4) shall not have application and no income shall be taxable under said section.

It has been specifically provided that when a capital asset is received by the specified person, from specified entity on its reconstitution, the provisions of section 45 (4) shall operate in addition to provisions of section 9B and the taxation shall be worked out in respect thereof independently.

On 2nd July 2021, CBDT inserted Sub-rule 5 under Rule 8AA of the Income Tax Rules which states the following:

If the amount is taxable under the head Capital Gains in the hands of specified entity, under section 45(4) of the Act then the capital asset shall be deemed as short-term capital asset if,

i) The capital asset was short term capital at the time of application of section 45(4) of the Act.

ii) The capital asset was forming part of the Block of Assets.

iii) The capital asset was self generated asset or self generated goodwill as defined u/s 45(4) Explanation 1.

iv) The capital assets not covered under any of the above clauses at the time of application of Sec 45(4) of the Act, are deemed as long term capital assets.

After this Sub-rule, new Rule 8AB was inserted which provides for attributing the amount of income taxable u/s 45(4) of the Act on the capital assets remaining with the specified entity.

It is provided that if the tax is payable u/s 45(4) of the Act by the specified entity on the amount paid to the specified person in excess of balance in his capital account, which **relates to revaluation of assets, valuation of self generated goodwill or self generated assets**, then for the purposes of section 48(iii), the said amount on which tax is payable u/s 45(4) of the Act shall be attributed over the balance capital assets in same proportion which the increase in or recognition of value of those capital asset bears to the total increase in or recognition of value of all capital assets by the specified entity.

If the tax is payable u/s 45(4) of the Act by the specified entity on the amount paid to specified person in excess of balance in his capital account **does not relate to revaluation of assets, valuation of self generated goodwill or self generated assets**, then for the purposes of section 48(iii), the said amount paid shall not be attributed on any of the remaining capital assets by the specified entity.

Notwithstanding anything stated in the above two paragraphs, if the tax is payable u/s 45(4) of the Act by the specified entity on the amount paid to specified person in excess of balance in his capital account **relates to the capital assets transferred to the specified person only**, then for the purposes of section 48(iii), the said amount paid shall not be attributed on any other capital asset by the specified entity.

(b) Insertion of Section 9B -

Where the specified person receives during the previous year any capital asset or stock in trade or both from a specified entity in connection with its dissolution or reconstitution, the specified entity shall be deemed to have transferred the said capital asset or stock in trade or both to the specified person in the year in which he received it.

Any profits and gains arising from such deemed transfer of capital asset by the specified entity shall be chargeable to Income Tax as 'Income from Capital Gains' in the previous year in which the said asset is received by the specified person.

Any profits and gains arising from such deemed transfer of stock in trade by the specified entity shall be chargeable to Income Tax as 'Income from Profits and Gains from Business and Profession' in the previous year in which the said stock in trade is received by the specified person.

For the purposes of this section, the fair market value of the capital asset or stock in trade or both on the date of receipt by the specified person shall be deemed to be the full value of consideration received or accruing as a result of such deemed transfer by the specified entity.

The power has been given to the Board under Section 9B(4) of the Act to pass the Order for Removal of Difficulties to issue guidelines for application of Section 9B and Section 45(4) with the approval of Central Government.

Section 9B(5) requires the Board to lay before each House of the Parliament the said Guidelines issued under Section 9B(4) of the Act. The aforesaid Guidelines issued by the Board shall be binding on the Income Tax Authorities and the assesses as well.

The Explanation to Section 9B states meaning of the terms, specified entity, specified person and reconstitution of the specified entity. The said definitions have been used in the new Section 45(4) of the Act. **Section 9B uses the word dissolution along with reconstitution however, Section 45(4) uses the word reconstitution only.** It appears that the meaning of the word 'reconstitution of the specified entity' does not include dissolution as it talks about cessation of one or more partners but does not talk about cessation of all partners.

(c) Section 48(iii) Mode of computation of capital gain:

Insertion of Section 9B and substitution of Section 45(4) also necessitated insertion of Section 48(iii) which deals with mode of computation of capital gain.

The income chargeable under the head "Capital gains" shall be computed, by deducting the amount chargeable to income-tax as income of such specified entity under section 45(4) which is attributable to the capital asset being transferred by the specified entity to the specified person calculated in the prescribed manner from the full value of the consideration received or accruing as a result of the transfer of the capital asset.

The amount which is chargeable to tax under section 45(4) shall be reduced for calculating capital gain under section 9B to avoid double taxation, that's why 48(iii) has been introduced in finance Act 2021

(d) Applicability:

These amendments will take effect from 1st April, 2021 and will, accordingly, apply in relation to the assessment year 2021-2022 and subsequent assessment years. The statement of objects and reasons forming part of the Finance Bill, 2021 also confirms the applicability of section 45(4) w.e.f. 1st April, 2021 i.e., w.e.f. A.Y. 2021-22. It means it has been a retrospective amendment and one has to consider the applicability of said two sections while filing the return of income for A.Y. 2021-22.

Chapter 2

Reconstitution Arising out of Change in Profit Sharing Ratio

The firm is said to be reconstituted when the profit-sharing ratios of the continuing partners are revised with respect to earlier agreed ratio on restructuring. The change in profit sharing ratios may arise on account of the following reasons:

1. Active partner of the firm becomes a sleeping partner
2. Heavy withdrawal of capital by one or more partners
3. Amount of time devoted for the firm's business by one or more partners undergoes a change
4. Introduction of capital in form of movable or immovable assets by one or more partners

Change in profit sharing ratio also arises on retirement, death or admission of one or more partners. The firm is also said to have been reconstituted in all the above said events.

The application of Section 9B arises when the capital asset or stock in trade of the firm is transferred to one or more partners of the firm. When the capital asset is transferred at fair market value to one or more partners, the resultant Capital Gains on transfer of capital assets are taxable in the hands of the firm. Similarly, when the stock in trade is transferred at fair market value to one or more partners, the profits and gains of business and profession on transfer of stock in trade are taxable in the hands of the firm. This may happen when any of the partners intend heavy withdrawal of capital for personal reasons or to become a sleeping partner in the firm.

Application of Section 45(4) arises when a specified person receives during the previous year any money or capital asset at fair market value or both at the time of reconstitution of the specified entity, to pay off the balance in his capital account as per the books of account of such specified entity at the time of reconstitution. Then any profits or gains arising from receipt of such money and / or capital asset at fair market value 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 and /or capital asset was received by the specified person.

It is apparent that when a specified person (partner of the reconstituted firm) receives any money or capital asset at fair market value or both, the valuation of which prevailing on the date of the reconstitution is in excess of capital to the credit of his account (without taking into account increase in the capital account of the specified person due to revaluation of any asset or due to introduction of self-generated goodwill or any other self-generated asset by the specified entity) in the books of the specified entity, the provisions of section 45(4) get triggered.

As long as, the capital account of the specified person shows a net credit balance after having debited his capital account with the amount of money paid and or market value of the capital asset of the specified entity transferred, the provisions of section 45(4) will not have application.

In case of reconstitution of the firm arising out of change in profit sharing ratio, all the partners continue as partners of the firm. Therefore, generally there is no likelihood of the partners capital account showing debit balance. There may be a transfer of money or capital asset or both to one or more partners whose share in profits is reduced but since they are continuing partner/partners, their capital balance generally shall be maintained credit/positive by the specified entity. In this scenario, there may be application of Section 9B but there are least chances of applicability of Section 45(4) of the Act.

One has to take care while finalizing the accounts of builders and developers in case of firms which have been reconstituted or dissolved in F Y 2020/21. Unsold stock of (finished goods) flats and shops of which the occupation certificate (OC) is received, are transferred to the capital account of partners after two years from the date of receipt of OC. The reason being, after two years from the date of receipt of OC, the deemed rentals of the unsold flats are taxable in the hands of the firm u/s 23(5) of the Act. If the unsold stock of (finished goods) flats or shops are transferred to partners otherwise than on reconstitution or dissolution, whether it will have to be transferred at fair market value? It appears that the answer is yes as provisions of section 43 CA will come in play as the said stock, being in the category of 'Land Building or both' will have to be billed to partners at fair market value.

Frequently Asked Questions:

Applicability of Section 9B and Section 45(4) of the Income tax Act in following cases:

1. On retirement of one of the partners, at the year end, some capital assets are transferred to him in the year of retirement and some capital assets are transferred in the subsequent year for settling the balance in his capital account.

Retirement of a partner amounts to reconstitution of a firm. If some capital assets are transferred to him at the market value in the year of retirement, Section 45(4) shall be applicable. However, applying the formula given in the section, it appears that after having transferred some capital assets at market value, his capital account still shows a credit balance. Hence, no income under the head capital gains shall be taxable in the hands of the firm u/s 45(4) of the Act. The credit balance in his capital account will be transferred to his Loan A/C at the year end. Next financial year when the firm transfers some more capital assets to settle the retiring partner's Loan A/C, there is no reconstitution of the firm as it has taken place in the preceding financial year. Therefore, there is no application of section 45(4) of the Act.

Section 9B shall be applicable in the year of retirement as there is reconstitution of a firm and some capital assets are transferred to retiring partner at the market value in the year of retirement. In subsequent year, there is no reconstitution of the firm but the asset is transferred to Loan A/C of the retiring partner. Still capital gains shall be taxable in the hands of the firm. There is no source to know as to whether the capital asset is transferred at market value or otherwise unless it is immovable property comprising of Land/ Building or both. If in the second year, flats/ shops are transferred to retired partner to square up his loan account, those will have to be transferred at market value as required u/s 43CA of the Act.

2. On retirement of a partner, if all capital assets are transferred to him at market value, there is no asset left for application of Section 45(4).

If one refers to Subrule 4 of Rule 8AB of Income tax Rules, one can get to know that, if the said tax paid u/s 45(4) of the Act by the specified entity **relates to the assets transferred to the specified person only**, then for the purposes of section 48(iii), the amount on which, tax is paid u/s 45(4) of the Act shall not be attributed on any other capital asset by the specified entity.

In the above case, it appears that all capital assets are transferred to the retiring partner and therefore, capital gains tax paid u/s 45(4) relates to the assets transferred to the specified person only. Therefore, the said amount on which capital gains tax is paid u/s 45(4) of the Act, need not be attributed over the other capital assets.

3. In a two partners firm, if one of the partners dies and his legal hair is admitted in his place as partner.

In such cases generally, the legal hair becomes a partner under a will of the deceased partner and the firm is reconstituted. The balance in capital account of the deceased partner is owned and carried over by the new partner who is his legal hair. As such, since there is no transfer of capital asset to the deceased partner or his legal hair, there shall not be application of section 9B or section 45(4) of the Act.

4. Capital Assets are not appearing in the books of account of the firm say self - generated goodwill, Trademark etc. and one of the partners retire. Capital assets are to be transferred to his capital account and he will be paid more than the balance in his capital account.

In this case, the provisions of section 9B and section 45(4) shall be applicable as there is a reconstitution of the firm. However, the self - generated goodwill and trade- marks will have to be valued by the registered valuer and the valuation report will have to be obtained from him. The excess amount payable to the retiring partner over and above the balance in his capital account will be subject to tax under section 45(4) of the Act. For example, amount subject to tax under section 45(4) is Rs. 25 lakhs. Valuation of goodwill is Rs. 30 lakhs and valuation of trademark is Rs. 20 lakhs. Then Rs. 25 lakhs subject to tax u/s 45(4) of the Act, shall be attributed to goodwill at 60% (Rs. 30 lakhs/Rs. 50 lakhs) = Rs. 15 lakhs and the said amount, in the same manner shall be attributed to trademark at 40% (Rs. 20 lakhs/Rs. 50 lakhs) = Rs. 10 lakhs.

Chapter 3
Tax implication of section 9B and 45(4) on admission of New Partner in Partnership firm

1. Introduction

1.1. Finance Act 2021 has brought in new income-tax provisions related to reconstitution and dissolution of Partnership firms, Association of persons and Body of Individuals (*not being a company or a co-operative society*). For which a new section 9B is inserted under the Chapter II (*Basis of Charge*) and old section 45(4) is being substituted with the new one.

1.2. Owing to these new provisions, there has been paradigm shift in the manner of taxation on account of reconstitution or dissolution of the firms. Amended provisions of section 45(4) tax the Profit or Gain arising to partners, who are taking with them any asset or money or both from the firm at the time of reconstitution of the firm (erstwhile section 45(4) was covering the case of dissolution). Provisions of section 9B charge to tax the gain arising to the partner in the hands of the firm whenever partner/s take away Capital asset or Stock in trade or both as a result of reconstitution or dissolution of the firm.

1.3. Apparently, section 9B is not covering the cases where Money is being received by the partners at the time of dissolution (*could be because, money is generated out of transactions which are already taxed like sales, realization from debtors, sale of assets etc*).

1.4. It is imperative to understand that these provisions get triggered only when any asset, money or stock in trade is received by the partner at the time of reconstitution or dissolution of the firm. Otherwise, these provisions do not get triggered.

1.5. Further, section 48 is also amended by inserting clause (iii). As per memorandum to the Finance bill 2021 the intention behind inserting this clause is to mitigate the double taxation which might have happened in a situation where an asset which was revalued and for which income under the proposed sub-section (4A) of section 45 of the Act was brought to tax is transferred subsequently by the specified entity (*however, instead of proposed new sub-section 4A, existing sub-section (4) was substituted*)

1.6. These amendments touch upon many nuances of reconstitution and dissolution of firm but, the topic to be discussed here is 'reconstitution' as clarified in the 'Explanation' to the newly inserted provisions of Sec.9B of the Income Tax Act.

2. Relevant Provisions

2.1. Before resuming to the detailed discussion on various taxation aspects, it is imperative to refer and understand provisions of section 9B and 45(4) which are reproduced below:

2.2. Provisions of section 9B read as under:

'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.

(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.—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.'

2.3. *Amended provisions of section 45(4) read as under:*

[(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:—

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:

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.]

2.4. As per clause 23 of section 2, **Firm includes Limited Liability Partnership Firm**.

3. Discussion

3.1. The meaning of 'reconstitution' as explained in section 9B, it provides for three different scenarios which result into 'reconstitution'. Amongst which clause (b) provides for the situation where, one or more new partners are admitted to the firm.

Clause 'b' is, as under,

(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

3.2. Above clause can be dissected as under,

- One or more new partners are admitted
- In Specified Entity (i.e. Firm) and
- Old Partners continues to be partner after such change (*i.e. admission*)

3.3. The moot question is whether, mere admission of new partner leads to taxation u/s 9B or section 45(4) ?

Generally, when a new partner is added, old partner may withdraw part of their share.

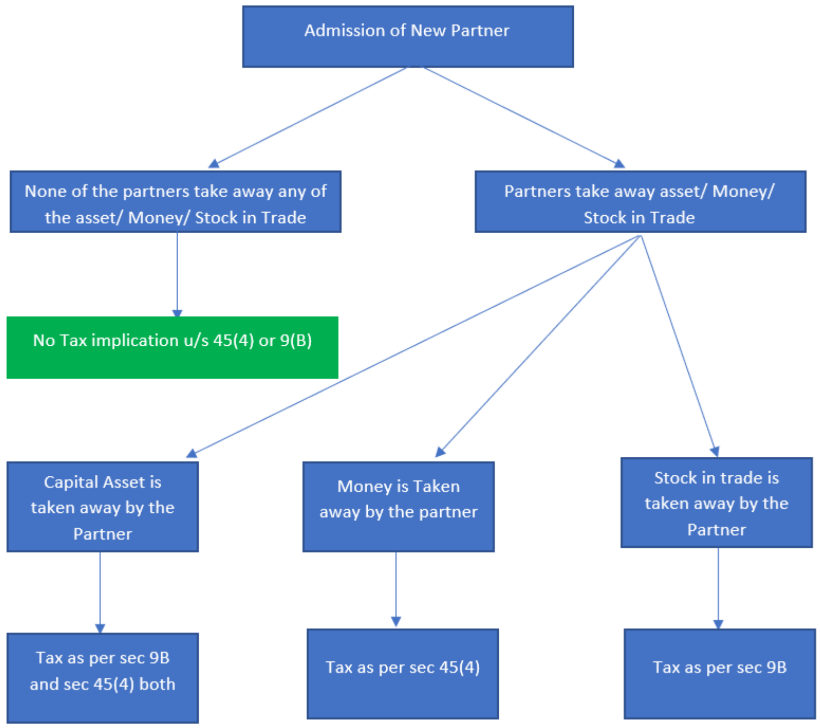
For example, A and B are partners with equal 'Profit/ loss Sharing Ratio' (*i.e.* 'PSR') in a firm M/s PQR having capital balance of Rs.100 each and having 4 capital assets (E, F, G and H) of book value Rs.50 each (*assume all assets are 'Long Term'*). A new partner Mr. C would be joining the firm PQR for 1/3rd share, so revaluation of assets is done at Rs.200/- each and Mr. A and Mr. B wishes to take away one capital asset each namely E and F.

3.4. Thus, in such a situation where the continuing partners take away the assets (*or money or stock in trade*), provisions of section 9B and 45(4) will get triggered at the time of admission of partner/s. Basically, capital asset/money/Stock in trade should be received by partner "in connection with" reconstitution/dissolution i.e. in cases where the capital accounts are credited at the time of admission of new partner and capital asset/money/stock in trade is withdrawn at a later date/ year then, also Sec.9B r.w. Sec.45(4) will be applicable.

3.5. Further, it may be noted that provisions of section 45(4) are triggered when there is transfer of Capital asset and/or monetary consideration is paid or both are received by the partners sequel to reconstitution. While provisions of section 9B gets triggered when partner(s) receives Capital Asset or Stock in trade or both. Thus, in case of transfer of Capital Asset to specified person provisions of section 9B as well as 45(4) both get attracted in the hands of specified entity.

3.6. Besides, if among the partners, there is an understanding where, consideration is paid without involving the Firm (*i.e. without routing such 'reconstitution' through the books of accounts of the 'Frim'*) i.e. in the individual capacity of the partners and there is 'reconstitution' where the Profit/ Loss/ Capital Ratio is changed then, though such situation is reconstitution it appears Sec.9B/ 45(4) gets no force of law.

3.7. Proposition explained in Para 3.5 above is explained in the following chart dealing with different scenarios:



4. Determination of amount of income

4.1. As discussed above, whenever partner receives any capital asset/stock in trade/money and it leads to gains in the hands of receiving partner then, such gains are deemed to be the income of the 'firm' of the year, in which such asset/Stock in trade/money is received by the partner in connection with reconstitution. In short receipt of asset/ stock-in-trade/ monetary consideration from the 'Firm' by a partner must have direct nexus with 'reconstitution'.

4.2. As per section 9B and 45(4), in case of Capital asset and stock in trade, the fair market value (*'FMV'*) on date of reconstitution will be considered as 'full value of consideration' received or accruing to the firm as a result of such (*deemed*) transfer.

4.3. Section 9B creates the charge of tax but, routes the taxability under respective heads of income i.e. if capital asset is transferred then, taxability is to be determined under the head 'Capital Gains' whereas, if 'stock in trade' is transferred then it is determined under the head 'Profit and Gains from business or profession' in the hands of the 'firm'. Though, section 9B is routing taxability of income under respective heads which is determined based on 'full value of consideration of assets transferred' and while doing so, the 'FMV' of the assets transferred is considered on the date of its transfer by the 'Firm' to the partner.

4.4. Since, section 9B routes the transaction to respective head of income, the computation would also be done as per relevant provisions i.e. in case of Capital asset, Full Value of consideration will be FMV (*as per section 9B*) while, cost of acquisition (*including indexed cost of acquisition*) and period of holding will be determined as is done regularly.

4.5. Section 45(4) provides the mechanism for computing the gains arising in the hands of partner which is deemed income of the 'firm'. A formula is provided in Section 45(4) to determine the gain. The formula provided under section 45(4) is, '**A= B + C – D**' , where **B** and **C** is the value of money and Fair market value of asset received by the partner respectively and **D** refers to the capital account balance of respective partner at the time of reconstitution and **A** represents chargeable capital gain.

4.6. Thus, taxable income u/s 45(4) would arise only in those cases where, aggregate Value of Money and FMV of capital asset is received by the partner which exceeds the capital account balance of the respective partner at the time of reconstitution.

4.7. Thus, in case capital asset is transferred then, provisions of section 9B and section 45(4) both will get attracted (*in the case of reconstitution*) and tax under both the sections would be computed and required to be paid by the 'firm' (*if any*).

4.8. For example,

In firm M/s PQR there are two partners namely Mr. A and Mr. B with equal PSR having capital balance of Rs.100 each and there are 4 capital assets being land (E, F, G and H) of book value Rs.50 each (assume Long term). A new partner Mr. C would be joining the firm PQR for 1/3rd share, so revaluation of assets is done at Rs.200/- each, considering the report of registered valuer as mentioned in rule 11U(g). Further, Mr. A and Mr. B wishes to take away one capital asset each namely E and F respectively.

Above facts can be demonstrated as under,

Assets	Existing values	Revalued Values	Assets (land)	Existing values	Revalued Values
Mr. A	100	400	**E (to be received by Mr. A)**	50	200
Mr. B	100	400	**F (to be received by Mr. B)**	50	200
			G	50	200
			H	50	200
Total	**200**	**800**	**Total**	**200**	**800**

The taxation u/s 9B will be as under (similar for Mr. A and Mr. B),

Particulars	Amount in INR	Remarks, if any
Full Value of consideration	200	FMV of Capital Asset
Less: Indexed cost of Acquisition	75	Assumed
Capital Gain	125	Long Term Capital Gain
Thus, tax	25	20%, (assume no surcharge cess etc for ease of calculations)
Net Book profit after taxes	100	(total Rs.200 for both the Capital asset i.e. G and H)

Whereas, the taxation u/s 45(4) will be as under (for Mr. A and Mr. B individually),

A= B + C – D

Value of,

B= Zero (as no money is being received by the partners)

C= FMV of capital asset received by the partner = Rs.200 (as given in example)

D=Capital balance **at the time of reconstitution**= Rs.100

Thus, A= 0 + 200 – 100*

= Rs.100/-

*(*as per second proviso to 45(4), the balance in capital account of specified person is to be calculated without taking into account any increase in the partner's capital account as a result of revaluation of asset/s thus Rs.100 is considered instead of Rs.200)*

Tax calculation on this amount is discussed ahead in para 4.10.

4.9. *It may be kindly noted that, as per section 45(4) capital balance **AT THE TIME OF RECONSTITUTION** has to be considered.*

However, *in the examples given in the guideline issued by CBDT on 2nd July 2021 (14/2021), it has been demonstrated that after determining gains u/s 9B, the amount of net book profit after paying taxes is to be transferred to the capital balances of the partners and such increase in capital account balance is to be considered for determining gains u/s 45(4) i.e. in the value of part 'D' of the formula stated above.*

In the instant example,

Gain as per section 9B is Rs.125/- therefore, tax on Long term capital asset is Rs.25 (here cess, surcharge are not included for the sake of easy understanding). The net book profit from transfer of capital asset is Rs.100/- (after taxes). Since, partner A and B are taking away one asset each i.e. E and F, total net book profit for both the assets is Rs.200 (after taxes). So, this gain of Rs.200/- is to be transferred to the capital account of respective partners in their PSR. Thus, the capital balance of partner A and B would become Rs.200 each (Rs. 100 existing + Rs.100/- amount of net book profit transferred to respective capital account in PSR)

Accordingly, the calculation u/s 45(4) would now be as under (similar calculation for Mr. A and Mr. B both)

A = 0 + 200 – 200 [value of money + FMV of capital asset- capital balance]

= Rs. 0 .

Since, Mr. A and Mr. B are receiving asset E and F having same values, total taxable income u/s 45(4) would be Rs.0 (Rs.0 each for in case of Mr. A and Mr. B both).

Considering such examples in guideline, it would be interesting to understand a case where, reconstitution is done in year 1 and capital asset is received by a partner in subsequent year. Whether capital balance AT THE TIME OF RECONSTITUON would be considered OR, as per the examples given in the guideline, the increased value of capital balance after crediting, to the respective capital account, the net book profit on transfer of capital asset, as per 9B)

4.10. Type of Gain i.e. Long term or short term

4.10.1. As per sub rule 5 of amended rule 8AA [as amended by the Income-tax Amendment(18th amendment), rule 2021], the amount or part of the amount chargeable u/s 45(4) shall be deemed to be from

i. short term capital asset, if it is attributed to

   a. capital asset which is short term capital asset at the time of taxation of amount under subsection (4) of section 45; or

   b. capital asset forming part of block of asset; or

   c. capital asset being self-generated asset and self-generated goodwill as defined in clause (ii) of Explanation 1 to sub-section (4) of section 45; and

ii. long term capital asset or assets, if it is attributed to capital asset which is not covered by clause (i) and is long term capital asset at the time of taxation of amount under sub-section (4) of section 45

In above discussed example, the excess amount so determined (FMV of capital asset minus capital balance at time of reconstitution) is attributable to remaining capital assets i.e. Asset G and Asset H, which are also Long-term capital asset. (please refer para no. 4.11 and 4.12)

4.10.2. Accordingly, the tax calculated u/s 45(4) will also be a long-term capital gain @ 20% i.e. Rs.20 [considering gain of Rs.100 u/s 45(4) as mentioned at para 4.8 above]

4.10.3. Further, it may be noted that the phrase ‘the amount or part of the amount’ used in sub rule (5) of rule 8AB, as mentioned above in para 4.9.1. above, is an interesting aspect.

4.10.4. In above example, assume, Capital Asset ‘H’ is a short-term capital asset then, in that case the attribution of the excess amount (*as determined* *through formula*) would be added/ loaded on remaining capital Assets of the firm i.e. Capital Asset 'G and H' which are Long term capital asset and Short-Term Capital Asset respectively. Since, the increase in valuation of both the asset is equal (*i.e. from book value of Rs.50 to revalued amount of Rs.200*), the attribution will be done equally between Capital Asset G and H. Thus, the capital Gain tax in such case will be equal i.e. half will be Long term and the other half will be Short term capital gain.

4.11. Attribution of tax paid u/s 45(4) as per newly inserted clause (iii) u/s 48

Further, as per newly inserted clause (iii) in section 48, the amount of income-tax chargeable u/s 45(4) is to be reduced from the full value of consideration of the assets transferred by the firm (*i.e. a specified entity*). The text of relevant provision is reproduced below:

(iii) in case of value of any money or capital asset received by a specified person from a specified entity referred to in subsection (4) of section 45*, the amount chargeable to income-tax as income of such specified entity under that sub-section which is* ***attributable to the capital asset*** *being transferred by the specified entity,* ***calculated in the prescribed manner:***

4.12. The manner of determining amount to be attributed to capital asset is prescribed by newly inserted 'Rule 8AB' and explained in the guideline issued by CBDT on 2nd July 2021 vide circular no.14/2021. Said 'Rule 8AB' provides that:

a. Amount of tax shall be attributable to the **REMAINING CAPITAL ASSETS** (sub rule 2 of rule 8AB)

b. Only if, such tax, on the aggregate of the value of money and the FMV of capital asset exceeding capital balance, **RELATES** to revaluation of any capital asset (sub rule 2 of rule 8AB)

c. If such excess **DOES NOT RELATES** to revaluation of any capital asset then no attribution is to be done (sub rule 3 of rule 8AB)

d. If such excess relates only to the capital asset received by partner then no attribution to be done (sub rule 4 of rule 8AB)

e. Such tax **SHALL RELATE** to revaluation of any capital asset or valuation of self-generated goodwill, if revaluation is based on a valuation report obtained from a registered valuer as defined in clause (g) of rule 11U (explanation no.1 in rule 8AB)

f. Amount of tax to be attributed shall be determined in proportion: increase in or recognition of value of that remaining asset to aggregate of increase in or recognition of value of all assets because of revaluation or valuation (sub rule 2 of rule 8AB)

4.13. Accordingly, continuing with the example discussed at para no. 4.8 above, let us determine the value of attribution to be done as per section 48(iii):

a. Tax chargeable u/s 45(4) = Rs.20 (*for both the assets as mentioned at paragraph 4.10.2 above*)

b. Said tax of Rs.20 is to be attributed proportionately to remaining capital assets G and H in the proportion to their increase in the value due to revaluation. In the instant example, both the assets G and H are increased by Rs.150 each from book value of Rs.50 to revalued amount to Rs.200 each. Thus, the attribution of Rs.20 has to be equal i.e. Rs.10 each amongst capital asset G and H.

c. Thus, whenever these two capital assets i.e. G and H are transferred, Rs.10 would be reduced from the full value of consideration. For example, Asset G is transferred in subsequent year for full value of consideration of Rs.350 then, from this full value of consideration Rs. 80 (*assumed to be indexed cost of acquisition*) and Rs.10 (*being attribution as per section 48(iii)*) would be reduced. Thus, net taxable capital gains would be Rs.260/-.

d. Since, attribution is to be done on remaining capital assets if, there are no capital assets remaining with the firm after distribution then, there would not be any attribution.

5. Conclusion:

5.1. In case where new partner is admitted, tax under section 9B and 45(4) would be determined only where any of the partner/s receives any capital asset/ stock in trade/ Money or combination thereof. That is to say, happening of reconstitution (*including admission of new partner*) triggers provisions of section 9B and 45(4) but, taxation will arise only when capital asset/ stock in trade/money is received by the partner.

5.2. Further, provisions of section **45(4) charges to tax the Profit or Gain arising to partner/s**, who receives any asset or money or both from the firm as a result of reconstitution of the firm but, the burden to pay tax on such gain is shifted on the firm (*by considering it as deemed income of the firm*). Provisions of section **9B charges to tax gains arising on transfer of assets/ payment of consideration to the partner as a result of 'reconstitution'/ dissolution in the hands of the firm**.

6. Frequently Asked Question

6.1. If partner/s receive/s stock in trade, would it be taxed twice i.e. first as per section 9B and then under then head PGBP?

Ans. No, provisions of section 9B routes the taxation to relevant heads of income. Thus, in case stock in trade is received by partner, it would be taxed as income U/Sec.28 i.e. PGBP of the Firm.

6.2. If the amount of tax u/s 45(4) is attributed to capital assets being part of Block of asset then, whether said amount of attribution be reduced from carrying amount of WDV of the 'block of asset'?

Ans. It appears the answer is 'No', since provisions of section 43(6) related with WDV and Actual cost have not undergone any change as of date. Thus, WDV won't be reduced by the value of attribution and accordingly depreciation would not be computed on the same.

6.3. Whether admission of minor to partner would have any separate implication?

Ans. Mere admission of new partner does not have any implication unless any capital asset/ stock in trade/ money is received by any partner in connection with such reconstitution. If, any partner receives any capital asset/money/ stock in trade then, taxation would be done according to the new scheme explained above.

6.4. Whether benefit of section 54EC would be available to the firm?

Ans. Since provision of section 9B states that the chargeability of tax on capital assets is under the head 'Capital Gains', the benefit of said provision would be available to the firm.

6.5. In case new partner pays consideration while joining the firm to the existing partners sans 'Firm' (i.e. outside the books of accounts) and reconstitution takes place then whether the provisions of section 9B and 45(4) are applicable?

Ans. It appears the answer is 'No'. Provisions of section 9B and 45(4) are invoked only when any capital asset, stock in trade or money is transferred by the firm

6.6. In case of transfer of capital asset, whether benefit of indexation is available for determining gains u/ 45(4) or section 9(B) or both?

Ans. Provisions of section 9B charges tax on the gains arising due to transfer of capital asset while the taxability is to be determined as per the provisions of head 'Capital Gain'. Thus, for determining capital gains provisions of section 48 have to be applied. While, provisions of section 45(4) taxes the gains arising to the partner/s and not the transfer of asset, thus benefit of indexation may not be allowed while determining gains u/s 45(4).

6.7. Whether benefit of newly inserted clause (iii) u/s 48 is available to capital assets transferred at time of reconstitution/ dissolution or other remaining capital assets?

Ans. According to the newly inserted rule 8AB and the guideline issued u/s 9B on 02nd July 2021 (14/2021) the attribution of taxes paid u/s 45(4) is to be done on REMAINING CAPITAL ASSETS i.e. Capital assets remaining after transfer of capital assets in connection with reconstitution or dissolution

[Please note: Above writeup is exclusively for situations arising in partnership firms (*including LLP*). There may be similar scenarios for AOP or BOI, but same are not discussed in this writeup.]

Chapter 4
Retirement of a Partner

1. Introduction

1.1 Under section 32(2) of the Indian Partnership Act, 1932, a partner of a firm may retire from a firm of partnership by anyone of the following modes,

— Retirement with the consent of all the other partners; (the consent may be either express or implied)

— Retirement by virtue of an express agreement between the partners; (the agreement may be either in the form of a clause in the partnership deed or an independent agreement)

— Retirement by giving notice in writing to all other partners of his intention to retire (in the case of a partnership at will)

1.2 The word retire in this section confines to the cases where the partner withdraws his interests & association with the 'Firm' as a partner from the agreed date and the remaining partners continue to carry the activities of the 'Firm'. The perception was it does not cover a case where, the partner withdraws from the firm without following the mode of dissolution of the 'Firm'.

2. Tax implication on Retirement

2.1 There has been a drastic change in the tax implication brought in by the Finance bill 2021 which is that when the firm is re-constituted due to retirement of the partner and the money and assets including stock in trade are settled by the firm against the capital of the retiring partner.

2.2 New Section 9B has been introduced as a charging section to state that where a specified person receives any capital asset or stock in trade or both from a specified entity in connection with dissolution or reconstitution 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.

2.3 Any profits & gains arising from such deemed transfer of capital asset or stock in trade or both shall be deemed to be the income of such specified entity i.e. the ‘firm’ of the previous year in which such capital asset or stock in trade or both were received by the specified person i.e. the ‘partner’ and chargeable to income tax as income of such specified entity under the head “profit and gains of business or profession” or under the head “Capital Gains” in accordance with the provisions of the Act depending upon the assets held by the ‘firm’ which are transferred to the retiring i.e. outgoing partner where ‘firm’ continues its activities with the remaining partners. This is stated to be reconstitution as per newly inserted provisions of Sec.9B of the Income Tax Act.

2.4 Further, section 45(4) has also been substituted stating that where a specified person receives during the previous year any money or capital asset or both from a specified entity in connection with 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 income of the specified entity of the previous year in which such money or capital asset has been or both were received by the person. It has been provided that the when the capital asset is received by the retiring partner the provisions of Section 45(4) shall operate in addition to the provisions of Section 9B.

2.5 The mode of computation of capital gains is given under Section 48 but, now Section 45(4) states the mechanism for computation of capital gains which is as under:

A = B+ C - D

Where,

A = income chargeable to income tax as income of the specified entity under the head capital gains.

B = value of any money received by the specified person (i.e. retiring partner) on the date of such receipt.

C = the amount of the fair market value (*i.e. FMV*) of the capital asset received by the received by the specified person (*i.e. the* retiring *partner*) on the date of such receipt.

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.

2.6 It has been provided now that, if the balance in the capital account of the retiring partner includes amount due to revaluation of any asset/s or accounting of any self-generated goodwill or asset then, such amount shall be reduced from the capital account of the retiring partner for the purpose of charging capital gain U/Sec.45(4).

2.7 Prior to amendment, it was a belief that any amount outstanding in the capital account of the partner was considered as cost to the firm. Earlier since the provisions of the Income Tax Act were silent while bringing into books of account of the 'firm' value of self-generated assets; revaluation of assets held by the 'firm' now, the amended provisions require to isolate accounting impact in the books of accounts of the 'firm' routed through the capital account of partners in the books of the 'Firm'. Earlier, at the time of retirement of the partner, the firm would calculate impact of self-generated goodwill, revaluation of assets and account for its counter effect by routing the same through partner's capital account based on the ratio stated in the partnership deed. As a result of such accounting in the partner's capital account and in the books of account of the 'Firm' (*narrated above*) by the 'Firm', the 'firm' could minimise its tax liability w.r.t. capital asset transferred to the retiring partner.

2.8 This was the belief of all though, courts interpreted that the effect of Section 45(4) (*earlier*) is that the profit or gains arising from the transfer of a capital asset to a partner by the firm on dissolution or otherwise would be chargeable as firm's income in the previous year in which such transfer of assets takes place. Accordingly, capital gains were computed on the basis of the fair market value adopted while transferring the asset/s to an outgoing partner. The expression "otherwise" was not read as 'ejusdem generis' with the expression 'dissolution of a firm or Body of Individuals or Association of persons'. The expression 'otherwise' has to be read in alignment with the word 'transfer of capital asset/s' by the 'firm' and construed as distribution of assets to an outgoing partner without 'dissolution of the firm'. If so read, it is clear that even when the firm is in existence and there is a transfer of capital asset to a retiring partner without dissolution then, such situation comes under the expression 'otherwise'. Thus, the transfer of assets of the partnership to the retiring partner/s would amount to the transfer of capital assets attracting capital gains in the hands of the 'firm' under section 45(4) of the Income Tax Act. Therefore, the word "otherwise" is construed to be applicable to a situation not only in the cases of dissolution of the 'firm' but also, in the cases of subsisting firms where totally new partners join the partnership firm – where some or all partners prior to such realignment/ reconstitution go out of the 'firm' and new partners join the firm and assets are transferred to the outgoing/ retiring partner/s. (CIT v A.N. Naik Associates 265 ITR 346 – Bom. HC).

2.9 In a situation described in para 2.8 above, asset/ consideration received by the outgoing partner was treated as capital receipt which escaped the tax liability in the hands of the partner and 'firm' was contending that since there is no dissolution as the 'firm' continues to exist there is no tax liability U/Sec.45(4) on the 'Firm'.

2.10 Prior to amendment of Section 45 (4) any transfer of capital asset/s to the retiring partner was believed to be not liable to capital gain tax under section 45(4). This belief was also extended to the cash i.e. monetary consideration paid by the 'firm' to the outgoing partner. As far as payment of consideration to the outgoing partner was concerned against concerned partner's capital account balance it was considered as not chargeable to tax either in the hands of the 'firm' on the contention that there is no transfer of capital asset and as far as the partner was concerned it was held that he is getting back his capital contribution in the 'firm'. Further, w.r.t. payment of monetary consideration at the time of retirement was considered as not taxable and then, neither the 'firm' nor the outgoing/ retiring partner were meeting any tax liability. However, this argument was held to be inapplicable where the outgoing/ retiring partner receives any asset other than monetary consideration at the time of retirement and then, the 'Firm' was liable to pay capital gains tax U/Sec.45(4) w.r.t. the value of an asset transferred to the outgoing partner.

2.11 Now, as per the amended provisions, if only money or money + capital assets or money + capital asset + stock-in-trade is transferred to the retiring partner then, the firm will come under the ambit of the amended provisions of Section 45(4) r.w. newly inserted provisions of Section 9B of the Income Tax Act.

2.12 Now, while charging the capital gains in the hands of the 'Firm' the amended provisions of section 45(4) consider not only the capital asset transferred to the retiring partner but also the monetary consideration received by the partner from the specified entity.

2.13 Now section 45(4) has been amended in such a manner that any consideration received by the retiring partner with the combination stated in para 2.11 above (*i.e. monetary consideration + assets transferred to him or only monetary consideration paid to an outgoing partner*) over and above the capital account balance of a partner as a result of reconstitution, it is treated as chargeable capital gain of the 'firm' (*though, in reality, it is the income of the retiring partner*) but, income tax shall be charged to the 'firm'.

2.14 Further in view of the insertion of 1st **proviso** in Sec.45(4) now, it is stated that the if the consideration received (*i.e., money + FMV of the assets transferred*) is less than the balance in the capital account of the retiring partner then, in such case the loss (*of the retiring partner*) shall not be allowed to the 'firm'. In such case the chargeable capital gain U/Sec.45(4) in the hands of the 'Firm' will be Rs. Nil.

Illustrations

1. A, B and C are the partners of a 'Firm' – 'A' wishes to retire/ exit from the partnership firm – B & C agree to pay 'A' in their individual capacity while purchasing 'A's share in the 'firm'. In this scenario, the capital balance of 'A' will be distributed among 'B' & 'C' as per agreed terms and then, Section 9B and Section 45(4) will not be triggered since, no capital asset, stock in trade or money has been paid/ transferred by the firm (*i.e. a specified entity*) to the outgoing/ retiring partner (*i.e. a specified person*) since, the continuing partners (*i.e. 'B' and 'C'*) have paid consideration to 'A' directly.

2. A, B and C are partners - A wish to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm - the firm pays to retiring partner 'A' money over and above his capital account balance. In this case, Section 45(4) will be triggered and the computation will be as per Rule 8AB.

3. A, B and C are partners - A wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm - The partnership firm is owning and possessing 3 capital assets - the partners decide that on retirement, 1 capital asset will be transferred to the retiring partner i.e. 'A'. In this case, Section 9B along with Section 45(4) will be triggered and computation of capital gain shall be done as per Rule 8AB.

4. A, B and C are partners – 'A' wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm - The partnership firm is having 3 capital assets - the partners decide that on retirement, one of the capital assets will be sold and, money is paid to the retiring partner i.e. 'A'. In this case, Section 45(4) will be triggered w.r.t. consideration paid to retiring partner and computation shall be done as per Rule 8AB (*besides computing capital gains on transfer of capital asset by the 'firm' in its hands*).

5. A, B and C are partners – 'A' wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm. The firm has stock-in-trade and its Fair-market Value (FMV) is say Rs.100. The partners decide that the stock-in-trade will be transferred to Retiring Partner 'A'. In this case only Section 9B will be triggered and the profits may be chargeable U/Sec.28 in the hands of the 'Firm'. In such scenario unlike the first proviso of Sec.45(4) there is no provision in Sec.28 which denies loss incurred by the 'firm' while transferring the 'stock-in-trade' to the firm.

6. A, B and C are partners. 'A' wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm - The partners enter into the reconstitution deed where; it is decided that the retiring partner will be paid in cash in five instalments that took over a period of five consecutive years. In this case, section 45(4) will be triggered and the year of taxation will be each of the five years in which 'firm' pays consideration to the retiring partner. This is because provisions of Sec.9B r.w. 45(4) states that charge of tax is attracted in the hands of the 'firm' in the year when the outgoing/ retiring partner receives consideration though, 'A' retires in year 1 i.e. the date on which the firm is reconstituted.

7. A, B and C are partners – 'A' wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm. A's capital account balance is say Rs. 100 and, he has lent to the 'firm' say Rs. 50 which is accounted in an account which is independent of capital account, in the books of the firm. In this case, while applying provisions of Sec.45(4) the capital account balance for the purposes of reconstitution will be considered as Rs. 150 since in the formula stated in Sec.45(4) (*i.e. A = B+C-D*), 'D' has been stated to include "*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 reconstitution of the firm"*.

8. A, B and C are partners – 'A' wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm. The firm has land and building which is held by the 'firm' as 'capital asset' - the 'firm' agrees to transfer land and building to 'A'. In this case, Section 9B and Section 45(4) will be triggered and, computation will be done as per rule 8AB. In this case provisions of section 50C may not be applicable since, a specific provision will prevail over the general provision and, two deeming provisions can't be applied simultaneously.

9. A, B and C are partners – 'A' wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm. The firm has land and building which is held by the 'firm' as its 'stock-in-trade' – it is agreed that at the time of reconstitution 'firm' shall transfer this land and building to 'A'. In this case, Section 45(4) will not be triggered and computation will be done as per rule 8AB, the resulting gain/ loss will be assessed U/Sec.28 where, provisions of section 43CA may not be applicable if, one is able to justify that the transferred 'land and building' are held by the Firm as 'Stock-in-trade' and same are transferred at 'Fair-market Value' while reporting income by the firm U/Sec.28. Here, though provisions of Sec.2(22B) may not be applicable but, its provisions may apply. There seems to be a grey area w.r.t. application of Sec.43CA if, the Assessing Officer challenges the 'FMV' of the land and building transferred to the partner which is held as 'stock-in-trade by the 'firm' while determining assessable income of the 'firm' U/Sec.28 of the Income Tax Act. In such situation whether there is application of Section 56 (2) (x) appears to be a debatable issue (*in the hands of retiring partner*).

9 A, B and C are partners – 'A' wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm. The firm has only one capital asset and the firm agrees to transfer its asset to A on his retirement. In this case Section 9B and Section 45(4) because of the drafting error there may be a situation where there could be double taxation of same transaction under both these sections. As per the rules for computation of tax to avoid double taxation, the income on which the tax has been paid under section 45(4) will have to be apportioned on the remaining assets which will not be possible in the present scenario since, there are no assets left with the firm and this would lead to double taxation in the hands of the firm.

10 A, B and C are partners – 'A' wishes to retire/ exit from the partnership firm – B & C agree to continue with the partnership firm. The firm has agreed to make conditional payment to A with a condition that 20% of the profits will be paid if, the firm is able to earn net profit in excess of Rs. 5 crores on completion of the project. In this case, section 45(4) will be triggered only if the firm is able to pay to the retiring partner and, the year of taxation of such payment will be the year in which the retiring partner i.e. A receives money on meeting the condition agreed at the time of retirement .

Section 48 provides for mode of computation of capital gains has been amended and new clause (iii) has been inserted to avoid double taxation.

The CBDT has issued guideline for operation and computation of business profits and capitals gains vide circular no. 14 of 2021 of the Income-tax Act,1961.

Chapter 5
Dissolution of Partnership Firm

1. Introduction

1.1. The definition of "dissolution" has not been provided in the Income tax Act. However, same is dealt with in detail under Chapter VI of The Indian Partnership Act, 1932 in Sec. 39 to 55 of said Act.

1.2. The term "dissolution" can be understood to mean the act of formal termination.

In the context of partnership, dissolution could imply two things:

a. Dissolution of partnership, wherein the relationship between partners is changed (known as "reconstitution" in general parlance); and

b. Dissolution of partnership firm, wherein the relations between all partners is terminated and firm ceases to exist.

1.3. Sec. 39 and 40 of the Indian Partnership Act read as below:

> ***39.*** *Dissolution of firm - The dissolution of partnership between all the partners of a firm is called "dissolution of the firm"*
>
> ***40.*** *Dissolution by agreement: A firm may be dissolved with the consent of all the partners or in accordance with a contract between the partners.*

1.4. Now, the newly inserted Section 9B of the Income Tax Act, 1961 has provided specifically for taxation on dissolution (*besides on reconstitution*) which was earlier (*i.e. prior to an amendment*) governed by provisions of Sec.45(4) of the Income Tax Act. Sec.9B is understood as a deeming provision and it covers within its ambit transfer of assets/ stock-in- trade sequel to dissolution and reconstitution of partnership firms. In the context of dissolution of a firm why transfer of other trade assets (*other than capital assets*) is not covered/ addressed creates confusion and then there appears an ambiguity what happens to transfer of such assets to the partners in view of specific provisions of Sec.9B . Whether one can contend that when a specific provision doesn't cover transfer of such assets then whether other provisions of Income Tax Act can be referred/ applied will be decided in times ahead. This is because 'specific provision will overrule the general provision' is not only accepted but respected proposition while interpreting provisions of tax laws which is also upheld in various court rulings.

1.5. Income Tax provisions with respect to the deemed transfer on reconstitution has been dealt with independently in a foregoing chapter on "Reconstitution of Partnership Firms".

1.6. For the purpose of learning the event of dissolution from the lens of income tax, we are concerned only with the dissolution of the partnership firm wherein, the relation between the partners come to an end and then, the 'firm' ceases to exist.

1.7. Now the amended provisions of sub-section (4) of Section 45 of the Income Tax Act deal with reconstitution of a firm only which needs to be read co-jointly with provisions of Sec. 9B of the Income Tax Act and, same is discussed in the foregoing chapter on "Reconstitution of Partnership Firms".

1.8. Therefore, hitherto i.e. from A.Y. 2021-22 onwards amended provisions of Section 45(4) will not be applicable to dissolution of partnership/ firm.

2. Relevant Provisions of the Income Tax Act, 1961

2.1. The newly inserted Section 9B is reproduced below:

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

9B. (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.

(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.*— 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.

2.2. Sec.9B(1) can be divided as follows (*for understanding its impact under certain situations*):

It is invoked when:

a. A specified person (partner/s)

b. Receives any capital asset or stock in trade or both

c. From a specified entity (*firm*)

d. And such receipt is in connection with either dissolution or reconstitution of the firm.

2.3. Consequences of above event:

a. There shall be a deemed transfer

b. Of the capital asset and/ or of stock in trade or both

c. From firm to the partner/s

d. The year of deeming the transfer of asset shall be the year in which such capital asset or stock in trade or both are received by the partner/s.

2.4. From the above, it will be clear that dissolution/ reconstitution doesn't get force of law unless assets referred above are received by the partner/s. To attract provisions of Sec.9B and 45(4) now, it is crucial that sequel to dissolution/ reconstitution, capital assets or stock-in-trade must be received by the partner/s then and then only provisions of Sec.9B/ 45(4) (*as the case may be*) can be applied. This means, suppose dissolution or reconstitution happens but, assets are not received by the partner/s then, such scenario can't be subject to application of provisions of Sec.9B/ 45(4) of the Income Tax Act is amply clear from the text of amended provisions of these sections.

2.5. Discussion on sub-section (1)

2.5.1. Receipt of Money by Partners on Dissolution

Now section 45(4) does not deal with the event of dissolution of firm and Section 9B does not provide for any deemed transfer when money is received by partner in connection with the dissolution of firm. Hence, it is evident that unless there is receipt of money / monetary consideration/ capital asset(*s*)/ stock-in-trade by partners from the partnership firm in connection with dissolution of partnership firm such situation is not dealt by section 9B and same proposition is extended to reconstitution of the firm dealt with the amended provisions of Section 45(4) read with Sec.9B. Further, it appears that a view emerges that receipt of monetary consideration is not chargeable to tax.

Such interpretation appears to be logical since, any amount of money lying with the firm is either brought in by the partners or represents income earned by the firm or may arise from a liability incurred while carrying activities by the firm. Hence, it appears that chargeability of distribution of monetary consideration is not treated as income since, then, it is partner's money which is repaid to them as per understanding among the partners at the time of reconstitution or dissolution.

2.5.2. Receipt of capital asset or stock in trade by the partner must be from the firm

Now receipt of capital asset or stock in trade by a partner from any person other than the firm, sequel to reconstitution is beyond the scope of provisions of either Sec.9B or Sec.45(4). This is because, in order to apply provisions of said sections there must be direct nexus between the firm and its partners and, unless any asset is passed through the 'firm', Sec.9B/ 45(4) can't be applied/ invoked.

2.5.3. Receipt must be "in connection with" Reconstitution or Dissolution of firm

Section 9B is triggered when the capital asset/s or stock in trade (*held by the firm*) is received by a partner from the 'firm' which must be "in connection with" reconstitution or dissolution of the firm. Any receipt by a partner of any capital asset or stock in trade from the firm otherwise than "in connection with" reconstitution or dissolution shall not be subject to provisions of Section 9B/ 45(4) (*of the amended provisions of Income Tax Act*).

2.5.4. Transfer will be deemed to have taken place in the year of receipt of capital asset/ stock-in-trade by the partner from the firm

The reconstitution or dissolution might have taken place in a particular anterior previous year however, for the purpose of Section 9B/ 45(4) the transfer shall be deemed to have taken place only in the previous year in which the capital asset or stock in trade or both are received by the partner/s.

2.6. Sub-section (2) of Sec.9B may be read as follows:

2.6.1. Clause (i) states that the transfer as per sub-section (1) shall be deemed to be

- income of the firm
- of the previous year in which the said capital asset or stock in trade or both are received by the partner/s.

2.6.2. Clause (ii) states that any income arising from receipt of capital asset/ stock-in-trade or both from the 'firm' will be chargeable to income tax under the head "Profits and gains of business or profession" or "Capital Gains" depending upon asset transferred. Here, one must keep in mind that such transfer of capital asset / stock-in-trade is as per books of accounts of the 'Firm' which are received by the partner/s (*as a result of dissolution or reconstitution*).

2.7. Sub-section (3) of Sec.9B provides for the determination of the full value of consideration of the transferred assets. It is provided that the fair market value of the asset is deemed to be transferred by the firm on the date of its receipt by the partner/s which shall be construed as full value of consideration.

2.7.1. There are 2 parts to the above provision.

Full value of consideration of the deemed transfer shall be:

a. Fair Market Value of the asset transferred

b. As on the date of receipt of such asset by the partner.

Here, w.r.t. 'fair market value' of capital asset, one may rely upon provisions of Sec.2(22B) of the Income Tax Act.

2.8. Sub-section 4 and 5 of Sec.9B are provisions with respect to authority of the Board to issue guidelines for the purpose of removing any difficulty that may arise in giving effect to the provisions of Section 9B and Section 45(4) of the Income Tax Act.

2.9. Illustration:

2.9.1. A, B & C are partners of the Firm M/s Tridev Enterprises carrying on business since 2012.

2.9.2.

Balance Sheet of the firm before retirement as on 25th March 2022 is as follows:

Capital & Liabilities	Amount (INR Crore)	Assets	Amount (INR Crore)
Partner's Capital		Purchased Goodwill (Capital Asset)	200
A	500		
B	100	Office Premises (Capital Asset)	110
C	300	Investments (Shares of listed cos.)	125
Loans from Banks	250	Loans advanced	75
Trade Payable	20	Trade Receivables	50
		Immovable Property (Stock in Trade – Current Asset)	600
		Cash & Bank Balances	10
Total	1170	Total	1170

The 3 partners decide to end the partnership and dissolve the firm w.e.f. 25th March 2022. On dissolution and suppose the partners decide to distribute assets and liabilities of the firm in a following manner:

Assets & Liabilities	Cost as per Books	Fair Market Value	To partner
ASSETS	INR Crore	INR Crore	
Purchased Goodwill (Capital Asset)	200	250	B
Office Premises (Capital Asset)	110	200	B
Investments (Shares of listed cos.)	125	300	B

Loans advanced	75	60	C
Trade Receivables	50	30	C
Immovable Property (Stock in Trade – Current Asset)			
Property 1	400	900	A
Property 2	200	600	C
Cash & Bank Balances	10	10	C
LIABILITIES			
Loans from Banks	250	250	B
Trade Payables	20	15	B

Now, we need to analyze the implications of agreement of the partners on the event of dissolution in the context of provisions of Section 9B sequel to such distribution (*which is followed with the receipt of asset by respective partner*).

2.9.3. Now, let us understand impact of such distribution of every asset and liability:

2.9.3.1. **Purchased Goodwill** (*which is different than the self-generated Goodwill*)

Since, a capital asset being goodwill is received by a partner (*i.e. a specified person*) from the firm (*i.e. a specified entity*) and such receipt is in connection with dissolution of the firm, there is a deemed transfer by the 'firm' to the partner.

The income will be chargeable in the hands of the firm.

Since, the deemed transfer pertains to a capital asset by the 'Firm', income will be chargeable under the head Capital Gains.

The fair market value of Goodwill (INR 250 Crore) will be considered as full value of consideration arising from such transfer.

If the transferred asset is subject to claim of Depreciation on 'Goodwill', then, income arising from its transfer will be deemed to be capital gains arising from transfer of 'short-term capital asset' and chargeable under Section 50 of the Income Tax Act, 1961.

2.9.3.2. **Office Premises** (*held as a Capital Asset*)

Since a capital asset, being 'office premises', is received by a partner (*i.e. by a specified person*) from the firm (*i.e. a specified entity*) and the said receipt is in connection with dissolution of the firm, there is a transfer by the firm to the partner.

The income will be chargeable in the hands of the firm.

Since, the transfer pertains to a capital asset the gain/ income will be chargeable under the head Capital Gains.

The fair market value of Office Premises (INR 200 Crore) will be considered as full value of consideration arising from deemed transfer.

As Depreciation must have been claimed on the office premises it will be part of 'block of asset' and then, income arising from its transfer will be chargeable as capital gain in the hands of the 'firm' (*i.e. a specified entity*) arising from transfer of a short-term capital asset as per provisions of Section 50 of the Income Tax Act, 1961.

2.9.3.3. **Shares of Listed Cos** (*held as Investments by the Firm*)

Since a capital asset, being investments in shares of listed companies, is received by a partner (*i.e. a specified person*) from the firm (*i.e. a specified entity*) and the said receipt is in connection with dissolution of the firm, there is a deemed transfer by the firm to the partner.

The income will be chargeable in the hands of the firm.

Since, the deemed transfer pertains to a capital asset, the income will be chargeable under the head Capital Gains.

The fair market value of the value of shares held (INR 300 Crore) will be considered as full value of consideration arising from the deemed transfer. Depending upon the period of holding of such investment capital gain will be chargeable accordingly as 'Long-term/ Short-term Capital Gain'.

2.9.3.4. **Loans advanced by the 'Firm'** (*i.e. a Capital Asset of the 'Firm'*)

The partner has received the right in his individual capacity to recover loans advanced by the firm to certain persons. The fair market value of such loans is estimated based on the expected amount recoverable from the parties. Due to certain doubtful debts, the fair market value of the loans may be less than the value accounted in the books of account.

Now the question arises, whether such loans/ advances (*which are not for the purpose of the business of the firm*) can be treated as a capital asset of the firm under section 2(14) of the Income Tax Act.

If the firm writes-off part of such loan as bad loan before distributing the same on reconstitution or dissolution then, whether the firm will get deduction of such write-off as a capital loss is a question that needs to be addressed based on facts associated with granting of loan by the 'Firm'. If the same is allowed as deduction, then the firm can set off such loss (*due to write-off' by the 'Firm'*) against capital gains chargeable in the hands of the firm as per provisions applicable to claim set-off of losses as per relevant provisions of Income Tax Act.

However, if the firm does not write off the unrecoverable part/ doubtful of recovery part of such loan and same is transferred to a partner at book value then, whether the partner can claim such capital loss due to non-recovery or short recovery is a question that may come up at a later date in the hands of a partner but not at the time of dissolution of the firm.

2.9.3.5. Trade Receivables

If the partner is assigned the right to recover the trade receivables sequel to dissolution by the firm then, the fair market value of such trade receivables need to be determined in the context of possibility of recovery from concerned parties. If there are doubtful debts then, the fair market value of such trade receivable at realizable value needs to be accounted in the books of account of the Firm accordingly i.e. after write-off of unrecoverable trade receivables such asset may be transferred by the firm to a partner (*at the time of dissolution*).

Trade receivables are different from stock-in-trade (*i.e. inventory*).

The firm should ideally write-off bad debts from the trade receivables before distributing the same on reconstitution or dissolution to a partner. The firm shall be entitled to deduction of bad debts under the head Profits and Gains of business or profession.

Now let us imagine a situation where, the firm fails to determine the unrecoverable part of the trade receivable or the trade receivable becomes bad at a later date and the firm has not written off the bad debt in its books of accounts at the time of reconstitution or dissolution. In such a scenario, if the firm does not write off bad debts and transfers the whole amount as it is to a partner at book value then, will a partner be allowed business loss or capital loss arising on short recovery is a question that may come up at a later date but, not at the time of dissolution of the firm.

2.9.3.6. **Stock-in-trade** (*i.e. immovable properties held by the firm as such*)

(i) Property 1

(ii) Property 2

Since stock in trade, being immovable properties, are received by a partner (*i.e. a specified person*) from the firm (*i.e. a specified entity*) and said receipt is in connection with dissolution of the firm, there is a transfer of stock in trade by the firm to a partner.

The income will be chargeable in the hands of the firm.

Since, the transfer pertains to a stock in trade, the income will be chargeable under the head Profits and Gains of Business or Profession in the hands of the 'firm'.

The fair market value of the said stock in trade shall be considered as full value of consideration arising from such transfer.

2.9.3.7. Cash & Bank Balances

Receipt of money by a partner from the firm does not invite applicability of provisions of section 9B therefore, there will be no implication on distribution of such asset to the partners in the hands of the 'Firm'.

2.9.3.8. **Loans from Banks** (*i.e. a liability of the 'Firm'*):

Section 9B does not refer to transfer of any liability to a partner on reconstitution or at the time of dissolution of the firm. However, since the loan will be taken over by the partner at book value, there should arguably be no implications of income tax on its transfer to a partner.

2.9.3.9. **Trade Payables** (*i.e. a liability of the 'Firm'*):

Section 9B does not refer to transfer of any liability by the 'firm' to a partner on reconstitution or dissolution of the firm.

In this case, the fair market value of the trade payables is INR 15 crore as against INR 20 crore as being payable in the books of accounts. This seems to be so due to waiver of recovery by some creditor.

The question here is whether the firm will have to record such waiver in its books of account before dissolution/ at the time of reconstitution? Also, irrespective of the treatment or recording in the books of the firm with respect to such a waiver of liability, the firm shall be liable to income tax on such income being waiver of liability u/s 41(1) of the Income Tax Act. There shall be no tax implications on the transfer of the balance liability to the partner on dissolution.

Chapter 6
Other Aspects

1. Reconstitution Without Consideration:

Where there is reconstitution of a partnership firm i.e. retirement, change in profit sharing ratio, but partner does not receive any capital asset, stock or cash, then there is no tax implication. Therefore, receipt of capital asset, stock or cash by partner is necessary to trigger taxation under section 9B and/or 45(4) of the Act.

This is because, section **9B.** in opening at sub-section *(1) provides that:*

"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 ………"

and section 45(4) provides:

"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……………………."

Thus, receipt of capital asset, stock or money can give raise to charge under section 9B or 45(4) of the Act.

2. Transfer of Agricultural Land:

If any firm owns agricultural land and it is given to the partner on retirement or, then how the sections 9B and 45(4) of the Act will deal with such reconstitution.

Definition of Agricultural Land is provided in section 2(1A) of the Act.

Capital Asset is defined under section 2(14) of the Act as follows:

2(*14*) "capital asset" means—

(*a*) property of any kind held by an assessee, whether or not connected with his business or profession;

(*b*) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992 (15 of 1992);

[5][*(c) any unit linked insurance policy to which exemption under clause (10D) of section 10 does not apply on account of the applicability of the fourth and fifth provisos thereof,*]

but does not include—

…………

(*iii*) agricultural land in India, not being land situate—

(*a*) in any area which is comprised within the jurisdiction of a municipality (whether known as a municipality, municipal corporation, notified area committee, town area committee, town committee, or by any other name) or a cantonment board and which has a population of not less than ten thousand; or

(*b*) in any area within the distance, measured aerially,—

(*i*) not being more than two kilometres, from the local limits of any municipality or cantonment board referred to in item (*a*) and which has a population of more than ten thousand but not exceeding one lakh; or

(*ii*) not being more than six kilometres, from the local limits of any municipality or cantonment board referred to in item (*a*) and which has a population of more than one lakh but not exceeding ten lakh; or

(*iii*) not being more than eight kilometres, from the local limits of any municipality or cantonment board referred to in item (*a*) and which has a population of more than ten lakh.

Explanation.—For the purposes of this sub-clause, "population" means the population according to the last preceding census of which the relevant figures have been published before the first day of the previous year;

Thus, it can be appreciated that 'Agricultural land' is not a capital asset within the meaning of section 2(14) of the Act which defines the same.

Section 9B(1) provides that

"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 ………"

Agricultural land is neither capital asset nor stock in trade.

Further section 45(4) provides:

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

Agricultural land is neither capital asset nor money.

Therefore, where partnership firm given 'Agricultural Land' to the partner on retirement

Or reconstitution of the firm, it does not give rise to any income to be reported under section 9B of 45(4) of the Act.

3. Other property not being capital assets:

For the reason cited above, it may be inferred that the assets listed below would not be treated as capital assets & therefore, section 2(14) & section 45(4) will not be attracted.

This is because of the following clauses from definition of Capital Asset available in section 2(14) of the Act:

(*iv*) 6 per cent Gold Bonds, 1977, or 7 per cent Gold Bonds, 1980, or National Defence Gold Bonds, 1980, issued by the Central Government;

(*v*) Special Bearer Bonds, 1991, issued by the Central Government ;

(*vi*) Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999 or deposit certificates issued under the Gold Monetisation Scheme, 2015 notified by the Central Government.

These bonds should not be held as stock in trade. In such circumstances not being money and being expressly excluded from definition of Capital Asset, both sections 9B and 45(4) will not attract.

4. Consideration Flowing from Partner:

Where for change in profit sharing ratio of partners, if consideration is paid by the partnership firm, it will attract tax liability as per sections 9B and/or 45(4) of the Act.

However, where for change in profit sharing ratio of partners, if consideration is paid by the partner of the firm, then there will be no tax liability as per sections 9B and/or 45(4) of the Act. Because, both the sections require passing of stock in trade, capital asset or money from the 'specified entity' i.e. partnership firm.

However, in such circumstances the receiving partner shall be liable for tax, as right to share profits is a capital asset. However, investment based exemption options shall also be available to the partner receiving consideration for reduction in his share.

Similarly, on retirement, where incoming partner pays any consideration to a retiring partner, firm will not be liable to tax, as no consideration has flown from the firm.

5. Carry forward and set off of losses in case of change in constitution of firm or on succession:

78. (1) Where a change has occurred in the constitution of a firm, nothing in this Chapter shall entitle the firm to have carried forward and set off so much of the loss proportionate to the share of a retired or deceased partner as exceeds his share of profits, if any, in the firm in respect of the previous year.

(2) Where any person carrying on any business or profession has been succeeded in such capacity by another person otherwise than by insheritance, nothing in this Chapter shall entitle any person other than the person incurring the loss to have it carried forward and set off against his income.

6. Assessment as a firm:

Under section 184 a firm shall be assessed as a firm for the purposes of this Act, if—

(i) the partnership is evidenced by an instrument; and

(ii) the individual shares of the partners are specified in that instrument.

Section requires a certified copy of the instrument of partnership to accompany the return of income of the firm of the previous year relevant to the assessment year in respect of which assessment as a firm is first sought.

It is further provided that where a firm is assessed as such for any assessment year, it shall be assessed in the same capacity for every subsequent year if there is no change in the constitution of the firm or the shares of the partners as evidenced by the instrument of partnership on the basis of which the assessment as a firm was first sought.

Where any reconstitution takes place in the previous year, the firm is required to furnish a certified copy of the revised instrument of partnership along with the return of income for the assessment year relevant to such previous year.

However, now rules do not allow attachment along with the return of income. Therefore, when the case comes for hearing or faceless assessment, it is advisable to furnish the revised instrument.

Where a firm does not comply with the provisions of section 184 for any assessment year, the firm shall be so assessed that no deduction by way of any payment of interest, salary, bonus, commission or remuneration, by whatever name called, made by such firm to any partner of such firm shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession." As a consequence such interest, salary, bonus, commission or remuneration shall not be chargeable to income-tax under clause (v) of section 28 in the hands of partner (Section 185).

Thus, while addressing the substantive law, it is necessary to comply with the procedural provisions, as well.