

PARTNERSHIP FIRM/ LLP

New changes brought into the income tax in respect of taxation of partnership firms, LLP, AOP & BOI on account of retirement / admission of partner(s) or dissolution of firms. Though the amendment has been introduced as rationalisation provisions, it has areas that needs to be addressed.



Income tax has amended the taxation of distribution of asset by partnership firm to the partner.

By Direct Tax Team, NPV & Associates

1.1. Partnership is the oldest firm of doing business. Majority of the business in India, are organised as a 'partnership'. Because as compared to corporate firm, it provides operational flexibility to owners with respect of infusion of capital, reorganisation of capital, decision making and matters relating to admission / retirement of partners and dissolution of firm. On the contrary major drawback is unlimited liability of partner and perpetual succession. Limited Liability Partnership (LLP) does a balancing act between benefit the firm and corporate entity. However, for income tax purpose LLP is assessed as firm / partnership.

1.2. Until now, issue of capital gain tax arose only at the time of distribution of capital asset by the firm to the partner on dissolution of the firm. On retirement of partner from the firm or admission of new partner to the firm, no capital gain tax was levied pursuant to series of judicial pronouncements.

IN THIS ISSUE

UNTIL NOW TAX INCIDENCE AROSE ONLY AT THE TIME OF DISSOLUTION OF PARTNERSHIP FIRM.

WITH AMENDED PROVISION TAX NET HAS BEEN EXPANDED TO INCLUDE EVERY KIND OF RECONSTITUTION OF FIRM BE IT ADMISSION, RETIREMENT OR JUST CHANGE IN PROFIT SHARING RATIO.

TAX LIABILITY CASTED ON FIRM IRRESPECTIVE OF THE FACT THAT IT MAY BE GAIN OF THE PARTNER.

THERE MAY BE DOUBLE TAXATION ON DISTRIBUTION OF ASSET ON RECONSTITUTION.



1.3. Finance Act 2021 (FA 2021) amended the law relating to taxation of reconstitution of partnership firm. Amendment applies to reconstitution of association of person (AOP) or body of individuals (BOI). The said amendment is summarised herein below and reference to firm shall also include AOP or BOI and reference to partner shall include member of AOP or BOI.

1.4. This amendment defines what is reconstitution with respect to firm, creates tax liability in the hands of firm on distribution of asset at the time of reconstitution and empowers CBDT to issue guidelines for the purpose of removing difficulties relating to the amendment.

1.5. The amendment relating to taxation of reconstitution of firm has been dealt with by section 45(4) and section 9B of the Income Tax Act, 1961 (the "Act"). Section 45(4) of the Act deals with taxation of receipt of money or capital asset by partner from the firm. And section 9B of the Act deals with taxation of receipt of capital asset or stock in trade by partner from the firm on dissolution or reconstitution.

1.6 Reconstitution with respect to firm is defined to mean admission of new partner, retirement of any of the existing partner or change in profit sharing ratio inter se between the partners.

Section 45(4) of the Act

1.7 Section 45(4) of the Act provides for taxation on account of receipt of money or capital asset by the partner from the firm in connection with reconstitution. It broadly deals with taxation on account of receipt of gain by the partner on account of revaluation of assets, self-generated asset, or goodwill of the firm at the time of reconstitution. Though it is gain earned by the partner at the time of reconstitution on account of receipt of money / asset over and above his invested capital, tax liability is fastened in the hands of the firm.

1.8 Section 45(4) has provided specific formula for computation of the gain, which is as under

FORMULA FOR COMPUTATION OF GAIN

$$A = B + C - D$$

where

A = Income chargeable to income-tax under this sub-section in the hands of the firm under the head capital gain

B = Value of any money received by the partner from the firm

C = Amount of fair market value of the capital asset received by the partner from the firm

D = Amount of balance in the capital account of the partner in the books of account at the time of reconstitution. Increase in capital account due to revaluation of any asset or due to self-generated asset or goodwill shall be ignored.

Section 9B of the Act

1.9. Section 9B of the Act deals with taxation of receipt of capital asset or stock in trade by the partner from the firm at the time of dissolution or reconstitution. Such receipt by the partner shall be deemed as transfer of asset by the firm.

1.10. Income arising on account of transfer of capital asset shall be chargeable to tax under the head capital gain and income arising on account of transfer of stock in trade shall be chargeable to tax under the head profit and gains of business or profession. Further, computation of income element shall be in accordance with the provision of respective applicable head of income.

1.11. Further, fair market value of capital asset or stock in trade on the date of reconstitution shall be deemed as full value of consideration received or accrued by the firm.

1.12. These two amendments are introduced by the FA 2021 as rationalisation of provision of transfer of capital asset to partner on dissolution or reconstitution and provide certainty in regarding applicability of capital gain taxation on account payment to partner in excess of balance standing to his capital account. However, amendments have opened a pandora box with host of new issues viz

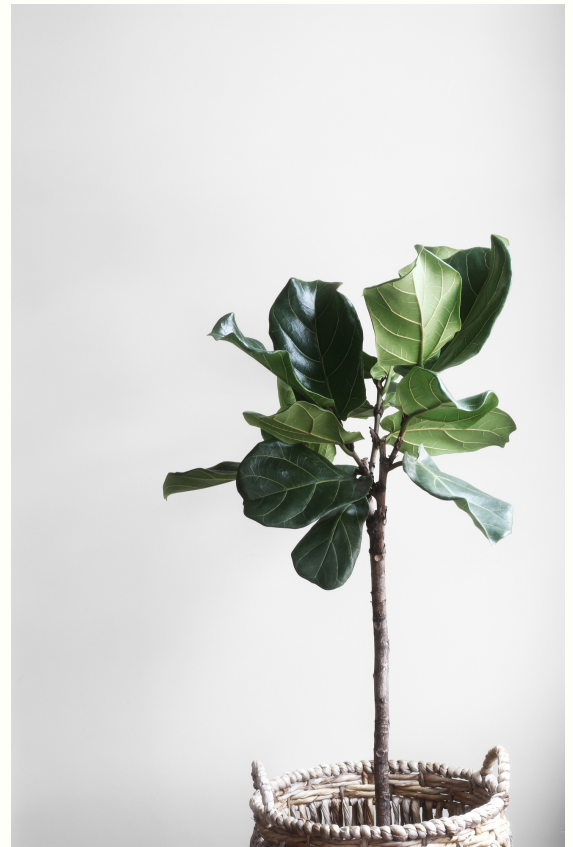
i)Applicability of rate of taxation viz., long term rate or short-term rate in respect of gain determined under section 45(4) of the Act.

ii)Whether exemption under section 54EC of similar section shall be available

iii)Whether profit computed under section 45(4) shall be available for set off against loss incurred from another capital asset.

iv)If capital balance in partners account at the time of reconstitution is negative, whether it is to be ignored at the time of computation of gain u/s 45(4).

v)Whether it amounts to double taxation at the time of retirement? Whether any remedy available?



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