

## ANALYSIS ON COMPUTATION OF CAPITAL GAINS ON DISSOLUTION OR RECONSTITUTION OF A PARTNERSHIP FIRM

Where any assets got transferred to the partner in any previous year on reconstitution or dissolution of the firm, the tax implications are always in question to us. To clarify whether such transfer is taxable in the hands of the firm or the partner, this article discusses the recent guidelines and clarifications issued by CBDT on the computation of capital gains.

### But first let us know the meaning of certain terms:

*Specified entity* means a firm or other Association of Persons (AOP) or Body of Individuals (BOI). For simplicity, here the 'specified entity' is referred to as a 'firm'.

*Specified person* means a person who is a partner of a firm or member of other AOP or in any previous year. For simplicity, here the 'specified person' is referred to as a 'partner'.

So as per the inserted sections of the Income Tax Act, on dissolution the partnership firm will attract the provisions of Section 9B and whenever there is a change in the profit-sharing ratio related scenarios which leads to the reconstitution then both Sections 9B and 45(4) will be applicable. Income taxability in such situations is discussed below.

### Does on the dissolution or reconstruction of a firm any asset transferred to the partner is taxable in the hands of the firm?

#### Income on receipt of capital asset or stock in trade by a partner from a firm [Section 9B]

- Section 9B provides that where a partner receives during the previous year any **capital asset** or **stock-in-trade** or **both** from a firm in connection with the **dissolution** or **reconstitution** of such firm, then the firm shall be deemed to have transferred such capital asset or stock-in-trade or both, to the partner *in the year in which such capital asset or stock in trade or both are received by that partner*.
- Any profits and gains arising from such deemed transfer of stock in trade taxable under the head 'Business or Profession' or capital asset under the head 'Capital Gain'.

<b>FAIR MARKET VALUE</b> <i>(On the date of its receipt by the partner)</i>	=	<b>FULL VALUE OF CONSIDERATION</b>
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#### Tax on receipt of money or capital asset by partner in connection with reconstitution of firm - Section 45(4)

Where a partner receives any *money or capital asset or both* from its firm in connection with the **reconstitution** of such firm, then any profits or gains arising from such receipts by the partner will be chargeable to income-tax in the hands of the firm under the head "Capital gains" in the year of such receipts.

**Computation of capital gain under Section 45(4) shall be as follows:**

$$A = B + C - D$$

**A** = Income chargeable to income-tax under this provision as income of the firm under the head 'Capital Gains';

**B** = Value of money received by partner on the date of such receipt;

**C** = Fair market value of the capital asset received by the partner on the date of such receipt; and

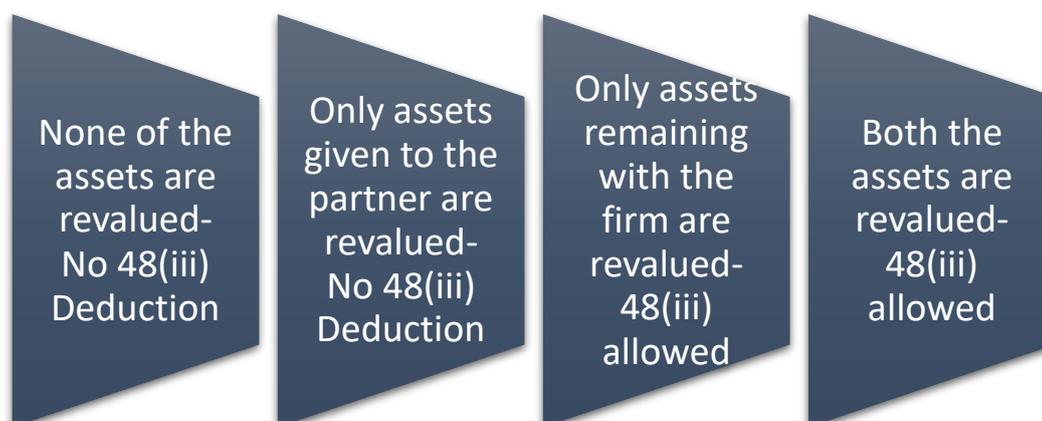
**D** = Balance in the capital account (represented in any manner) of the partner in the books of account of the firm at the time of reconstitution.

*Where the value of A is negative, it shall be deemed to be nil.*

**Additional Deduction under Section 48(iii) of the Income Tax Act, 1961**

- To remove the impact of such double taxation, the Finance Act, 2021, has amended Section 48.
- 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.

**Following four scenarios may arise on the reconstitution of the firm:**



**Rule 8AB of The Income-Tax Rules, 1962: Method of Appropriation to Capital Assets**

- (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.*

The partnership firm is required to furnish the details of the amount attributed to the capital asset remaining with it in **Form No. 5C**.

### Practical Aspect

A, B, C, and D are 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 (Revalued amount Rs 50 Lakhs)
Building	25 (Revalued amount Rs 35 Lakhs)

The firm gives Rs. 10 lakhs and land to Mr. A. Such land was acquired by the firm 3 years ago.

### **What is the method prescribed, to calculate the income of the firm under Section 9B?**

As any profit or loss on the transfer of capital asset to a partner will be taxable. To calculate such income the method is given below-

#### **Taxability under Section 9B**

Income from the head of Capital Gains	Amount (in lakhs)
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

### **How to calculate Income on receipt of capital asset to partner by the firm?**

#### **Taxability under Section 45(4)**

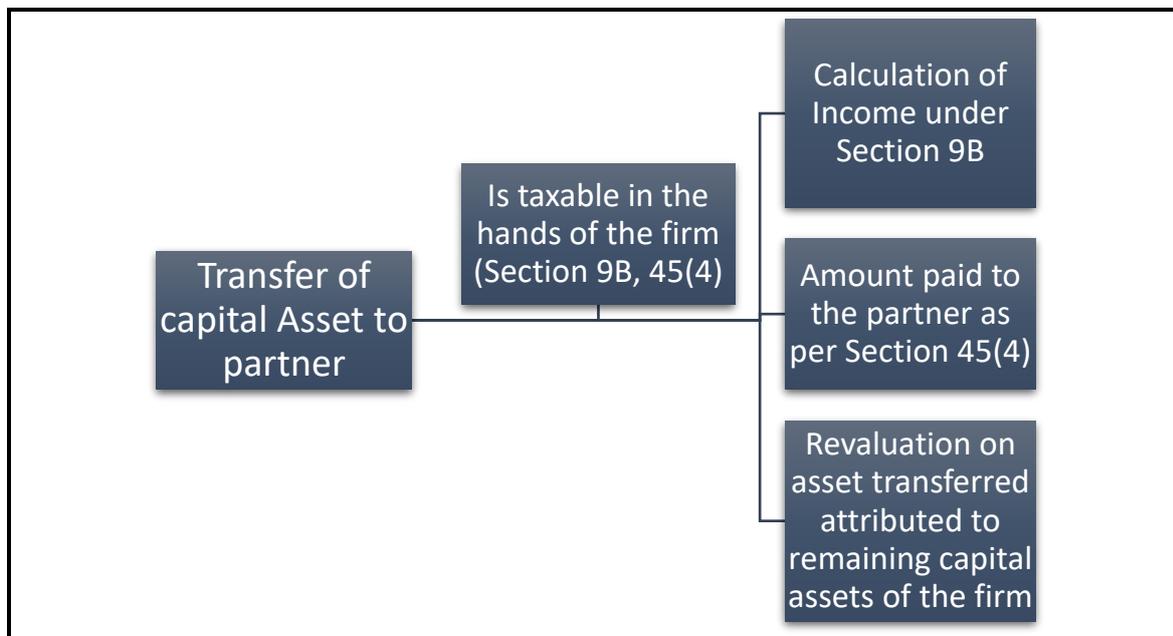
Income from the head of Capital Gains	Amount (in lakhs)
FMV of land [A]	50
Money [B]	10
Total consideration received [C = A + B]	60
Capital balance at the time of reconstitution [D]	10
Deemed Capital Gains in the hands of Firm [E = C – D]	50

### **How will firm record the revaluation in capital asset?**

Since the firm has revalued building in addition to land, which means all the assets of the firm are revalued, then deduction of Section 48(iii) will be allowed and Sub-rule (2) of Rule 8AB would be applicable, therefore, the entire capital gains of Rs. 50 lakhs as calculated under Section 45(4) would be attributable to the remaining assets of the firm i.e., building.

Also, the firm will disclose the amount attributed among the capital assets in **Form No. 5C** before filing the income tax return.

When the asset will be sold in future, then such added amount will be deducted as per Section 48(iii) to avoid double taxation.



### Conclusion:

To conclude, Section 9B deals with the taxability of the income arising to the firm on transfer of capital asset to a partner in connection with dissolution or reconstitution whereas Section 45(4) deals with the income which arises to the partner on receipt of a capital asset in connection with the reconstitution.

However, to avoid double taxation reduction of cost of acquisition, improvement and expenditure incurred in connection with transfer from full value of consideration of capital asset while computing income chargeable under the head capital gains is provided.

In other words, a portion of the capital gains so taxed shall be reduced from the full value of consideration of the capital asset being transferred by the firm. Such portion shall be attributable to only that capital asset which is being transferred by the firm as given in Rule 8AB. This method of attribution shall be applicable from AY 2021-22.

### Quick Links:

Format of Form 5C

[https://www.incometaxindia.gov.in/communications/notification/notification\\_76\\_2021.pdf](https://www.incometaxindia.gov.in/communications/notification/notification_76_2021.pdf)

Circular No. 14 dated July 2, 2021

[https://www.incometaxindia.gov.in/communications/circular/circular\\_14\\_2021.pdf](https://www.incometaxindia.gov.in/communications/circular/circular_14_2021.pdf)