NEW SYSTEM OF TAXATION OF ALLOTMENT OF ASSETS TO PARTNERS MEMBERS IN CASE OF FIRMS AOP AND BOI.

S Ramasubramanian FCA

May 2021

Earlier law provided that the firm will be liable to capital gains tax on allotment or distribution of any capital assets to its partners on dissolution or otherwise. See S.45(4)

Several courts including Supreme court held that payment of a sum of money to a partner in excess of capital account is not chargeable to capital gains in partner's hands.

Finance Bill 2021 proposed to change the system of taxation of capital gains by proposing to amend S.45(4) and introduce a new section 45(4A) with effect from A.Y 2021-22

The proposed amendments were poorly drafted. There were a lot of conceptual and interpretational issues

Finance Act, 2021 gave a complete go-by to the proposals in the Finance Bill. It introduced S9B and amended S.45(4)

Even after the Act got the President's assent another communication correcting some errors was issued.

This only shows that the haste with which amendments were thought of and rushed through without a proper review.

S 9B Salient Features

introduced with effect from A.Y 2021-22

It applies to specified entities.

Specified entities are firms, AOPs and BOIs. It specifically excludes company or a co-operative society. Since the definition of firm u\s 2(23) includes an LLP, specified entities include LLPs also.

It applies when a specified person receives a capital asset or stock-in-trade

In connection with the dissolution or reconstitution of a specified entity .

Specified person is defined to mean a partner or a member of AOP/BOI

Reconstitution has been defined to mean

a)Retirement of a partner or a member of specified entity, or

b)Admission of a new partner or member and at least one existing partner or member continues to be a partner or member, or

c)There is a change in the profit-sharing ratio.

S 9B(2) states that the income from deemed transfer of stock-in-trade or capital asset shall be deemed to be income of specified entity in the year in which such assets are received by specified person. .

Such an income shall be assessed under the head “Profits and Gains of Business or Profession” or “Capital Gains” as the case may be in accordance with the provisions of the Act.

S.9B(3) stipulates that fair market value of the asset involved in deemed transfer shall be the full value of consideration received by the specified entity.

S.9B(4) and (5) empower the CBDT to remove any difficulties by issuing appropriate guidelines. Such guidelines have to be issued with approval of Central Government.

S 45(4) Salient Features

Substituted with effect from A.Y 2021-22

Notwithstanding anything contained in S.45(1) profits or gains arising from receipt of money or capital asset by a specified person from a specified entity in connection with a reconstitution shall be chargeable to tax under the head “Capital Gains” in the hands of specified entity

The income will be taxed in the year in which the asset or money is received by the specified person.

The determination of chargeable quantum of capital gains u\s S 45(4) is as per the formula given below:-

A=B+C-D

A= Chargeable Capital Gains

B= Value of money received by the specified person

C = Fair Market Value of Capital Asset

D= Balance in capital account of specified person.

Balance in capital account is to be calculated without taking into account amounts credited towards revaluation of assets or self- generated goodwill or any other self-generated asset.

If”A” in the above formula iis negative, its value shall be zero

Self Generated goodwill or asset includes goodwill or asset which has been acquired without incurring any cost or generated during the course of business.

Explanation 2 below S.45(4) makes it clear that even if capital gains is charged to tax u\s 9B, it will be charged once again u\s 45(4) independently. It means there will be double taxation.

S 48(iii) has been introduced with effect from A.Y 2021-22

It states that in computing the income under the head “Capital Gains” a deduction will be allowed of the capital gains charged u\s 45(4) in accordance with rules to be framed .

Language of S.48(iii) is obscure . The exact import of this Explanation can be fully understood only when the rules are framed.

Issues U/S 9B

Though S. 9B and 45(4) apply to Firms, AOP and BOI, for the purpose of this presentation we will refer to “firm” instead of “specified entity” and “partner” instead of “specified person”.

Purpose of introducing a new section 9B and placing it in Chapter-II Basis of Charge instead of amending S.28 and 45 respectively is not clear.

Perhaps the legislature wanted to avoid duplication.

There is no clarity on this issue.

Taxability is the year of receipt of asset by partner.

If assets are received in different years, tax will be levied in those years.

How tax will be levied in case of dissolution?

Whether S 189 will apply? In the absence of a fiction that firm will continue to exist can one resort to S.189.

On a plain reading of S.189 I believe S.189 will apply and there is no need to have a separate fiction created in 9B for existence of firm.

S.9B states that FMV of asset shall be the full value of consideration.

But it does not lay down any guidelines for determination of FMV unlike S.50S, 43CA etc.

Definition of FMV u\s 2 (22B) has to be applied.

In case of immovable properties there is no mandate for adoption of stamp duty valuation or guidance value . FMV is the price which would be fetched if the asset is sold in the open market by a willing seller to a willing buyer.

In a given case FMV can be less than stamp duty valuation.

But practically, stamp duty valuation is likely to be adopted

Another issue that needs to be discussed is that S.28 has not been amended to include allotment of stock-in trade to a partner on dissolution or reconstitution of a firm..

S 29 states that income referred to in S.28 has to be computed in accordance with S.30 to 43D.

Since S.28 has not been amended, computation provisions in S.30 to 43D will not apply.

This means that artificial disallowance section like 40A(3) etc will not apply.

The other view is that S.9B(2)(ii) clearly stipulates that income under the head “Profits and Gains of Business or Profession” will have to be computed in accordance with the provisions of the Act.

Hence S 30 to 43D will apply.

There are practical problems in applying S.40A(3) to stock-in-trade.

If stock-in-trade was purchased in an earlier year by paying cash and it is held in stock and such stock is allotted to a partner, the question arises when the disallowance is to be made.

In the year of dissolution it cannot be disallowed because what is claimed is not the purchase cost but value of opening stock.

Supreme court in a number of cases has held that the closing stock of previous year has to be opening stock of next year and there cannot be any difference.

But this issue does not arise in case of capital gains. S 48 refers to “Capital Gains” computation and not to “capital Gains chargeable u\s 45(1)”.

Hence. S.48 applies to computation of capital gains under any section including S.9B.

Another issue is whether the firm can claim deduction u\s 54EC.

S.54EC presupposes receipt of consideration and investment of capital gains in eligible bonds.

In the absence of any consideration received by firm, it cannot claim exemption u\s 54EC.

The other view is that S.54EC does not specifically refer to consideration. It only requires investment of an amount equal to capital gains.

Hence, firm can claim deduction u\s 54EC in respect of capital gains computed in terms of S.9B.

In a case where S.9B is attracted on account of dissolution of firm, it is not possible to claim deduction u\s 54EC.

S.54EC requires the bonds to be held by the assessee for a period of 5 years which condition cannot be satisfied by a dissolved firm.

So 54EC can be claimed only in case of reconstitution of firm.

Issues U/S 45(4)

The notice of amendment placed before parliament stated that the expression used in S.45(4) is "*…any profits or gains arising from receipt of such money by the specified person…*"

But the published text uses the expression "any profits or gains arising from receipt by the specified person"

As stated earlier, the above correction was made through an errata.

It is not clear whether the published text was approved by parliament and assented by President. It is not clear at what stage the error was noticed.

If it can be proved that errata was issued without sanction of Parliament its validity can be challenged.

S.45(4) does not say explicitly state on which asset the capital gain is charged.

It just says that profits and gains on receipt of capital asset or money or both by the partner shall be charged to tax under the head “Capital gains”

Can one say that the capital gains is with reference to capital asset received by partner?

The answer is obviously no. There can be receipt pf only money without receipt of capital asset.

Can it be said that it is with reference to partner’s interest in the firm?

Though it is possible to infer that capital gains are with reference to partner’s interest in the firm, on a strict interpretation it cannot be so inferred.

S.45(4) is a charging section and it should be strictly interpreted.

In the absence of reference to a specific capital asset, it cannot be said by a process of interpretation that partner’s interest in the firm is the underlying capital asset in S.45(4).

The importance of above discussion is now explained.

Rate of tax leviable on chargeable Capital gains depends on whether the capital asset is long term or short term.

Unless it is determined whether the asset is long term or short term capital asset, the tax rate cannot be found out.

One of the cardinal principles of interpretation of a charging section is that there the rate of tax or amount of tax should be certain.

If the tax rate is not certain charge fails.

Please see Supreme Court in Govind Saran Ganga Saran vs Commissioner of Sales Tax 60 STC 1. 155 ITR 144.

Since it is not possible to ascertain as to what type of capital asset is being charged to tax u\s 45(4), one cannot determine whether it is short term or long term.

If the nature of asset cannot be determined the applicable tax rate cannot be determined with certainty and hence, the charges u\s 45(4) fails.

The partner should receive money actually.

Mere credit to capital account is not sufficient.

Allotment of agricultural land which is not a capital asset u\s 2(14) does not fall u\s 45(4) .

But it will fall u\s 9B if such agricultural land is held as stock-in-trade

What happens when a partner dies and the legal heir receives the amount in excess of capital account standing to credit of deceased partner. It is not really material whether the firms is dissolved on death of a partner or not.

In the absence of a specific provision to this effect legal heirs are not liable. S.159 also does not apply as there was no receipt at all by the deceased partner.

“D” in the formula is the amount standing to the credit of capital account of partner.

Whether loan taken from partner can be treated as capital of partner?

One view is that there is no difference between capital, current and loan account and all these accounts represent the capital of partner. Hence, loan will be treated as part of capital.

The other view is that partners have consciously treated it as a loan and not as capital.

Of course this issue does not pose much practical problem as loan can be transferred to capital account or paid separately and extra money payable can be adjusted accordingly.

If a firm keeps reserve accounts, the share of partner in such reserves will form part of capital account.

If “D” in the formula is debit or negative balance, what will be the impact?

Will it be added to B and C on the mathematical principle double negative makes a positive?

Or will it be ignored and taken as zero. Please note that first proviso to S.45(4) says that if “A” is negative it will be zero and does not in anyway deal with “D”

Can it be said that “D” will be zero but it will be added to “B” on the basis of principle laid down by Supreme Court in Mahindra & Mahindra 404 ITR 1 wherein it was held that waiver of loan would amount to receipt of money.

The special bench of ITAT in 15 ITR 1 held that for the purpose of S.50B if the net worth is negative then it should be added to arrive at the capital gains .

Double Taxation & Mitigation

As stated earlier, Explanation 2 below S.45(4) clearly states that there will be double taxation of capital gains both u\s 9B and 45(4) when capital assets are allotted to a partner.

It is constitutionally permissible to doubly tax the same income in the same person’s hands if Legislature specifically enacts so. Please see 77 ITR 107, 44 ITR 876, 404 ITR 738.

S 48(iii) mitigates the effect of double taxation. How that mitigation will happen depends on the Rules to be prescribed .

S.48(iii) states that deduction will be allowed in computing the capital gains .

Can it apply to capital assets allotted to a partner which is chargeable to tax u\s 45(4)?

The answer must be no. The capital asset allotted is no longer in possession of the firm. There will not be an occasion for firm to transfer such an asset once again.

Will the Rules be prescribed in such a way that the capital gains charged u\s 45(4) will be adjusted while computing the capital gains u\s 9B?

Or the capital gains so charged u\s 45(4) will be spread over the cost of existing assets and the capital gains arising out of transfer of such capital assets will be at a lesser figure because the cost of those assets are increased as per Rules?

If it is to be so, there will be complication arising out of application u\s 50.

Obviously, the WDV of depreciable assets will not get altered.

Adjustment has to be made in S.50 itself. Whether such an adjustment can be made through Rules?

These are certain difficulties that need to be sorted out.

Let us wait for the Rules and split hairs or tear our hairs(other than bald people like me)

Comparison between S9B and 45(4)

S.9B	S.45(4)
It would apply upon receipt of capital asset or stock-in-trade or both by a partner from the firm on the dissolution or reconstitution of a firm	It would apply upon receipt of capital asset or cash or both by a partner from the firm in connection with reconstitution of the firm
Allotment of stock-in-trade is covered	Allotment of stock-in-trade is not covered
For the purpose of computation under Section 9B, FMV is deemed to be FVC and computation would be in accordance with Chapter IV-C or D i.e. ‘Profits and gains of business or profession’ or ‘Capital Gains’	Computation mechanism is given under Section 45(4) in the form of formula

Comparisons	S.9B	S. 45(4)
Reconstitution	✓	✓
Dissolution	✓	✗
Cash to partner	✗	✓
Capital asset to partner	✓	✓
Stock in trade to partner	✓	✗


Thank you!