

Analysis of Section 9B of Income Tax Act, 1961

Provisions related to Distribution of Assets by Firm to the Partners (Changes introduced by Finance Act 2021)

- **Approach**

- 1. Provisions in Existence
- 2. Newly introduced Provisions [9B/45(4)/ 48(iii)]

We will have a look at Section 9B only in following slides

- 3. Provisions of Section 9B
- 4. Analysis of Section 9B
- 5. Examples

Note: Amended Sections apply to Specified entities being Firm/AOP/BOI and accordingly to Specified persons being Partner/Members. For the sake of convenience, I have considered specified entity as Firm and Specified Person as Partner

Analysis of Section 9B of Income Tax Act, 1961

Provisions in Existence

Section 45(4) of Income Tax Act, 1961 provided for chargeability of capital gain on the distribution of capital assets **on the dissolution of a firm or otherwise** in the year in which the said transfer takes place and the fair market value of the asset on the date of such transfer was to be deemed to be the sale consideration u/s 48.

There was controversy surrounding the applicability of section 45(4) in case of distribution of capital assets otherwise than dissolution of firm as several courts have held that section 45(4) triggers only in the case of dissolution of a firm and not in other cases of reconstitution of firm.

What was the view of the Courts Before

- The Courts have taken a view that the distribution, division or allotment of assets by a partnership firm upon dissolution or reconstitution is nothing but a mutual adjustment of rights between the partners:
 - (a) *CIT v. Dewas Cine Corporation*, [1968] 68 ITR 240 (SC) (adjustment of the rights of the partners in a dissolved firm is not a transfer).
 - (b) *Malabar Fisheries Co. v. CIT*, [1979] 120 ITR 49/2 Taxman 409 (SC) [the consequence of the distribution, division or allotment of assets by the partnership which follows upon dissolution after discharge of liabilities is nothing but a mutual adjustment of rights between the partners and there is no question of any extinguishment of the firm's rights in the partnership assets amounting to a transfer of assets within the meaning of section 2(47)].

Analysis of Section 9B of Income Tax Act, 1961

Amendment by Finance Act, 2021

- Insertion of a new Section 9B in the Income Tax Act, 1961 providing for chargeability of income tax on distribution of capital asset or stock-in-trade by a firm to its partner in connection with its dissolution or reconstitution.
- Substitution of the existing section 45(4) of the Income Tax Act, 1961 with a new section 45(4).
- Further, clause (iii) has been inserted by the Finance Act, 2021 in section 48 to provide that if any money or capital asset is received by a specified person from a specified entity, then the amount chargeable to income-tax as income of such specified entity under section 45(4), which is attributable to the capital asset being transferred by the specified entity, shall be calculated in the prescribed manner and shall be allowed as a deduction in computing capital gains.
- The aforesaid amendments are applicable from 1st April 2021 and will accordingly apply for the AY 2021-22 relevant to Financial Year 2020-21.

Essentials of any Tax Laws

- 155 ITR 144 (SC) (Although it is related to Sales Tax)
- GOVIND SARAN GANGA SARAN V/s COMMISSIONER OF SALES TAX AND ORS
- 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 these components are not clearly and definitely ascertainable it is difficult to say that the levy exists in 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.

Does Section 9B meet the criteria ?

Section 45(4) Introduction related

- This recast section was introduced at the time of passing of the Finance Bill 2021.
- The notice of Amendment placed before parliament stated that the expression used in Section 45(4) is “any profits or gains arising from receipt of such money by the specified persons”
- Recast section reads as under :

45(4) Notwithstanding anything contained in sub-section (1), 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, and notwithstanding

Section 45(4) Introduction related

anything to the contrary contained in this Act, such profits or gains shall be determined in accordance with the following formula,

This correction was made through an errata. It is not clear at what stage this error was noticed i.e. whether before or after the assent by the President. If errata was issued without sanction of the Parliament, its validity may face a rough weather.

(Source of this slide is from Public Domain)

Newly introduced Section 9B

- **Income on receipt of capital asset or stock in trade by specified person from specified entity.**
- ‘9B. (1) *Where a specified person receives during the previous year any capital asset or stock in trade or both from a specified entity in connection with the dissolution or reconstitution of such specified entity, then the specified entity shall be deemed to have transferred such capital asset or stock in trade or both, as the case may be, to the specified person in the year in which such capital asset or stock in trade or both are received by the specified person.*
- (2) 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

Newly introduced Section 9B

- (ii) chargeable to income-tax as income of such specified entity under the head “Profits and gains of business or profession” or under the head “Capital gains”, **in accordance with the provisions of this Act.**
- (3) For the purposes of this section, fair market value 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 of the capital asset or stock in trade or both by the specified entity.
- (4) If any difficulty arises in giving effect to the provisions of this section and sub-section (4) of section 45, the Board may, with the approval of the Central Government, issue guidelines for the purposes of removing the difficulty.
- (5) Every guideline issued by the Board under sub-section (4) shall, as soon as may be after it is issued, be laid before each House of Parliament, and shall be binding on the income-tax authorities and on the assessee.

Newly introduced Section 9B

Explanation. — For the purposes of this section, —

- (i) “reconstitution of the specified entity” means, where—
 - (a) one or more of its partners or members, as the case may be, of such specified entity ceases to be partners or members; or
 - (b) one or more new partners or members, as the case may be, are admitted in such specified entity in such circumstances that one or more of the persons who were partners or members, as the case may be, of the specified entity, before the change, continue as partner or partners or member or members after the change; or
 - (c) all the partners or members, as the case may be, of such specified entity continue with a change in their respective share or in the shares of some of them;
- (ii) “specified entity” means a firm or other association of persons or body of individuals (not being a company or a co-operative society);
- (iii) “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.’.

Analysis of Section 9B of Income Tax Act, 1961

Condition/ Event	Possible Interpretation	Issues
a specified person receives during the previous year	What is necessary is an actual receipt and not a constructive receipt during the previous year	Thus, if Partner's Account is debited and asset account credited in the Books of Firm this will not trigger
any capital asset or stock in trade or both from a specified entity	Strictly receipt should of these assets	<p>[Section 45(4) covers money too and hence this distinction is necessary]</p> <p>The term "capital asset" is defined in section 2(14). The definition applies unless the context otherwise requires. However, it appears that an asset which is not capital asset within the meaning of section 2(14) is not a capital asset for the purposes of section 9B. To illustrate, agricultural land which is not a capital asset under section 2(14) cannot be regarded as a capital asset for the purposes of section 9B and the transfer of such an asset will not result in any tax implication under section 9B. On the other hand, all capital assets (whether movable or immovable or actionable claim, etc.) are covered by the expression capital asset.</p>

Analysis of Section 9B of Income Tax Act, 1961

Condition/ Event	Possible Interpretation	Issues
in connection with the dissolution or reconstitution of such specified entity,	Receipt during the previous year of asset/s should be in connection with dissolution or reconstitution	Previously the words used were on dissolution or otherwise . Now the words are <i>in connection with</i> . Thus, if dissolution has taken place in FY 19-20 and assets are distributed in FY 2021 this section will trigger. So what is essential is nexus between dissolution/ reconstitution and distribution. Both these events need not be in the same previous year .

Analysis of Section 9B of Income Tax Act, 1961

Condition/ Event	Possible Interpretation	Issues
<p>then the specified entity shall be deemed to have transferred such capital asset or stock in trade or both, as the case may be, to the specified person in the year in which such capital asset or stock in trade or both are received by the specified person.</p>	<p>In such an event Firm shall be deemed to have transferred assets in the year in which such asset is received by Partner. (Not before and Not later)</p>	<p>Time gap between Dissolution and Distribution. On dissolution Firm ceases to exist. How you will do the assessment of the Firm in the year when Partner receives this Asset.</p> <p>(Possible Solution is in the wording of Section 189 which is quite extensive.)</p>

Analysis of Section 9B of Income Tax Act, 1961

Condition/ Event	Possible Interpretation	Issues
		<p>189. (1) Where any business or profession carried on by a firm has been discontinued or where a firm is dissolved, the [Assessing] Officer shall make an assessment of the total income of the firm as if no such discontinuance or dissolution had taken place, and all the provisions of this Act, including the provisions relating to the levy of a penalty or any other sum chargeable under any provision of this Act, shall apply, so far as may be, to such assessment.</p>

Notes:

- Deemed Transfer u/s 9B (1)
- Head of Income is provided u/s 9B(2)
- Placement of Section 9B in Chapter II Basis of Charge could not be understood
- Capital Gains calculation adequately provides that Capital Gains shall be calculated under the Chapter based on the computation provisions.
- As regards Business Income Section 28 is not amended. Whether this can pose any issue when Stock in Trade is given to the Partner and Income is to be assessed under the head PGBP.

So the flow of the Section is:

- Deeming Provision dealing with Deeming Transfer (Sub Section 1)
- Head of Income (Sub Section 2)
- Computation Related Issue (Sub Section 3)

(3) For the purposes of this section, fair market value 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 of the capital asset or stock in trade or both by the specified entity.

Where ever intention of the legislature was to consider a specific FMV, indication is available in the Section. One notes that there is no such indication in Section 9B or Section 45(4). Therefore, provisions of Section 2(22B) shall apply.

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- 2B) "fair market value", in relation to a capital asset, means—
- (i) the price **that the capital asset** would ordinarily fetch on sale in the open market on the relevant date; and
 - (ii) where the price referred to in sub-clause (i) is not ascertainable, such price as may be determined in accordance with the rules made under this Act;

Thus this will not apply to Stock in Trade

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm –s.9B

(4) Applicability of Section 45(1) for charging capital gain on such deemed transfer of capital asset:

Consequently the normal provision of section 45(1) read with section 48 and section 49 will apply on such distribution of capital asset on its dissolution or reconstitution by the firm to its partner

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm –s.9B

(5) Applicability of Section 28 for charging income tax under the head "Profits and gains of business or profession" on such deemed transfer of stock in trade:

As far as the deemed transfer of stock in trade by a firm to its partners on its dissolution or reconstitution is concerned, the normal provision of section 28 will apply for determining profits and gains from such deemed transfer of stock in trade for the purpose of charging income tax on such deemed transfer.

Accordingly the difference between the cost of acquisition or manufacture or purchase and the fair market value is chargeable to tax in the hands of the firm as profits and gains of business or profession.

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm –s.9B

(6) Meaning of Reconstitution of the firm:

For the purpose of this section, reconstitution of the firm means:

- (a) Retirement of one or more of its partners;
- (b) Admission of one or more new partners in such a circumstances that one or more existing partners continue as partner after the change;
- (c) Change in profit sharing ratio of such firm.

(7) Applicability of above provisions in case of other association of persons or body of individuals (AOPs or BOIs):

The above provisions are also applicable mutatis mutandis in case of other association of persons or body of individuals (not being a company or a co-operative society.)

Reconstitution Examples

A, B, C, D are partners of X & Co.

Situation	Whether Reconstitution
If A (or any of the partner) retires,	X Co. is considered to be reconstituted under clause (a)
If E joins as a partner and A, B, C, D continue as partners.	X Co. will be considered as reconstituted under clause (b) since E has joined and old partners remain.
IF E, F join and none of the existing partners continue to remain as partner.	The requirement of clause (b) is that new partner should join and at least one or more of the old partners (being A, B, C, D) should continue. In this case, none of the existing partners continues. Hence, there is no reconstitution under clause (b). However, as per clause (a), there is a reconstitution even if one partner retires. Hence, due to retirement of old partners, the event would be considered as reconstitution under clause (a), although not under clause (b).

Reconstitution Examples

Situation	Whether Reconstitution
There is a change in profit sharing ratio (PSR) from equal to A-30%; B-20%; C-30%; D- 20%.	Yes, the change in PSR will constitute reconstitution under clause (c), since all partners are continuing and there is change in PSR of all of them.
There is a change in PSR from equal to A-30%; B-20%; C-25%; D- 25%.	The PSR of only A&B has changed where PSR of C&D has remained same. The wordings used in clause (c) are "a change in their respective share or in the shares of some of them". Thus, even if there is a change in PSR of only some of the partners, it would still constitute reconstitution.
A retires and new PSR is B-33%, C-33%, D-34%.	It would not be reconstitution under clause (c) since all the existing partners are not continuing; however, it would constitute reconstitution under clause (a), since an existing partner ceases to exist as a partner.

Reconstitution Examples

A, B, C, D are partners of X & Co.

Situation	Whether Reconstitution
If E admitted and the PSR changes from equal to A-20%; B-20%; C-20%; D-20%; E-20%.	Since all the partners continue, and there is change in PSR, clause (c) applies. It can also be said to be reconstitution under clause (b).

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm – S.9B

Method of Computation of Capital Gain on such deemed transfer

<i>Particular</i>	<i>Amount</i>
Sale Consideration	XXXXXXXXXX
<i>Less: Expenses incurred in connection with such transfer</i>	XXXXXXXXXX
<i>Less: Cost of Acquisition/ Indexed Cost of Acquisition</i>	XXXXXXXXXX
<i>Less: Cost of Improvement/ Indexed Cost of Improvement</i>	XXXXXXXXXX
<i>Less: The amount chargeable to income-tax in the hands of firm u/s 45(4) which is attributable to the capital asset being transferred by the firm, calculated in the prescribed manner*</i>	XXXXXXXXXX
<i>Capital Gain (Short Term/ Long Term)</i>	XXXXXXXXXX

*Note- It is consequent to amendment made in section 48 of Income Tax Act, 1961 by the Finance Act, 2021.

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm – S. 9B

Board is empowered to remove any difficulty by issuing guidelines:

Power has been given to the Board to remove, with the approval of the Central Government, any difficulty that may arise in giving effect to **the provisions of section 9B and section 45(4)** by issuing guidelines for the purposes of removing the said difficulty. Every guideline so issued by the Board will be laid before each House of Parliament, and will be binding on the income-tax authorities and on the assessee

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm –S.9B

Example

Understanding the applicability of the above section i.e. section 9B

Basic information:

Firm Name M/s ABC & Associates

Partner's Name Mr. A, Mr. B, & Mr. C

Profit sharing ratio 1/3rd each

Illustration (1): Distribution of Capital Assets & Stock in trade in the case of dissolution

Date of dissolution 01.04.2021

Distribution to Partners Immovable Property (Stamp Duty Value of Rs. 15 lakhs) given to Mr. A [Indexed cost of acquisition of immovable property- Rs. 8 lakh]

Stock in trade (FMV of Rs. 12 lakhs) given to Mr. B [Cost of Purchase of such stock- Rs. 9 lakh]

Shares (FMV of Rs. 10 lakhs) given to Mr. C [Indexed cost of acquisition of shares- Rs. 9 lakh]

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm –s.9B

Computation of Capital Gain under section 9B read with section 45(1) & section 48 (In the hands of firm i.e. M/s ABC & Associates)

<i>Particular</i>	<i>Immovable Property (Rs.)</i>	<i>Shares (Rs.)</i>
<i>Sale Consideration</i>	15,00,000	10,00,000
<i>Less: Indexed cost of acquisition</i>	8,00,000	9,00,000
<i>Capital Gain</i>	7,00,000	1,00,000
<i>Total Capital Gain</i>	8,00,000	

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm – S.9B

Computation of Business Income under section 28
(In the hands of firm i.e. M/s ABC & Associates)

<i>Particular</i>	<i>Stock in trade (Rs.)</i>
<i>Sale Consideration (FMV)</i>	<i>12,00,000</i>
<i>Less: cost of purchase</i>	<i>9,00,000</i>
<i>Business Income</i>	<i>3,00,000</i>

Thus capital gain of Rs. 8,00,000 and business income of Rs. 3,00,000 will be chargeable to tax in above case.

Note- As this is the case of dissolution of firm, section 45(4) will not be applicable

Receipt of Capital Asset/Stock-in-Trade by Partner from Firm –s.9B

ISSUES

- Receipt only from specified entity – not from other partners
- If assigned to other partners, will s. 45(1) or s. 56(2)(x) apply?
- Period of holding of capital asset - to be determined on the basis of date of acquisition of capital asset – date of transfer would be date of receipt by partner.
- Can s. 54EC exemption be claimed in respect of CG u/s. 9B ?
- What is date of transfer – date of dissolution /change of constitution or **date of receipt** ?