AMENDMENTS PERTAINING TO PARTNERSHIP FIRM VIDE FINANCE ACT, 2021

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A. Background

- Under the Income-tax Act, 1961 ('**IT Act**'), a partnership firm is considered to be a separate taxable entity as compared to its partners. Further, profits and gains of a partnership firm are taxable at the firm level and any distribution to partners is exempt under section 10(2A) of the IT Act.

- However, under the Partnership Act, 1932 ('PA'), partnership has been defined as a relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. Further, a partnership firm[1] is not a separate legal entity as compared to a company registered under the Companies Act. Accordingly, any property / asset held by a partnership firm is legally owned by all partners of the firm (jointly and severally).

- On account of the above difference between the IT Act and the PA, provisions under the IT Act pertaining to partnership firm have evolved over time.

B. Legislative History

- Prior to Financial Year ('**FY**') 1987-88, any distribution of capital assets on dissolution of firm was not regarded as a transfer under section 47(ii) of the IT Act and hence such a transaction was exempt from capital gains tax. This exemption was provided since partnership firm was not considered as a separate legal entity and all partners of the partnership firm had a joint or common interest in all properties/ assets of the firm (since partnership firm did not legally own any property/ asset).

- Accordingly, as a tax planning exercise, it was possible to convert partnership assets into individual assets without paying any capital gains tax on such transfers.

- To fix this loophole, the Legislature introduced section 45(4) in the IT Act *vide* Finance Act, 1987. As per the newly introduced section 45(4) of the IT Act, capital gains tax was payable by the partnership firm on distribution of capital assets to its partners either upon dissolution or otherwise. Consequently, exemptions under section 47(ii) of the IT Act were omitted.

- However, the new provision under section 45(4) of the IT Act ended up resulting in long-drawn litigation between the tax payers and the department, especially on the manner in which the term 'otherwise' should be interpreted (whether the term 'otherwise' would include retirement of partner or change in the profit sharing ratio?). Further, the judicial precedents on this issue were inconsistent.

- Further, this section was applicable only on distribution of capital assets and not on distribution of money or any other asset (other than capital asset) to partners even if such distribution was in excess of the balance lying in the capital account of the respective partner.

- On account of the above limitations, it was possible for tax payers to structure their transactions in

[1] *Excluding a Limited Liability Partnership ('**LLP**')*

such a manner that the erstwhile section 45(4) of IT Act would fall short to tax such transaction.

- For better understanding, illustrations covering the below scenarios have been provided in **Annexure 1**.

  i) Transfer of property / assets by using partnership as a holding vehicle

  ii) Retirement of one of the partners basis revaluation of Properties / Assets

  Having discussed the ambiguity / loopholes in the existing provisions, we shall now discuss the amendments introduced vide Finance Act, 2021

C. Amendments introduced vide Finance Act, 2021

- The Finance Act, 2021 has made substantial amendments to the tax laws governing partnership firms by way of insertion of new section 9B, substitution of existing section 45(4) and amendment to section 48 of the IT Act with retrospective effect from FY 2020-21.

- The Finance Act, 2021 proposed to rationalize the provisions of transfer of capital asset to partner on dissolution or reconstitution. The extract from the Memorandum to Finance Bill, 2021 is reproduced below:

  "It has been noticed that there is uncertainty regarding applicability of provisions of aforesaid sub-section [45(4) of the IT Act] to a situation where assets are revalued or self-generated assets are recorded in the books of accounts and payment is made to partner or member which is in excess of his capital contribution."

- Accordingly, section 45(4) of the IT Act was substituted for a new section which is applicable where a partner[2] receives any capital asset or money from a partnership firm[3] which is in excess of his capital balance at the time of reconstitution of the firm.

- Further, section 9B of the IT Act was introduced directly in the Finance Act, 2021passed by the Indian Parliament on 24 March 2022(without any reference in the Finance Bill, 2021) and hence there is no specific explanation provided for introduction of this section in the Memorandum to Finance Act, 2021. Also, there were considerable modifications in language of the revised section 45(4) of the IT Act in the Finance Act, 2021 as compared to the language provided in the Finance Bill, 2021.

- Nonetheless, the explanation provided in the Memorandum to Finance Bill, 2021 i.e. 'Rationalization of provision of transfer of capital asset to partner on dissolution or reconstitution' should act as a guiding principle while interpreting the provisions of newly inserted section 9B, substituted section 45(4) and amended section 48 of the IT Act.

[2] *The amendment defines the term 'specified person' as a person who is a partner in a firm or a member of other Association of Person ('**AOP**') or Body of individuals ('**BOI**'). However, for sake of simplicity, term 'partner' has been referred in the article*

[3] *The amendment defines the term 'specified entity' as a firm or AOP or BOI. However, for sake of simplicity, the term firm has been referred in the article*

Section 9B of the IT Act- Income on receipt of capital asset or stock in trade

- Section 9B of the IT Act is applicable when a partner receives any capital asset or stock in trade or both from a partnership firm in connection with dissolution or reconstitution of the partnership firm.

- Such receipt of capital asset or stock in trade is considered to be a transfer and any gains on such a transfer is taxable in the year of receipt (by partner)in the hands of partnership firm under the head Profits and Gains from Business or Profession ('**PGBP**') or under the head Capital Gains ('**CG**')as the case may be.

- The section 9B of the IT Act has defined the term reconstitution of partnership firm to include retirement of one or more partners or admission of one or more partners or change in respective share of all partners in the Partnership firm.

- Section 9B of the IT Act levies tax in the hands of partnership firm on profit made by the partnership firm on transfer of capital asset / stock in trade.

- Further, Central Board of Direct Taxes ('**CBDT**') has also issued Circular No 14 of 2021 dated 2 July 2021to provide guidelines for the purpose removing any difficulty in giving effect to provisions of section 9B and section 45(4) of the IT Act. The circular has been discussed at the end with specific illustrations to understand the applicability and computation mechanism of section 9B and section 45(4) of the IT Act.

Section 45(4) of the IT Act – Income on receipt of capital asset

- Section 45(4) of the IT Act is applicable when a partner receives any money or capital asset or both from a partnership firm in connection with reconstitution of a partnership firm. This section is applicable in addition to section 9B of the IT Act and taxation under section 45(4) of the IT Act shall be worked out independently.

  Such receipt of capital asset or stock in trade is considered to be a transfer and any gains on such transfer is taxable in the year of receipt (by partner) in the hands of partnership firm under the head CG.

- Section 45(4) also provides a computation mechanism to calculate profits or gains which is as under:

A = B + C – D

A = Profit or gains

B = Value of money received by partner

C = Fair market value of capital asset received by partner

D = The amount of balance in the capital account of partner (without considering any increase on account of revaluation of any asset or self-generated goodwill / asset) in the books of partnership firm

If the value of 'A' in the above formula is negative, it shall be considered to be zero

- Section 45(4) of the IT Act levies tax in the hands of partnership firm on profits made by the partner on excess distributions received as compared to its balance in the capital account in the books of partnership firm

Amendment in section 48 of the IT Act

- The computation mechanism to calculate capital gains under section 48 of the IT Act was amended to provide a cost step equivalent to the amount taxed under section 45(4) of the IT Act to the remaining capital assets with the partnership firm.

- Rule 8AB has been introduced in the Income-tax Rules, 1962 ('IT Rules') to provide for a methodology to attribute income taxable under section 45(4) of the IT Act to capital assets remaining with the partnership firm.

- As per Rule 8AB of the IT Rules, where the amount chargeable under section 45(4) of the IT Act relates to revaluation of any capital asset or valuation of self-generated asset or self-generated goodwill, such amount should be attributable to the remaining assets in the ratio of increase in value of respective asset (on account of revaluation) to the aggregate increase in value of all assets (on account of revaluation).

Stage 1: Balance sheet of the firm prior to revaluation of asset

Particulars	Amount	Particulars	Amount
Partner's capital		Property / asset	100
- A	100		
- B	100	Cash	200
- C	100		
Total	**300**	**Total**	**300**

Stage 2: Balance sheet of the firm post revaluation (Property / asset– 300; Self-generated asset 100)

Particulars	Amount	Particulars	Amount
Partner's capital		Property / asset	300
- A	100	Self-generated asset	100
- B	100		
- C	100	Cash	200
Revaluation reserve	300		
Total	**600**	**Total**	**600**

Stage 3: Partner C retires by taking over cash of 200

- As per section 45(4) of the IT Act, **100** [*200 (money received) less 100 (balance in capital account)*] is taxable in the hands of the partnership firm. This profit of 100 is attributed to remaining assets in the following manner:

  i) Property / Assets: [100 * (300-100) / (400 – 100)] = **67**

  - *Revised Cost of acquisition* = **167** (100 + 67);

  ii) Self-generated / Asset: [100 * (100-0) / (400 – 100)] = **33**

  - *Revised Cost of acquisition* = **33** *(0 + 33)*

- Further, it has also been clarified that such cost step-up is only for the purpose of calculation of capital gains on transfer of such assets in future and no depreciation will be available on such cost step-up.

Sr No	Particulars	Prior to amendment introduced vide Finance Act, 2021	Post amendment introduced vide Finance Act, 2021	
		45(4) of the Act	**Section 9B of the IT Act**	**Section 45(4) of the IT Act**
1	Introduced	Finance Act, 1987	Directly introduced in the Finance Act, 2021	First introduced in Finance Bill, 2021. Modifications were made in the language inserted in the Finance Act, 2021.
2	Effective date	FY 1987-99	FY 2020-21	FY 2020-21
3	Applicability	Dissolution or otherwise	Dissolution or reconstitution of firm	Reconstitution of firm
4	Receipt by partner	Any capital asset	Any capital asset or stock in trade	Any money or capital asset
5	Head under which income	CG	PGBP or CG	CG
6	Computation mechanics	As per section 48 of the IT Act	Circular No 14 of 2021 dated 14 July 2021	CG = Value of money received + FMV of capital asset - balance in capital account at the time of reconstitution[4]
7	Can loss be set-off against other sources of income	Should be available under general provisions of the IT Act	Should be available under general provisions of the IT Act	No, any loss basis the above formula to be ignored

[4] *Read with Circular No 14 of 2021 dated 14 July 2021*

D. Decoding Circular No 14 of 2021 dated 14 July 2021

For the purpose of removing difficulties in interpretation of section 9B and 45(4) of the IT Act, CBDT issued guidelines to understand the manner in which these sections would apply with the help of examples[5].

Example 1 (all amounts are in lac)

Stage 1: Balance sheet of the firm prior to any reconstitution

Particulars	Amount	Amount	Particulars	Amount	Amount	Valuation report
Partner's capital			Land			
- A	10		- S	10		70
- B	10		- T	10		70
- C	10	30	- U	10	30	50
Total		**30**	**Total**		**30**	**1 9 0**

Stage 2: Partner A to retire (take over Land U at the valuation of 50 and cash consideration of 11)

Discharge of consideration to A on his retirement

Particulars	Amount
Cash consideration	11
Transfer of Land U	50
Total	**61**

Capital gains under section 9B of IT Act (transfer of land)

Particulars	Amount
Sales consideration	50
Less: Indexed COA	(15)
Capital gains	35
Tax @ 20% (tax outflow) (A)	**7**

Capital gains in books of firm

Particulars	Amount
Sales consideration	50
Less: COA	10
Capital gains	40
Tax	7
Net profit (post tax)	33
Credit to each Partner	11

[5] *For the sake of simplicity, examples have been discussed with same numbers as provided in the CBDT circular*

Balance sheet of the firm post transfer of land U (without adjusting capital account of A as if land is sold to external party)

Particulars	Amount	Amount	Particulars	Amount	Amount
Partner's capital			Land		
- A	21		- S	10	
- B	21		- T	10	
- C	21	63	- U	50	70
Provision of tax		7			
Total		**70**	**Total**		**70**

Capital gains under section 45(4) of IT Act (profit of partner)

Particulars	Amount
Sales consideration	61
Less: Partner's capital	(21)
Capital gains	40
Tax @ 20% (tax outflow) (B)	**8**

This transaction would not have been taxable under the erstwhile provisions of section 45(4) of the IT Act

Balance sheet of the firm post retirement of partner A

Particulars	Amount	Amount	Particulars	Amount	Amount
Partner's capital			Land (refer note 1)		
- A	-		- S	30	
- B	21		- T	30	
- C	21	42	- U	0	60
Payable to A		11	DTA (refer note 2)		8
Provision of tax (9B)		**7**			
Provision of tax [45(2)]		**8**			
Total		**68**	**Total**		**68**

Notes:

1. Cost step-up to existing assets is only for computation of capital gains on sale of assets.

   - Cost step up of Land S is **20** [40 * [60 / 120)]

   Revised Cost of acquisition = **30** (10 + 20)

   - Cost step up of Land T is **20** [40 * [60 / 120)

   Revised Cost of acquisition = **30** (10 + 20)

   Alternatively, assets can be recorded as per valuation report + cost step up and creation of a revaluation reserve. However, accounting treatment to be confirmed with auditors.

2. The additional payment of taxes of 8 lacs, would reduce the tax liability on sale of land S & T in future since cost step-up is provided on the capital gains on which tax is paid. However, accounting treatment to be confirmed with auditors.

Example 2 (all amounts are in lac)

Stage 1: Balance sheet of the firm prior to any reconstitution

Particulars	Amount	Amount	Particulars	Amount	Amount	Valuation report
Partner's capital			Land			
- A	10		- S	10		70
- B	10		- T	10		70
- C	10	30	- U	10	30	50
Total		**30**	**Total**		**30**	**190**

Stage 2: Patnership firm sells land U for cash consideration of 50

Capital gains under section 9B of IT Act (transfer of land)

Particulars	Amount
Sales consideration	50
Less: Indexed COA	(15)
Capital gains	35
Tax @ 20% (tax outflow) (A)	**7**

Capital gains in books of firm

Particulars	Amount
Sales consideration	50
Less: COA	(10)
Capital gains	40
Tax	7
Net profit (post tax)	33
Credit to each Partner	11

Balance sheet of the firm post sale of land U

Particulars	Amount	Amount	Particulars	Amount	Amount
Partner's capital			Land		
- A	21		- S	10	
- B	21		- T	10	20
- C	21	63	Cash		50
Provision of tax		7			
Total		**70**	**Total**		**70**

Retirement of A and distribution of cash consideration of 61 by firm to settle his capital account

Capital gains under section 45(4) of IT Act (profit on interest in firm)

Particulars	Amount
Sales consideration	61
Less: Partner's capital	(21)
Capital gains	40
Tax @ 20% (tax outflow) (B)	**8**

This transaction would not have been taxable under the erstwhile provisions of section 45(4) of the IT Act

Particulars	Amount	Amoun	Particulars	Amount	Amount
Partner's capital			Land (refer note 1)		
- A	-		- S	30	60
- B	21		- T	30	
- C	21	42			
Payable to A		11	DTA (refer note 2)		8
Provision of tax (9B)		**7**			
Provision of tax [45(2)]		**8**			
Total		**68**	**Total**		**68**

Notes:

1. Cost step-up to existing asset is only for tax purposes. Accounting treatment to be confirmed with auditors.

2. The additional payment of taxes of 8 lacs, would reduce the tax liability on sale of land S & T in future since cost step-up is provided on the capital gains on which tax is paid. However, accounting treatment to be confirmed with auditors.

Example 3

Stage 1: Balance sheet of the firm prior to any reconstitution

Particulars	**Amount**	**Amount**	**Particulars**	**Amount**	**Valuation report**
Partner's capital			Land	30	45
- A	100		Patent T	45	60
- B	10		Cash	225	225
- C	100	300	Goodwill (self generated)		30
Total		**300**	**Total**	**300**	**360**

Partner A to retire (take over Land at the valuation of 45 and cash consideration of 75

Particulars	**Amount**
Cash consideration	75
Transfer of Land	45
Total	**120**

Capital gains under section 9B of IT Act (transfer of land)

Particulars	**Amount**
Sales consideration	45
Less: Indexed COA	(45)
Capital gains	0
Tax @ 20% (tax outflow) (A)	**0**

Capital gains in books of firm

Particulars	**Amount**
Sales consideration	45
Less: COA	(30)
Capital gains	15
Tax	0
Net profit (post tax)	15
Credit to each Partner	5

Balance sheet of the firm post transfer of land (without adjusting capital account of A – as if land is sold to external party)

Particulars	Amount	Amount	Particulars	Amount
Partner's capital			Land	45
- A	105		Patent T (WDV)	45
- B	105		Cash	225
- C	105	315	Goodwill (self-generated)	
Total		**315**	**Total**	**315**

Capital gains under section 45(4) of IT Act (profit ofpartner)

Particulars	Amount
Payment to settle capital balance	120
Less: Partner's capital	105
Capital gains	15
Tax @ 20% (tax outflow) (B)	**3**

Particulars	Amount	Amount	Particulars	Amount
Partner's capital			Land	-
- A	0		Patent T (refer note 1)	50
- B	105		Cash	150
- C	105	210	Goodwill (self-generated)	10
			(refer note 1)	
Provision of tax (9B)		**0**	DTA (refer note 2)	3
Provision of tax [45(2)]		**3**		
Total		**213**	**Total**	**213**

Notes:

1. Cost step-up to existing assets is only for computation of capital gains on sale of assets and not for claiming depreciation. Accounting treatment to be confirmed with auditors.

- Cost step up of Patent is **5** [15 * [15 / 45)]

  Revised Cost of acquisition = **50** (45 + 5)

- Cost step up of Goodwill (self-generated) is **10** [15 * [30 / 45)]

  Revised Cost of acquisition = **10** (0 + 10)

2. The payment of taxes of 3 lacs, would reduce the tax liability on sale of Patent T and Goodwill since cost step-up is provided on the capital gains on which tax is paid. Accounting treatment to be confirmed with auditors.

E Key observations for future transaction/ Issues on which clarity is awaited

- Tax implications on distribution of any capital asset or stock-in-trade or money in absence of reconstitution or dissolution of the partnership firm

- *Taxability under section 9B and section 45(4) of the IT is applicable only in case of reconstitution or dissolution of firm*

- Taxation on receipt of money by a partner at the time of dissolution

- *Section 45(4) of IT Act covers cases of reconstitution only and not the cases of dissolution*

- Taxation on receipt of capital asset / stock in trade in hands of legal heir in case of death of partner

- *Taxability under section 9B and section 45(4) is applicable on receipt of capital asset / stock in trade by partner of a partnership firm*

Annexure 1

Illustration 1: *Transfer of property / assets by using partnership as a vehicle*

Stage 1: Balance sheet of the firm prior to revaluation of assets

Particulars	Amount	Particulars	Amount
Partner's capital		Property / assets	200
- A	100		
- B	100		
Total	**200**	**Total**	**200**

Stage 2: Property / assets of the firm are revalued

Particulars	Amount	Particulars	Amount
Partner's capital		Property / assets	400
- A	100		
- B	100		
Revaluation reserve			
- A	100		
- B	100		
Total	**400**	**Total**	**400**

Stage 3: New partners are introduced on contribution of cash

Particulars	Amount	Particulars	Amount
Partner's capital		Property / Assets	400
- A	100		
- B	100	Cash	400
- C	200		
- D	200		
Revaluation reserve			
- A	100		
- B	100		
Total	**800**	**Total**	**800**

Stage 4: Erstwhile partners retire by taking out cash equivalent to their capital (Capital + revaluation reserve)

Particulars	Amount	Particulars	Amount
Partner's capital		Property / Assets	400
- C	200		
- D	200	Cash	0
Total	**400**	**Total**	**400**

Important observations

- In this case, there is no tax outflow for the firm or the partners since capital asset is not distributed to any of the partners.
- Commercially A and B have sold Property / asset to C and D without paying any taxes.
- The amendment under section 45(4) of the IT Act levies tax on gains made by A and B on unrealised gains (in the books of firm) on Property / Asset.

Illustration2: *Retirement of one of the partners basis revaluation of Property / Assets*

Stage 1: Balance sheet of the firm prior to revaluation

Particulars	Amount	Particulars	Amount
Partner's capital		Property / Assets	
- A	100	- X	100
- B	100	- Y	100
- C	100	- Z	100
Total	**300**	**Total**	**300**

Step 2: Assets of the firm are revalued

Particulars	Amount	Particulars	Amount
Partner's capital		Property / Assets	
- A	100	- X	250
- B	100	- Y	250
- C	100	- Z	250
Revaluation reserve			
- A	150		
- B	150		
- C	150		
Total	**750**	**Total**	**750**

Stage 3: Partner C takes over Property / Asset Z and retires

Particulars	Amount	Particulars	Amount
Partner's capital		Property / Assets	
- A	100	- X	250
- B	100	- Y	250
Revaluation reserve			
- A	100		
- B	100		
Profit and loss	100		
Total	**500**	**Total**	**500**

Important observations

- In this case, firm pays taxes on capital gains on distribution of Property/asset to C. How ever, C does not pay any taxes.
- Commercially C's share of 250 includes initial capital of 100 and his share of profit of **150** [1/3 * (750 - 300)] on <u>all three Properties / assets</u>
- The amendment under section 45(4) of the IT Act levies tax on gains made by C on unrealized gains on Property X and Y

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