

TAX FLASH NEWS

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CBDT issues guidelines on the taxability of transfer of assets by a partnership firm to its partners on its dissolution or reconstitution

The Finance Act, 2021 introduced a new Section 9B in the Income-tax Act 1961 (the Act) with effect from assessment year 2021-22. It provides that whenever a 'specified person'¹ receives any capital asset or stock in trade or both from a 'specified entity'² in connection with the dissolution or reconstitution of such specified entity, then it shall be deemed that the specified entity have transferred such capital asset or stock in trade or both to the specified person (deemed transfer). This deemed transfer would be in the year in which such capital asset or stock in trade or both are received by the specified person. Any profits and gains arising from such transfer is deemed to be the income of such specified entity. Further, the income of such specified entity can be taxable as 'business income' or 'capital gain'.

The Fair Market Value (FMV) of the capital asset or stock in trade or both, on the date of its receipt by the specified person, shall be deemed to be the full value of the consideration received or accruing as a result of such deemed transfer.

Similarly, the Finance Act 2021 amended Section 45(4) to provide that where a specified person receives 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 such receipt by the specified person shall be chargeable to tax as income of the specified entity under the head 'Capital gains'. It has been further deemed that this income shall be the income of the specified entity of the previous year in which such money or capital asset or both were received by the specified person. A formula to calculate such profits and gains has also been provided. Section 45(4) levies capital gains tax on realisation by the partner in excess of his/her capital account balance, in connection with reconstitution.

Once such value appreciation is taxed at the stage of reconstitution, the provisions of Section 48(ii) provides for attributing such value appreciation to remaining capital assets of the specified entity, which is creditable as and when such remaining capital assets are transferred by the specified entity, post reconstitution, as a reduction from the sale consideration.

Further, 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 Section 45(4) shall operate in addition to the provisions of Section 9B and the taxation under the said provisions thereof shall be worked out independently.

Recently, the CBDT has issued a Circular³ prescribing guidelines with respect to the taxability on account of distribution of assets by a partnership firm to its partners on its dissolution or reconstitution. Further, CBDT has also issued Notification⁴ amending rules with respect to the method of determination of period of holding of capital assets in certain cases. Similarly, CBDT has introduced a rule with respect to the attribution of income taxable under Section 45(4) to the capital assets remaining with the specified entity, under Section 48.

¹ 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

² Specified entity means a firm or other association of persons or body of individuals (not being a company or a co-operative society)

³ CBDT Circular No. 14/2021, dated 2 July 2021

⁴ CBDT Notification No. 76/2021, dated 2 July 2021

Amendment in Rules

CBDT amended⁵ rules with respect to method of determination of period of holding of capital assets in certain cases. It has been provided that in the case of the amount which is chargeable to income-tax as income of specified entity under Section 45(4):

- The amount or a part of it shall be deemed to be from transfer of short-term capital asset, if it is attributed to –
 - Capital asset which is a short term capital asset at the time of taxation of amount under Section 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)
- The amount or a part of it shall be deemed to be from transfer of long-term capital asset or assets, if it is attributed to capital asset which is not covered by the above provision.

CBDT introduced new rule⁶ under the Income-tax Rules, 1962 (the Rules) with respect to the attribution of income taxable under Section 45(4)⁷ to the capital assets remaining with the specified entity, under Section 48:

- For the purposes of Section 48(iii)⁸, where the amount is chargeable to income-tax as income of specified entity under Section 45(4), the specified entity shall attribute such amount to capital asset remaining with the specified entity in a manner provided in this rule.
- Where the aggregate of the value of money and the FMV 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 Section 45(4), relates to revaluation of any capital asset or valuation of self-generated asset or self-generated goodwill, of the specified entity:
 - Such amount should be attributed to the capital asset remaining with the specified entity for purpose of Section 48(iii) in 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.
- Where the aggregate of the value of money and the FMV of the capital asset received by the specified person, in excess of the balance in his capital account, charged to tax under Section 45(4) 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 so charged to tax shall not be attributed to any capital asset for the purposes of Section 48(iii).
- Notwithstanding anything contained in the above rules, where the aggregate of the value of money and the FMV of the capital asset received by the specified person, in excess of the balance in his capital account, charged to tax under Section 45(4) relate only to the capital asset received by the specified person from the specified entity, the amount so charged to tax shall not be attributed to any capital asset for the purposes of Section 48(iii).
- The specified entity shall furnish the details of amount attributed to capital asset remaining with the specified entity in Form No. 5C. Form No. 5C shall be furnished electronically either under digital signature or through electronic verification code.

CBDT Guidelines

Issue	Guidelines
It was noticed that the amount taxed under Section 45(4) is required to be attributed to the remaining capital assets of the specified entity, 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 specified	<p>CBDT clarified that Rule 8AB (notified vide Notification No. 76, dated 2 July 2021) also applies to capital assets forming part of block of assets.</p> <p>It is further clarified that in case the capital asset remaining with the specified entity is forming part</p>

⁵ Rule 8AA - Method of determination of period of holding of capital assets in certain cases

⁶ Rule 8AB - Attribution of income taxable under Section 45(4) to the capital assets remaining with the specified entity, under Section 48

⁷ Section 45(4) – Taxability of capital gain arising from receipt of any money or capital asset or both from a specified entity

⁸ In case of value of any money or capital asset received by a specified person from a specified entity referred to in Section 45(4), the amount chargeable to income-tax as income of such specified entity under that sub-section which is attributable to the capital asset being transferred by the specified entity, calculated in the prescribed manner

<p>entity does not pay tax again on the same amount. It is further noticed that this attribution is given in the Act only for the purposes of Section 48.</p> <p>It may be seen that Section 48⁹ only applies to capital assets which are not forming block of assets. For capital assets forming block of assets there is Section 43(6)(c) to determine written down value (WDV) of the block of asset and Section 50 to determine the capital gains arising on transfer of such assets. However, it was not clear that amount taxed under Section 45(4) can also be attributed to capital assets forming part of block of assets.</p>	<p>of a block of asset, the amount attributed to such capital asset under Rule 8AB shall be reduced from the full value of the consideration received or accruing as a result of subsequent transfer of such asset by the specified entity, and the net value of such consideration shall be considered for reduction from the written down value of such block under Section 43(6)(c) or for calculation of capital gains under Section 50.</p>
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Examples of the application of Section 9B and Section 45(4)

Question	Answer
<p>Example 1</p> <p>(i) There are three partners 'A', 'B' and 'C' in a firm 'FR', having one third share each. Each partner has a capital balance of INR 10 lakh in the firm. There are three pieces of lands 'S', 'T' and 'U' in that firm. Book value of each of the land is INR 10 lakh. All these three lands were acquired by the firm more than two years ago.</p> <p>(ii) Partner 'A' wishes to exit. The firm revalues its lands based on valuation report from a registered valuer, as defined in Rule 11U, and as per that valuation report fair market value of lands 'S' and 'T' is INR 70 lakh each, while fair market value of land 'U' is INR 50 lakh.</p> <p>(iii) On the exit of partner 'A', the firm decides to give him INR 11 lakh of money and land 'U' to settle his capital balance.</p> <p>(iv) The indexed cost of acquisition (COA) of land 'U' is INR 15 lakh.</p>	<p>Tax implication under Section 9B</p> <ul style="list-style-type: none"> On account of the deeming provisions of Section 9B, it is deemed that the firm 'FR' has transferred land 'U' to partner 'A'. Thus, an amount of INR 35 lakh [INR 50 lakh (FMV) - INR 15 lakh (COA)] would be charged to tax in the hands of firm 'FR' under the head 'capital gains'. For partner 'A', the cost of acquisition of this land would be INR 50 lakh. Further, it is assumed that the tax is INR 7 lakh. Further as a accounting treatment net book profit after tax of INR 33 lakh (capital gains of INR 40 lakh without indexation less tax of INR 7 lakh) is to be credited in the capital account of each of the three partners, i.e. (INR 11 lakh each). Thus, partner 'A' capital account would increase to INR 21 lakh.. <p>Tax implication under Section 45(4)</p> <ul style="list-style-type: none"> As against capital balance of INR 21 lakh, partner 'A' has received INR 61 lakh [(INR 11 lakh of money + land 'U' (INR 50 lakh)]. Thus, INR 40 lakh is required to be charged to tax under Section 45(4). This shall be in addition to an amount of INR 35 lakh charged to tax under Section 9B. <p>Attributing capital gains under section 45(4) to remaining capital assets of firm</p> <ul style="list-style-type: none"> On account of Section 48(iii), read with Rule 8AB, INR 40 lakh is to be attributed to the remaining assets of the firm 'FR' on the basis of increase in their value due to revaluation based on the valuation report of registered valuer.

⁹ Mode of computation

	<ul style="list-style-type: none"> • In this case as per revaluation there are only two capital assets remaining: lands 'S' and 'T'. In both cases the value has increased by (INR 60 lakh each). Thus, out of INR 40 lakh, INR 20 lakh shall be attributed to land 'S' and INR 20 lakh to land 'T'. • When either of these lands gets sold, this amount attributed to them would be reduced from sales consideration under Section 48(iii). • The amount of INR 40 lakh which is charged to tax under Section 45(4) shall be charged as long term capital gains in view of Rule 8AA(5), since it is attributed to land 'S' and land 'T' which are both long term capital assets at the time of taxation of INR40 lakh under Section 45(4).
<p>Example 2</p> <p>In this example, instead of allotment of land U to the retiring partner, the specified entity sells land U to an outsider at FMV and settles retiring partner's capital account by paying only cash of 61 lakh.</p>	<p>Section 9B is not applicable but the normal capital gains taxation provisions are applicable at the time of sale of capital asset by the specified entity in favor of an outsider. The net result of capital gains tax incidence in Example 2 is the same as Example 1 (due to applicability of Section 9B in Example 1).</p>
<p>Example 3</p> <p>(i) There are three partners 'A', 'B' and 'C' in a firm 'FR', having one third share each. Each partner has a capital balance only INR 100 lakh in the firm.</p> <p>(ii) There is a piece of land 'S' of book value of INR 30 lakh. There is patent 'T' of written down value of INR 45 lakh. And there is cash of INR 25 lakh. The land was acquired by the firm more than two years ago. The patent was acquired/developed/ registered one year back.</p> <p>(iii) Partner 'A' wishes to exit. The firm revalue its land and patent based on valuation report from a registered valuer, as defined in Rule 11U, and as per that valuation report fair market value of land 'S' is INR 45 lakh and fair market value of patent 'T' is INR 60 lakh.</p> <p>(iv) As per the valuation report there is also self-generated goodwill of INR 30 lakh.</p> <p>(v) On the exit of partner 'A', the firm decides to give him INR 75 lakh in money and land 'S' to settle his capital balance.</p>	<p>Tax implication under Section 9B</p> <ul style="list-style-type: none"> • On account of the deeming provisions of Section 9B, it is deemed that the firm 'FR' has transferred land 'S' to partner 'A'. However, since the sale consideration is equal to indexed cost of acquisition (assumed), there will not be any capital gains tax. • For partner 'A', the cost of acquisition of this land would be INR 45 lakh. • The net book profit of INR 15 lakh [45 lakh (FMV) – 30 Lakh (book value) – 0 tax] is to be credited in the capital account of each of the three partners, i.e. INR 5 lakh each. Thus partner 'A' capital account would increase to INR 105 lakh. <p>Tax implication under Section 45(4)</p> <ul style="list-style-type: none"> • As against capital balance of INR 105 lakh, partner 'A' has received INR 120 lakh (money of INR 75 Lakh plus land 'S' of fair market value of INR 45 lakh). Thus, INR 15 Lakh is required to be charged to tax under Section 45(4). <p>Attributing capital gains under Section 45(4) to remaining capital assets of firm</p> <ul style="list-style-type: none"> • On account of Section 48(iii), read with Rule 8AB and this guidance note, the above INR 15 lakh is to be attributed to the remaining capital assets of the firm 'FR' on the basis of increase in the value due to revaluation of existing capital assets, or due to recognition of the value of self-generated goodwill based on the valuation report of registered valuer. • In this case as per this report the value of patent 'T' has increased by INR 15 lakh and the self-

	<p>generated goodwill value has been recognised at INR 30 lakh. Thus, one third on INR 15 lakh (i.e. 5 lakh) would be attributed to patent 'T', while two third of INR 15 lakh (i.e. INR 10 lakh) would be attributed to self-generated goodwill.</p> <ul style="list-style-type: none"> • INR 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, this INR 5 Lakh attributed shall be reduced from the full value of the consideration received or accruing as a result of transfer of patent 'T' by the firm 'FR', and the net value shall be considered for reduction from the written down value of the intangible block under Section 43(6)(c) or for calculation of capital gains, under Section 50. • Similarly, when goodwill gets sold subsequently, INR10 lakh would be reduced from its sales consideration under Section 48(iii). • The amount INR15 lakh which is charged to tax under Section 45(4) shall be charged as short term capital gains, as INR 5 lakh is attributed to the Patent 'T' which is part of block of assets and INR 10 lakh is attributed to self-generated goodwill. In accordance with Rule 8AA(5) of the Rules, both of these are to be characterised as short term capital gains.
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For the purpose of calculation of depreciation under Section 32, the written down value (WDV) of the block of asset 'intangible' of which Patent 'T' is part, would remain INR 45 lakh and would not be increased to INR 60 lakh due to revaluation during the year. However, in determining the amount on which depreciation is allowable under the Act following points should be considered:

- Explanation 2 of Section 32(1) provides that the term 'written down value of the block of assets' shall have the same meaning as in Section 43(6)(c).
- Section 43(6)(c), with respect to block of assets provides that the aggregate of the WDV of all the assets falling within that block of assets at the beginning of the previous year is to be increased by the actual cost of any asset falling within that block, acquired during the previous year. This clause does not allow any increase on account of revaluation.
- Section 43(1) which defines 'Actual cost' as actual cost of the assets to the taxpayer. In revaluation, there is no actual cost to the taxpayer.

Further, Section 32 does not allow depreciation on goodwill. If in the given example 'self-generated goodwill' is replaced by 'self-generated asset', even then the depreciation will not be admissible on the amount of INR 30 lakh recognised in valuation. In this regard it may be highlighted that the above mentioned provisions, are also applicable to 'self-generated asset' and since there is no actual cost to taxpayer in case of 'self-generated asset', depreciation is not allowable under Section 32 on an asset whose actual cost is nil.

Our comments

The CBDT guideline and rules will provide clarity to the taxpayers on the taxability of transfer of assets by a partnership firm to its partners on its dissolution or reconstitution. The new rules will provide much needed clarity for attribution of income and determination of long term and short-term capital gains at the hands of the reconstituted entity.

However, there are certain issues where the clarification has not been provided for example transfer of stock-in-trade to retiring partner v/s. sale of stock-in-trade to outsider and settlement of the account of retiring partner, whether capital gains under section 45(4) attributed to self-generated goodwill can be reduced while computing capital gains from the slump sale, etc.

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