Partner vis-à-vis Capital Gain – Version 2.0

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In our earlier version on the captioned subject matter, we have extensively dealt with taxation in the hands of the firm and the partners at the time of admission or dissolution and connected issues therein. We have framed four issues and tried to answer them with the help of judicial precedents on the subject. The article can be accessed here Partner vis-à-vis Capital Gains | SBS Blog. We strongly recommend to read the above article before proceeding to read the subject article.

For ready reference, the conclusion of the above article, the version 1.0 is as below[1]:

Issue #	Issue	Response
Issue #1	When a firm pays certain amounts to the retiring partner, can it be said that there is a transfer from partner in favour of continuing partners?	• Gujarat HC judgement in Mohanbhai Pamabhai has held that on retirement, the partners settles out their rights and nothing more happens. Since the rights were worked out, it cannot be said that there is a transfer from the partner towards the firm or continuing partners. The said judgement was approved by Supreme Court (SC). • So, until the judgement of Bombay High Court (HC) in Tribhuvandas G Patel (supra), the view which continued is that at the time of retirement, the partners only settle their rights and no transfer can be inferred. However, the Bombay HC distinguished the judgment of Mohanbhai Pamabhai (supra) by stating that in such case, the settlement among the partners has taken on the basis of notional sale of assets, which was evident from the recording of the terms of retirement and so the judgment of Mohanbhai Pamabhai (supra) would apply only where the retiring partner was settled based on the footing of notional sale. • Since, in the facts of Tribhuvandas G Patel, the retiring partner was paid certain amount in addition to his credit in his capital account and there was a deed which stated that retiring partner relinquishes his rights in the firm towards continuing partners, the Bombay HC inferred that there is a transfer by a retiring partner towards the firm and accordingly the amount received minus amount lying in credit of capital account was subjected to tax. • The Bombay HC further stated that the retiring partner while going out and while receiving what is due to him in respect of share may assign his interest by a deed or take amount and give receipt and acknowledge that he has no more claim on his co-partners. In a case, where he assigns his interest by a deed, then it would be transfer and in the other case, where he states that he has no further claims on the co-partners, there would not be transfer. • The Bombay HC further rejected the plea of assessee that dissolution and retirement are one and the same and the decision of Malabar Fisheries Co (supra) should be applied even

[11] For legends and other references, please visit the link shared above.

in case of retirement. The plea was taken to take shelter from Section 47(ii) which stated that distribution in terms of dissolution is not transfer. However, the Bombay HC stated that there was a difference between retirement and dissolution and instance of retirement was not provided in Section 47(ii) to take an exemption by the retiring partner.

- The said judgment was followed subsequently in the matter of HR Aslot (supra) and NA Mody (supra), this too by Bombay HC.

- Post this, the Andhra Pradesh (AP) HC in L Raghu Kumar (supra) has followed Mohanbhai Pamabhai (supra), which is also affirmed by Supreme Court by that time and held that there cannot be any transfer inferred when a partner retires from the firm. The Court has stated that the judgments of Bombay HC in Tribhuvandas G Patel (supra) and HR Aslot (supra) were based on facts and cannot be directly applied to facts in L Raghu Kumar (supra). The AP HC further stated that the view of Bombay HC stating that the retirement and dissolution are separate events was erroneous by referring Narayanappa v. Bhaskara Krishnappa (supra).

- The only shortcoming in judgment of L Raghu Kumar (supra) was that though the court has stated that the judgments of Tribhuvandas G Patel (supra) and HR Aslot (supra) were not applicable, it failed to apply the tests laid down. The Court has not took look about the mode employed for the retirement or what was the amount that was received by retiring partner, is it, lumpsum amount or amount lying credit to his account.

- When the matter was taken to SC by Revenue, the SC has affirmed the decision of AP HC in L Raghu Kumar (supra) by making reference to its earlier judgment in Mohanbhai Pamabhai (supra).

- The judgment of Bombay HC in Tribhuvandas G Patel (supra) was reversed by SC, when the matter was taken to them by assessee. The SC followed the decision of Sunil Siddharathbhai (supra) and Mohanbhai Pamabhai (supra) and held that the conclusion arrived by Bombay HC is erroneous.

- Since the judgement of Tribhuvandas G Patel (supra) was reversed by SC, all subsequent judgments which were delivered based on the Bombay HC judgment would be bad law. If such a view is taken, then it appears that the judgment of Mohanbhai Pamabhai of SC should be applicable even today and all retirements should be held as not transfers and accordingly should not be subjected to tax.

- However, it appears that the Tribunals post reversal of Tribhuvandas G Patel by SC, also follows the judgment of Bombay HC by stating that Tribhuvandas G Patel deals with the issue, whether retirement is also covered under Section 47(ii) and now that said section is omitted, the said judgement cannot be applied.

- The Pune ITAT in Shevantibhai C Mehta (supra), Mumbai ITAT in Sudhakar M Shetty (supra) and Bangalore ITAT in Savitri Kadur (supra) followed the decision of Tribhuvandas G Patel (supra), even after reversed by SC.

- From the perusal of the judgments of Tribunal, it can be inferred that as long as the settlement to retiring partner is happening to the extent of amount lying in his capital account, there cannot be any transfer. This is by following the judgement of Mohanbhai Pamabhai (supra). Where the settlement is more than credit in the capital account or lumpsum amount without reference to capital account, there exists transfer and difference between amount received and credit in capital account is treated as capital gain in the hands of retiring partner. The Bangalore ITAT in Savitri Kadur (supra) stated that even the credit in capital account is by reason of profits arising out of revaluation, said aspect should not bring any tax impact, thereby subtly distinguishing the judgment of Mumbai ITAT judgment in Sudhakar M Shetty (supra).

- From the above discussion, it is evident that there exists two different views regarding the taxation of amounts received by retiring partner. The same are listed as under:

<u>View #1 – Follow Mohanbhai Pamabhai:</u>

- By following the decision of SC in Mohanbhai Pamabhai, the retiring partner can take a stand that there exists no transfer, when he retires from the firm.

<u>View #2 – Follow Tribhuvandas G Patel:</u>

- If the retiring partner is settled only the credit lying in his capital account, then he can still follow View#1 and take a stand that there should not be any tax.

- If the retiring partner is receiving an additional amount or lumpsum amount and there is a deed in place stating that retiring partner relinquishes his rights in assets of the firm to the continuing partners, such amounts may be taxed as capital gains. This was by following the Tribhuvandas G Patel (supra) despite it was reversed by SC.

<u>Conclusion:</u>

- As far as the amounts received are equivalent to credit lying in the capital account of retiring partner, there would not be any tax. The issue arises only if there is a lumpsum or additional amount.

- Even in such cases, we are of the view that the judgment of SC in Mohanbhai Pamabhai still holds good even today. This is for the reason that though the ITA was amended to insert Section 45(3) and Section 45(4) to arrest the tax abuse strategies, there is no amendment to get the amounts received on retirement, which suggest that the legislature favours with the view of Mohanbhai Pamabhai.

Issue #2	When a firm allocates certain assets to retiring partner, can it be said that there is a transfer of capital asset by such firm to the retiring partner?	• In the above issue, we have discussed, what would be the taxability when the retiring partner is in receipt of amount. In this issue, we shall deal with taxability when the retiring partner is allotted a capital asset instead of money. • Ideally, the taxability should not be dependent upon the mode of discharge of consideration. Hence, irrespective of the fact, that retiring partner has received money or capital asset, the taxation should not change. • However, the Bombay HC in AN Naik & Associates (supra) held that allocation of capital asset to retiring partner would be taxable under Section 45(4) in the hands of the firm. The HC stated that the term 'otherwise' used in Section 45(4) covers 'retirement' because it has to be read in connection with 'transfer' used therein but not with 'dissolution'. • Accordingly, the Bombay HC held that the distribution of capital asset to retiring partner is taxable in the hands of the firm. The HC has come to such conclusion keeping the intention of legislature behind insertion of Section 45(4). The Court stated that if Section 45(4) is to be interpreted only to cover the cases of 'dissolution', then the entire intention to get Section 45(4) goes into drain. • We are of the view that subject to our comments above, the above decision lays down a good proposition.
Issue #3	When a firm distributes capital assets at the time of dissolution, can it be said that there is a transfer of capital asset by such firm to the persons?	• The SC in Malabar Fisheries Co (supra) has held that there exists no transfer when a firm dissolve. The SC stated that the firm and partners are not different and accordingly held that there cannot be transfer from firm to partners, when the firm dissolves. • However, this is fixed after insertion of Section 45(4). The said section was brought into the tax net only to override the above judgement. Hence, post 1988, when a firm distributes capital assets on its dissolution, the said transaction would be transfer in terms of Section 45(4) and accordingly taxable.
Issue #4	When a personal asset is being contributed as capital to a partnership firm in which the contributor becomes a partner, can it be said that there is a transfer of capital asset by such person to the firm?	• The SC in Sunil Siddharathbhai (supra) has stated that when a person asset is contributed to the firm, there exists a transfer for the reason that the contributing partner loses his exclusive right in the property, which earlier he has. However, the SC stated that the amount recorded in books of the firm may not represent the true value of consideration and accordingly stated that the charge fails in absence of methodology for determination of consideration. • In order to overcome this aspect, the legislature inserted Section 45(3) treating that said transaction as transfer and consideration as the amount that was being recorded in the books of the firm.

With the above in background, now, let us proceed to examine the recent changes to the above positions. The changes were initially made vide Finance Bill, 2021 to Section 45 of ITA. However, the changes proposed in

Finance Bill, 2021 were not carried in toto when the Finance Act, 2021 was enacted. The changes proposed by Finance Bill and not carried out in Finance Act and vice-versa forms part of the annexure to this article.

From the annexure, it is evident that, Section 45(4) which is proposed to be replaced by Finance Bill, 2021 have been replaced with a different language in the Finance Act, 2021. Further, the new sub-section, which is proposed to be introduced by Finance Bill, 2021 vide (4A), was never found in the Finance Act, 2021. Further, a new section 9B was introduced in Finance Act, 2021, which was never found in the Finance Bill, 2021.

Amidst this, let us proceed to analyse the current position which was introduced vide Finance Act, 2021. Before proceeding further, we need to understand the difference between Section 9B and Section 45(4):

Section 45(4)	**Section 9B**
Notwithstanding anything contained in sub-section (1), where a specified person receives during the previous year ***<u>any money or capital asset or both</u>*** from a specified entity in connection ***<u>with the reconstitution</u>*** 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 sub-section as income of the specified entity under the head 'capital gain'. • 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.	1) Where a specified person receives during the previous year ***<u>any capital asset or stock in trade or both</u>*** from a specified entity in connection ***<u>with the dissolution or reconstitution</u>*** 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 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 –

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.	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.'.

Implications under Section 9B:

- Section 9B has been introduced vide Finance Act, 2021. The new section aims to tax the specified entity when said entity allots any capital asset or stock in trade (for brevity 'SIT') to a specified person in connection with dissolution or reconstitution of the specified entity. The specified entity is required to pay tax in the year in which the specified person receives the capital asset or stock in trade.

- The specified entity is defined to mean a firm or other association of persons or body of individuals. A company and co-operative society have been specifically excluded. The phrase 'reconstitution of specified entity' has been defined to cover three instances, namely, in case of partnership, retirement of partners from partnership firm, admission of partner into partnership firm and change in profit sharing ratio. The phrase 'specified person' has been defined to mean a person who is a partner in any previous year. Accordingly, in case of retiring of partner, the retired partner, in case of admission, the new partner and in case of change in partner sharing ratio, all the partners would be falling under the definition of 'specified person'.

- As stated above, Section 9B aims to cover two events, namely the dissolution or reconstitution. It is important to note that the earlier Section 45(4) was dealing only with dissolution and the question, whether reconstitution is covered under the said sub-section or not, was not clear. It was only in the matter of AN Naik & Associates[2], the Bombay High Court has held that retirement is also covered under the sub-section (4) under the ambit of 'otherwise'. To this extent, the new Section 9B has made it clear that the reconstitution is also covered. Hence, receipt of any capital asset or stock in trade by retiring partner would be taxable under the appropriate head in the hands of firm. In other words, if the retired partner is allotted a capital asset, when he is retiring from the firm, the firm is required to pay tax under the head 'capital gain'. In case, if stock in trade is allotted, then the same will be taxable under the head 'profits and gains from business or profession' (for brevity 'PGBP') in the

[2] [2004] 265 ITR 346 (Bom)

hands of the firm. The firm is required to pay tax in the year in which the specified partner (in the above example, the retiring partner) receives the capital asset or stock in trade as the case may be.

- The next aspect is on the value on which the firm is required to pay tax. The section stipulates that the fair market value of capital asset or stock in trade on the date of receipt by specified person shall be deemed to be the full value of consideration. Hence, in case of capital asset, the firm is required to pay tax after adopting the mode of computation as per Section 48. The fair market value of capital asset on the date of its receipt by the specified partner shall be deemed to be the full value of consideration and the cost of acquisition and cost of improvement can be reduced to arrive the gain. In case of stock in trade, the profits have to be arrived after adopting the provisions of Section 29.

- It is important to note that Section 9B covers only, in case where the specified person, receives the capital asset or stock in trade. In case, if the specified partner receives money, then the said section is not applicable. Further, the old Section 45(4) is in a way introduced as new Section 9B except for the taxation of stock in trade, which was absent in the old Section 45(4). With this understanding of Section 9B, let us proceed to understand Section 45(4) in its new avatar.

Implications under Section 45(4):

- The said sub-section deals with taxation in the hands of specified entity when the specified person receives money or capital asset in the event of reconstitution of specified entity. For the purposes of this sub-section, the phrase 'specified entity', 'specified person' and 'reconstitution of specified entity' have the same meaning as laid down in Section 9B.

- As stated earlier, the said sub-section deals with taxation only in case of 'reconstitution of specified entity'. Hence, for the instances of dissolution, the provisions of this sub-section shall not be applicable. The judgment of AN Naik & Others (supra) in a way is implemented by making it explicitly clear that the new sub-section covers reconstitution.

- Before proceeding to understand more about the new Section 45(4), it is important to also understand what new section is trying to achieve. On a reading of the new section, it is evident that the specified entity is made to pay tax on the amounts which are in excess of the capital account balances of the specified person. The capital account balances are the bare capitals and real accretions and the formula prescribed makes it sure that the revaluation profits and other similar increases in capital accounts are to be excluded. Hence, the new section is trying to tax the excess amount over the capital account balances to the specified person. A question that arises for consideration is, what is the specified entity foregoing/extinguishing/transferring to the specified person, so as to bring the specified entity under obligation to pay tax, especially under the head 'capital gains'. Ideally, the specified person is transferring/extinguishing/foregoing his rights against another partners and for such, he is in receipt of capital asset or money and if he receives more amount that his capital account balance, he should be required to pay tax as gain accrues in his hands. Does the legislature intends to put this tax obligation in the hands of specified entity qua the new Section 45(4)? Or Is this taxation event wrongly placed under the head 'capital gains'. There is no clarity in this aspect. It is important to note that the specified entity is paying and not receiving to be under obligation to tax except because of the obligation under Section 45(4).

- Keeping the above at the bay, let us proceed to examine other issues arising from interpretation of Section 45(4). To recap, the profits/gains arising from allotting of capital asset or stock in trade would be deemed to be income of the specified entity and the entity is required to pay tax on the same in terms of Section 9B. The role of Section 45(4) is not to tax the same transaction but to tax the excess amount over the capital account balances.

- The next aspect is determination of the excess amount over the capital account balances. The sub-section states that tax is payable B + C – D. The 'B' is defined to mean that value of money received by the specified person from the specified entity on the date of receipt. The 'C' is defined to mean the amount of fair market value of capital asset received by the specified person on the date of its receipt. The 'D' is defined to mean the balance in capital account (represented in any manner) of the specified person in books of account of specified entity at the time of its reconstitution. As stated earlier, the proviso to the said sub-section states that balance in the capital account is to be calculated without taking into account the increase in the capital account due to revaluation of any asset or due to self-generated goodwill or any other self-generated asset.

- From the above, it is evident that the specified entity in the year in which the specified person receives money or capital asset as a result of reconstitution of the specified entity, has to pay tax on difference of the fair market value of capital asset and money and amount lying in the capital account of the specified person at the time of reconstitution. The capital account should be free from all the increases from revaluation of asset or self-generated good will or other self-generated asset. The difference, if positive, the same is taxable under the head 'capital gains' and if negative, ignored for the purposes of taxation. In other words, the law does not recognize any loss and taxes only the profit.

- The said sub-section is silent about the instances, where for example, the retiring partner is in receipt of stock in trade. It appears that eh same is not covered in the ambit of Section 45(4). However, the firm continue to be taxable under the head 'profits and gains from business or profession', since in such cases, the provisions of Section 9B are applicable. However, it is important to note that money paid on dissolution is not covered either under Section 9B or Section 45(4), since the former deals only with capital asset or stock in trade and the latter deals only with reconstitution.

- The below table gives a quick understanding on the obligations in different events and settlement thereof.

				Settlement by way of allotment of	
Event	**Section 9B**	**Section 45(4)**	**Money**	**Capital Asset (CG)**	**SIT (PGBP)**
Dissolution	Covered	Not Covered	-	9B	9B
Reconstitution	Covered	Covered	45(4)	9B and 45(4)	9B and 45(4)

- Further, the phrase 'money' is neither defined under the Act nor under the Section 45(4). It simply states that *'if any specified person receives any money or capital asset or both'*. However, while computing the value in the formula provided, it states that *'value of any money received by a specified person'*. From the above, there is a possibility for interpreting the phrase 'money'.

- One line of interpretation would be that the word 'money' cannot be interpreted to mean cash or amount paid through bank alone and include all other assets which can be readily convertible into money, namely stock in trade, debtors and other similar items. For example, let us say, the value of capital balance is Rs 150 and against to such amount, the partner is paid Rs 180. The said payment instead of happening entirely in cash, let us assume, has been made Rs 100 in cash (including bank), Rs 50 through transfer of debtors and stock in trade of Rs 30.

- In this scenario, if one considers amount received in cash as receipt of money, Rs 100 would be the value of money received by such person. However, such person actually has received Rs. 180 against the capital balance of Rs.150. Considering the intention behind the insertion of new section 45(4), one may argue that not alone cash/money but liquid assets should also be considered.

- However, one may argue that since 'money' was only specifically spelt out in Section 45(4), there cannot be inclusion of any other assets. This is especially when the Section 9B specifically talks about stock in trade and its absence in Section 45(4) cannot be read into. Also, on a similar footing, whenever the legislature wants to include the same, it has specifically mentioned such inclusion, for example as in the case of Section 56(2)(x).

- Further, in continuation to above, one may add another line of argument that in cases where the specified person is paid in other assets instead of money, the excess amount over the capital balance may be taxed in his hand instead of specified entity. This is also not clear and has to be answered in the coming days.

- In our view, the value of money stands only to be included, since the Section 45(4) does not ask to add other kind of liquid assets. The settlement in stock in trade would be captured under Section 9B and the settlement in debtors (as stated above) may be taxed in hands of the specified person instead of specified entity and the settlement in money is taxed in the hands of specified entity in terms of Section 45(4). The replacement of 'capital asset' with 'other asset' as appeared in the Finance Bill, 2021 would have made our lives much easier. May be, that is for the coming days. We need to await and see.

- Now, with the above understanding, let us take some case studies to dig further and to understand the practical aspects of the sections.

Case Studies:

- The above Section 9B and Section 45(4) have to be applied in the right manner. As stated earlier, Section 9B is applicable in a situation of receipt of capital asset or stock in trade when there is a reconstitution or dissolution of a specified entity. However, Section 45(4) is applicable in a situation of receipt of capital asset or money when there is a reconstitution of a specified entity. Undoubtedly, on a conjoint reading, lot of confusion would arise.

- In order to understand the above two sections, let us break the provisions into two parts. Part I is with regard to reconstitution of a specified entity and Part II with regards to dissolution of a specified entity.

Part I: Reconstitution of Specified Entity:

- As stated earlier, at the time reconstitution of a specified entity, both Section 9B as well as Section 45(4) would be applicable. Let us proceed to understand the operation of Section 9B and Section 45(4) at the time of reconstitution of specified entity.

- First, we shall proceed to understand the provisions of Section 9B at the time of reconstitution of a specified entity. Section 9B states that where any specified person receives ***any capital asset or stock in trade*** at the time of reconstitution (dissolution will be dealt in Part II) of any specified entity, such receipt of capital asset or stock in trade would be considered as transfer of capital asset or stock in trade by a specified entity in the normal course of a business.

- In other words, Section 9B requires that, in the above situation, income of a specified entity shall be computed as if such entity has transacted with outside person. Accordingly, specified entity is liable to pay tax on capital gains or business profits under Section 45 or Section 28 of the Act, as the case may be.

- With the above analysis, let us proceed to analyse the provisions of Section 45(4) at the time of reconstitution of a specified entity. Section 45(4) states that when any specified person receives any capital asset or money at the time of reconstitution from any specified entity, such receipt of capital asset or money would deemed to be considered as capital gains in the hands of specified entity.

- However, computation of capital gains under Section 9B is different from that of new Section 45(4). The computation mechanism under provisions of Section 9B is same as old Section 45(4) qua transfers of capital assets. Whereas new Section 45(4) has been enacted through the Finance Act, 2021 in order to tax the excess amounts over capital account balances (may be referred as to goodwill) of a specified person who retires from the specified entity.

- When any retiring person receives any consideration namely, capital asset or money in excess of the balance in the capital account of specified person, such excess amount would be considered as capital gains in the hands of specified entity under Section 45(4). Further, while computing the balance in the capital account, self-generated goodwill should not be considered.

- Let us understand the above provisions by way of an example. M/s ABC Firm has three partners, Mr A, Mr B and Mr C formed on January 01, 2021. The balance sheet of the firm as on 1st July 2021 is as follows:

Particulars		Amount	Particulars		Amount
Capital Accounts			**Immovable Properties**		
Mr A	100		Land P	70	
Mr B	100		Land Q	80	
Mr C	100	300	Land R	100	250
Unsecured Loans		150	Stock in Trade		200
Provisions		100	Cash in Hand		30
			Other Current Assets		70
Total		550	Total		550

- During the year, Mr A wishes to retire from the firm. So, three partners agreed to revalue the assets as on the date for the purpose payment of capital balance to Mr A. The revaluation profits have been transferred to partners' capital account. The balance sheet of the firm subsequent to the revaluation is as follows:

Particulars		Amount	Particulars		Amount
Capital Accounts			**Immovable Properties**		
Mr A	140		Land P	100	
Mr B	140		Land Q	120	
Mr C	140	420	Land R	150	370
Unsecured Loans		150	Stock in Trade		200
Provisions		100	Cash in Hand		30
			Other Current Asset		70
Total		670	Total		670

- As the capital balance of Mr A stood at Rs. 140, it has been agreed to pay the capital balance to Mr A in the following possible options:

Settlement	**Option – 1**	**Option – 2**
Land P		100
Stock in Trade		20
Cash[3]	140	20
Total	140	140

[3] **As firm does not have enough cash balance, it would transfer Land P and stock in trade to third person to realise cash**

From the above example, let us compute the tax payable under Section 9B and Section 45(4) under both the options.

Option – 1:
Computation under Section 9B:

- In this option, as retiring partner is receiving cash alone, provisions of Section 9B would not be applicable.

- However, as the capital asset being Land P and stock in trade have been transferred to third parties, income of the firm has to be computed under the normal provisions of the Act. As the land is held for a period less than 2 years, it would be considered as short-term capital asset.

- Accordingly, the specified entity would have paid tax on the gain of Rs 30 (100 – 70 being the cost of acquisition), assuming the margin on stock in trade is 50% and tax rate applicable at 25%, the profit that would be remaining for distribution is Rs 30, which would be transferred to resultant[4] partner's capital account in the agreed proportion.

Computation of Capital Gains under Section 45(4):

- Now, let us proceed to compute the capital gains under Section 45(4). As stated earlier, for the purpose of computation of capital gains, the formula prescribed section 45(4) needs to be applied, A = B + C – D

Item	Description	Scenario 1	Scenario 2
B	value of any money received by the specified person	140	140
C	amount of fair market value of the capital asset received by the specified person	-	-
D	amount of balance in capital account without considering revaluation profit	100	110
A = B+C-D	Income Chargeable under Capital Gains in hands of Specified Entity	40	30
Tax	Tax @ 25%	10	7.5

- As evident from the table above, in Scenario 1, the capital balance appears as Rs 100 and in Scenario 2, Rs 110. The common thing in both the scenarios is removal of revaluation profit from the capital account balance. Since the capital account balance is Rs 140 and the profits arising from revaluation is Rs 40, the balance would be Rs 100. However, in Scenario 2, there is an extra balance of Rs 10 as against in Scenario 1. The rationale behind the extra balance of Rs 10 in Scenario 2 is explained as under.

- The guidelines issued by CBDT asks the capital gains arising from deemed transfer of capital assets (profits arising from transfer of stock in trade too) to the retiring partner to all the partners including the retiring partner. As stated above, the profits after tax of Rs 30 is to be distributed to all the partners including retiring partner. Hence, the capital account balance of Mr A would be Rs 110 [Rs 100 + Rs 10].

- However, the addition of Rs 10 appears to be reasonable only if it is assumed that the deemed transfer takes place prior to the retirement of partner. Let us say, in a case, where Mr A is agreed to be paid Rs 140 and the same is settled by way of allotting an asset after a period of 6 months, then distribution of profit to the retiring partner would look like putting the clock back. As of now, it is not clear, whether the guideline is applicable only in cases, where the settlement is done immediately prior to retirement. We need to wait and see the development in this connection.

[4] The issue, whether the profit has to be shared only to the resultant partners or all the partners including retiring partner is dealt at the time of dealing with Section 45(4).

Option 2:

Computation under Section 9B:

- In this option, as retiring partner is receiving capital asset and stock in trade, by invoking Section 9B, capital gains and PGBP has to be computed as per the normal provisions of the Act. Considering the same numbers as taken in Option 1, the profits after tax would be Rs 30.

- Subsequent to the payment of tax, net profit of Rs 30 would be transferred to resultant[5] partners account in the agreed proportion.

Computation of Capital Gains under Section 45(4):

- Now, we shall proceed to compute the capital gains under Section 45(4). As stated earlier, for the purpose of computation of capital gains, the formula prescribed Section 45(4) needs to be applied, A = B + C – D.

Item	Description	Scenario 1		Scenario 2	
		View 1	View 2	View 1	View 2
B	value of any money received by the specified person	40	20	40	20
C	amount of fair market value of the capital asset received by specified person	100	100	100	100
D	amount of balance in capital account without considering revaluation profit	100	100	110	110
A = B+C-D	Income Chargeable under Capital Gains in hands of Specified Entity	40	20	30	10
Tax	Tax @ 25%	10	5	7.5	2.5

- Scenario 1 deals with taking the capital account balance only be removing the revaluation profit and not adding up the profit in terms of Section 9B. Whereas, Scenario 2 deals with the determination of capital account balance as per guidelines prescribed by CBDT. Under View 1, we have taken the view that the value of money includes all the amounts which are liquid in nature. Under View 2, we have taken the view that value of money is only the money received and not included other assets.

- From the above analysis, it can be concluded that Section 9B is nothing but combination of old Section 45(4) and Section 28. So, as regards to Section 9B there would not be any new additional burden on the taxpayer by the Finance Act, 2021.

- Now, let us proceed to analyse the additional burden on the taxpayer by virtue of new Section 45(4). As stated earlier, new Section 45(4) has been made in order to tax amount withdrawn by the specified person on reconstitution. In nutshell, new Section 45(4) is taxing the specified entity on revaluation of assets/recognition of self -generated assets/goodwill. In the above example, ABC has revalued assets to the extent of Rs 120 (Rs 30 on Land P, Rs 40 on Land Q and Rs 50 on Land R respectively). As the capital asset being Land P has been transferred to Mr A, it seems that an amount of income Rs 30 is doubly taxed in the hands of ABC. Once as a transfer of asset under Section 9B and second time under Section 45(4) being excess over capital account balance received by the partner.

- Hence, in order to mitigate effect of the double taxation, Section 48(iii) has been inserted so as to provided that income which is considered under Section 45(4) on account of revaluation of assets or recognition of assets shall be attributable to remaining assets of the specified entity and such amount has to be reduced while computing the capital gains of remaining assets when such assets have been transferred in future by the specified entity.

[5] As discussed above.

- In this regard, Rule 8AB has been notified for the purpose of computation of amount to be attributable to remaining assets of the specified entity. Rule 8AB provides the following procedure for attributing the amount to remaining assets:
    - Where the income considered under Section 45(4) is related to revaluation of assets or recognition of self-generated goodwill or assets, such income has to be attributed to remaining assets of the specified entity in proportionate to the increase in the value of asset to total increase in the value of all assets (total assets means assets other than the capital asset received by the specified person).
    - Where the income considered under Section 45(4) is not related to revaluation of assets or recognition of self-generated assets/goodwill, such income should not be attributed to other assets.
    - Where the income considered under Section 45(4) is related to revaluation of capital asset received by the specified person alone, such income should not be attributed to other assets of the specified entity.
- Further, it has been provided through Rule 8AB, that income considered under Section 45(4) shall relate to revaluation of assets or recognition of self-generated assets only when such revaluation/recognition is based on the valuation report obtained from a registered valuer as defined under Rule 11U(g). It is further provided that no depreciation on account increase in the value of asset shall be allowed on account of revaluation or recognition of assets of the specified entity.
- Let us understand, the attribution of income under Rule 8AB from the above example discussed. ABC firm has revalued the assets at the time of retirement of Mr. A from the firm. Rule 8AB states that income considered under Section 45(4) shall be attributable to remaining assets of the specified entity:

Capital Assets	Book Value	Revaluation Profit	Attribution of Income to Other Assets
Land P	70	30	-
Land Q	80	40	13.33 (30*40/90)
Land R	100	50	16.67 (30*50/90)

- Given the above analysis, Section 48(iii) has been inserted to mitigate the effect of double taxation by virtue of Section 45(4). The profit of Rs 30[6] would be attributed to the remaining assets and same would be reduced from the full value of consideration while computing the capital gains when such asset is transferred by the specified entity in future.
- Further, while reading of Section 45(4) for the purpose of computation of capital gains, the question that arises is whether such capital gain is short-term or long term. As discussed earlier, Section 45(4) is taxing the revaluation profits of the assets of specified entity. Hence, determination of nature of capital gains should have to depend upon on nature of assets of the specified entity which are revalued. In this regard, a new sub-rule 5 has been inserted in Rule 8AA which state that:
    - amount/part of it shall be deemed to be from transfer of short-term capital asset, if it is attributed to:
        a. capital asset which is short term capital asset at time of taxation of amount under Section 45(4).
        b. capital asset forming part of block of asset
        c. capital asset being self-generated asset/goodwill

    - the amount or a part of it shall be deemed to be from transfer of long-term capital asset or assets, if it is attributed to capital asset which is not covered by above clause and is long term capital asset at the time of taxation of amount under Section 45(4).

[6] If the interpretation that the phrase 'money' includes other liquid assets, then the profit and attribution may vary.

Part II: Dissolution of Specified Entity:

- In Part I, the tax implications under Section 9B and Section 45(4) has been discussed when there is re-constitution of a specified entity. In Part II, let us try to understand the tax implications when there is a dissolution of firm.

- Before moving forward, let us understand the difference between re-constitution and dissolution of a specified entity. Reconstitution of a specified entity to mean retirement of one or more persons or admission of one or more partner along with the old partners or change in the profit sharing. Whereas dissolution of the specified entity to mean exit of all partners by way discontinue of the business of the specified entity.

- As stated earlier, Section 45(4) has been enacted to tax the revalued profits of the specified entity. However, at the time of dissolution of the entity, there would not be any such type of revaluation of assets and hence, Section 45(4) would not be warranted. Hence, at the time of dissolution of a specified entity, specified entity needs to be computed tax under Section 9B alone.

- Let us understand the effect of Section 9B, Section 45(4) and Section 48 (iii) in the following example. Mr X, Mr Y and Mr Z have decided to purchase land in their individual capacity and have purchased the same in the following manner:

Person	Value	Sale Value (after 18 months)	Capital Gain	Tax @ 25%
Mr X	1,000	1,200	200	50
Mr Y	1,000	1,500	500	125
Mr Z	1,000	1,800	800	20
Total	3,000	4,500	1,500	375

- Now, if in the above example, instead of purchase of land in their individual capacities, three persons have decided to form a partnership firm for the purchase of lands. In such case, the following would be the situation:

Particulars		Amount	Particulars		Amount
Capital Accounts			Immovable properties		
Mr X	1,000		Land X	1,000	
Mr Y	1,000		Land Y	1,000	
Mr Z	1,000	3,000	Land Z	1,000	3,000
Total		3,000	Total		3,000

- 18 months after the formation of firm, Mr Z has decided to retire from the firm, and they have agreed to transfer Land Z to Mr Z as final settlement of capital. The revalued prices of the land as on the date of retirement of Mr Z:

Land	Book Value	Revalued Value	Increase in Value
Land X	1,000	1,200	200
Land Y	1,000	1,500	500
Land Z	1,000	1,800	800
Total	3,000	4,500	1,500

- As Mr Z is in receipt of capital asset at the time of reconstitution of the firm, Section 9B and Section 45(4) would come into play. In the first instance, capital gain under section 9B has to be computed in accordance with the provisions of the Act and FMV of such asset would be considered as full value of consideration and the tax at the rate of 25% would be Rs 200 [(1800-1000)*25%]

- Subsequent to the computation of net profits under Section 9B, such profits net-off of taxes has to be transferred to partner's capital account in their capital ratio i.e. Rs 600 (800-200) has to be transferred to partner's capital.

Person	Amount Invested	Profit on deemed transfer of Asset	Balance in Capital Account
Mr X	1,000	200	1,200
Mr Y	1,000	200	1,200
Mr Z	1,000	200	1,200[7]
Total	3,000	600	3,600

- Now, as Mr Z is receiving Land Z, capital gains under Section 45 (4) needs to be computed as under:

Item	**Description**	**Amount**
B	value of any money received by the specified person	-
C	amount of fair market value of the capital asset received by specified person	1,800
D	amount of balance in capital account without considering revaluation profit	1,200
A = B+C-D	Income Chargeable under Capital Gains in hands of Specified Entity	600
Tax	Tax @ 25%	150

- Rule 8AB states that income considered under Section 45(4) shall be attributable to remaining assets of the specified entity. The attribution of income under Section 45(4) to remaining assets of the firm is as follows:

Land	Book Value	Revalued Value	Increase in Value	Attribution of Income
Land X	1,000	1,200	200	240 (600*200/700)
Land Y	1,000	1,500	500	360 (600*300/700)
Land Z	1,000	1,800	800	-
Total	3,000	4,500	1,500	

- Subsequently, after the three months of retirement of Mr Z, the remaining partner have decided to dissolve the firm and it has been agreed between them that Land X would be given to Mr X and Land Y would be given to Mr Y.

- As partner of firm has received capital asset at the time of dissolution of firm, capital gain needs to be computed having regard to Section 9B. FMV of such would be considered as full value of consideration. Further, income as considered under Section 45(4) at the time of retirement of Mr Z needs to be reduced from the full value of consideration as per Section 48(iii) read with Rule 8AB.

Particulars	Land X	Land Y
Income from Capital Gains		
Full Value of Consideration (FMV)	1200	1500
Cost of Acquisition	1000	1000
Reduction of Income as per Section 48(iii)	240	360
Short Term Capital gains	(40)	140
Total Income	-	100
Tax @ 25%	-	25

- Further, as there is no reconstitution of the firm, Section 45(4) would not be applicable. In this case, the firm has liable to pay a total tax of Rs 375 (Rs 200 and Rs 150 on retirement of Mr Z and Rs25 on dissolution of the firm) which is same as amount paid when such lands were purchased individually.

[7] This is based on discussion we had for Scenario 1 in Option 1 for 'Computation of Capital Gains under Section 45(4)'

Conclusions – Post Amendment:

With the above in background, let us now, revisit the issues and conclusions arrived pre-amendment to analyse the current position.

Issue #	Issue	Response
Issue #1	When a firm pays certain amounts to the retiring partner, can it be said that there is a transfer from partner in favour of continuing partners?	**Position – Pre Amendment:** **View #1 – Follow Mohanbhai Pamabhai:** • By following the decision of SC in Mohanbhai Pamabhai, the retiring partner can take a stand that there exists no transfer, when he retires from the firm. **View #2 – Follow Tribhuvandas G Patel:** • If the retiring partner is settled only the credit lying in his capital account, then he can still follow View#1 and take a stand that there should not be any tax. • If the retiring partner is receiving an additional amount or lumpsum amount and there is a deed in place stating that retiring partner relinquishes his rights in assets of the firm to the continuing partners, such amounts may be taxed as capital gains. This was by following the Tribhuvandas G Patel (supra) despite it was reversed by SC. **Conclusion:** • As far as the amounts received are equivalent to credit lying in the capital account of retiring partner, there would not be any tax. The issue arises only if there is a lumpsum or additional amount. • Even in such cases, we are of the view that the judgment of SC in Mohanbhai Pamabhai still holds good even today. This is for the reason that though the ITA was amended to insert Section 45(3) and Section 45(4) to arrest the tax abuse strategies, there is no amendment to get the amounts received on retirement, which suggest that the legislature favours with the view of Mohanbhai Pamabhai. **Position – Post Amendment:** • By the replacement of earlier sub-section, with new sub-section, the legislative intent was made clear to tax the specified entity on the amounts paid or allotment of capital assets to the specified persons at the time of reconstitution. • Hence, the judgments of Mohanbhai Pamabhai and others which followed them have to give way to the new amendment and accordingly the specified entity has to pay, even in the cases where there is a retirement of partner. • The new sub-section makes it clear to tax the difference of the fair market value of asset (including money) and the balance in the capital account, by whatever name called. Hence, the balances in capital account and current account has to be clubbed and deducted from the fair market value to arrive the

		value for taxation in the hands of the specified entity. Appropriate care has to be taken that the capital and current account balances were not overstated on account of revaluation of assets or self-generated good will or asset. • From the above, it is evident that the judgments in the matter of Tribhuvandas G Patel (supra), wherein it was stated that the amounts paid in excess of capital account balances is to be brought to tax was now in a way provided legislative blessing. • The only aspect that was remaining to be addressed is that allotment of money paid at the time of dissolution. Since the said mode was not covered either under Section 9B or Section 45(4).
Issue #2	When a firm allocates certain assets to retiring partner, can it be said that there is a transfer of capital asset by such firm to the retiring partner?	**Position – Pre Amendment:** • In the above issue, we have discussed, what would be the taxability when the retiring partner is in receipt of amount. In this issue, we shall deal with taxability when the retiring partner is allotted a capital asset instead of money. • Ideally, the taxability should not be dependent upon the mode of discharge of consideration. Hence, irrespective of the fact, that retiring partner has received money or capital asset, the taxation should not change. • However, the Bombay HC in AN Naik & Associates (supra) held that allocation of capital asset to retiring partner would be taxable under Section 45(4) in the hands of the firm. The HC stated that the term ‘otherwise’ used in Section 45(4) covers ‘retirement’ because it has to be read in connection with ‘transfer’ used therein but not with ‘dissolution’. • Accordingly, the Bombay HC held that the distribution of capital asset to retiring partner is taxable in the hands of the firm. The HC has come to such conclusion keeping the intention of legislature behind insertion of Section 45(4). The Court stated that if Section 45(4) is to be interpreted only to cover the cases of ‘dissolution’, then the entire intention to get Section 45(4) goes into drain. • We are of the view that subject to our comments above, the above decision lays down a good proposition. **Position – Post Amendment:** • The view stated in Issue#1 under the ‘Position – Post Amendment’ holds good here too.
Issue #3	When a firm distributes capital assets at the time of dissolution, can it be said that there is a transfer of capital asset by such firm to the persons?	**Position – Pre Amendment:** • The SC in Malabar Fisheries Co (supra) has held that there exists no transfer when a firm dissolve. The SC stated that the firm and partners are not different and accordingly held that there

		cannot be transfer from firm to partners, when the firm dissolves. • However, this is fixed after insertion of Section 45(4). The said section was brought into the tax net only to override the above judgement. Hence, post 1988, when a firm distributes capital assets on its dissolution, the said transaction would be transfer in terms of Section 45(4) and accordingly taxable. **Position – Post Amendment:** • This is now replaced by Section 9B. Hence, any capital asset transferred by the specified entity at the time of dissolution, the transfer would be chargeable under the head 'capital gains' by virtue of Section 9B and not Section 45(4). As stated earlier, the new Section 45(4) does not cover the dissolution.
Issue #4	When a personal asset is being contributed as capital to a partnership firm in which the contributor becomes a partner, can it be said that there is a transfer of capital asset by such person to the firm?	**Position – Pre Amendment:** • The SC in Sunil Siddharathbhai (supra) has stated that when a person asset is contributed to the firm, there exists a transfer for the reason that the contributing partner loses his exclusive right in the property, which earlier he has. However, the SC stated that the amount recorded in books of the firm may not represent the true value of consideration and accordingly stated that the charge fails in absence of methodology for determination of consideration. • In order to overcome this aspect, the legislature inserted Section 45(3) treating that said transaction as transfer and consideration as the amount that was being recorded in the books of the firm. **Position – Post Amendment:** • There is no change to the above position even post amendment.

(Any doubts/issues in the article can be directed to harsha@sbsandco.com)