Taxation on Reconstitution of Firms - Radically Revamped!

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Sachin Vasudeva
SCV & Co. LLP

Finance Act 2021 has amended the provisions regarding taxability of specified entities at the time of reconstitution of such entities. Finance Bill 2021 sought to substitute section 45 (4) with a new sub-section (4) and also proposed to insert sub-section (4A) in section 45. While sub-section (4) dealt with taxability at the time of receipt of a capital asset by the specified person at the time of dissolution/reconstitution, sub-section (4A) dealt with taxability on receipt of money or any other asset by the specified person on happening of the said event. Various representations were made by the stakeholders against the proposed amendments and the legislature in its wisdom withdrew those proposed amendments and substituted the existing sub-section (4) of section 45 with a new sub-section (4) and inserted section 9B in the Act to deal with the taxability arising on reconstitution and dissolution of specified entities. Section 48 of the Act has also been amended by inserting sub-clause (iii). An attempt has been made in this article to critically examine the amendments and highlight certain issues which could arise going forward.

Section 45(4)

The said section applies to a Specified Entity (SE) when there is a reconstitution of the SE as a result of which a Specified Person (SP) ceases to be a partner/member or one or more new partners are admitted in the SE or existing partners/members continue with change in their respective shares or in shares of some of them. SE has been defined to mean a firm, AOP and BOI and SP has been defined to mean a partner or a member as the case may be. Since the definition of firm in the section 2(23) of the Act covers a LLP so the said section equally applies to a LLP.

This section is **notwithstanding** section 45(1) and provides that where a specified person **receives** during the previous year any **money or capital asset or both** from a specified entity **in connection with** the reconstitution of such specified entity, then any profits or gains arising from receipt of such money by the specified person shall be chargeable to income-tax **as income of such 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 such money or capital asset or both were **received by the specified person.**

The section provides for a computation mechanism to tax such gains which is- **A = B+C-D**; where,

A = income chargeable to income-tax under this sub-section as income of the specified entity under the head "Capital gains";

B = value of any money received by the specified person from the specified entity on the date of such receipt;

C = the amount of fair market value of the capital asset received by the specified person from the specified entity on the date of such receipt; and

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

Explanation 2 to the said section provides- 'For the removal of doubts, it is clarified that when a capital asset is received by a specified person from a specified entity in connection with the reconstitution of such specified entity, the provisions of this sub-section shall operate in addition to the provisions of section 9B and the taxation under the said provisions thereof shall be worked out independently.'

As the said section overrides section 45(1) of the Act, the concept of 'transfer' and the 'year of transfer' is of no relevance while interpreting section 45(4) of the Act as the chargeability to tax is on 'receipt' of 'money' or 'capital asset' by the SP. Therefore, the taxability gets triggered in the year when the SP receives 'money' or 'capital asset' (stock-in-trade is not covered) in connection with reconstitution of the SE. Would the term 'money' include foreign currency? One view is that 'money' in its ordinary meaning does not include foreign currency and it would only include transaction in Indian Rupees, however in the computation formula the variable 'B' is defined to mean 'value of money'. This gives an indication that even if foreign currency were to be paid to the SP, it could get covered in this section.

The use of the term 'receives' indicates that it has to be an actual receipt and not a constructive receipt by the SP. Accordingly, if an amount were to be credited to the capital account of the SP, would that amount to receipt in the hands of the SP and trigger taxability?. The answer should be No, as mere receipt in the capital account does not entitle the SP to withdraw that amount from the SE and therefore till the time the SP does not have the right to withdraw the amount credited to his capital account, mere credit should not result in taxability under this section.

The next issue which arises is that since the income is chargeable to tax under the head capital gains whether the gain is a short-term gain or a long-term gain and what would be the rate of tax. As mentioned above, this section overrides section 45(1) of the Act wherein the incidence of tax is on 'transfer' of a capital asset. As, 45(1) of the Act is overridden so is the incidence of tax linked to transfer of the asset. Section 2(42A) which defines the term 'short term capital asset' provides that a 'short term capital asset' means a capital asset held by an assessee for not more than thirty- six months immediately preceding the date of its transfer and a 'long term capital asset' is defined to be an asset other than a short-term asset. Therefore, by necessary implication, even long-term capital asset is linked with the concept of transfer.

Section 45(4) of the Act as explained hereinabove is a charging and a computation section in itself and provides for incidence of tax upon receipt of capital asset and therefore has no dependence on 'transfer' of the asset for the tax to be levied. Furthermore, as the definition of 'transfer' given in section 2(47) of the Act has not been amended, it gives rise to a very perplexing situation which is that whether the gain arising under section 45(4) of the Act is long term or a short-term gain. This is because determination of long term or short term is linked to the period of holding before the 'transfer'. As the concept of transfer is overridden can there be a situation where this gain is neither long term nor short term? One may argue that while the tax under section 45(4) is on receipt of the asset by the SP and there is indeed a 'transfer' of an asset taking place at the level of the SE before the receipt by the SP so re-course can be taken to section 2(42A) and other relevant sections of the Act but the counter argument to this is that the period of holding of that asset will be taken for computing the gain in the hands of the SE under section 45(1) or section 50 which is independent of computation under section 45(4) which is only deeming the tax on the SP in hands of the SE and therefore that period of holding cannot be considered. Alternatively, it can also be argued that the number of years the SP has been a partner/member in the SE be considered as the period for determining the short term or long-term criteria. Be that it may, this issue is not free from controversy. If the final word on this is that the gain is neither a short-term or long-term gain then other unintended consequences such as denial of indexation, set off of losses and denial of deductions will follow.

There is also a challenge in terms of the rate of tax. If the concept of short-term/long term has to be read in the section then depending upon the period of holding of the asset/number of years the SP has been a partner/member the rate of tax can be determined but as discussed above, if the gain is neither short-term nor long-term then the rate of tax should be the normal rate of tax as applied to the SE.

The Hon'ble Apex Court in the case of Govind Saran Ganga Saran v Commissioner of Sales Tax [TS-5014-SC-1985-O] while adjudicating a matter under the Central Sales Tax Act, 1956 laid down the attributes of a charging section. The Court held that 'The components which enter into the concept of a tax are well known. The first is the character of the imposition known by its nature which prescribes the taxable event attracting the levy, the second is a clear indication of the person on whom the levy is imposed and who is obliged to pay the tax, the third is the rate at which the tax is imposed and the fourth is the measure or value to which the rate will be applied for computing the tax liability. If those components are not clearly and definitely ascertainable, it is difficult to say that the levy exists in a point of law. Any uncertainty or vagueness in the legislative scheme defining any of those components of the levy will be fatal to its validity.' Therefore, there is a possibility of scrutiny on the validity of section 45(4) of the Act.

The explanation to section 45(4) specifically mentions about this section being in operation in addition to section 9B and therefore to that extent there is an element of double taxation. There is, however, an amendment made in section 48(iii) of the Act which seems to provide relief from this aspect of double taxation but even that section is not very happily worded and therefore there could be controversies surrounding that as well. It is also important to note here that section 45(4) is applicable for AY 2021-22 and to that extent it is retrospective in its application.

Section 9B

This section deals with a situation where a SP receives during the previous year any capital asset or stock in trade or both from a SE in connection with the dissolution or reconstitution of such SE, then the SE shall be deemed to have transferred such capital asset or stock in trade or both, as the case may be, to the SP in the year in which such capital asset or stock in trade or both are received by the specified person. The section further provides that any profits and gains arising from such deemed transfer of capital asset or stock in trade or both, as the case may be, by the specified entity shall be—

(i) Deemed to be the income of such specified entity of the previous year in which such capital asset or stock-in-trade or both were received by the specified person; and

(ii) Chargeable to income tax as income of such SE under the head 'profits and gains of business or profession' or under the head 'capital gains' in accordance with the provisions of this Act.

The aforesaid section seeks to tax gains arising from dissolution and reconstitution of the SE. The chargeability is again in the year of receipt, but the normal computation provisions would apply in this case as the section uses the words 'in accordance with the provisions of this Act'. However, for computation of business income, section 29 of the Act refers to income under section 28 of the Act. Section 28 of the Act has not been amended to include the said deemed income and therefore can an argument be taken that the income under the head business cannot be computed and therefore it cannot be taxed. This argument may not hold good as every deeming fiction has to be taken to its logical conclusion and section 9B when uses the words 'profits and gains' one could reduce the cost price of the asset being transferred from its Fair Market Value and compute the profit for the purpose of taxing the same.

Other issues

On a conjoint reading of section 45(4) and 9B of the Act the other issues that arise are:

- What if the asset being transferred is forming a part of the block of assets of the SE and upon transfer of the asset the block still continues to exist. For the purposes of section 43(6) of the Act, moneys payable has to be reduced from the block of assets to determine the WDV. 'Moneys payable' is a defined term under the Act and does not envisage such a situation. Therefore, would depreciation be continued to be charged on the asset even though the asset is not in the books of the SP. One would expect certain amendments in various sections to deal with this aspect soon.

- There is no clarity on the cost of the asset in hands of the SP if the SP were to sell the asset subsequently. In an ideal situation, the cost should be the FMV of the asset which has been taken for the purposes of computation of capital gains by the SE but in the absence of any clarity there is room for litigation.

- Section 45(4) and 9B uses the term Fair Market Value (FMV) of the capital asset. One generally associates any reference to FMV to stamp duty value because of section 50CA/43CA and rule 11UA. Therefore, the question is whether the stamp duty value can be considered for section 9B and 45(4) of the Act while determining the FMV. The likely answer to this question is 'No' as all the aforesaid sections are specific in terms of its application and one would have to resort to the general definition of FMV given in section 2(22B) of the Act which defines FMV to be the price that the capital asset would ordinarily fetch on sale in the open market.

Concluding remarks

These are some of the issues which may arise due to these newly inserted provisions and by no means is this an exhaustive list. The point that is important is that in trying to provide certainty to one aspect for which the amendment has been made so many doors of uncertainties have been opened. It is hoped that necessary amendments or clarifications are provided to obviate litigation on these aspects.