COMPUTATION MECHANISM U/S 9B, 45(4) & 48(iii) AND INTRICACIES THEREOF

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The partnership firm does not enjoy the status of a separate legal entity, hence the partners always had a vested interest in the partnership. Based on this principle, the Supreme Court in the case of Mohanbhai Pammabhai has held that withdrawal at the time of retirement of a partner is not taxable, since withdrawal is nothing but a vested right in the partnership. This principle was used as a tax planning tool thus, the Finance Act 2021 has amended the law by taxing any excess withdrawal by a partner beyond its capital balance.

In this article, we will understand the amended law, the interplay between sections 45(4) and 9B, attribution u/s 48(iii) and the issues arising out of the said amendment while practically applying it.

Section 45(4)

The amended Section 45(4) is applicable when a **specified person** (partner or member) **receives**, any **money or capital asset or both** from a **specified entity** (Firm, AOP or BOI) in connection with the **reconstitution** (admission, retirement or change in profit sharing ratio), then any profits/gains arising from the receipt by the specified person shall be deemed to be the income of the specified entity.

The important point here to note is :

- there is an amendment in the point of taxation, it is changed from the **date of transfer** to the **date of receipt** by the specified person
- the section primarily seeks to tax the transfer of vested right in partnership by a partner and the same is deemed to be the income in the hands of the partnership.

The profits/gains shall be determined in accordance with the following formula:

A = B+C-D, wherein:

A	income chargeable to tax in the hands 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

It provides that where the value of A is negative, its value shall be deemed to be zero. It further provides the capital balance at D should not include any amount increased on account of revaluation or self-generated goodwill or self-generated asset.

An explanation is further inserted to say that the provision of this sub-section will operate in addition to the provisions of section 9B and the taxation under both the sections will be worked out independently.

Interplay with section 9B

As Section 9B is covered in detail in separate article, we would briefly touch upon the provision of section 9B to understand the interplay between both the sections:

Section 9B is applicable when a specified person receives any capital asset or stock in trade or both from a specified entity in connection with the dissolution or reconstitution of the specified entity. The time of transfer for the specified entity will be deemed to be the day on which the asset is received by the specified person.

The following table gives a summary of the applicability of sections 45(4) and 9B, to understand the differences better:

Particulars	**Section 45(4)**	**Section 9B**
Withdrawal of money	Yes, applicable	Not Applicable
Withdrawal of Capital asset	Yes, applicable	Yes, applicable
Withdrawal of Stock in trade	Not Applicable	Yes, applicable
Reconstitution	Yes, applicable	Yes, applicable
Dissolution	Not Applicable	Yes, applicable
Charge created on	Transfer of an interest in a partnership	Transfer of capital asset or stock in trade
Deeming fiction	Deems the gain to be of partnership firm and not the partner	Deems date of transfer to be the date of receipt of the asset by a partner

As it can be seen from above, whenever the partner withdraws any capital asset on reconstitution of the firm, there is a trigger of 9B as well as section 45(4).

Let us understand the computation with the help of an example:

M/s ABC & Co.			
Liabilities	**Amount**	**Asset**	**Amount**
Capital A/c		Capital Asset 1 (FMV is Rs. 150)	90
A	50	Capital Asset 2	50
B	50	Bank	10
C	50		
Total	**150**	**Total**	**150**

M/s ABC & Co. is a partnership firm with A, B & C as its equal partners. Mr. A retires from the partnership and takes over Asset1 (which is a long term asset) whose indexed cost is 120.

Analysis:

Circular 14 of 2021 explains the calculation of 9B & 45(4) as follows:

1. Section 9B

In accordance with provision of Section 9B, it is deemed that the firm has transferred the Capital asset 1 and thus, the computation u/s 9B will be as follows:

Particulars	Amount (in Rs.)
Full value of consideration	150
Less Indexed cost	120
Long term gains on the sale of asset	30
Tax on above @ 20%*	6

(Surcharge and cess are ignored only for ease of calculation)

2. Revised Capital of retiring partner for the purpose of section 45(4) will be:

Particulars	Amount (in Rs.)
A's Capital balance	50
Add: A's share in Book Gain on sale of the asset (150-90) /3	20
Less: Share of Tax	(2)
Revised Capital Balance of Mr. A	**68**

3. Gains u/s 45(4)

Particulars	Amount (in Rs.)
Value of Money received	Nil
FMV of the asset taken over	150
Revised Capital Balance of Mr. A	(68)
Sum chargeable to tax u/s 45(4)	**82**

The amount chargeable to tax in the hands of the firm shall be Rs 30 u/s 9B and Rs 82 u/s 45(4)

Having understood the computation, let us now understand Rule 8AA(5) to evaluate whether the gain u/s 45(4) is a long term gain or short term gain:

Rule 8AA: Method of determination of the period of holding of capital assets in certain cases

Rule 8AA(5) states the amount chargeable to tax u/s 45(4) shall be **deemed to be**:

from the transfer of Short term Capital Asset (STCA), if it is attributed to	A capital asset which is a short term capital asset at the time of its taxation
	Capital asset forming a part of the block of asset
	Self-generated asset or self-generated goodwill
from the transfer of Long Term Capital Asset (LTCA), if it is attributed to	Capital Asset which is not covered in the above clause and is a long term asset at the time of its taxation

The plain reading of the section suggests that the capital gains arising on transfer of Capital asset 1 will be deemed to be from the transfer of long term capital asset.

However, there are issues regarding Rule 8AA(5) :

1. Rule 8AA r. w. Explanation 1(ii) to s. 2(42A) is primarily meant for the determination of the holding period. However, Rule 8AA(5) does not deal with the determination of the holding period and instead seeks to define directly the nature of CG. Further, while s. 2(42A) provides authority to define STCA, Rule 8AA(5) even determines gains arising from the transfer of LTCA

2. Section 45(4) was primarily enacted to tax the transfer of an interest of a partner in the partnership firm. It deems the income to be charged in the hands of the firm but it specifically doesn't describe the nature of the asset. However, Rule 8AA(5) provides to the contrary – and deems a firm to have transferred STCA or LTCA – which conflicts with fiction created by s. 45(4).

3. While the issue involves a legal subject and requires inputs from the legal fraternity, these illustrative features suggest that, as one possible view of the matter, the rule is misconceived and is prescribed without the appropriate backup authority of the law

Having understood the computation under section 9B & section 45(4), we now understand the allowability of the deemed income charged in the hands of the firm as a future cost.

Section 48(iii) r.w. Rule 8AB

S. 45(4) proceeds on basis that any distribution to a partner in excess of his capital account balance represents a share of such partner in value appreciation of capital assets retained by the firm. Such a share is taxable in hands of the firm at the stage of receipt by a partner. Once such value appreciation is taxed at the stage of retirement, s. 48(iii) r. w. Rule 8AB provides for attributing such value of appreciation to remaining capital assets of the firm (viz. other than capital assets distributed to the retiring partner), which is creditable as a reduction from sale consideration, as and when such remaining capital assets are transferred by firm post-retirement. This avoids double taxation of income.

The attribution will be as follows:

Where CG u/s 45(4) relates to	Basis of attribution
Revaluation of any capital asset (taken over by the partner)	No attribution
Revaluation of any capital asset (remaining with the firm)	CG u/s 45(4) x $\frac{\text{increase in value of capital asset}}{\text{Aggregate of increase/recognition of all assets}}$
Valuation of Self-generated assets or Self-generated goodwill	CG u/s 45(4) x $\frac{\text{recognition of value of self-generated goodwill}}{\text{Aggregate of increase/recognition of all assets}}$
Does not relate to any of above	No attribution

The rule has inserted an explanation to state that no depreciation will be allowed on the increased value or self-generated goodwill. Moreover, the attributed amount, won't qualify as cost for the purpose of indexation, thus, no indexation will be available on the said attribution

The rule further specifies the following conditions to claim the aforesaid attribution:

1. Revaluation should be based on a valuation report obtained from a valuer eligible to be appointed as a registered valuer under Wealth-tax Act, 1957
2. Firm to furnish details in Form No. 5C on or before the due date of filing the return of income.

Section 48 r.w Rule 8AA only specifies the attribution to a capital asset not forming a part of the block of asset, however, the guidelines issued by CBDT vide circular 14 of 2021 provides the relief by extending reference to capital asset forming part of the block of assets.

Thus, at the time of transfer by the firm, post-retirement, of such depreciable capital asset forming part of the block of assets, s. 45(4)CG attributed thereto is reduced from money payable (or sale consideration) and only such net amount is reduced from WDV (or charged as STCG).

Guidelines also clarify that 'actual cost' of remaining capital assets remains intact and consequently, no depreciation or indexation benefit is available on the amount so attributed.

To understand the working under Rule 8AA & 8AB we hereby take the following example:

M/s PQR& Co.			
Liabilities	**Amount**	**Asset**	**Amount**
Capital A/c		Asset 1 (FMV 600)	60
P	100	Asset 2 (FMV 900)	240
Q	100		
R	100		
Total	**300**	**Total**	**300**

Firm M/s PQR & co. has 3 equal partners. Both the assets are long term capital assets. The firm has self-generated goodwill of Rs 600. Thus, the net worth of the Firm is Rs 2100 with each partner's intrinsic interest worth Rs 700/-. Mr. P retires from the firm and his account is settled by giving him Asset 1 and cash of Rs 100. The indexed cost of Asset 1 is Rs 90

Analysis:

As already explained the computation u/s 9B will be

Particulars	Amount (in Rs.)
Full value of consideration	600
Less Indexed cost	(90)
Long term gains on the sale of asset	510
Tax on above @ 20%*	102

(Note: Surcharge and cess are ignored only for ease of calculation)

Revised Capital of retiring partner for the purpose of section 45(4) will be:

Particulars	Amount (in Rs.)
P's Capital balance	100
Add: P's share in Book Gain on sale of the asset (600-60) /3	180
Less: Share of Tax	(34)
Revised Capital Balance of Mr. A	**246**

Gains *u/s 45(4)*

Particulars	Amount (in Rs.)
Value of Money received	100
FMV of the asset taken over	600
Revised Capital Balance of Mr. A	(246)
Sum chargeable to tax u/s 45(4)	**454**

As per s. 48(iii) r. w. Rule 8AB, s. 45(4) CG of Rs 454 is attributed as follows:

Where CG Relates to	Basis of Attribution	Amount
Asset 1 – Taken over by partner	No attribution	Nil
Revaluation of Asset 2 (900-240 = 660)	$454 \times \frac{600}{(660+600)}$	216
Valuation of self-generated goodwill	$454 \times \frac{600}{(660+600)}$	216

An important point to note is that the Rule states increase/recognition of **<u>all assets</u>** needs to be considered in the denominator. Thus, a question here arises whether the increase in revaluation of Asset 1 also needs to be considered? If the same is considered, the attribution will get further diluted, thus defeating the purpose of avoiding double taxation. Though the reading of rules gives ambiguity, the guidelines issued under the aforementioned circular ignores the revaluation of the asset taken over by the partner as a part of the denominator. Though circular is going beyond section, it is benefiting the tax payers. The said circular will be binding on the department and the benefit of ignoring the increased revaluation of the asset taken over by a partner can be taken.

As per Rule 8AA(5), S 45(4) capital gains of Rs 454 shall be classified as STCG & LTCG as follows:

45(4) Gains attributable to	**Amount attributes as per Rule 8AB**	**Nature of Gain**
Asset 2	238	LTCG
Self-Generated Goodwill	216	STCG

Further, assuming Asset 2 is sold in future years at Rs 1000/- and the indexed cost of Asset (ignoring step-up cost u/s 48(iii)) is Rs.300/- The Capital gains will be computed as follows:

Particulars	**Amount (in Rs.)**
Sale Consideration	1000
Less: Step up cost u/s 48(iii)	(238)
Less: Indexed Cost	(300)
LTCG	462

Having understood the preliminary scope and operation of section 9B, 45(4), 48(iii) and Rule 8AA & 8AB we hereby understand some of the issues:

1. Gains arising on recognition of self-generated Goodwill deemed to be short term

S. 45(4) CG attributable to self-generated goodwill/asset is deemed as STCG, even if such self-generated goodwill/asset is held for more than 3 years by the firm. The rationale for the same is unclear.

2. Subsequent transfer of goodwill

If s. 45(4) Capital Gains pertains to self-generated goodwill/asset, the firm gets relief only at the time of sale of such goodwill/asset in the future as a standalone capital asset, which, in most cases, is an unlikely event. In event of the sale of such goodwill/ asset as a part of a slump sale, then the subject matter of transfer is an undertaking and not goodwill as a standalone capital asset, there is no clarity whether s. 45(4) CG attributed to self-generated goodwill/asset can be reduced while computing CG from slump sale.

3. Subsequent transfer of the remaining asset in the firm being a tax-neutral transfer

For all practical purposes, the amount attributed u/s. 48(iii) to remaining capital assets of the firm remains in abeyance and can be activated only upon transfer thereof by the firm in the future. If the firm transfers such remaining capital assets as tax-neutral transfer (say, by way of gift or conversion under Chapter XXI of Companies Act, 2013), difficulty may arise in claiming the benefit of s. 48(iii):

- Since the transaction is tax neutral transfer in the hands of the firm, the firm may not be able to claim the benefit
- The successor of the firm (who acquires such assets through tax-neutral transfer) may need to cross the hurdle of the restrictive scope of s. 48(iii), which apparently grants benefit only where the transfer is "by the specified entity" itself i.e. firm, and not by the successor.

4. When Stock in trade and capital asset both are taken over by the retiring partner

To understand the issue, let us take an example as follows:

M/s XYZ& Co.			
Liabilities	**Amount**	**Asset**	**Amount**
Capital A/c		Asset 1 (FMV 600)	300
X	500	Asset 2 (FMV 1200)	900
Y	500	Stock in trade (FMV 600)	300
Z	500		
Total	**1500**	**Total**	**1500**

Firm M/s XYZ& co. has 3 equal partners. Both the assets are long term capital assets. Thus, the net worth of the Firm is Rs 2400 with each partner's intrinsic interest worth Rs 800/-. Mr. X retires from the firm and his account is settled by giving him Asset 1 and 1/3rd of stock in trade. The indexed cost of Asset 1 is Rs 450

Analysis:

As already explained the computation u/s 9B will be

Particulars	Amount (in Rs.)
Full value of consideration	600
Less: Indexed cost	450
Long term gains on the sale of asset – I	**150**
Tax on above @ 20%*	30
#FMV of Transfer of Stock in trade	200
#Less: Cost	100
#Business profits on above – II	**100**
#Tax on above @ 30%*	30

(*Note: Surcharge and cess are ignored only for ease of calculation)

#The guidelines issued are silent on the treatment, in cases where stock in trade is taken over. Explicit guidelines with regard to the treatment of stock in transfer are expected from CBDT. There are two views possible w.r.t to it consideration while calculating the revised capital:

One can say that double taxation is only with respect to the capital asset being transferred since the same is taxable u/s 9B and 45(4). Thus, the gains only with respect to the transfer of capital asset ought to be adjusted in the partner capital balance.

On the contrary, one can state that the section clearly mentions 'amount standing to the credit of the partner capital' means after considering all the profits/gains/losses till the date of retirement. Moreover, the analogy prescribed in the circular states that '*This exercise is required to be carried out since section 9B of the Act mandates that it is to be deemed that the firm has transferred the asset to partner".* Thus, the distribution of share business profit should be allowed to avoid double taxation without any dilution.

Thus, Rs 150 will be taxable under the head capital gains and Rs 100 will be taxable under the head business and profession.

Based on the above analogy, the Revised Capital of retiring partner for the purpose of section 45(4) will be:

Particulars	Considering credit of profit on transfer of stock in trade	Not considering credit of profit on transfer of stock in trade
X's Capital balance	500	500
Add: X's share in Book Gain on sale of the asset (600-300) /3	100	100
Less: Share of tax on LTCG	(10)	(10)
Add: Share of Profit & loss on the transfer of stock in trade (200-100)/3	33	-
Less: Share of tax on business profits	(10)	-
Revised Capital Balance of Mr. A	**613**	**590**

Gains u/s 45(4)

Particulars	Considering credit of profit on transfer of stock in trade	Not considering credit of profit on transfer of stock in trade
Value of Money received	Nil	Nil
FMV of the asset taken over	600	600
Revised Capital Balance of Mr. A	(613)	(590)
Sum chargeable to tax u/s 45(4)	**(13)**	**10**

In the first scenario, the capital gains u/s 45(4) will be deemed to be nil. Hence no further attribution is required u/s 48(iii).

In second scenario, as per s. 48(iii) r. w. Rule 8AB, s. 45(4) CG of Rs 10 is attributed as follows:

Where CG Relates to	Basis of Attribution	Amount
Asset 1 – Taken over by partner	No attribution	Nil
Revaluation of Asset 2 (1200-900 = 300)	$10 \times \frac{300}{(300+300^{**})}$	5
Revaluation of Stock in Trade (600-300 = 300)	Not Applicable	???

Note: Rule 8AB states that the **numerator will be an increase in or recognition of the **capital asset,** however, the **denominator** will be an increase in or recognition of the value of **all assets.**

The term 'all assets' is not clearly defined, it can have 2 interpretations:

- Literal interpretation: It includes all assets including current assets
- Other view is that the rule speaks of only capital asset, self-generated goodwill, or any self-generated asset, thus the denominator should also be an aggregate of only those assets.

However, the rule further states that if the CG u/s 45 is not on account of revaluation of a capital asset or self-generated asset/goodwill, no amount shall be attributable to any capital asset. In our example the CG u/s 45 is also on account of the revaluation of stock in trade, hence its attribution cannot be made to Asset 1.

Since the provision of section48(iii) is not applicable in the case of stock in trade, as seen from the above, the tax paid on the transfer of stock in trade is not allowed as a step-up cost.

Further, as per Rule 8AA(5), S 45(4) capital gains of Rs 10, in the second scenario, shall be classified as STCG & LTCG as follows:

45(4) Gains attributable to	Amount attributes as per Rule 8AB	Nature of Gain
Asset 2	5	LTCG
Stock in trade	???	???

Since stock in trade is not a capital asset, it is not possible to decide the nature of capital gain. Can it be said that the computation mechanism fails, by applying the law laid down by the Honourable Supreme Court in case of B. C. Srinivasa Setty 128 ITR 294?

A similar situation will arise when there is a takeover of agricultural land by a partner on his retirement since agricultural land is not a capital asset as per section 2(14).

5. What if there is a decrease on account of revaluation?

Rule 8AB only mentions "increase in or recognition of capital asset' hereby implying that only upward revaluation ought to be considered while the downward revaluations are to be ignored. Thus, in cases where there is an increase in the revaluation of only 1 asset and that asset is taken over by the partner, no attribution will be allowed.

6. What about the revaluation of liabilities?

Section 45(4) only states to compute capital balance without considering the amount of **increase** in any asset or recognition of self-generated goodwill. Thus, following the analogy as stated in the point before, the capital balance can include a decrease in the revaluation of liabilities.

For the purpose of attribution under rule 8AB, in case the CG u/s 45(4) is on account of decrease in revaluation of liabilities, a similar situation will arise as stated in **Issue 4.**Further, the nature of capital gains is also not ascertainable as envisaged in Issue 4

7. What if the partner is retired based on the DCF method of valuation?

Where the retiring partner is paid cash on basis of the DCF method or an ad-hoc valuation, and the firm does not obtain any valuation report from an approved valuer, it is not possible to apply Rule 8AA(5).

8. Whether one can claim deduction u/s 54EC in case the asset transferred is a long term capital asset?

The Supreme court in the case of Dempo Company Ltd. [2016] 74 taxmann.com 15, approved Bombay HC's decision in the case of ACE Builders (P.)Ltd. [2006] 281 ITR 210 which granted deduction u/s. 54E on CG computed u/s.50 from the sale of LTCA being a depreciable asset, for the following reasons

- Deeming fiction in s.50is confined only to s.48 and 49 – and does not apply to other provisions of the act such as s.54E, which makes no distinction between depreciable and non-depreciable assets.
- Fiction in s.50 deems CG as STCG and does not convert depreciable asset which is LTCA into STCA.

Rule 8AA(5) employs phrase which is similar to s. 50, and states that s.45(4) CG attributable to depreciable assets "shall be deemed to be from the transfer of STCA". Is such deeming fiction limited only to the characterisation of CG for purpose of s. 45(4), which has the impact of denial of indexation benefit?

The fiction of STCG in relation to CG u/s. 45(4) is created via Rule 8AA(5). The legal validity of Rule 8AA(5) is in question since it is going beyond the scope of section 2(42A). However, assuming the said rule is valid, such rule is notified under the authority of s. 2(42A) which defines STCA for the entire act. Unlike in the case of s.50- which merely overrides s.48/49, the fiction of Rule 8AA(5) r. w. s. 2(42A) is created at the very root of the definition of STCA. Capital gains so computed will therefore be STCG for all provisions of the Act. There is no requirement thereafter, to examine the nature of capital asset every time while examining different provisions of the Act such as s. 74, 112, etc. Consequently, the ratio of SC decision will have no applicability to capital gains computed under s. 45(4) r.w. Rule 8AA(5).

9. Is tax u/s. 45(4) triggered in the event of a partner retiring from the firm, or upon actual receipt from the firm?

Assume, a partner retires in March 2022and his account is settled in March 2024by cash payment from the firm. Whether s. 45(4) is triggered in hands of the firm in FY 2021-22 (viz. year of retirement) or FY 2023-24 (viz. year of actual receipt)?

As per one view, s. 45(4) is triggered in FY 2021-22. As per the Indian Partnership Act as also u/s. 24(5) of the LLP Act, immediately upon retirement, a debt (viz. right to receive) is determined in favour of the retiring partner, representing the value of his share in the firm's assets. Determination of such a debt due to the partner in lieu of extinguishment of his partnership interest is a constructive receipt, which triggers s. 45(4) in hands of the firm immediately.

Another view is that s. 45(4) is triggered in FY 2023-24 viz. on actual receipt; S. 45(4) refers to 'received' which is different than 'receivable'. Wherever Legislature desired to capture receipt on the accrual basis, it has consciously employed 'receivable' or 'due to' or 'repayable' (Example: Refer TDS provisions). The Hon'ble Supreme Court in the case of **Moon Mills Ltd.(1966) (59 ITR 574)** dealt with the balancing charge provision in the 1922Act which provided for taxation of insurance money "received". The Hon'ble Supreme Court held that the balancing charge was fictional in the business chapter, and such fiction cannot be extended beyond what was clearly contemplated therein. SC did not attribute the word 'received' as an equivalent to 'receivable', and SC upheld taxation in the year of actual receipt, despite the taxpayer having adopted the mercantile method of accounting and insurance compensation shown as receivable in books. Also, fact that other aspects of the business chapter were computed as per the mercantile method was regarded as irrelevant by SC while dealing with the fictional provision relating to balancing charge which was based on actual receipt.

The issue is fact-specific. The Honourable supreme court in the case of Standard Triumph Motor Co. Ltd. [1993] 67 Taxman 160 held that the time of receipt depends upon when funds are made available by the firm at disposal of the retiring partner. In the present case, if the retiring partner had an unfettered right to withdraw funds in FY 2021-22 itself, the mere fact that he chose to withdraw funds only in FY 2023-24 may not arguably defer taxability u/s. 45(4). On other hand, where terms of the partnership deed suggest that partner could have withdrawn funds only in FY 2023-24, arguably, s. 45(4) may trigger only in FY2023-24.

10. Where retiring partner's account is settled by the firm over a period, in instalments

To illustrate, the partner retires in year 1, and his capital balance at the time of retirement is 3 Lakhs. His share of 10 Lakhs is settled in 2 equal instalments, 5 Lakhs paid in year 1 and the balance 5 Lakhs paid in a year. As per the partnership deed, such a partner could not have withdrawn funds at any point of time prior to actual receipt from the firm in years 1 and 2.

An open issue could be, whether s.45(4)can be defended in year 2 on the ground that the person is not at all a 'specified person' in year 2 since he ceased to be a partner in year 1 itself? Definition of 'specified person' in s. 9B refers to a person who 'is' a partner of a firm in 'any previous year'.

Another issue could be, whether component D of the formula in s. 45(4)(representing partner's capital account balance) can be deducted twice over years 1 and 2? A better view appears to be that, the aggregate deduction of component D across years 1 and 2cannot exceed the partner's capital balance at the time of retirement. Permitting deductions at every instalment would result in duplicated deduction, which is not permitted in law unless specifically provided. In the above facts, component D of 3 Lakh once reckoned while computing CG u/s. 45(4) in year 1, cannot be reckoned again in year 2

11. Whether s. 45(4) is prospective or retroactive?

S. 45(4) is applicable from AY 2021-22. Assume, the partner retired prior to the introduction of s. 45(4) - say, on 31March 2020 and cash payable to him on retirement from the firm got crystallised prior to 31 March 2020, but such cash is actually received by him only after1 April 2020 - is charge u/s. 45(4) triggered?

In one view, s. 45(4) should be given a retroactive effect and applies to every receipt post 1 April 2020 even where reconstitution or part receipt would have happened before 1 April 2020. S. 45(4) is a deeming fiction linked to receipt-based taxation, along the lines of s. 45(1A) and 46(2). Fact that reconstitution may have occurred prior to 1 April 2020 does not dilute deemed taxability linked to the event of receipt. Also, s. 45(4) does not grandfather past reconstitution; unlike other amendments in Act. Also, s. 46(2) has been applied in respect of distributions by liquidator post 1 April1961, while earlier distributions were exempt.

As another view (which appears to be defensible), s. 45(4) should NOT be given a retroactive effect and is inapplicable to receipts post 1 April2020 where reconstitution happened before 1 April 2020. Reconstitution is defined as where a person “ceases” to be a partner of a firm - emphasis on 'ceases' supports that cessation needs to occur only after new provisions are introduced on statute – where cessation is before 1 April 2020, there is no 'reconstitution', and hence, s. 45(4) is inapplicable. Further, terms such as 'specified person' and 'specified entity' are coined by statute for the first time post 1 April 2020.It would be incorrect to attribute such terminologies to past transactions carried out when such concepts never existed on statute. Also, to attract charge u/s. 45(4), there has to be 'profits or gains' from receipt in hands of a partner is necessary. In the present case, the retiring partner's entitlement stood determined prior to 1 April 2020, receipt post 1 April 2020 does not yield any 'profits or gains' – rather, it is the realisation of pre-existing right or debt. In the commercial sense, no 'profits or gains' were made by the partner post 1 April 2020. To attract tax u/s. 45(4), receipt post 1 April 2020 should lead to income or enrichment of partner. Also, a specific provision along the lines of Explanation to s. 45(5) is needed to cover past reconstitutions into the ambit of s. 45(4). Also, a comparison with s. 46(2) under the alternative view is inappropriate since the liquidation of the company is a continuing event while retirement/ reconstitution is a snapshot event. Further, in liquidation, there is unlikely to be any prior debt realised by a shareholder from the company.

12. Impact of partner's capital account having a negative balance

The formula as prescribed u/s 45(4) of A=B+C-D, where D represents the balance in the capital account of the partner (represented in any manner). The issue is whether component D, being a negative figure, can be assumed as zero, or, should be considered as a negative figure to effectively increase CG?

Mumbai Tribunal (SB) decision of Summit Securities Ltd. [2012] 19taxmann.com 102 held that, though negative net worth of the undertaking, if 'deducted' as cost of acquisition in terms of s. 50B, effectively leads to an addition to the full value of sale consideration, the same needs consideration and cannot be assumed as nil. Considering the ratio of such a decision, it is possible to argue in the context of component D that negative capital balance may effectively lead to an increase in component A thus same needs to be considered.

In defence, an argument that tax payers may like to raise is that component D can only mean a positive figure since the language of s.45(4) defines component D as “balance in the capital account”, and “balance” always refers to a positive figure and cannot envisage a negative figure. As a counter to such argument, the tax authority may suggest that as per the SC decision in the case of J. K. Industries vs. UOI [2007] 165 Taxman 323, words of accounting language used in a statute should be interpreted as understood in accounting practice – and hence, expression “balance” should be interpreted in an accounting sense, to mean either a positive figure (in case of credit balance) or a negative figure (in case of debit balance).

13. Impact of retirement at book value

Assume, the retiring partner's account is settled at book value which is equivalent to his capital balance, and such settlement is as per long-standing terms of the partnership deed.

Arguably, such a settlement may not have any adverse implications u/s. 45(4) as there is no excess over capital balance and such settlement merely reflects working out of pre-existing rights.

In a different scenario, assume, there is retirement where the partner retires by receiving only his capital balance and nothing in excess thereof – despite there being a higher entitlement basis partnership deed.

Arguably, actual receipt by a partner from the firm is relevant - s. 45(4) does not have any deeming fiction for taxation w. r. t. the fair value of partnership interest.

However, s. 56(2)(x) implications in hands of continuing partners (which are enriched on account of lower payment to retiring partner) may require evaluation.

Conclusion:

There can be ample conditions and situations based on which the computation mechanism can be affected. The new proposition has created ambiguity in many aspects if practically applied like constitutional validity, failure of computation mechanism, etc. thereby opening doors for litigation. Proper guidelines and amendment in current law is required to clear the ambiguity.