

Case Studies on computation of capital gains on dissolution or reconstitution of a partnership firm

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1. Introduction

Where a partner receives any amount or property on dissolution or reconstitution of the firm, the income-tax implications in the hands of the partner and the firm have been completely overhauled by the Finance Act, 2021. Section 9B has been inserted, and Section 45(4) has been amended by the Finance Act, 2021.

Section 9B deals with the taxability of the income arising to the firm on the transfer of any capital asset or stock to a partner in connection with dissolution or reconstitution. Section 45(4) deals with the income arising to a partner on receipt of money or capital asset in connection with the reconstitution of the firm. The income arising to partner from such receipt is to be computed by reducing the capital balance in his Account from the aggregate of the fair Market value of assets and money received on reconstitution. The partner's capital balance is to be computed without considering the increase in his capital account due to revaluation of any asset or due to recognition of self-generated goodwill or any other self-generated asset by the firm. As the revaluation gain is being reduced from the partner's capital account while computing capital gain under section 45(4), the revaluation gain attributable to assets that are not transferred to the partner at the time reconstitution is also getting taxed in the hands of the firm. This would result in double taxation when the firm transfers its remaining asset in the future. To remove the impact of such double taxation, the Finance Act, 2021, has amended Section 48. This section allows certain deductions from the full value consideration of a capital asset while computing capital gain, namely, cost of acquisition, cost of improvement, and expenditure incurred in connection with the transfer.

An additional deduction has been allowed under Section 48(iii) in respect of the capital gains charged to tax under section 45(4), which is attributable to the capital asset remaining with the firm. In other words, a portion of the capital gains so taxed under Section 45(4) shall be reduced from the full value of consideration of the capital asset remained with the firm after reconstitution. The CBDT was empowered to prescribe the method of such attribution.

2. Insertion of New Rule

In exercise of such power, CBDT has inserted a new Rule 8AB to provide that where the amount is chargeable to tax as income of partnership firm under Section 45(4), the firm shall attribute such amount to capital asset remaining with it in the following manner:

- (a) Where the amount chargeable to tax under Section 45(4) relates to revaluation of any capital asset or valuation of a self-generated asset or self-generated goodwill of the firm, the amount attributable to the capital asset remaining with it shall be the

- amount which bears to the amount charged under Section 45(4) in the same proportion as the increase in, or recognition of, the value of that asset because of revaluation or valuation bears to the aggregate of increase in, or recognition of, the value of all assets because of the revaluation or valuation; or
- (b) Where the amount chargeable to tax under Section 45(4) does not relate to the revaluation of any capital asset or valuation of a self-generated asset or self-generated goodwill of the firm, or relate only to the capital asset received by the partner from the firm, the amount charged to tax under Section 45(4) shall not be attributed to any capital asset for the purposes of Section 48(iii).

The CBDT has also clarified that Rule 8AB is also applicable to the capital assets forming part of a block of assets. The partnership firm is required to furnish the details of the amount attributed to the capital asset remaining with it in Form No. 5C.

3. Essential conditions to claim deduction under Section 48(iii)

The deduction under Section 48(iii) is allowed if the following conditions are satisfied:

- (a) There should be a reconstitution of the partnership firm;
- (b) Capital asset or money or both should be given to the partner;
- (c) Capital gain is computed and taxed in the hands of the firm under Section 45(4); and
- (d) The book value (or historical value or WDV) of atleast one of the capital asset remaining with the firm after such reconstitution should be less than fair market value. It also includes the valuation of a self-generated asset.

In case of dissolution, provisions of Section 45(4) are not applicable, so the applicability of section 48(iii) does not arise. Section 48(iii) will come in force in case of reconstitution only.

One of the essential conditions to claim deduction under Section 48(iii) is that the asset should be revalued on reconstitution. These assets can be classified into two groups – assets given to the partner and assets remaining with the firm. Following four scenarios may arise on reconstitution of the firm:

- (a) None of the assets are revalued;
- (b) Only assets given to the partner are revalued;
- (c) Only assets remaining with the firm are revalued; and
- (d) Both the assets are revalued.

Rule 8AB provides that if the amount chargeable to tax under Section 45(4) does not relate to the revaluation of any capital asset or relate only to the capital asset received by the partner from it, the amount charged to tax under Section 45(4) shall not be attributed to any capital asset for the purposes of Section 48(iii). Thus, no adjustment shall be made in the scenario (a) and (b) mentioned above. The adjustment in the remaining two scenarios shall be made as per the below provision.

4. Computation of deduction under Section 48(iii)

On the reconstitution of a partnership firm, both Section 9B and Section 45(4) apply. To compute the deduction under Section 48(iii), Section 9B shall be applied first and then Section 45(4).

Section 9B deals with the taxability of income arising in the firm's hands due to deemed transfer of a

capital asset or stock in trade on reconstitution. The income arising on such deemed transfer shall be credited to the partners' capital account. After such adjustment, the balance in the capital account will be considered for computation of taxable income under Section 45(4). Thus, in case of reconstitution, these provisions shall apply in the following sequence:

Step 1: Determine the capital gains or business income under Section 9B.

Step 2: Compute the partnership firm's total income, including income computed in the above step on the date of reconstitution.

Step 3: Compute tax on total income computed in the above step.

Step 4: Compute net income (*Step 2 – Step 3*)

Step 5: Credit the net income computed in the above step to the partner's capital account in their profit sharing ratio.

Step 6: Compute the amount of capital gains taxable under Section 45(4).

Step 7: Attribute the amount taxable under Section 45(4) to the assets remaining with the firm.

Step 8: The attribution of capital gain computed in the above step shall be made as per the following formula:

$$\text{Asset remaining with partnership firm} = \frac{\text{Revaluation gain in concerned asset}}{\text{Revaluation gain in all assets remaining with the firm}}$$

To determine the period of holding under *Step 6*, Rule 8AA has been amended to provide that the capital gains or part of it shall be deemed to be from the transfer of short-term capital asset if it is attributed to:

- (a) Capital asset which is short term capital asset at the time of taxation of amount under Section 45(4); or
- (b) Capital asset forming part of a block of asset; or
- (c) Capital asset being a self-generated asset and self-generated goodwill as defined in Section 45(4).

However, such capital gains or part of it shall be deemed to be long-term if it is attributed to a capital asset being transferred that is not covered above and is a long-term capital asset at the time of taxation of amount under Section 45(4).

As multiple capital assets (both long-term and short-term) could be given to the partner on reconstitution, the rule does not provide any guidance on the ultimate nature of the resultant capital gains. In such a situation, resultant capital gains can be bifurcated into short-term and long-term in proportion to the full value of consideration of each such asset (i.e., FMV on the date of reconstitution). However, clarity in this regard should be sought from the CBDT.

5. Case Studies

5.1. Example 1

A, B, C, and Dare equal partners in a partnership firm. Each having a capital balance of Rs. 10 lakhs. A decides to retire from the firm on 1st April. At the time of his retirement, Firm had the following assets:

Nature of Asset Book Value/Written Down Value (in lakhs)

Land	40
Building	25
Cash	140

Situation A:

Firm revalued its land and building at Rs. 50 lakhs and Rs. 35 lakhs respectively. The firm gives Rs. 10 lakhs and land to Mr. A. Such land was acquired by the firm 3 years ago.

Taxability under Section 9B

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land [A]	50
Book value of land (ignoring indexation of cost of acquisition) [B]	40
Long-term capital gains in the hands of Firm [C = A – B]	10
Tax rate [D]	20%
Tax on capital gains [E = C * D]	2
Amount to be attributed to partners account [F = C – E]	8

Taxability under Section 45(4)

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land [A]	50
Money [B]	10
Total consideration received [C = A + B]	60
Opening balance in capital account [D]	10
Attribution due to transfer of land [E = 8 * 1/4]	2
Capital balance at the time of reconstitution [F = D + E]	12
Deemed Capital Gains in the hands of Firm [G = C – F]	48
Tax rate*	20%
Tax on deemed capital gains	9.6

* Since the capital gains are attributable to the land, which is a long-term capital asset, the nature of capital gains would be long-term by virtue of Rule 8AA.

Since the firm has revalued building in addition to land, Sub-rule (2) of Rule 8AB would be applicable, and entire capital gains of Rs. 48 lakhs would be attributable to the building. The firm shall furnish the details of such attribution electronically in Form No. 5C.

Situation B:

Firm revalued its land and building at Rs. 50 lakhs and Rs. 35 lakhs respectively. The firm gives both

land and building to Mr. A. The land was acquired 3 years ago, and the building was acquired 6 months ago.

Taxability under Section 9B

<i>Particulars</i>	<i>Amount (in lakhs)</i>
Land	
FMV of land [A]	50
Book value of land (ignoring indexation of cost of acquisition) [B]	40
Long-term capital gains in the hands of Firm [C = A - B]	10
Tax rate [D]	20%
Tax on capital gains [E = C * D]	2
Amount to be attributed to partners account [F = C - E]	8
Building	
FMV of building [A]	35
WDV of building [B]	25
Short-term capital gains in the hands of Firm [C = A - B]	10
Tax rate [D]	30%
Tax on capital gains [E = C * D]	3
Amount to be attributed to partners account [F = C - E]	7

Taxability under Section 45(4)

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land [A]	50
FMV of building [B]	35
Total consideration received [C = A + B]	85
Opening balance in capital account [D]	10
Attribution due to transfer of land [E = 8 * 1/4]	2
Attribution due to transfer of Building [F = 7 * 1/4]	1.75
Capital balance at the time of reconstitution [G = D + E + F]	13.75
Deemed capital gains in the hands of Firm [H = C - G]	71.25 ^[See Note]
Capital gains attributable to long term capital asset [I = H * A/(A+B)]	41.91
Capital gains attributable to Short term capital asset [J = H * B/(A+B)]	29.34
Tax on long term capital gains [K = I * 20%]	8.38
Tax on Short term capital gains [L = J * 30%]	8.80

Note: Since the capital assets received by a specified person are both short-term and long-term capital asset, the capital gains is bifurcated into short-term and long-term gains on the basis of FMV of the assets.

Since the amount chargeable under Section 45(4) relate only to the capital asset received by the partner from the firm, the amount charged to tax under Section 45(4) shall not be attributed to any capital asset by virtue of sub-rule (3) of Rule 8AB. The specified entity shall not be required to file Form No. 5C.

Example 2

X, Y, and Z are equal partners in a partnership firm XYZ. Each was having a capital balance of Rs. 20 lakhs. X decides to retire from the firm. At the time of his retirement, XYZ had the following assets and liabilities:

Nature of Asset/Liabilities Book Value/Written Down Value (in lakhs)

Land	40
Building	25
Cash	140
Debtors	20
Creditors	25

XYZ revalued its land and building at Rs. 50 lakhs and Rs. 35 lakhs respectively. The firm decides to give Rs. 10 lakhs and land to Mr. X. Further, all debtors and creditors are also transferred to Mr. X. Such land was acquired by the firm 3 years ago.

Taxability under Section 9B

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land [A]	50
Book value of land (ignoring indexation of cost of acquisition) [B]	40
Capital Gains in the hands of XYZ [C = A - B]	10
Tax rate [D]	20%
Tax on capital gains [E = C * D]	2
Amount to be attributed to partners account [F = C - E]	8

Capital Account Balance of Mr. X at the time of reconstitution

<i>Particulars</i>	<i>Amount (in lakhs)</i>
Opening Balance [A]	20
Attribution due to transfer of land [B = 8 * 33%]	2.67
Debtors [C]	(20)
Creditors [D]	25
Closing Balance [E = A+B-C+D]	27.67

Taxability under Section 45(4)

<i>Particulars</i>	<i>Amount (in lakhs)</i>
Fair Market Value of land [A]	50
Money[B]	10
Total consideration received [C = A + B]	60
Capital balance at the time of reconstitution [D]	27.67
Deemed Capital Gains in the hands of XYZ [E = C - D]	32.33

Since the firm has revalued building in addition to land, Sub-rule (2) of Rule 8AB would be applicable, and entire capital gains of Rs. 32.33 lakhs would be attributable to a building. The firm shall furnish the details of such attribution electronically in Form No. 5C.

Example 3

X, Y, and Z are equal partners in a partnership firm XYZ. Each was having a capital balance of Rs. 20 lakhs. X decides to retire from the firm. At the time of his retirement, XYZ had the following assets and liabilities:

Nature of Asset/Liabilities Book Value/Written Down Value (in lakhs)

Land	40
Building	25
Machinery	15
Cash	140
Debtors	20
Creditors	25

XYZ revalued its land, building and machinery at Rs. 50 lakhs, Rs. 35 lakhs and Rs. 10 lakhs respectively. The firm decides to give Mr. X Rs. 10 lakhs in addition to the land. Such land was acquired by the firm 3 years ago.

Taxability under Section 9B

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land [A]	50
Book value of Land (ignoring the indexation of cost of acquisition) [B]	40
Capital Gains in the hands of XYZ [C = A – B]	10
Tax rate [D]	20%
Tax on capital gains [E = C * D]	2
Amount to be attributed to partners account [F = C – E]	8

Taxability under Section 45(4)

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land [A]	50
Money [B]	10
Total consideration received [C = A + B]	60
Opening balance in capital account [D]	20
Attribution due to transfer of land [E = 8 * 1/3]	2.67
Capital balance at the time of reconstitution [F = D + E]	22.67
Deemed Capital Gains in the hands of XYZ [G = C – F]	37.33
Tax rate*	20%
Tax on deemed capital gains	7.47

* Since the capital gains are attributable to the land, which is a long-term capital asset, the nature of capital gains would be long-term by virtue of Rule 8AA.

The firm has revalued building and machinery in addition to the transferred asset. However, no attribution shall be made to the value of machinery as there is a devaluation, and the rule provides that attribution is to be made in the proportion of the increase in the value of the asset. Thus, Sub-rule (2) of Rule 8AB would be applicable, and entire capital gains of Rs. 37.33 lakhs would be attributable to the building. The firm shall furnish the details of such attribution electronically in Form No. 5C.

Example 4:

X, Y, and Z are equal partners in a partnership firm XYZ. Each partner is having a capital balance of Rs. 20 lakhs. X decided to retire from the firm. At the time of his retirement, XYZ has the following assets

and liabilities:

<i>Nature of Asset/Liabilities</i>	<i>Book Value/Written Down Value (in lakhs)</i>
Land	40
Building	25
Cash	140
Debtors	20
Creditors	25

XYZ revalued its land and building at fair market value of Rs. 50 lakhs and Rs. 35 lakhs respectively. The firm gives Rs. 10 lakhs and land to Mr. X. Such land was acquired by the firm 3 years ago. Stamp Duty of land was Rs. 60 lakhs.

Taxability under Section 9B

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land [A]	50
Stamp Duty Value of Land [B]	60
Full Value of Consideration [C = A] ^[See note]	50
Book value of Land (ignoring the indexation of cost of acquisition) [D]	40
Capital Gains in the hands of XYZ [E = C - D]	10
Tax rate [F]	20%
Tax on capital gains [G = E * F]	2
Amount to be attributed to partners account [H = E - G]	8

Note: Section 9B provides that fair market value of the capital asset on the date of its receipt by partner shall be deemed to be the full value of the consideration received or accruing as a result of deemed transfer of the capital asset by firm. Section 50C provides that where consideration received or accruing on account of transfer of land or building is less than the value adopted by stamp value, the value so adopted is deemed to be the full value of consideration received or accruing for the purposes of computing capital gain. Both the provisions create a deeming fiction for determination of full value of consideration.

Similar issue, in the context of Section 45(3), was addressed by the Mumbai ITAT in the case of *ACIT v. Amartara Pvt. Ltd* [2021] 128 taxmann.com 125 (Mum. -Trib.). The ITAT held that the deeming fiction provided in section 50C cannot be extended to another deeming fiction created by the statute by way section 45(3). Applying the same principles, it would be reasonable to conclude that Section 9B being a specific provision will prevail over the general provisions of Section 50C. Thus, the stamp duty value of an immovable property shall be ignored for determination of full value of consideration under Section 9B.

Taxability under Section 45(4)

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land [A]	50
Money [B]	10
Total consideration received [C = A + B]	60
Opening Balance of capital Account [D]	20

Attribution due to transfer of land [E = 8 * 1/3]	2.67
Capital balance at the time of reconstitution [F = D + E]	22.67
Deemed Capital Gains in the hands of XYZ [G = C – F]	37.33

Since the firm has revalued building in addition to land, Sub-rule (2) of Rule 8AB would be applicable, and entire capital gains of Rs. 37.33 lakhs would be attributable to the building. The firm shall furnish the details of such attribution electronically in Form No. 5C.

Example 5:

A, B, C, and D are equal partners in a partnership Firm. Each was having a capital balance of Rs. 30 lakhs. A decides to retire from the firm on 01-07-2021. At the time of his retirement, firm has the following assets:

Nature of Asset Book Value/Written Down Value (in lakhs)

Land-X	40
Land-Y	50
Building	65
Cash	15

Firm revalued its land-X, land-Y and building at Rs. 50 lakhs, Rs. 60 lakhs and Rs. 85 lakhs respectively. The firm gives Rs. 10 lakhs and land-X to Mr. A. Both the lands were acquired by the firm 3 years ago. Profits earned by firm (net of expenses and tax) till 30-06-2021 was Rs. 4 lakhs.

Taxability under Section 9B

<i>Particulars</i>	<i>Amount (in lakhs)</i>
FMV of land-X [A]	50
Book value of Land-X (ignoring the indexation of cost of acquisition) [B]	40
Capital Gains in the hands of firm [C = A – B]	10
Tax rate [D]	20%
Tax on capital gains [E = C * D]	2
Amount to be attributed to partners account [F = C – E]	8

Taxability under Section 45(4)

<i>Particulars</i>	<i>Amount (in lakhs)</i>
Fair Market Value of land-X [A]	50
Money [B]	10
Total consideration received [C = A + B]	60
Opening balance in capital account [D]	30
Attribution of profit earned till the date of reconstitution [E = 4 * 1/4]	1
Attribution due to transfer of land-X [F = 8 * 1/4]	2
Capital balance at the time of reconstitution [G = D + E + F]	33
Deemed Capital Gains in the hands of Firm [H = C – G]	27
Tax rate*	20%
Tax on deemed capital gains	5.4

* Since the capital gains are attributable to the land, which is a long-term capital asset, the nature of capital gains would be long-term in accordance with the provisions of Rule 8AA.

Since the firm has revalued land-Y and building in addition to land-X, Sub-rule (2) of Rule 8AB would be applicable, and entire capital gains of Rs. 27 lakhs would be attributable to the land-Y and building in proportion to the revaluation gain.

Example 6:

Assume in Example 5 above, firm transfers land-Y and building on 31-03-2021 for Rs. 65 lakhs and 95 lakhs respectively.

Attribution of amount chargeable under Section 45(4)

<i>Particulars</i>	<i>Amount (in lakhs)</i>
Amount chargeable under Section 45(4) [A]	27
Revaluation gain on land-Y [B]	10
Revaluation gain on building [C]	20
Total revaluation gain on remaining assets [D = B + C]	30
Attribution of amount to land-Y [E = A * B/D]	9
Attribution of amount to building [F = A * C/D]	18

Taxability on subsequent transfer of building

<i>Particulars</i>	<i>Amount (in lakhs)</i>
Opening WDV [A]	65
Money received on transfer of such building [B]	95
Attribution of amount chargeable under Section 45(4) [C]	18
Closing WDV [A – (B-C)]	(12)

Since block ceases to exist, Rs. 12 lakhs would be chargeable to tax in the hands of firm as short term capital gains at the rate of 30%.

Taxability on subsequent transfer of land-Y

<i>Particulars</i>	<i>Amount (in lakhs)</i>
Full value of consideration [A]	65
Cost of acquisition (Ignoring the indexation of cost of acquisition) [B]	50
Attribution of amount chargeable under Section 45(4) [C]	9
Capital Gains [D = A – B – C]	6

Since such land was acquired 3 years ago, resultant capital gains of Rs. 6 lakhs would be chargeable to tax in the hands of firm as long term capital gains at the rate of 20%.

(Source: Taxmann.com)