Taxation of Partnership Firms under Income Tax Act : Recent Amendments

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Taxation of partnership firms has always been a controversial issue specially with reference to taxability of withdrawal of capital over and above the balance by partners at the time of retirement or receipt of money or assets on reconstitution or dissolution of a partnership firm.

➢ Partnership and Partner

As per Sec 4 of the Partnership Act, "Partnership" is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. Persons who have entered into partnership with one another are called individually "partners" and collectively a "firm", and the name under which their business is carried on is called the "firm name". As per this definition various judgments have held that partner and partnership firm are not different entity and are one and the same hence any money received from the firm after retirement or on dissolution is not a gain in the hands of the firm or partner except in case of any asset received on dissolution or otherwise of the firm {As per erstwhile Sec. 45(4)}.

➢ Erstwhile Sec. 45(4)

As per judicial precedents if any partner received any money on his retirement from the firm where the firm continues even after his retirement and no asset is received by the partner at his retirement or on dissolution then such money even if over and above the capital account balance of that partner were not deemed to be taxable in the hands of firm or partner.

➢ New Sec. 9B & substituted Sec. 45(4)

To overcome the shortcomings of erstwhile Sec. 45(4) and to make negatived the relevant precedents, substitution of Sec 45(4) and introduction of new provision being Sec. 9B in the act has taken place. In this article I have discussed changes brought in by Finance Act,2021 being made effective from Assessment Year 2021-22 in respect of taxation of partnership firms specially with reference to receipt of money or asset received by partners on dissolution or reconstitution of partnership firms.

➢ Specified entity and Specified Persons

Before we proceed to discuss these issues, two words used in Sec. 9B & 45(4) of the I.T. Act must be understood here, "specified entity" and "specified person".

Specified entity means, "a firm or other association of persons or body of individuals (not being a company or a co-operative

society)", "specified person" means a person, who is a partner of a firm or member of other association of persons or body of individuals (not being a company or a co-operative society) in any previous year". Firm includes LLP.

In the following discussion even if the word "partner", & "partnership firm", is used, but it will be denoting and covering specified person and specified entity respectively here for the purposes of Sec. 9B & 45(4).

➢ Dissolution or reconstitution of a partnership firm Sec. 9B

As per newly inserted Sec. 9B of the act, if any partner receives any capital asset or stock in trade on dissolution or reconstitution of partnership firm, then it will be deemed that such partnership firm has transferred capital asset or stock in trade to the partner in the previous year in which, such asset or stock is received by such partner.

Reconstitution of the firm means if any partner ceases to be a partner, or admission of any partner where one or more partner as were before the change continue after change, or another situation where no incoming or outgoing partner but change in share of partners.

Then any profit and gains arising on deemed transfer of such stock or asset shall be deemed to be, "profit & gains of business or profession", or "capital gains" of the partnership firm of the previous year in which such asset or stock is received by the partner. Computation of such profits & gains of business or profession or the capital gains shall be made as per provisions of the act.

If any capital asset or stock in trade is not received by the partner, e.g. if value of asset or stock is revalued on reconstitution at the time of admission or retirement of a partner then in such a case since no asset or stock is received by existing or incoming partner then Section 9B will not come into play, or if any asset received by the partner is not a capital asset, e.g. if rural agricultural land is received by the partner then it being not a capital asset as per Sec. 2(14) of the act hence it will be out of purview of Sec. 9B.

The fair market value of capital asset or stock in trade on the date of receipt of such asset or stock by the partner shall be deemed to be the full value of consideration in the hands of firm.

➢ Reconstitution of a partnership firm Sec. 45(4)

As per substituted Sec. 45(4) w.e.f. A.Y. 2021-22 if any partner receives any money or capital asset upon reconstitution of the firm then profits and gains arising from such receipt of money or asset by the partner shall be deemed to be the capital gain in the hands of the firm in the year of receipt of asset or money by the partner. Such capital gain shall be calculated as per the following formula :-

A = B + C – D

Where,

A = income of the firm U/s 45(4) under the head "Capital gains";

B = value of any money received by a partner from the firm on the date of such receipt;

C = the amount of fair market value of the capital asset received by the partner from the firm on the date of such receipt; and

D = the amount of balance in the capital account (represented in any manner) of the partner in the books of account of the firm at the time of its reconstitution:

Provided that if the value of "A" in the above formula is negative, its value shall be deemed to be zero :

Provided further that the balance in the capital account of the partner in the books of account of the firm is to be calculated without taking into account the increase in the capital account of the partner due to revaluation of any asset or due to self-generated goodwill or any other self-generated asset.

From the above formula it is clear that profit and gain being capital gain shall be calculated by adding value of money received and FMV of capital asset received by the partner and deducting his capital account balance, such capital account balance shall be considered ignoring any increase in capital account balance arisen due to revaluation of any asset or valuation or revaluation of any self generated asset or goodwill. If the result is negative it shall be ignored and if the result is positive it is deemed to be the capital gain in the hands of the firm.

No loss can be there under the head capital gains as a result of sec. 45(4) of the act.

➢ Sec. 9B vs. 45(4)

Sec. 9B is applicable for capital asset and stock in trade whereas Sec 45(4) is applicable for capital asset and any money received only, sec. 9B is applicable on dissolution and reconstitution but provisions of Sec. 45(4) is applicable only in case of reconstitution of the firm and not in case of dissolution of the firm.

➢ Sec. 48(iii)

Sec. 48(iii) specifies that gains computed U/s 45(4) to be attributed to remaining capital assets of the firm.

➢ CBDT Circular and notification

Sec. 9B(4) states that if any difficulty arises in giving effect to the provisions of 9B and 45(4), the Board may, with the approval of the Central Government, issue guidelines for the purposes of removing the difficulty. Every guideline issued by the Board shall, as soon as may be after it is issued, be laid before each House of Parliament, and shall be binding on the income-tax authorities and on the assessee.

Accordingly CBDT issued guidelines vide circular No. 14/2021 dt. 02-07-2021 specifying that as the amount taxed U/s 45(4) of the Act is required to be attributed to the remaining capital assets of the firm, so that when such capital assets get transferred in the future, the amount attributed to such capital assets gets reduced from the full value of the consideration and to that extent the firm does not have to pay tax again on the same amount. This attribution is given in the Act only for the purposes of section 48 of the Act. Section 48 of the Act only applies to capital assets which are not forming block of assets. For capital assets forming block of assets there is Sec. 43(6)(c) of the Act to determine WDV of the block of asset and section 50 of the Act to determine the capital gains arising on transfer of such assets. However, the Act has not yet provided that amount taxed U/s 45(4) of the Act can also be attributed to capital assets forming part of block of assets and which are covered by these two provisions. The guideline clarified that rule 8AB of the Income Tax Rules, notified vide notification no. 76 dated 02.07.2021 also applies to capital assets forming part of block of assets. Wherever the term capital asset is appearing in the rule 8AB of the Rules, it refers to capital asset whose capital gains is computed under section 48 of the Act as well as capital asset forming part of block of assets. Further, wherever reference is made for the purposes of section 48 of the Act, such reference may be deemed to include reference for the purposes of Sec. 43(6)(c) of the Act and section 50 of the Act.

For the purpose of Sec. 48 of the act CBDT notified vide Noti. No. 76 - rule 8AA(5) and rule 8AB on 02-07-2021. Rule 8AA(5) specifies that in case of the amount which is chargeable to income-tax as income of partnership firm U/s 45(4) under the head Capital gains such

gain shall be deemed to be STCG if such gain attributed to capital asset which is short term capital asset at the time of taxation of amount U/s 45(4); or capital asset forming part of block of asset; or capital asset being self-generated asset and self-generated goodwill as defined in clause (ii) of Explanation 1 to Section 45(4); and such gain shall be deemed to be LTCG if it is attributed to capital asset which is not STCG and is long term capital asset at the time of taxation of amount U/s 45(4).

For example if Rs.50 Lakh is be attributed to remaining asset "A" & "B" in the ratio of 50:50 (being equal upward revaluation of A:B), i.e., Rs. 25 Lakh each. When either of these asset would be sold in future, Rs. 25 Lakh amount attributed shall be reduced from sales consideration under section 48(iii) of the Act. The amount of Rs. 50 Lakh charged to tax under section 45(4) of the Act shall be deemed to be long-term capital gains in view of Rule 8AA, considering Rs. 50 Lakh has been attributed to asset "A" and "B", both being long term capital assets at the time of taxation under section 45(4) of the Act. In simple words, nature of gain u/s 45(4) is determined on the basis of nature of remaining assets to which attribution is required to be made.

Rule 8AB specifies that for the purposes of clause (iii) of section 48, where the amount is chargeable to income-tax as income of partnership firm U/s 45(4), the specified entity shall attribute such amount to capital asset remaining with the firm in a manner provided in rule 8AB. Where the aggregate of the value of money and the fair market value of the capital asset received by the partner from the firm, in excess of the balance in his capital account, chargeable to tax U/s 45(4), relates to revaluation of any capital asset or valuation of self-generated asset or self-generated goodwill, of the partnership firm, the amount attributable to the capital asset remaining with the firm for purpose of clause (iii) of section 48 shall be the amount which bears to the amount charged U/s 45(4) the same proportion as the increase/recognition of, value of that asset because of revaluation or valuation bears to the aggregate of increase/recognition of, value of all assets because of the revaluation or valuation. Where the aggregate of the value of money and the fair market value of the capital asset received by the partner from the firm, in excess of the balance in his capital account, charged to tax U/s 45(4) does not relate to revaluation of any capital asset or valuation of self-generated asset or self-generated goodwill, of the partnership firm, the amount charged to tax U/s 45(4) shall not be attributed to any capital asset for the purposes of clause (iii) of section 48. Where the aggregate of the value of money and the fair market value of the capital asset received by the partner from the specified entity, in excess of the balance in his capital account, charged to tax U/s 45(4) relate only to the capital asset received by the partner from the firm, the amount charged to tax U/s 45(4) shall not be attributed to any capital asset for the purposes of clause (iii) of section 48. The firm shall furnish the details of amount attributed to capital asset remaining with the firm in Form No. 5C. on or before the due date specified U/s 139(1) for the assessment year in which the amount is chargeable to tax U/s 45(4).

All the discussions on Sec. 9B & 45(4) of the act in the above article is brief and said provisions will have to be analysed in the light of specified relevant section, rules and different situations. The views herein are guiding but before taking any conclusion with regard to circumstances detailed analysis of relevant sections and rules should be taken care of.

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