

CASE STUDIES ON RECONSTITUTION/ DISSOLUTION OF PARTNERSHIP FIRMS – SECTION 9B, 45(4) AND 48(III) OF THE INCOME-TAX ACT, 1961



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Introduction

The Finance Act, 2021 (FA 2021) has overhauled the tax implications in the hands of firm/ Association of Persons(AOP)/ Body of Individuals (BOI) (specified entity) where a partner/ member (specified person) receives cash or property on dissolution or reconstitution of the specified entity. The amendments by way of introduction of section 9B and section 48(iii) to the Income-tax Act, 1961 (Act) and substitution of section 45(4) of the Act have come into effect from 1 April 2021 viz. Assessment Year (AY) 2021-22.

The said provisions introduced by the FA 2021 have been well-explained at length in the previous articles of this publication. The same have been briefly summarised hereunder for the benefit of readers before we delve into the case studies:

- **Section 9B** of the Act provides that where a 'specified person' (partner of firm/ member of AOP/ BOI) receives any capital asset or stock-in-trade or both from a specified entity in connection with the dissolution or reconstitution(as defined) of such specified entity, it shall be considered as a deemed transfer of such capital asset or stock-in-trade by the specified entity. Any profits and gains arising from such deemed transfer of capital asset or stock-in-trade shall be chargeable to tax as income of the specified entity under the head 'profits and gains of business and profession' or 'capital gains', as the case may be, in the year in which such capital asset or stock-in-trade were received by the specified person. Tax is triggered in the year of receipt of capital asset/ stock-in-trade by the specified person and not in the year of transfer by the specified entity.

The fair market value of such capital asset or stock-in-trade as 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 by the specified entity.

- **Section 45(4)** of the Act provides that notwithstanding anything contained in section 45(1) of the Act, where a specified person receives any money or capital asset or both from a specified entity in connection with reconstitution (as defined) of such specified entity, then any profits and gains (as computed in the specified manner) arising from such receipt by the specified person shall be chargeable to tax as income of the specified entity under the head 'capital gains'. Such income shall be deemed to be the income of the previous year in which such money or capital asset or both were received by the specified person.

Where a capital asset is received by the specified person from the specified entity in connection with reconstitution of the specified entity, the provisions of section 45(4) shall operate in addition to the provisions of section 9B and the taxation under the said provisions shall be worked out independently.

With respect to capital gains chargeable to tax under section 45(4) of the Act, **Rule 8AA(5)**of the Income-tax Rules, 1962 (Rules) provides that the capital gains taxable under section 45(4) of the Act shall be deemed to be from transfer of short-term capital asset if it is attributed to:

- Capital asset which is short term capital asset at the time of taxation under section 45(4)
- Capital asset forming part of block of assets
- Self-generated asset or self-generated goodwill

and shall be deemed to be from transfer of long-term capital asset if it is attributed to capital asset (other than those covered above) which is long term capital asset at the time of taxation under section 45(4) of the Act.

- As per the provisions of **section 48(iii) of the Act read with Rule 8AB**, the amount chargeable to tax under section 45(4) of the Act (which represents specified person's share in value appreciation of the remaining capital assets of the specified entity) shall be attributed to remaining capital assets of the specified entity (as per Rule 8AB) and the same shall be deducted from the full value of the consideration as and when such remaining capital assets are transferred by the specified entity in future. This is intended to avoid double taxation of the income.

By virtue of the guidelines issued by the Central Board of Direct Taxes (CBDT) in **Circular No. 14/2021 dated 2 July 2021** (CBDT Guidelines), the aforesaid principle of attribution contained in section 48(iii) is equally made applicable to the capital assets forming part of the block of assets and hence, amount so attributed shall be reduced from the moneys payable or sales consideration, as the case may be, for the purposes of section 43(6)(c) or section 50 of the Act. However, the actual cost of the capital asset remains intact and thus, no depreciation or indexation benefit is available on the amount so attributed.

For the purposes of the present article, I have assumed that some of the fundamental issues/controversies such as (a) applicability of the above amendments introduced by FA 2021 in a scenario where dissolution/ reconstitution has taken place prior to 1 April 2020 and date of receipt by specified person is on or after 1 April 2020, (b) constitutional validity of the amendments, (c) where money/ property is received from the specified entity by legal heirs of deceased specified person in connection with dissolution/ reconstitution of the firm, (d) where money/ property is received in instalments by the specified person, strictly, not from the specified entity (say, post dissolution of specified entity, specified entity is converted into company, by continuing partners) etc. would have been dealt in the respective previous articles in this publication. Case studies on practical application of these amendments have been discussed hereunder.

Case study 1: Distribution of capital asset on dissolution of firm

Facts

- A partnership firm, AB & Associates, consists of two partners, A and B, having equal share in profits and capital.

Indicative balance sheet of the firm is as under:

Liabilities	INR	Assets	INR
Partner's Capital		Land (FMV = 10 lakh)	2,00,000
A	1,00,000		
B	1,00,000		
Total	2,00,000	Total	2,00,000

- Land is held as a long-term capital asset
- The firm is to be dissolved and on dissolution, land is distributed equally amongst the partners
- Fair market value (FMV) of the land as on the date of distribution to partners is INR 10 lakh
- Indexed cost of acquisition assumed to be INR 3 lakh

Tax implications

- Distribution of land to the partners on dissolution of the firm shall be deemed to be a transfer of capital asset by the firm and taxable in the hands of firm under section 9B of the Act as under:

Full value of consideration as per section 9B(3) of the Act (FMV of land as on the date of receipt)	10,00,000
Less: Indexed cost of acquisition	(3,00,000)
Long-term capital gains in the hands of firm as per section 9B of the Act	7,00,000

- Section 45(4) of the Act has no applicability in the given case since capital asset is received by the partner on dissolution of the firm.

Case study 2: Distribution of stock-in-trade on retirement of partner from firm

Facts

- A partnership firm, ABC & Associates, consists of three partners, A, B and C, having equal share in profits and capital.
- Indicative balance sheet of the firm is as under:

Liabilities	INR	Assets	INR
Partner's Capital		Land (FMV = 12 lakh)	3,00,000
A	1,00,000		
B	1,00,000		
C	1,00,000		
Total	3,00,000	Total	3,00,000

- Land is held as stock-in-trade by the firm
- Mr. C retires from the firm and his account is to be settled by distribution of $1/3^{\text{rd}}$ of the land held as stock-in-trade
- FMV of the land as on the date of retirement is INR 12 lakh

Tax implications

- Receipt of land by Mr. C on his retirement shall be deemed to be a transfer of stock-in-trade by the firm and taxable in the hands of firm under section 9B of the Act as under:

Full value of consideration as per section 9B(3) of the Act (FMV of one-third share of the land as on the date of receipt)	4,00,000
Less: Cost of acquisition	(1,00,000)
Profits and gains from business and profession in the hands of firm as per section 9B of the Act	3,00,000

- Section 45(4) of the Act has no applicability in the given case since stock-in-trade is received by the partner on retirement from the firm.

Case study 3: Settlement in cash on retirement of partner from firmFacts

- A partnership firm, ABC & Associates, consists of three partners, A, B and C, having equal share in profits and capital.
- Indicative balance sheet of the firm is as under:

Liabilities	INR	Assets	INR
Partner's Capital		Land (FMV = 12lakh)	3,00,000
A	1,00,000		
B	1,00,000		
C	1,00,000		
Total	3,00,000	Total	3,00,000

- Land is held as a long-term capital asset by the firm. Indexed cost assumed to be same as the cost of acquisition.
- FMV of the land as on the date of retirement is INR 12 lakh
- Mr. C retires from the firm and his account is settled by paying him cash of INR 4 lakh.

Tax implications

Receipt of money by Mr. C on his retirement from the firm shall be chargeable to tax as income of the firm under the head 'capital gains' under section 45(4) of the Act.

- Such capital gains shall be computed as under in accordance with the provisions of section 45(4) of the Act:

Money received by Mr. C (B)	4,00,000
FMV of capital asset received by Mr. C (C)	NA
Balance in the capital account of Mr. C at the time of retirement(D)	(1,00,000)
Capital gains in the hands of firm under section 45(4) of the Act (A = /B + C - D)	3,00,000

- Section 9B of the Act has no applicability in the given case since only cash is received by the partner on retirement from the firm.
- Capital gains taxable under section 45(4) of the Act amounting to INR 3 lakh is attributable to the revaluation of land. As per the provisions of section 48(iii) read with Rule 8AB(2) of the Rules, INR 3 lakh shall be reduced from the sale consideration on transfer of land in future by the firm.
- For instance, if firm sells land for INR 15 lakh in future and the cost of acquisition is INR 3 lakh, INR 3 lakh attributable under section 48(iii) of the Act shall be reduced from the sales consideration and net capital gains will be computed as INR 9 lakh [15L (sales consideration) – 3L (cost) – 3L (attribution as per section 48(iii) of the Act)].
- As per the Explanation 1 to Rule 8AB, for the purposes of attribution of capital gains taxed under section 45(4) of the Act, the revaluation should be based on a valuation report obtained from a registered valuer.

Case Study 4: Distribution of capital asset on retirement of partner from firm

Facts

- A partnership firm, ABC & Associates, consists of three partners, A, B and C, having equal share in profits and capital.
- Indicative balance sheet of the firm is as under:

Liabilities	INR	Assets	INR
Partner's Capital		Land (FMV = 12lakh)	3,00,000
A	1,00,000		
B	1,00,000		
C	1,00,000		
Total	3,00,000	Total	3,00,000

- Land is held as a long-term capital asset by the firm. Indexed cost is assumed same as the cost of acquisition.
- FMV of the land as on the date of retirement is INR 12 lakh
- Mr. C retires from the firm and his account is settled by distribution of one-third portion of the land valuing INR 4 lakh (comprising of capital balance of 1 lakh and 1/3rd share in value appreciation of land (of 9 lakh) amounting to 3 lakh).

Tax implications

- Distribution of one-third land to Mr. C on his retirement from the firm shall be deemed to be a transfer of capital asset by the firm and taxable in the hands of firm under section 9B of the Act as under:

Full value of consideration as per section 9B(3) of the Act (FMV of land as on the date of receipt)	4,00,000
Less: Indexed cost of acquisition	(1,00,000)
Long-term capital gains in the hands of firm as per section 9B of the Act	3,00,000

- Distribution of one-third land to Mr. C on his retirement from the firm shall also be chargeable to tax as income of the firm under the head 'capital gains' under section 45(4) of the Act. Such capital gains shall be computed as under in accordance with the provisions of section 45(4) of the Act:

Money received by Mr. C (B)	NA
FMV of capital asset received by Mr. C (C)	4,00,000
Balance in the capital account of Mr. C at the time of retirement (Original balance in capital account of Mr. C of 1 lakh + 1/3 rd share in value appreciation of land distributed to Mr. C amounting to 1 lakh (1/3 * 3L) (D)	(2,00,000)
Capital gains in the hands of firm under section 45(4) of the Act (A = B + C - D)	2,00,000

- As per the CBDT Guidelines, value appreciation (net of tax) in the capital asset transferred to the retiring partner is to be credited to the capital account of each of the partners, including the retiring partner and such revised capital account balance is to be considered for the purposes of computing capital gains under section 45(4) of the Act. Accordingly, Mr. C's share in the appreciation of land value allotted to him (viz. 3L * 1/3) is added to his capital account balance.
- Capital gains taxable under section 45(4) of the Act amounting to INR 2 lakh shall be attributable to the remaining assets of the firm i.e. balance 2/3rd portion of land remaining with the firm. As per the provisions of section 48(iii) read with Rule 8AB(2) of the Rules, INR 2 lakh shall be reduced from the sale consideration on transfer of balance land in future by the firm.
- For instance, if firm sells land for INR 10 lakh in future and the cost of acquisition is INR 2 lakh (ignoring indexation), INR 2 lakh attributable under section 48(iii) of the Act shall be reduced from the sales consideration and net capital gains will be computed as INR 6 lakh [10L (sales consideration) - 2L (cost) - 2L (attribution as per section 48(iii) of the Act)].

- As per the Explanation 1 to Rule 8AB, for the purposes of attribution of capital gains taxed under section 45(4) of the Act, the revaluation should be based on a valuation report obtained from a registered valuer.

Case Study 5: Settlement in cash on retirement of partner from firm and attribution of capital gains as per section 48(iii) of the Act

Facts

- A partnership firm, ABC & Associates, consists of three partners, A, B and C, having equal share in profits and capital.
- Indicative balance sheet of the firm is as under:

Liabilities	INR	Assets	INR
Partner's Capital		Land (FMV = 12lakh)	3,00,000
A	1,00,000	Goodwill (FMV = 6lakh)	
B	1,00,000		
C	1,00,000		
Total	3,00,000	Total	3,00,000

- Land is held as a long-term capital asset by the firm. Indexed cost is assumed same as the cost of acquisition
- FMV of the land as on the date of retirement is INR 12 lakh
- Firm also has self-generated goodwill worth INR 6 lakh
- Mr. C retires from the firm and his account is settled in cash after taking into account FMV of land and self-generated goodwill. Thus, as against his capital balance of 1 lakh, he is paid INR 6 lakh (comprising of capital balance of 1 lakh + 1/3rd share in value appreciation of land and self-generated goodwill (9 lakh + 6 lakh) amounting to 5 lakh).

Tax implications

- Section 9B of the Act has no applicability in the given case since only cash is received by the partner on retirement from the firm.

Distribution of cash to Mr. C (in excess of his capital balance) on his retirement from the firm shall be chargeable to tax as income of the firm under the head 'capital gains' under section 45(4) of the Act. Such capital gains shall be computed as under in accordance with the provisions of section 45(4) of the Act:

Money received by Mr. C (B)	6,00,000
FMV of capital asset received by Mr. C (C)	-
Balance in the capital account of Mr. C at the time of retirement (D)	(1,00,000)
Capital gains in the hands of firm under section 45(4) of the Act (A = B + C - D)	5,00,000

- Capital gains taxable under section 45(4) of the Act amounting to INR 5 lakh shall be attributable to the remaining assets of the firm i.e. land and self-generated goodwill and shall be reduced from the sale consideration on future transfer of such remaining assets of the firm.
- As per the provisions of section 48(iii) of the Act read with Rule 8AB(2) and Rule 8AA(5) of the Rules, the tax implications shall be as under:

Where capital gains under section 45(4) relates to	Basis of attribution as per Rule 8AB	Calculation	Nature of capital gains	Capital gains on future transfer ¹
Revaluation of land	Capital gains u/s 45(4) * A / C	$5L * 9L / 15L = 3L$	Long-term capital gains	6L (12L - 3L - 3L)
Valuation of self-generated goodwill	Capital gains u/s 45(4) * B / C	$5L * 6L / 15L = 2L$	Short-term capital gains	4L (6L - 2L).

A = Revaluation of land

B = Valuation of self-generated goodwill

C = Increase in value of all assets because of revaluation or valuation

- As per the Explanation 1 to Rule 8AB, for the purposes of attribution of capital gains taxed under section 45(4) of the Act, the revaluation should be based on a valuation report obtained from a registered valuer.

Case Study 6: Distribution of capital asset on retirement of partner from firm and attribution of capital gains as per section 48(iii) of the Act

Facts

- A partnership firm, ABC & Associates, consists of three partners, A, B and C, having equal share in profits and capital.
- Indicative balance sheet of the firm is as under:

¹Assuming the same is transferred at the revalued amount

Liabilities	INR	Assets	INR
Partner's Capital		Land (FMV = 18lakh)	6,00,000
A	5,00,000	Depreciable assets	9,00,000
B	5,00,000	Goodwill (FMV = 3lakh)	
C	5,00,000		
Total	15,00,000	Total	15,00,000

- Land is held as a long-term capital asset by the firm. Indexed cost is assumed same as the cost of acquisition
- FMV of the land as on the date of retirement is INR 18 lakh
- Firm also has self-generated goodwill worth INR 3 lakh and depreciable assets worth INR 9 lakh
- Mr. C retires from the firm and his account is settled by giving him one-third portion of the land (valuing to INR 6 lakh) and cash of INR 4 lakh. Thus, as against his capital balance of INR 5 lakh, he is paid INR 10 lakh (comprising of capital balance of 5 lakh + 1/3rd share in value appreciation of land and self-generated goodwill (12 lakh + 3 lakh) amounting to 5 lakh).

Tax implications

- Distribution of one-third land to Mr. C on his retirement from the firm shall be deemed to be a transfer of capital asset by the firm and taxable in the hands of firm under section 9B of the Act as under:

Full value of consideration as per section 9B(3) of the Act (FMV of land as on the date of receipt)	6,00,000
Less: Indexed cost of acquisition	(2,00,000)
Long-term capital gains in the hands of firm as per section 9B of the Act	4,00,000

- Long term capital gains tax rate is assumed to be 25%. Accordingly, profit after tax on deemed transfer of land amounts to INR 3 lakh (4 lakh – 25% tax on it) which is credited to each partner's capital account in equal ratio.
- Thus, as per the CBDT Guidelines, revised capital account balance of Mr. C amounts to INR 6 lakh (original balance of 5L + share in profit after tax pertaining to appreciation in value of land allotted to Mr. C) for the purposes of computing capital gains under section 45(4) of the Act.
- Distribution of cash and land to Mr. C (in excess of his capital balance) on his retirement from the firm also shall be chargeable to tax as income of the firm under the head 'capital gains' under section 45(4) of the Act. Such capital gains shall be computed as under in accordance with the provisions of section 45(4) of the Act:

Money received by Mr. C (B)	4,00,000
FMV of capital asset received by Mr. C (C)	6,00,000
Balance in the capital account of Mr. C at the time of retirement (D)	(6,00,000)
Capital gains in the hands of firm under section 45(4) of the Act (A = B + C - D)	4,00,000

- Capital gains taxable under section 45(4) of the Act amounting to INR 4 lakh shall be attributable to the remaining assets of the firm and shall be reduced from the sale consideration on future transfer of such remaining assets of the firm.
- As per the provisions of section 48(iii) of the Act read with Rule 8AB(2) and Rule 8AA(5) of the Rules, the tax implications shall be as under:

Where capital gains under section 45(4) relates to	Basis of attribution as per Rule 8AB	Calculation	Nature of capital gains	Capital gains on future transfer ²
Revaluation of land	Capital gains u/s 45(4) * A / C	4L * 12L / 15L = 3.2L	Long-term capital gains	4.8L (12L - 4L - 3.2L)
Valuation of self-generated goodwill	Capital gains u/s 45(4) * B / C	4L * 3L / 15L = 0.8L	Short-term capital gains	2.2L (3L - 0.8L).

A = Revaluation of land

B = Valuation of self-generated goodwill

C = Increase in value of all assets because of revaluation or valuation

- As per the CBDT Guidelines, capital gains chargeable to tax under section 45(4) of the Act can also be attributed to depreciable assets and can be reduced from the moneys payable/ sales consideration for the purposes of section 43(6)(c) and section 50 of the Act. However, in the present case, there is no revaluation in depreciable assets and accordingly, no amount of capital gains under section 45(4) is attributed to such depreciable assets.
- As per the Explanation 1 to Rule 8AB, for the purposes of attribution of capital gains taxed under section 45(4) of the Act, the revaluation should be based on a valuation report obtained from a registered valuer.

Case Study 7: Distribution of capital asset on retirement of partner from firm and attribution of capital gains as per section 48(iii) of the Act

Facts

- A partnership firm, ABC & Associates, consists of three partners, A, B and C, having profit sharing ratio and capital as under:

²Assuming the same is transferred at the revalued amount

Partners	Profit sharing ratio	INR
A	25%	5,00,000
B	25%	5,00,000
C	50%	10,00,000
Total	100%	20,00,000

- Mr. C retires from the firm and his account is settled by giving him self-generated patent (worth INR 60 lakh) and cash of INR 15 lakh.
- On retirement, all the assets of the firm including stock-in-trade are revalued at FMV and taken into account for settlement purposes.
- The details of the assets of the firm and revaluation as on the date of retirement are given as under:

Assets	Book	FMV	Appreciation in value
Depreciable assets	10,00,000	25,00,000	15,00,000
Self-generated patent	-	60,00,000	60,00,000
Land	30,00,000	75,00,000	45,00,000
Stock-in-trade	20,00,000	30,00,000	10,00,000

- Land and patent are held as long-term capital asset by the firm. Indexed cost is assumed same as the cost of acquisition.

Tax implications

- Distribution of self-generated patent to Mr. C on his retirement from the firm shall be deemed to be a transfer of capital asset by the firm and taxable in the hands of firm under section 9B of the Act as under:

Full value of consideration as per section 9B(3) of the Act (FMV of patent as on the date of receipt)	60,00,000
Less: Indexed cost of acquisition	-
Long-term capital gains in the hands of firm as per section 9B of the Act	60,00,000

- Long term capital gains tax rate is assumed to be 20%. Accordingly, profit after tax on transfer of self-generated patent by firm amounts to INR 48 lakh (60 lakh – 20% tax on it) which is credited to each partner's capital account in their profit-sharing ratio.
- Thus, as per the CBDT Guidelines, revised capital account balance of Mr. C amounts to INR 34 lakh (original balance of 10L + share in profit after tax (50% * 48L) pertaining to appreciation in value of patent allotted to Mr. C) for the purposes of computing capital gains under section 45(4) of the Act.

- Distribution of cash and patent to Mr. C (in excess of his capital balance) on his retirement from the firm shall be chargeable to tax as income of the firm under the head 'capital gains' under section 45(4) of the Act. Such capital gains shall be computed as under in accordance with the provisions of section 45(4) of the Act:

Money received by Mr. C (B)	15,00,000
FMV of capital asset received by Mr. C (C)	60,00,000
Balance in the capital account of Mr. C at the time of retirement (D)	(34,00,000)
Capital gains in the hands of firm under section 45(4) of the Act (A = B + C - D)	41,00,000

- Capital gains taxable under section 45(4) of the Act amounting to INR 41 lakh shall be attributable to the remaining capital assets of the firm and shall be reduced from the sale consideration on future transfer of such remaining assets of the firm.
- As per the provisions of section 48(iii) of the Act read with Rule 8AB(2) and Rule 8AA(5) of the Rules, the tax implications shall be as under:

Where capital gains under section 45(4) relates to	Basis of attribution as per Rule 8AB	Calculation	Nature of capital gains	Capital gains on future transfer ³
Revaluation of depreciable assets	Capital gains u/s 45(4) * A / D	41L * 15L / 120L = 5.12L	Short-term capital gains	9.88L (25L - 10L - 5.12L)
Valuation of self-generated patent	Capital gains u/s 45(4) * B / D	41L * 60L / 120L = 20.5L	Short-term capital gains	NA
Revaluation of land	Capital gains u/s 45(4) * C / D	41L * 45L / 120L = 15.38L	Long-term capital gains	29.62L (75L - 30L - 15.38L)

A = Revaluation of depreciable assets

B = Valuation of self-generated patent

C = Revaluation of land

D = Increase in value of all assets because of revaluation or valuation

- As per the CBDT Guidelines, capital gains chargeable to tax under section 45(4) of the Act is to be also attributed to depreciable assets and reduced from the moneys payable/ sales consideration for the purposes of section 43(6)(c) and section 50 of the Act.
- Since patent is allotted to the retiring partner, there is no question of attribution of capital gains chargeable to tax under section 45(4) for the purposes of section 48(iii) of the Act read with Rule 8AB.

³Assuming the same is transferred at the revalued amount

- As per the Explanation 1 to Rule 8AB, for the purposes of attribution of capital gains taxed under section 45(4) of the Act, the revaluation should be based on a valuation report obtained from a registered valuer.

The revaluation of stock-in-trade is not considered for the purposes of attribution of capital gains chargeable to tax under section 45(4) of the Act.

Conclusion:

Without an iota of doubt, the taxation of specified entities on their dissolution/ reconstitution has become more complex and controversial. For instance, partner's capital balance (fixed + current) could be built-up over various years and could comprise of various adjustments such share in profits, withdrawal from firm, share in revaluation of assets etc. and to determine partner's capital balance without taking into account revaluation of assets/ self-generated goodwill for the purposes of section 45(4) of the Act would be a challenging task. Further, where there is revaluation/ devaluation of various assets including stock-in-trade, attribution of capital gains taxable under section 45(4) of the Act for the purposes of section 48(iii) of the Act could also become tricky.

Accordingly, it is better to have clear commercial understanding between the firm and the partners on tax implications arising on dissolution/ reconstitution of the firm as also maintain proper documentation to substantiate the tax position adopted by the firm.

