Irrationalisation of Provision of Transfer of Capital Asset to Partner on Dissolution or Reconstitution

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INTRODUCTION

1 The Supreme Court in *CIT v. Dewas Cine Corporation (1968) 68 ITR 240 (SC) and CIT v. Bankey Lal Vaidya [1971] 79 ITR 594 (SC)* held that the distribution, division or allotment of assets between partners of a firm consequent on its dissolution amounts to a mutual adjustment of rights of the partners and such transaction was neither a sale nor exchange nor transfer of assets of the firm. Further in *Malabar Fisheries Co. v. CIT [1979] 120 ITR 49 (SC)* it was held that there was no transfer in terms of extinguishment of rights of the Firm in the Capital asset when the capital asset is distributed to the partner on dissolution. The relevant portion of said decision which explains the reason for said legal position is as under :

> "18. Having regard to the above discussion, it seems to us clear that a partnership firm under the Indian Partnership Act, 1932, is not a distinct legal entity apart from the partners constituting it and equally, in law, the firm as such has no separate rights of its own in the partnership assets and when one talks of the firm's property or firm's assets all that is meant is property or assets in which all partners have a joint or common interest. If that be the position, it is difficult to accept the contention that upon dissolution the firm's rights in the partnership assets are extinguished. The firm as such has no separate rights of its own in the partnership assets but it is the partners who own jointly in common the assets of the partnership and, therefore, the consequence of the distribution, division or allotment of assets to the partnership which follows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between the partners and there is no question of any extinguishment of the firm's rights in the partnership assets amounting to a transfer of assets within the meaning of section 2(47) of the Act. In our view, therefore, there is no transfer of assets involved even in the sense of any extinguishment of the firm's rights in the partnership assets when distribution takes place upon dissolution."

1.1 Thereafter, in *Sunil Siddharthbhai v. CIT [1985] 156 ITR 509 (SC)* it was held that partner's bringing in his capital asset into partnership as capital contribution was not chargeable to capital gains tax u/s 45 as no consideration is received by partner within the meaning of section 48 and no profit or gain accrues to him in commercial sense.

1.2 The above legal position i.e. (i) no liability to tax in the hands of the partner at the time of contributing capital asset as well as distribution of same on dissolution and (ii) no liability under stamp Act (as there is no transfer) led to tax evasion by some assessee who abused the legal position by making sale of asset through the medium of Partnership firms i.e. by conversion of personal asset into partnership asset and then again converting said partnership asset into personal asset of other partner. As per CBDT Circular No 495 dtd 22nd September,1987 reported (1987) 168 ITR ST 100-101, to plug this escape route of avoiding capital gains tax, Section 45(3) and Section 45(4) were introduced w.e.f 1/4/1988.

1.3 Though Section 45(4) was introduced to deal with evasion of tax, the Income Tax Department unsuccessfully tried to apply said provisions to genuine transactions of Reconstitution of firms even when there was no distribution of capital asset. This was generally done when the firm underwent reconstitution and before such reconstitution the assets of the firm were revalued and the Retiring partners received enhanced value of the property upon retirement. In catena of decisions, it was held that that after retirement of partners, the partnership continued and the business was also carried on by the remaining partners. Further, there was thus no dissolution of the firm and there was no distribution of capital asset so as to fall within the ambit of Section 45(4). In *Addl. CIT v. Mohanbhai Pamabhai (1987) 165 ITR 166 (SC)* Supreme Court had approved the decision of Gujarat HC in *CIT v. Mohanbhai Pamabhai, [1973] 91 ITR 393 (Guj)* wherein it was held that when a partner retires from partnership firm and receives consideration in terms of money which includes proportionate share of goodwill therein, the same is not taxable as there is no 'transfer'. Relying on Mohanbhai Pamabhai, the Apex Court had in the case of *CIT v. R.Lingamallu Raghukumar (2001) 247 ITR 801 (SC)* held that even if consideration paid to retiring partner, exceeds the balance in its capital account, the same shall not be chargeable to tax. The present amendment to Section 45(4) is to enlarge the Scope of Section 45(4) by going beyond the original object for which same was enacted and in doing so reversing the legal position settled by various judicial precedents

EXISTING SECTION 45(4)

2 The existing provisions of section 45(4) provides that the profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm or other association of persons or body of individuals (not being a company or a co-operative society) or otherwise, shall be chargeable to tax as the income of such firm or other association of persons or body of individuals of the previous year in which the said transfer takes place. Further, the fair market value of the asset on the date of such transfer shall be deemed to be the full value of the consideration for the purposes of section 48.

2.1 The existing Section 45(4) is substituted by Section 45(4) and insertion of new Section 45(4A).

PROPOSED SECTION 45(4) & 45(4A)

3 New proposed sub-section (4) of section 45 of the Act applies in a case where a specified person who receives during the previous year any capital asset at the time of dissolution or reconstitution of the specified entity.

3.1 The capital asset represents the balance in the capital account of such specified

person in the books of the specified entity at the time of its dissolution or reconstitution. In this situation, the profit and gains arising from the receipt of such capital asset by the specified person shall be chargeable to income-tax as income of the 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 the capital asset was received by the specified person.

3.2 For the purposes of section 48 of the Act, the fair market value of the capital asset on the date of such receipt shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.

3.3 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 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.

4 New proposed section sub-section (4A) of section 45 of the Act applies in a case where a specified person receives during the previous year any money or other asset at the time of dissolution or reconstitution of the specified entity.

4.1 The money or other asset is required to be in excess of the balance in the capital account of such specified person in the books of accounts of the specified entity at the time of its dissolution or reconstitution. In this situation, the profits or gains arising from the receipt of such money or other asset by the specified person shall be chargeable to income-tax as income of the 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 the money or other asset was received by the specified person.

For the purposes of section 48 of the Act,

- value of the money or the fair market value of other asset on the date of such receipt shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset; and
- the balance in the capital account of the specified person in the books of accounts of the specified entity at the time of its dissolution or reconstitution shall be deemed to be the cost of acquisition. 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 increase in the capital account of the specified person due to revaluation of any asset or due to selfgenerated goodwill or any other self-generated asset.

5 For the purposes of above two sub-sections,-

- specified person is proposed to be defined as a person who is partner of a firm or member of other association of persons or body of individuals (not being a company or a cooperative society), in any previous year;
- specified entity is proposed to be defined as a firm or other association of persons or body of individuals (not being a company or a cooperative society);and
- self-generated goodwill and self –generated assets are proposed to be defined as 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.

6 Consequential amendment is also proposed in section 48 of the Act to provide that in case of specified entity, the amount included in the total income of such specified entity under sub-section (4A) of section 45 which is attributable to the capital asset being transferred, shall be reduced from the full value of the consideration to compute income charged under the head capital gains. This is to be calculated in the manner to be prescribed later. This is to mitigate the double taxation which may have happened but for this provision in a situation where an asset which was revalued and for which income under the proposed sub-section (4A) of section 45 of the Act was brought to tax is transferred subsequently by the specified entity.

REASON FOR AMENDMENT.

7 As per the Memorandum explaining the provisions, reason for the amendment is stated as under:

"……it has been noticed that there is uncertainty regarding applicability of provisions of aforesaid sub-section 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."

7.1 The above reason for amendment clearly show that the object to re-introduce Section 45(4) in new avatar and insertion of new Section 45(4A) is different than the object of introducing it originally. It now proposes to tax transactions which otherwise could not have been taxed as per the scheme and object of the Indian Partnership Act, 1932 read with the Income tax Act, 1961.

7.2 The triggers for the amendment seems to be the two recent decisions of (i) Madras High Court in *National Company v. Asstt. CIT, [2019] 415 ITR 5 (Mad)*, wherein it was held that capital asset received by the partner at the time of reconstitution of partnership firm by way of retirement is not covered by the provisions of Section 45(4) and consequently not liable to capital gains, [the court distinguished the decision of the Bombay High court in *CIT v. A.N. Naik Associates, [2004] 265 ITR 346 (Bom)* wherein it was held that transfer of capital asset to partner on retirement was covered u/s 4(4)] and (ii) Bombay High Court in *PCIT v. Electroplast Engineers [2019] 263 Taxman 120 (Bom) (HC)* wherein under a Deed of Retirement cum Reconstitution of the Partnership, the original two partners retired from the firm and three new partners continued the business of the firm. Goodwill was evaluated and the retiring partners were paid certain sum for their share of goodwill in proportion of their share in partnership. It was held that in the instant case all that happened was the firm's assets were evaluated and the retiring partners were paid their share of the partnership asset. There was clearly no transfer of capital asset taxable u/s 45(4).

ANALYSIS OF PROPOSED AMENDMENT

A separate Code

8. Section 45(4)/(4A) are applicable notwithstanding provisions of Section 45(1). It is now a charging provision. The requirement of "transfer" u/s 2(47) is no longer there. There is no requirement of distribution of Capital Asset i.e. no requirement of physical division,

allocation etc of capital asset. Receipt of capital asset is sufficient. Further receipt of money in settlement on retirement is also covered though same does not constitute transfer. Reconstitution of firm is now specifically covered. The provision also provides for what would be the sale consideration and what would be the cost of acquisition. Hence, Section 45(4)/(4A) will have to be treated as a separate code for computation of capital gains.

Reconstitution.

10 In *CIT v. Omprakash Premchand & Co (1997) 227 ITR 590 (MP)* it is held that reconstitution and dissolution of firms are two distinct legal concepts. Dissolution brings the partnership to an end, while reconstitution means continuation of the partnership under altered circumstances.

10.1 Section 31 & 32 of the Partnership Act deals with re-constitution of Partnership firms. It covers the situation of admission, retirement, death and insolvency of partner. Section 187 of the Income Tax Act, deals with Assessment of Partnership firms where there is change in constitution of Partnership firms. Said Section not only covers admission and retirement but also covers change in profit sharing ratios made during the subsistence of the firm.

Retirement.

11 In *National Company v. Asstt. CIT (Supra)* it was held that distribution of Capital asset on retirement was not covered within the ambit of Section 45(4). In *CIT v. R Lingmallu Rajkumar (Supra)* it was held that the excess amount received by the assessee on retirement from the two partnership firms is not assessable to capital gains u/s 45(4) in the hands of the partner. Similarly in *PCIT v. Electroplast Engineers (Supra)* it was held that share in goodwill paid to partner in excess of his balance on retirement is not exigible to tax in the hands of the firm u/s 45(4). In *CIT v. Dynamic Enterprises [2013] 359 ITR 83 (Kar)(HC) (FB)* there was revaluation of asset pursuant to admission of new partners and retirement of few old partners and after such revaluation the retiring partners were paid cash. It was held that where retiring partner took cash towards value of his share in partnership firm and there was no distribution of capital assets among partners, there was no transfer of capital asset and, therefore, no profits or gains chargeable to tax under section 45(4) arose in hands of assessee-firm.

11.1 Thus, under existing provisions of Section 45(4), upon reconstitution of the firm, i.e upon retirement of partner, or admission cum retirement then such reconstitution did not give rise to a taxable event. Further, settling the account of a partner in cash on retirement did not result in distribution of capital asset and was thus excluded from the applicability of Section 45(4).

11.2 As per the amended Section 45(4) and Section 45(4), such reconstitution would fall within the ambit of Section 45(4) and Section 45(4A). Further, where the partner receives only money on reconstitution of the firm, even then there will be a taxable event u/s 45(4A). Thus, the ratio of above decisions rendered in the context of original Section 45(4) will no longer be a good law.

Admission & Change in profit sharing Ratio.

12 In *ITO v. Smt Paru D Dave [2008] 110 ITD 410 (Mum)(Trib)* asset was revalued and the revalued amount was credited to two partners who were the only partners of the firm. After few days, new partners were admitted who brought capital and gave loans to the firm and the profit sharing ratio of the assessee was reduced.

Both the partners had subsequently withdrawn the revalued amounts credited to their accounts. The income tax department sought to tax such withdrawal by applying Section 45(4). It was held that Section 45(4) is not applicable. The relevant portion is as under :

> "16. In the facts before us the partnership asset was revalued by the partners at the start of the year and the difference on account of revaluation of asset was credited to the partners account. The revaluation of partnership assets was anterior to the introduction of new partners. Revaluation of assets by partnership firm does not attract capital gains. The revaluation of assets of partnership and the credit of revalued amount to the capital account of partners in their respective share ratio does not entail any transfer as defined under section 2(47) of the Income-tax Act. The introduction of new partners to a partnership firm owning immovable assets and consequent reduction in the share ratio of present partners does not entail any relinquishment of their rights in the partnership property. On introduction of new partners, there is realignment of share ratio inter se between the partners only to the extent of sharing the profits or losses, if any of the partnership business. When any new partner is introduced into an existing partnership firm, the profit sharing ratios undergo a change, which does not amount to transfer as defined under section 2(47) of the Act, as there is no change in the ownership of assets by the partnership firm. As during the subsistence of the partnership firm, the partners have no defined share in the assets of the partnership and thus on realignment of profit sharing ratio, on introduction of new partners, there is no relinquishment of any non-existent share in the partnership assets as the asset remained with the firm. Such an arrangement is not covered by the provisions of section 45(4) of the Act, which covers the case of dissolution of partnership firm. Accordingly, no capital gains arises on such relinquishment of share ratio in the partnership firm. We confirm the order of CIT(A) and dismiss the grounds of appeal raised by the revenue."

It appears that ratio of above decision will no longer hold good as reconstitution i.e admission of a partner is now covered by Section 45(4) & (4A) and thus where there is change in profit sharing ratio pursuant to such reconstitution whereby the partners receive the money over and above the amounts in their capital account on the date of such reconstitution then such change in profit sharing ratio will be cover by Section 45(4)/4(4A). It will not matter that revaluation was anterior in time to reconstitution since while calculating the balance in the capital account, increase on account of revaluation is to be ignored.

Change in profit sharing ratio by inter-se transfer between partners.

13 In *Anik Industries Ltd v. DCIT [2020] 116 taxmann.com 385 (Mum)(Trib)* assessee was contesting the chargeability of Capital Gains of Rs.400 Lakh received by it on account of reduction in share in a partnership firm namely M/s. Mahakosh Property Developers from 30% to 25%. The reduction in share in partnership was transferred to existing partners and

the compensation was settled by credit to the current account of Assesse and debit to the current accounts of other partners. Both the Assessee as well Department did not dispute that there was Reconstitution on account of change in profit sharing Ratio. According to AO, said payment was nothing but consideration for intangible asset i.e. the loss of share of partner in the goodwill of the firm. As per ITAT the provisions of s.45(4) shall have no application since it was not a case of distribution of capital assets on the dissolution of firm rather it was a case of reduction in share of one partner which was taken over by existing partners. The firm has continued its business with existing partners including the assessee.

13.1 In the above case, as per proposed Section 45(4A) the partnership firm M/s Mahakosh Property Developers would be taxed as the partner had received money provided of-course such money received by the partner exceeds the balance in his capital A/c with the firm. However, the issue whether Reconstitution would cover change in profit sharing ratio [as provided u/s 187] without there being any admission or retirement of partner will be subject matter of litigation. According to me, both Section 45(4A) and Section 187 will have to be read harmoniously and change in profit sharing ration may fall within the ambit of Section 45(4A).

Death

14 In *CIT v. Moped & Machines [2006] 281 ITR 52 (MP)(HC)* there were two partners. The firm stood dissolved by operation of law as one partner died. It was held that there was no transfer u/s 2(47) on dissolution and further there was no distribution of assets as only one partner remained after the death of other partner. Thus, Section 45(4) had no application.

However, under the proposed Section 45(4)/45(4A), the requirement of distribution of capital asset and transfer of capital asset is no longer there. The only requirement is the event of dissolution of the firm and receipt of capital asset by the partner. Thus, in the above case, there is dissolution of the firm as well as receipt of the assets of the firm by the surviving partner. Consequently, firm will be liable to tax u/s 45(4)/45(4A).

Minor

15 In *CIT v. Hari Nath Ram Nath [1997] 224 ITR 713 (All)(HC)* in the context of Section 187, it was held that where on attainment of majority of two minors admitted to benefit of partnership one opted to become a partner while other opted out of partnership which necessitated execution of fresh partnership deed, it was a case of reconstitution of firm.

15.1 In *CGT v. Chhotalal Mohanlal [1987] 166 ITR 124 (SC)* a case pertaining to Gift Tax, it was held that reduction in share of father upon admission of minor sons is gift of goodwill, liable for gift tax. Thus, where minor sons are admitted it will amount to Reconstitution of partnership Firm. Upon such Re-constitution, if any partner (including the new minor partners) receives money or other asset (i.e. including receipt of right to share in the profits from other partner), then provisions of Section 45(4)/45(4A) may be attracted even though the firm continues and there is no distribution of any Capital Asset.

Conversion

16 In *CIT v. Texspin Engg. & Mfg. Works [2003] 263 ITR 345 (Bom)(HC)* Assessee-firm which claimed that it had been converted into limited company under Part IX of Companies Act, was subjected to capital gains tax under section 45(4) on

ground that there was transfer of assets by way of distribution and such transfer was on dissolution of firm. It was held by the High court that in instant case properties of erstwhile firm vested in limited company which was different from distribution on dissolution and, hence, very first condition for application of section 45(4), that is, transfer by way of distribution of capital asset was not satisfied.

16.1 It appears that above legal position with respect to Section 45(4) in case of conversion will no longer hold good as requirement of transfer and distribution is dispensed with for charging capital gains.

Capital A/c v Current A/c

17 The decision in *Anik Industries Ltd v. DCIT (supra)* also raises another issue. Whether settlement of accounts through current account or say loan account would be covered by Section 45(4)/(4A). The twin requirement is of receipt of Capital asset/money or other asset and such receipt is in excess of balance in capital account. Thus, if the twin requirements are satisfied then even if settlement on re-constitution is through the current account same would fall within the ambit of Section 45(4)/(4A).

Income taxable in the hands of the Specified Entity.

17.1 In *Sudhakar Shetty (2011) 130 ITD 197(Mum), ITO v. Fine Developers [2013] 55 SOT 122 (Mum) & Mahul Construction Corporation v. ITO [2018] 168 ITD 120 (Mum)* it was held that Capital gains u/s 45(4) will be taxable in the hands of the Partner and not the firm. The ratio of these decisions to this extent will no longer be valid.

"or other assets" – Scope.

18 One of the areas of litigation would be the determination of the scope of the term "or other assets" used in Section 45(4A). An important issue would be whether other assets would include stock-in trade of the firm. In *ITO v. Fine Developers [2013] 55 SOT 122 (Mum)* it was held that Section 45(4) would not have application to Section 45(4). However it could now be contended that earlier Section 45(4) used the word Capital Assets only and not "other assets". But the applicability of Section 48 for computing Capital gains and amendment to Section 48 with respect to capital gains computed u/s 45(4A) would indicate that stock in trade may not be covered within the ambit of Section 45(4A). It appears that Section 45(4A) is inserted to cover cases where money is received by the partner or money and other assets including capital assets are received by the partner on dissolution/ reconstitution and it is in that context that the words "money or other assets" are used.

Cost of Acquisition & Indexation.

19 In Section 45(4) cost of acquisition is given as

> "(b) the cost of acquisition of the capital asset shall be determined in accordance with the provisions of this chapter."

In Section 45(4A) cost of acquisition is given as

> "(b) the balance in the capital account of the specified person in the books of accounts of the specified entity at the time of its dissolution or reconstitution shall be deemed to be the cost of acquisition."

19.1 The above different version of cost of acquisition in Section 45(4) & 45(4A) raise following ambiguities :

(1) If cost of acquisition of the capital asset is to be taken u/s 45(4) then why Section 45(4) states "which represents balance in his capital account".

(2) If cost of acquisition of the capital asset is to be taken u/s 45(4) then whether upto the extent of capital balance it is taxable u/s 45(4) and thereafter it is to be taxed u/s 45(4A) and whether practically both the Sections could operate simultaneously.

(3) If cost of acquisition u/s 45(4) is the balance in capital account then why different cost of acquisitions are prescribed for 45(4) & 45(4A).

(4) Why memorandum explaining the provisions only provide for one method of cost of acquisition i.e. the one prescribed u/s 45(4A).

19.2 As regards indexation, no specific mention is made about the same in Section 45(4)/(4A) is made about the same though what would be cost of acquisition for the purposes of Section 48 is prescribed. However, as Section 48 is made applicable it appears that cost of acquisition will be indexed cost of acquisition in case of Long term capital gains. It will be welcoming if this issue is clarified in the Act.

CONCLUSION

20 The present amendment will be effective from the 1st April, 2021 and will accordingly apply to the assessment year 2021-22 and subsequent assessment years. Thus transactions of dissolution/reconstitution which have taken place after 1/4/2000 and before this Bill will also be covered by bthe amended provisions. Judicially it is well settled under the Income Tax Act, 1961 that amended provisions which modify accrued rights or which impose obligations or create new liabilities or attach new disability have to be treated as prospective unless the language of the statute is clear that it has retrospective operation. In *CIT v. Walfort Shares & Stock Brokers (P.) Ltd. [2010] 326 ITR 1 (SC)* it is stated that "Retrospective operation of law should not be given so as to effect, alter or destroy an existing right and to create new liability or obligation. New liability cannot be created by a subsequent amendment in respect of a transaction when such law was not in the Statute book." Also, the retrospective application of laws goes against the assurance given by the present government that taxation laws will be applicable prospectively.

20.1 The present amendments as pointed out above has overturned catena of judicial precedents. The scheme and theme of Indian partnership Act, 1932 is completely divorced from the applicability of the Income Tax Act, 1961. Partnerships as structure for carrying on business are easily created, terminated and involve least compliance. They are most convenient structure for businessman who are not highly educated and professional. Present amendments which are ambiguous, prone to litigation and which run contrary to the foundation of Partnership laws will discourage citizens from adopting Partnership structure to conduct business.

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