

Taxation on Reconstitution of Firms - Radically revamped [Part II]

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Taxation at the time of reconstitution of firms has undergone a paradigm shift by virtue of amendments made by Finance Act, 2021. The newly inserted section 45(4) and section 9B have thrown up many interpretational issues such as determination of nature of capital gains, treatment when the asset transferred is part of the block of assets and what would be the cost of the asset in the hands of the partner receiving the capital assets from the firm amongst others which were covered in Part I of the analysis. Recently, the CBDT has amended Rule 8AA and inserted Rule 8AB in the Income-tax Rules, 1962 (the Rules) to address some of the issues. An attempt has been made in this article to explain the working of these new Rules and highlight some of the other issues which still remain unaddressed.

Rule 8AA(5)

Sub-Rule (5) has been inserted in Rule 8AA of the Rules w.e.f. 2nd July 2021 and provides as under:

In case of the amount which is chargeable to income-tax as income of specified entity under sub-section (4) of section 45 under the head - "Capital gains",-

- (i) *the amount or a part of it shall be deemed to be from transfer of*
- (a) *capital asset which is short term capital asset at the time of taxation of amount under sub-section (4) of section 45;*
- (b) *capital asset forming part of block of asset; or*
- (c) *capital asset being self-generated asset and self-generated goodwill as defined in clause (ii) of Explanation 1 to section 45 and*
- (ii) *the amount or a part of it shall be deemed to be from transfer of long term capital asset or assets, if it is covered by clause (i) and is long term capital asset at the time of taxation of amount under sub-section (4) of section 45.*

A tabular representation of the above Rule is as under:

S.No.	Where capital gain is attributed in whole or in part to	Nature of Capital gain
1	Capital asset which is short term as per the Act at the time of taxation under section 45(4) (by class of asset)	Deemed to be Short-term capital gain
2	Capital asset forming part of the block of the asset (by class of asset)	
3	Self-generated goodwill/asset (by class of asset)	
4	Any other capital asset not covered above and which is a long-	Long-term capital gain

term capital asset at the time of
taxation under section 45(4)

The said sub-rule proceeds on the assumption that while section 45(4) is notwithstanding section 45(1) the incidence of tax linked to transfer of the asset is not overridden. Legal pundits would like to challenge this but for now the said sub-rule provides a mechanism to determine whether the gain determined under section 45(4) is long term or short term and consequently also addresses the issue of rate of tax to be applied on such gain.

Rule 8AB

Rule 8AB has also been inserted w.e.f. 2nd July 2021 and the relevant portion of the Rule is given below:

(1) For the purposes of clause (iii) of section 48, where the amount is chargeable to income-tax as income of specified entity under sub-section (4) of section 45, the specified entity shall attribute such amount to capital asset remaining with the specified entity in a manner provided in this rule.

(2) Where the aggregate of the value of money and the fair market value of the capital asset received by the specified person from the specified entity, in excess of the balance in his capital account, chargeable to tax under sub-section (4) of section 45, relates to revaluation of any capital asset or valuation of self-generated asset or self-generated goodwill, of the specified entity, the amount attributable to the capital asset remaining with the specified entity for purpose of clause (iii) of section 48 shall be the amount which bears to the amount charged under sub-section (4) of section 45 the same proportion as the increase in, or recognition of, value of that asset because of revaluation or valuation bears to the aggregate of increase in, or recognition of, value of all assets because of the revaluation or valuation.

(3) Where the aggregate of the value of money and the fair market value of the capital asset received by the specified person from the specified entity, in excess of the balance in his capital account, charged to tax under sub-section (4) of section 45 does not relate to revaluation of any capital asset or valuation of self-generated asset or self-generated goodwill, of the specified entity, the amount charged to tax under sub-section (4) of section 45 shall not be attributed to any capital asset for the purposes of clause (iii) of section 48.

(4) Notwithstanding anything contained in sub-rules (2) or (3), where the aggregate of the value of money and the fair market value of the capital asset received by the specified person from the specified entity, in excess of the balance in his capital account, charged to tax under sub-section (4) of section 45 relate only to the capital asset received by the specified person from the specified entity, the amount charged to tax under sub-section (4) of section 45 shall not be attributed to any capital asset for the purposes of clause (iii) of section 48.

A reading of the above rule suggests that the said rule deals with the 'Attribution of income taxable under sub-section (4) of section 45 to the capital assets remaining with the specified entity, under section 48.' The attribution mechanism therefore would come into play when the taxation is triggered on the excess amount which relates to revaluation of a capital asset or valuation/revaluation of self-generated goodwill based on a valuation report obtained from a registered valuer. The value so determined under this sub-rule would be a permissible deduction under clause (iii) of section 48 of the Act.

Application of Rule 8AA(5) and Rule 8AB

Vide Circular No. 14 dated 2nd July 2021, the Board has clarified that the amount taxed under sub-section (4) of section 45 of the Act is required to be attributed to the remaining assets as per section 48(iii) of the Act. Though this circular has been issued pursuant to provisions of section 9B and section 45(4) of the Act which empower the Board to issue clarifications, the said Circular goes on to clarify that the method of attribution contained in the said rule would equally apply to assets forming part of the block of the asset. The intent of the Board to clarify this aspect for section 43(6) and section 50 is laudable but whether it is legally permissible to do so is a question that would be tested in times to come by the judiciary. This is because there is no enabling provision in either section 43(6) or section 50 to

empower the Board to issue such a clarification.

Let us try to understand the application of section 9B, 45(4) and the said rules through the examples given in the Circular.

Example 1

There are three partners A, B and C in a firm "ABC", having one third share each. Each partner has a capital balance of Rs 10 lakh in the firm. There are three pieces of lands "S", "T" and "U" in that firm and there is no other capital asset in that firm. Book value of each of the land is Rs 10 lakh. All these three lands were acquired by the firm more than two years ago. Partner "A" wishes to exit. The firm re-values its lands based on valuation report from a registered valuer, as defined in rule 11U of the Rules, and as per that valuation report fair market value of lands "S" and "T" is Rs 70 lakh each, while fair market value of land "U" is Rs 50 lakh. On the exit of partner "A", the firm decides to give him Rs 11 lakh of money and land "U" to settle his capital balance.

Balance Sheet of ABC Firm

Liabilities	Amount (Rs)	Assets	Amount in (Rs)
Capital Balance-A	10,00,000	Land S	10,00,000
Capital Balance-B	10,00,000	Land T	10,00,000
Capital Balance-C	10,00,000	Land U	10,00,000
Total	30,00,000	Total	30,00,000

Computation of tax under section 9B

Particulars	Tax under section 9B (Rs)
FMV of capital asset received	50,00,000
Indexed cost of land #	15,00,000
Long-term Capital Gain*	35,00,000
Tax on above @20%	7,00,000

assumed for simplicity

*As asset is held for more than two years

The firm would pay a long term capital gain tax of Rs.7 lakh i.e. 20% of Rs.35 lakh (without considering surcharge and cess). As section 9B deems that the firm has transferred the land effect of the transaction would need to be given to the capital account of the partner as well. The capital account of the partner would be as under:

Retiring Partner's (A) capital account-

Particulars	Debit (Rs)	Particulars	Credit (Rs)
Share of Tax	2,33,333	Opening balance	10,00,000
Balance	21,00,000	By share of profit on revaluation of land U	13,33,333
Total	23,33,333	Total	23,33,333

Calculation of tax under section 45(4)

The calculation of tax under section 45(4) of the Act is based on the formula given in the said section which is as under:

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:

Particulars	Amount (Rs)
Cash paid to partner (B)	11,00,000
FMV of the asset (C)	50,00,000
Capital balance (D)	21,00,000
Capital gains (A)	40,00,000
Tax payable @ 20%	8,00,000

The aforesaid tax would be in addition to the tax payable under section 9B of the Act.

Having determined the gain under section 45(4), the next step would be to determine its nature i.e. whether it is long-term or short-term. As this gain of Rs.40 lakh is attributed to land S&T which are long term capital assets at the time of taxation under section 45(4), the said gain of Rs.40 lakh would be a long term capital gain.

Further, as per Rule 8AB, the amount of capital gains determined under section 45(4) of the Act i.e. Rs.40 lakh shall be reduced from the consideration under section 48(iii) of the Act upon the sale of the other capital assets owned by the firm i.e. Land S and T. Considering the apportionment formula in the Rule and the fact that the revaluation amount for Land S and Land T is the same, the aforesaid amount of Rs.40 lakh shall be equally attributed to Land S and Land T. Thus, upon sale of either of the land S and T, Rs.20 lakh would be reduced from the sale consideration as and when the actual sale takes place.

Example 2

There are three partners "A", "B" and "C" in a firm, having one third share each. Each partner has a capital balance of Rs.100 lakh in the firm. There is a piece of land "S" of book value of Rs.30 lakh. There is patent "T" of written down value of Rs.45 lakh and there is cash of Rs.225 lakh. The land was acquired by the firm more than two years ago. The patent was acquired/developed/ registered one year back.

Partner "A" wishes to exit. The firm re-values its land and patent based on valuation report from a registered valuer, as defined in rule 11 U of the Rules, and as per that valuation report fair market value of land "S" is Rs.45 lakh and fair market value of patent "T" is Rs.60 lakh. As per the valuation report there is also self-generated goodwill of Rs.30 lakh. On the exit of partner "A", the firm decides to give him Rs.75 lakh in money and land "S" to settle his capital balance.

Balance Sheet of ABC Firm

Liabilities	Amount (Rs)	Assets	Amount in (Rs)
Capital Balance-A	1,00,00,000	Land S	30,00,000
Capital Balance-B	1,00,00,000	Patent (depreciable asset)	45,00,000
Capital Balance-C	1,00,00,000	Cash	2,25,00,000
Total	3,00,00,000	Total	3,00,00,000

Computation of tax under section 9B

Particulars	Tax under section 9B (Rs)
FMV of capital asset received	45,00,000
Indexed cost of land #	45,00,000
Long-term Capital Gain	Nil
Tax on above @20%	Nil

assumed for simplicity

Retiring Partner's (A) capital account-

Particulars	Debit (Rs)	Particulars	Credit (Rs)
Share of Tax	Nil	Opening balance	1,00,00,000
Balance	1,05,00,000	By share of profit on revaluation of land	5,00,000
Total	1,05,00,000	Total	1,05,00,000

Calculation of tax under section 45(4)

Particulars	Amount (Rs)
Cash paid to partner (B)	75,00,000
FMV of the asset (C)	45,00,000
Capital balance (D)	1,05,00,000
Capital gains (A)	15,00,000

On account of clause (iii) of section 48 of the Act, read with rule 8AB of the Rules, Rs.15 lakh is to be attributed to the remaining capital assets of the firm as per the formula given in Rule 8AB.

Calculation of the amount of attribution

S.No.	Asset	Book Value/WDV(Rs)	FMV(Rs)	Increase (Rs)	Attribution(Rs)
1	Patent	45,00,000	60,00,000	15,00,000	5,00,000
2	Goodwill	Nil	30,00,000	30,00,000	10,00,000
	Total			45,00,000	

In this case, as per the report of the valuer the value of patent "T" has increased by Rs.15 lakh and the self-generated goodwill is valued at Rs.30 lakh. The aggregate increase in the remaining assets is Rs.45 lakh. Thus, one third of Rs.15 lakh i.e. Rs.5 lakh would be attributed to patent "T", while two third of Rs.15 lakh i.e. Rs.10 lakh would be attributed to self-generated goodwill. Rs 5 lakh attributed to patent "T" shall not be added to the block of the assets and no depreciation shall be available on the same. When patent "T" gets transferred subsequently, Rs.5 lakh attributed to the value of patent shall be reduced from the full value of the consideration received or accruing as a result of transfer of patent "T" by the firm and the net value shall be considered for reduction from the written down value of the intangible block under sub-clause (c) of clause (6) of section 43 of the Act or for calculation of capital gains, as the case may be, under section 50 of the Act. Similarly, when goodwill gets sold subsequently, Rs.10 lakh would be reduced from its sales consideration under clause (iii) of section 48.

The amount Rs.15 lakh which is charged to tax under sub-section (4) of section 45 of the Act shall be charged as short-term capital gains, as Rs.5 lakh is attributed to the Patent "T" which is part of block of assets and Rs.10 lakh is attributed to self-generated goodwill. In accordance with sub-rule (5) of Rule 8AA of the Rules, both of these are to be characterised as short-term capital gains.

Other Issues and concluding remarks

While the Rule provides clarity on the computational aspect there are still some issues which are open to debate and which are:

Validity of Rule 8AA(5)

The Act does not empower the CBDT to issue any rule to determine the nature of capital gains i.e. be it long term or short term. Under 2(42A) of the Act the CBDT can only issue clarifications on the period of holding. It cannot deem a particular transaction as long term or short term like it is sought to be done in Rule 8AA. Presuming that it is valid then another aspect which would be relevant is whether this Rule would apply for AY 2021-22. If an analogy were to be drawn from the year of applicability of Rule 8D, it would be fair to interpret that even Rule 8AA(5) should be prospective in its application.

Determination of the Nature of Gain where the Retiring Partner Receives only Cash in the Excess of Capital Balance

This aspect has not been directly covered by the Board circular and therefore there could be some controversy around it. The rule only covers the aspect of capital gain attributed to remaining assets when gain is on account of revaluation of assets. For eg. if Rs 1 crore is being paid to a retiring partner against his capital balance of Rs 60,00,000/- then what would be the nature of such gain i.e. will it be short-term or long term. While the Rule and the Circular is silent on this aspect, a reasonable interpretation that emerges could be to attribute the excess towards self-generated goodwill and accordingly cover the same under the Rules and determine the nature of the gain. The other view that there is no computation mechanism to determine the nature of the gain and therefore the charge fails would be a very aggressive view and prone to litigation.

Taxability in the Hands of the Legal Heir of the Deceased Partner

The answer to the above issue should be that the amount received by the legal heir should not be taxable under section 45(4) in the hands of the firm as the legal heir is not the specified person under the said section. Under section 159, a legal heir can be taxed on the amount that the legal heir is receiving if it would have been taxable in the hands of the deceased as if he had not died. The tax under section 45(4) is on the firm and not on the deceased partner and therefore the amount received by the legal heir should neither be taxable in the hands of the firm nor in the hands of the legal heir.

Adjustment of Time Value of Money

The mantra of the Department is to collect tax today and allow for an adjustment tomorrow. This aspect ignores the time value of money as also the fact that the asset to which the gain is attributable to, may never be sold.

Concluding Remarks

This paradigm shift in taxation at the time of reconstitution of firms is very complex and will take time for the assesses to absorb. By no stretch of imagination the list of issues raised is exhaustive as there could be many other interpretational issues which may emerge when these sections would be applied in real life situations. Therefore, the moot point remains that was it wise to introduce a new scheme of taxation which is so complex and to unsettle the position which had been made clear by judicial rulings.