



Taxation of Limited Liability Partnership

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**CA Anish Thacker
CA Nikhil Tiwari**

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Limited Liability Partnership (LLP) History

- ▶ The concept originated in Italy as a Medieval European Business mode later on followed by France, Germany, Great Britain, USA, Japan.
- ▶ Indian history:

1957	Suggested by iron, steel & hardware merchant chambers- rejected by 7th Law commission
1997	Recommended by Abid Hussain Committee on Small Scale Industries
2003	Naresh Chandra Committee Report (Regulation of Private Companies and Partnerships) highlighted the grave need to introduce LLPs in India
2005	JJ Irani Expert Committee on Company Law recommended introduction of LLPs
15 December 2006	LLP Bill introduced in Parliament
1 May 2008	Union Cabinet gave its approval to introduction of a new bill (2008 LLP Bill) replacing the LLP Bill
21 October 2008	LLP Bill 2008 introduced in Parliament
7 January 2009	President's assent given to the LLP Bill 2008 after being passed in Lok Sabha and Rajya Sabha
31 March 2009	LLP Act Notified & came into existence (based primarily on UK LLP Act, 2000 and Singapore LLP Act, 2005)

- ▶ LLP Taxation around the world:
 - ▶ Tax Transparent e.g. U.K. and Singapore
 - ▶ Tax Opaque e.g. Belgium, Australia and India
 - ▶ Tax Flexible (left to the decision of the partners) e.g. USA

LLPs under the Income-Tax Act, 1961 (Contd.)

► **Rate of tax:**

Income	Tax	Surcharge	Health & Education Cess	Effective Tax Rate
NORMAL PROVISIONS:				
LLPs and Partnership Firms:				
Up to Rs. 1 Crore	30%	NA	4%	31.20%
Above Rs. 1 Crore	30%	12%	4%	34.94%
Domestic Company:				
Turnover in FY 2020-21 <400 Crores				
Up to Rs. 1 Crore	25%	NA	4%	26%
Rs. 1 Crore to Rs. 10 Crores	25%	7%	4%	27.82%
More than 10 Crores	25%	12%	4%	29.12%
Turnover in FY 2020-21 >400 Crores				
Up to Rs. 1 Crore	30%	NA	4%	31.20%
Rs. 1 Crore to Rs. 10 Crores	30%	7%	4%	33.38%
More than 10 Crores	30%	12%	4%	34.94%

LLPs under the Income-Tax Act, 1961 (Contd.)

► Rate of tax (Contd.):

Income	Tax	Surcharge	Health & Education Cess	Effective Tax Rate
ALTERNATE MINIMUM TAX (LLPS AND PARTNERSHIP FIRMS):				
Up to Rs. 1 Crore	18.5%	NA	4%	19.24%
Above Rs. 1 Crore	18.5%	12%	4%	21.55%
MINIMUM ALTERNATE TAX (DOMESTIC COMPANIES)				
Up to Rs. 1 Crore	15%	NA	4%	15.6%
Rs. 1 Crore to Rs. 10 Crores	15%	7%	4%	16.69%
More than 10 Crores	15%	12%	4%	17.47%

LLPs under the Income-tax Act, 1961

- ▶ **Section 2(23)** - defines 'firm', 'partner' and 'partnership' to also include LLP (as defined under LLP Act, 2008) and its partners.
 - ▶ **Section 184** - in order for an LLP to be assessed as firm under the Income-tax Act, 1961 it has to satisfy the following criteria:
 - ▶ Partnership is evidenced by an instrument i.e. written agreement;
 - ▶ Individual share of the partners is specified in the deed; and
 - ▶ **Section 185** – where conditions of section 184 are not complied with no deduction on account of interest, salary, bonus, remuneration or commission, by whatever name called, paid/payable to a partner shall be allowed while computing income under the head 'Profits and Gains on Business and Profession'. Consequently, relevant income from interest/remuneration etc. shall not be chargeable in the hands of the concerned partners.
 - ▶ Non deductibility of interest, remuneration etc. to partners as per section 185 is restricted to the computation of PGBP income only and not for computation of income under the other heads. For example, while computing income from house property, any interest paid by LLP to its partners on loans given by them may be claimed as deduction subject to provisions of section 24 of the Act.
 - ▶ The LLP shall be assessed as AOP in case if conditions mentioned under section 184 are not complied or in case where section 144 is invoked
- ▶ **Section 2(17)(ii)** – defines companies to inter-alia include body corporates incorporated outside india i.e. foreign LLPs. Accordingly, provisions as applicable to foreign companies would also apply to foreign LLPs.
 - ▶ Incorporation- matter of local law?
 - ▶ Implication of DTAA, if any

- ▶ **Sec.2(22)(e) – Deemed dividend** – not applicable to LLPs

Control and Management	Status
Situated fully in India	Resident
Situated partly in India	Resident
Wholly situated outside India	Non-resident

LLPs under the Income-tax Act, 1961 (Contd.)

Income from Business and Profession:

- ▶ **Section 36(1)(iii) read with section 40(b)(iv)** - Interest paid to partners is allowable deduction provided authorized by and in accordance with the partnership deed - capped at 12% – authorized/ amended from middle of the year – pro-rata allocation.
- ▶ **Section 40(b)(i)** – No salary, bonus, commission or remuneration to silent partners.
- ▶ **Section 40(b)(ii)** – No remuneration to working partners if not authorized or in accordance with the deed – section 40(b)(iii) – authorized/ amended from middle of the year – pro-rata allocation
- ▶ **Section 40(b)(v)** – remuneration authorized or in accordance with the deed – capped at

first Rs. 3,00,000 of the book-profit or in case of a loss	Rs. 1,50,000 or 90% of the book-profit, whichever is more
balance of the book-profit	60% of book-profit

- ▶ **Section 28(v)** - Partner's interest, salary, bonus, commission or remuneration taxed under the head 'income from business and profession' – no withholding required under section 192.
- ▶ **Section 44AD (Presumptive Taxation)** – specifically excludes LLPs

LLPs under the Income-tax Act, 1961 (Contd.)

Income from Business and Profession (Contd.):

- ▶ **Section 44ADA** – specifically excludes LLPs
 - ▶ Ministry of Corporate Affairs vide Office Memorandum No. CRC/LLP/e-Forms dated 6 March 2019 barred entities carrying on manufacturing and allied activities from adopting LLPs as business structure.
 - ▶ However, w.e.f. 17 April 2019, the MCA has withdrawn such restriction on carrying out manufacturing and allied activities by LLP. Thus, LLP can now carry out manufacturing and allied activities in terms of definition of business
- ▶ Whether income assessable under the non business head/s which are credited to profit and loss shall form part of 'book profit' u/s 40(b) of Act?
 - ▶ **Serajudddin & Bros. vs. CIT [(2012) 24 taxmann.com 46 (Calcutta)]** - income assessable even under the non business heads shall not be excluded from net profit.
- ▶ Whether despite specific ceiling on allowable quantum of interest and remuneration etc. paid to partners, revenue can invoke the provisions of disallowance of alleged unreasonable or excessive interest and remuneration etc. u/s 40A(2) of Act?
 - ▶ **CIT vs. Great City Manufacturing Co. [(2013) 33 taxmann.com 258 (Allahabad HC)]** - when remuneration is paid to a working partner as defined in section 40(b) and said payment is authorised by deed, there is no justification for treating any amount of remuneration as excessive under section 40A(2) provided aggregate remuneration to all the partners is also within ceiling prescribed u/s 40(b).
 - ▶ Further, the Hon'ble Mumbai Tribunal in the following cases has held that no disallowance under Section 40A(2) can be made if there no comparable cases available and there is no evasion of tax:
 - ▶ **Indo Enterprises (ITA No. 1221/Pun/2016) dated 19 September 2018;**
 - ▶ **Indo Saudi Services (Travel) (P.) Ltd. (2009) (310 ITR 306) (Bom HC)**

LLPs under the Income-tax Act, 1961 (Contd.)

Income from Business and Profession (Contd.):

- ▶ Whether quantum of interest and remuneration etc. to partners is required to be specified in the LLP agreement or a simple recital authorizing partners to mutually decide the quantum of remuneration from time to time will do?
 - ▶ No unity of opinions on this question between different High Courts - **CBDT Circular No. 739, dated 25 March 1996** has also taken a view that simple authorisation of payment of remuneration etc. in the deed is not sufficient but remuneration payable to each individual working partner has to be specified in the deed or manner of quantification of such remuneration has to be laid down in such deed and only then the remuneration to a working partner can be allowed as deduction.

LLPs under the Income-tax Act, 1961 (Contd.)

Income from Capital Gains:

- ▶ **Section 45(3)** – profit or loss on transfer of capital asset by a person to a firm in which he is or becomes a partner – by way of capital contribution – chargeable to tax as capital gains in the year of transfer – amount recorded in the books of the firm deemed to be full value of consideration
 - ▶ Capital contribution in kind – to be “accounted and disclosed” in prescribed manner as per section 32(2) of the LLP Act, 2008 - Rule 23(2) of LLP Rules – prescribes valuation of contribution in kind by approved valuer
 - ▶ Amount recorded in books of LLP lower than 50C or 50CA valuation. Issue – 45(3) vs. 50C/ 50CA valuation
 - ▶ **DCIT vs M/s Amartara Pvt. Ltd. [(ITA No. 6050/Mum/2016) (Mumbai ITAT)]** – deeming fiction under one section cannot be extended to another deeming fiction – section 45(3) prevails over section 50C
 - ▶ **United Marine Academy (2011) [9 ITR(T) 639] (Mumbai SB)**
 - ▶ For LLPs, capital contribution by partner – subject to 56(2)(x)?- Smt. Vasumati Prafullachand (ITA No. 161/PUN/2015) dated 13 December 2017

- ▶ **Section 45(4) read with section 9B** – levy of on realization by partner in excess of his capital account balance, in connection with reconstitution (retirement, admission or change in share) – gain is computed from partner’s perspective but is taxable in hands of the firm
 - ▶ Gains computed using the formula A (i.e. capital gains chargeable in the hands of the firm) = B (i.e. value of any money on the date of such receipt) + C (i.e. FMV of capital asset on the date of such receipt) – D [i.e. partner’s capital account balance (represented in any manner) in books of firm at time of its reconstitution (without taking into account increase (a) due to revaluation of any asset or (b) due to self-generated goodwill/ asset (i.e. goodwill/ asset acquired without incurring any cost for purchase or generated during the course of the business or profession)]
 - ▶ Capital gains (A) will be nil if result of formula is negative
 - ▶ Refer Circular No. 14/2021 dated 2 July 2021

LLPs under the Income-tax Act, 1961 (Contd.)

Income from Capital Gains (Contd.):

- ▶ **Section 47(xiiib) – Conversion of company into LLP** - transactions not regarded as transfer - transfer of a capital asset or intangible asset by a private company/ unlisted public company to a LLP or transfer of a share or shares held in the company by a shareholder as a result of conversion of the company into LLP as per section 56/ 57 of the LLP Act, 2008
 - ▶ Conditions to be fulfilled:
 - ▶ all assets and liabilities immediately before conversion become the assets and liabilities of the LLP;
 - ▶ all the shareholders immediately before conversion become the partners of the LLP in the same ration as on the date of conversion;
 - ▶ the shareholders do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of share in profit and capital contribution in the LLP;
 - ▶ the aggregate of the profit sharing ratio of the shareholders in the LLP shall not be less than fifty per cent at any time during the period of five years from the date of conversion;
 - ▶ the total sales, turnover or gross receipts in the business of the company in any of the three previous years preceding the previous year in which the conversion takes place does not exceed sixty lakh rupees;
 - ▶ the total value of the assets as appearing in the books of account of the company in any of the three previous years preceding the previous year in which the conversion takes place does not exceed five crore rupees; **and**
 - ▶ no amount is paid, either directly or indirectly, to any partner out of balance of accumulated profit standing in the accounts of the company on the date of conversion for a period of three years from the date of conversion.
 - ▶ Non-compliance – section 47A(4) profits – profits and gains deemed to be the profits and gains chargeable to tax in the year of non-compliance in hands of successor limited liability partnership or the shareholder of the predecessor company, as the case may be.
 - ▶ Two type of conditions viz.:
 - ▶ Required to be fulfilled at the time of conversion – if not fulfilled at the time of conversion itself – non compliant conversion
 - ▶ Required to be fulfilled till specified period after conversion:
 - ▶ If violated in year of conversion – non-compliant conversion – **Aravali Polymers LLP [47 taxmann.com 335 (Kolkata ITAT)]**
 - ▶ If violated later on within specified period - section 47A(4) to apply

LLPs under the Income-tax Act, 1961 (Contd.)

Income from Capital Gains (Contd.):

- ▶ **Section 47(xiiib) (Contd.) – Conversion of company into LLP –**
 - ▶ **ACIT vs. Celerity Power LLP [(2019) 174 ITD 433 (Mumbai Tribunal)]**
 - ▶ Transaction involving conversion of a private limited company or unlisted public company to a LLP as contemplated in section 47(xiiib) is 'transfer', however, same on cumulative satisfaction of conditions (a) to (f) of proviso to section 47(xiiib) would not be chargeable to 'capital gains' under section 45.
 - ▶ Section 47A(4) comes into play only for purpose of withdrawing an exemption earlier availed by an assessee under section 47(xiiib)
 - ▶ Capital gains involved in transfer of capital assets on conversion of private limited company to assessee LLP, de hors applicability of section 47A(4), would be subject to liability of assessee LLP (as a successor entity) under section 170
 - ▶ Where upon conversion of a private limited company into assessee - LLP entire undertaking of erstwhile company got vested into assessee-LLP, book value was to be regarded as full value of consideration for purpose of computation of capital gains under section 48

LLPs under the Income-tax Act, 1961 (Contd.)

Income from Capital Gains (Contd.):

▶ **Section 47(xiiib) (Contd.) – Conversion of company into LLP -**

There may be a doubt as to whether transfer of reserves and surplus (standing in converting company's accounts before conversion) to capital or current accounts of partner of successor LLP be avoided for utilisation for three years from the date of conversion so as to prevent allegation of any violation of afore-mentioned conditions? The answer seems to be in affirmative and it is better that amount standing credit to general or other reserves or as balance in P&L a/c. in the accounts of converting company be kept as credited to the reserves in the books of successor LLP upto three years from the date of conversion.

- ▶ Depreciation on assets transferred to LLP - explanation 2C to section 43(6) - No step up in WDV – same WDV to continue as in books of company on the date of conversion.
 - ▶ **JSW Steel Ltd. (ITA No. 156/Bang/ 2011) dated 29 November 2019**
- ▶ Fifth proviso to section 32(1) of Act - the aggregate depreciation allowable to converting company and successor LLP for the year of conversion shall not exceed the amount of depreciation calculated as if subject conversion had not taken place - such total allowable depreciation for year of conversion shall be apportioned between converting company and successor LLP in the ratio of number of days for which the assets were used by each of them in the year of conversion. [Refer **Archroma India (P.) Ltd. (2021) (124 taxmann.com 432) (Mumbai - Trib.)**]- Depreciation on WDV of assets taken over by assessee from transferor company was to be computed as per fifth proviso to section 32(1) in case of slump sale.
- ▶ Cost of other non depreciable assets – section 49(1)(iii)(e) - cost to previous owner i.e. company
- ▶ Section 35DDA(4) - balance amortisation of any VRS expenditure incurred by the converting company before its conversion into LLP - continue to be allowed to successor LLP as if no conversion has taken place provided all the conditions of section 47(xiiib) are complied with - 35DDA(5) - no amortisation allowed to converting company in the year of conversion and such balance amortisation will be allowed only in the hands of successor LLP in the year of conversion and subsequent year/s, as the case may be.

LLPs under the Income-tax Act, 1961 (Contd.)

Income from Capital Gains (Contd.):

- ▶ **Section 47(xiiib) (Contd.) – Conversion of company into LLP -**
 - ▶ 40(a)(i) or 40(a)(ia) or u/s 43B – whether successor LLP would be allowed deduction for expenditure incurred and disallowed in an earlier year by converting company - Considering the legal effect of the conversion as specified in section 58(4) of LLP Act, 2008 and in absence of any specific prohibition in the Income-Tax Act, 1961, such benefits should be available to successor LLP as the section 58(4) of the LLP Act, 2008 is an overriding provision and all rights, privileges are transferred and vested in successor LLP from the date of registration of conversion without requirement of any further assurance, act or deed.
 - ▶ Explanation 13 to section 43(1) – in case deduction under section 35AD of the Act had been allowed or is allowable in respect of any capital asset to the predecessor company - the cost shall be taken as 'Nil' at the time of conversion.
 - ▶ Section 49(2AAA)- Where the capital asset, being rights of a partner referred to in section 42 of the Limited Liability Partnership Act, 2008 (6 of 2009), became the property of the assessee on conversion the cost of acquisition of the asset shall be deemed to be the cost of acquisition to him of the share or shares in the company immediately before its conversion
- ▶ **Section 72A(7)(a) and 72A(7)(b) –**
 - ▶ Unabsorbed non speculative business loss and unabsorbed depreciation of converting company - deemed to be the similar to loss or depreciation of successor LLP for the year of conversion provided all the conditions of proviso to section 47(xiiib) had been fulfilled –
 - ▶ A fresh period of 8 years after the year of conversion as provided in section 72 seems to be available for set off - reason being this view is that the transferred loss is treated as loss of successor LLP for the year of conversion
 - ▶ So far as transferred depreciation is concerned, it can be set off by successor LLP against any income and upto indefinite period as depreciation and loss are viewed differently under the Act.
 - ▶ However, in view of proviso to section 72A(6A), if any of the conditions specified in proviso to section 47(xiiib) are violated, the amount of set off of transferred non-speculative business loss or depreciation made in any year in the hands of successor LLP, shall be deemed to be income of said LLP in the year of such violation.

LLPs under the Income-tax Act, 1961 (Contd.)

Other provisions:

- ▶ **Section 68** – First proviso, as to satisfactory explanation of ‘source of source’ of certain cash credits, are applicable to companies only and not to a LLP. **(Amendment by Finance Act, 2022)**
- ▶ **Section 140** – verification of income tax returns - designated partners can sign and file the income tax return – if designated partner not available to sign, then any partner or authorized signatory.
- ▶ **Section 145** – ICDS – applicable to LLPs
- ▶ **Section 167C** - each partner of LLP is jointly and severally liable to pay tax due from the LLP if it cannot be recovered from the LLP - If such partner proves that the non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the limited liability partnership then he will not be liable to discharge this liability.
- ▶ **Section 269SS/ 269T** - In case of Company any receipt/ payment of funds from/ to unsecured loans in cash will attract disallowance - In case of LLP, the partners can bring in capital in cash.
- ▶ **Various audits under the Income-Tax Act, 1961** – Applicable to LLPs

Change in Constitution

▶ **Section 79** of Income-Tax Act – Restriction on carry forward and set off of losses in certain cases of change in shareholding $\geq 51\%$ as provided in section 79 of Act is applicable to companies only and **not to LLPs**.

▶ **Section 78** of Income-Tax Act - **Applicable to LLP**

- Change in constitution of a firm
- Applicable on retirement or death of partner
- Not entitled to carry forward and set off loss proportionate to share of the retired or deceased partner exceeding his share of profits in the previous year

▶ **Liability to partners of LLP in liquidation:**

Irrespective of provision of LLP Act, if tax, penalty interest or any other sum payable under the Act due from a LLP in respect of any income of any year or from any other person in respect of any income of any year during which such other person was a LLP, remain unrecoverable then each person who was a partner of LLP for any period during the said relevant year shall be jointly and severally liable for payment of such dues unless he proves that non-recovery of those dues is not attributable to his gross neglect, misfeasance or breach of duty in respect of affairs of the LLP.

Other tax benefit and limitations:

▶ Tax benefits to LLP:

▶ Certain provisions not applicable to LLP such as:

- Section 2(22) does not apply
- Explanation to Section 73- The deeming fiction of Explanation to section 73 of Act treating share dealing business as speculation business is also not applicable to a LLP as the same is applicable to Companies and their shares.

▶ Tax Limitations:

▶ LLP is not eligible for certain tax benefits such as:

- Section 35(2AB)- Deduction for Expenditure on Scientific research
- Section 35DD- Amortisation of expenditure in case of amalgamation or demerger.
- Benefit of lower tax rate of 25% (Companies with turnover < 250 crores)
- Section 80-IA(4)(i) - Deduction on profits of infrastructure projects
- Section 115BBD – Tax on certain dividends received from foreign companies **(Not applicable to any AY beginning on or after 1 April 2023)**

Other tax benefit and limitations:

▶ Section 80-IAC:

Parameters	Details
Nature of benefit	Profit linked deductions for eligible start-ups
Qualifying taxpayers	<p>Company or LLP satisfying following conditions</p> <ul style="list-style-type: none"> • Incorporated after 1 April 2016 but before 1 April 2023 • Registered as 'start up' with DPIIT • Holds a certificate of eligible business from Inter Ministerial Board • Turnover does not exceed Rs. 100 Cr in the previous year for which deduction is claimed • Engaged in eligible business which involves innovation, development or improvement of products or processes or services or a scalable model with high employment generation or wealth creation
Quantum & Period of benefits	100% of the profits and gains derived from eligible business for any 3 consecutive years out of 10 years from the year of incorporation, at option of taxpayer
Key conditions	<ul style="list-style-type: none"> • Eligible business should not be formed by: <ul style="list-style-type: none"> • Splitting up or reconstruction of business already in existence (except where revived after destruction in natural calamity, accidental fire, riots or during war) • Transfer of second hand plant and machinery (exceeding 20% of total value of P&M and other than imported P&M on which no depreciation is claimed by any person under ITA) • Needs to keep check on turnover cap of Rs. 25 Cr
Procedural compliances	<ul style="list-style-type: none"> • Maintaining separate accounts and furnishing audit report along with ROI • ROI to be filed on or before due date and claim to be made in ROI • Fair pricing of inter-unit transfer of goods or services or transactions with other parties to avoid artificial profits.
Sunset date	LLP or company to be incorporated on or before 31 March 2023

Other Issues

Applicability of s. 14A on share of profit received (positive or negative)?:

Section 14A not applicable in case of share of profit of partner in income of firm

- ▶ Sudhir Kapadia (ITA No. 7888/Mum/2003) dated 26 February 2007 (Mum Trib.) (Favorable)
- ▶ A. H. Baldota (2006) (10 SOT 757) (Mum Trib.) (Against)
- ▶ Vishnu Anant Mahajan (2012) (16 ITR 621) (Ahmedabad SB) (Against)

Section 14A of the ITA not applicable in case there is loss from partnership firm

- ▶ Kumar Properties and Real Estate Pvt. Ltd. (ITA No.2977/PUN/2017) dated 28 April 2021 (Favourable)
- ▶ M/s Chayadeep Enterprises LLP vs. The ITO (ITA No. 677/Bang/2019 AY 2014-15) (SMC) (Favourable)

Partner gives loan to firm in cash. S. 269SS?:

- ▶ V. Sivakumar (2013) (354 ITR 9) (Mad)- Transactions between the partner and the firm do not partake the character of a Loan or Deposit and therefore, there is no applicability of the provisions of Section 269SS of the Act

Can a working partner earn remuneration from 2 Firms?:

- ▶ Yes - M/s Sachi Sarees vs. ACIT (2019) (55 CCH 553) (Kol Trib.)

Survey in firm. Income surrendered. Can remuneration paid to partners from the surrendered income allowed u/s 40(b)?:

- ▶ Yes – Silver Place vs. DCIT (2018) (53 CCH 300) (Pune Trib.)- Additional income disclosed by the assessee in the survey action u/s.133A partakes the character of business and therefore, the assessee is entitled to the benefits of excess remuneration qua the additional income as per the provisions of section 40(b) of the Act.

Other Issues

Capital contribution of partners is capital borrowed for the purposes of business or profession and for allowance of deduction of interest payments, requirement of section 36(1)(iii) needs to be fulfilled -

- ▶ **Munjal Sales Corp v CIT [2008] (298 ITR 298) (SC)**

What will be the tax implications u/s 41(1) if the LLP so converted recovers any expenditure or remits or ceases to hold any trading liability, the allowance or deduction of which was made to the company so being converted?

Tax provisions not applicable to LLPs but applicable to companies:

- ▶ **Certain provisions of Income Tax Act are not applicable to LLPs which are applicable to companies:**
 - ▶ Section 2(22)- Deemed dividend;
 - ▶ Section 32AC- Deduction in respect of investment in new plant and machinery;
 - ▶ Section 34A- Restriction of unabsorbed depreciation and unabsorbed investment allowance for limited period in case of domestic companies;
 - ▶ Section 35(2AB)-)- Deduction for Expenditure on Scientific research;
 - ▶ Section 35CCD- Deduction in respect of expenditure on skill development;
 - ▶ Section 35D- Amortisation of certain preliminary expenses;
 - ▶ Section 35DD- Amortisation of expenditure in case of amalgamation or demerger;
 - ▶ Section 35E- Deduction for expenditure on prospecting etc. for certain minerals;
 - ▶ Section 44AD, Section 44ADA- Presumptive Taxation;
 - ▶ Section 44D- Special provisions for computing income by way of royalties in case of foreign companies;
 - ▶ Section 46- Capital gains on distribution of assets by companies in case of liquidation;
 - ▶ Section 68- First proviso to Section 68 (Source of Source)
 - ▶ Explanation to Section 73- The deeming fiction of Explanation to section 73 of Act treating share dealing business as speculation business is also not applicable to a LLP as the same is applicable to Companies and their shares.
 - ▶ Section 79- Carry forward and set off of losses in case of change in shareholding;
 - ▶ Section 92- Transfer pricing provisions applicable to companies
 - ▶ Section 115A- Tax on dividend, royalty, technical service in case of foreign companies;
 - ▶ Section 115BAA, Section 115BAB- Benefit of lower rate of tax in case of certain domestic companies;
 - ▶ Section 115BBD- Tax on certain dividends received from foreign companies;
 - ▶ Section 115BBDA- Tax on certain dividends from domestic companies;
 - ▶ Section 115JA, 115JAA, 115JB- MAT provisions applicable to companies;
 - ▶ Section 115O- Tax on distributed profits of domestic companies;
 - ▶ Section 115QA- Tax on distributed income to shareholders on buy back

Repatriation of Capital

- ▶ The profits in case of a company, the common ways of repatriating capital are share buy-backs or capital reduction.
- ▶ In case of buy-back, there are certain statutory thresholds on the quantum of buy back (up to a maximum of 25%) along with conditions regarding the buy-back. Further, distributions made on a buy-back are taxable at 20% on the quantum of gains arising to the shareholders from such buy-back and such tax is levied on the company and not the shareholder. Therefore claiming of treaty reliefs / benefits may be open to challenges.
- ▶ In the event of a capital reduction, there are no statutory thresholds nor is there any buy back equivalent tax on the distributions made. However, capital reduction is a court process and hence may prove to be time consuming.
- ▶ In a LLP, repatriation of capital contribution is permissible without any statutory thresholds. Further, there is no buy back equivalent tax on the distributions made hence the gains made by a partner on such repatriation would be taxable only in the hands of the partner. Therefore, in the event of capital contribution received by an overseas partner, it may be possible for such overseas partner to claim relief under an applicable tax treaty. Thus, by using suitable LLPs structures, repatriation of capital contribution may become simpler and more tax efficient.

Special Economic Zones

- ▶ Most captives / development centres have units registered under Special Economic Zones ("SEZ") to avail of various benefits, particularly tax incentives (subject to fulfilment of the prescribed conditions).
- ▶ Since the law governing SEZs was enacted before the statutory introduction of LLPs, the SEZ Act does not specifically refer to LLP as an entity which can be used for setting up units in a SEZ.
- ▶ However, the type of entities covered under the SEZ Act includes firms, association of persons / body of individuals (whether incorporated or not) and therefore LLPs may also be eligible for setting up units in SEZs (and accordingly avail the prescribed benefits). Further, since LLPs are also regulated entities (and recognized under law), there appears to be no reason why such LLPs should not be entitled for availing SEZ benefits.
- ▶ Although, availing SEZ benefits for companies converting into a LLP would need to be closely examined in lieu of the existing rules prescribed under the SEZ Act along with the practices followed by SEZs in each state. In the context of subsidiaries of foreign technology companies, this would be an important consideration for using LLP structures and availing associated SEZ benefits.

Significant amendments to Partnership taxation brought in by Finance Act, 2021

Finance Act 2021 made some significant amendments to Section 45, Section 48 and introduced a new Section 9B of the ITA related to partnership taxation which had overriding effect on certain judicial precedents. However, it also provided clarity on certain matters such as:

- i. Meaning of the term 'reconstitution' of firm;
 - ii. Applicability of these sections in case of change in profit sharing ratio;
 - iii. Linkage of capital balance of partners by including the same in the computation provided in Section 45(4) of the Act;
 - iv. Manner of computation of capital gains in case both Section 9B and 45(4) are linked with Section 48(iii).
- ▶ Further the amendments also widens the scope of taxability of taxation of partnership firm by clearly covering the cases of dissolution, retirement, death, admission and change in profit sharing ratio under the definition of reconstitution.

Significant amendments to Partnership taxation brought in by Finance Act, 2021

Section 9B

- ▶ Provides for taxation on firm, by deeming receipt of capital asset or Stock in trade or both by specified person (partner) from specified entity (firm) in connection with dissolution or reconstitution as a **deemed transfer**
- ▶ Firm is taxable much in the same manner as firm would have transferred such assets in favour of an outsider
- ▶ Any profits and gains arising from such deemed transfer is deemed to be the income of firm
- ▶ Chargeable as capital gains or business income in accordance with provisions of ITL
- ▶ FMV of capital asset or stock in trade or both on date of such receipt by partner is deemed to be full value of consideration received or accruing
- ▶ Placement of s.9B in ITL is not very clear

Section 45(4)

- ▶ Levies capital gains tax on realization by partner in excess of his capital account balance, in connection with reconstitution
- ▶ Gains are computed from partner's perspective but are taxable in hands of firm
- ▶ If a partner receives any money or capital asset or both from a firm in connection with reconstitution of firm, firm shall be liable to pay capital gains tax as per following formula:
- ▶ $A = B + C - D$, where
- ▶ A = Capital gains chargeable as income of firm
- ▶ B = Value of any money on the date of such receipt
- ▶ C = FMV of capital asset on the date of such receipt
- ▶ D = Partner's capital account balance (represented in any manner) in books of firm at time of its reconstitution (without taking into account increase (a) due to revaluation of any asset or (b) due to self-generated goodwill/asset)
- ▶ Capital gains (A) will be nil if result of formula is negative
- ▶ Self-generated goodwill or asset means that:
 - ▶ which has been acquired without incurring any cost for purchase or
 - ▶ which has been generated during the course of the business or profession

Significant amendments to Partnership taxation brought in by Finance Act, 2021

Rule 8AA & 8AB of the Income-tax Rules, 1962 :

- ▶ The CBDT had recently notified Rule 8AA(5) laying down the method of determining period of holding of capital asset for the purposes of Section 45(4) of the ITA and Rule 8AB prescribing the manner of attribution of income taxable under Section 45(4) to remaining capital assets of the firm.
- ▶ As per Rule 8AB , gains taxable under Section 45(4) shall be attributable to capital assets remaining with the firm in the ratio of increase in the value of the assets due to revaluation. Accordingly it shall be noted that in case of decrease in value of the asset due to revaluation, then there shall be no attribution of gains liable to tax to remaining assets.
- ▶ Further, the gains that are taxable under Section 45(4) of the ITA shall be allocated to the assets remaining with the firm. However, such allocation shall be only to the assets that existed with the firm at the time of retirement of the partner.
- ▶ Additionally, it shall be noted that the firm is eligible for deduction under Section 48(iii) only if there is a revaluation of the assets at the time of reconstitution of the firm. In case the assets are not revalued, then firm may be not be eligible for deduction.

Significant amendments to Partnership taxation brought in by Finance Act, 2021

Aspects Common to Section 9B and Section 45(4)

- ▶ 'Specified entity' means firm/LLP/AOP/BOI - not being a company or a cooperative society
- ▶ 'Specified person' means a person, who is a partner of firm or member of AOP/BOI in any previous year
- ▶ When a capital asset is received by a partner from a firm in connection with reconstitution of firm, s.45(4) shall operate in addition to s.9B and taxation u/s. 9B shall be worked out independently
- ▶ "Reconstitution" of the firm means, where:
 - One or more partners cease to be partners; or
 - One or more new partners are admitted in such circumstances that one or more persons who were partners before the change, continue as such after the change; or
 - All the partners continue with a change in their respective shares or in the shares of some of them
- ▶ Difficulty in giving effect to the above provisions can be removed by issuance of guidelines by CBDT – to be placed before both Houses of Parliament and binding on both taxpayer and tax authority
 - ▶ CBDT issued guidelines via Circular No. 14/2021 dated 2 July 2021

Comparative Analysis

S.N.	Parameters	Erstwhile s. 45(4)	New s. 9B	New s. 45(4)
1.	Taxable entity	Firm*	Firm*	Firm*
2.	Event of trigger of taxability	Transfer of capital asset by way of distribution, on dissolution or otherwise of firm	Receipt of capital asset or stock in trade or both by partner in connection with dissolution or reconstitution of firm	Receipt of money or capital asset or both by partner in connection with reconstitution of firm
3.	Year of taxability	Transfer of capital asset	Receipt by partner	Receipt by partner
4.	Head of income	Capital gains	Capital asset - Capital gains Stock in trade - Business income	Capital gains - as per formula $A = B + C - D$
5.	Quantum of consideration	FMV of capital asset on date of transfer	FMV of capital asset or stock in trade or both on date of receipt by partner	Value of money (B) + FMV of capital asset (C) on date of receipt by partner
6.	Cost of acquisition	As per s.48/49 in respect of capital asset transferred	As per s.48/49 in respect of capital asset transferred	Partner's capital account balance (represented in any manner)** at the time of reconstitution

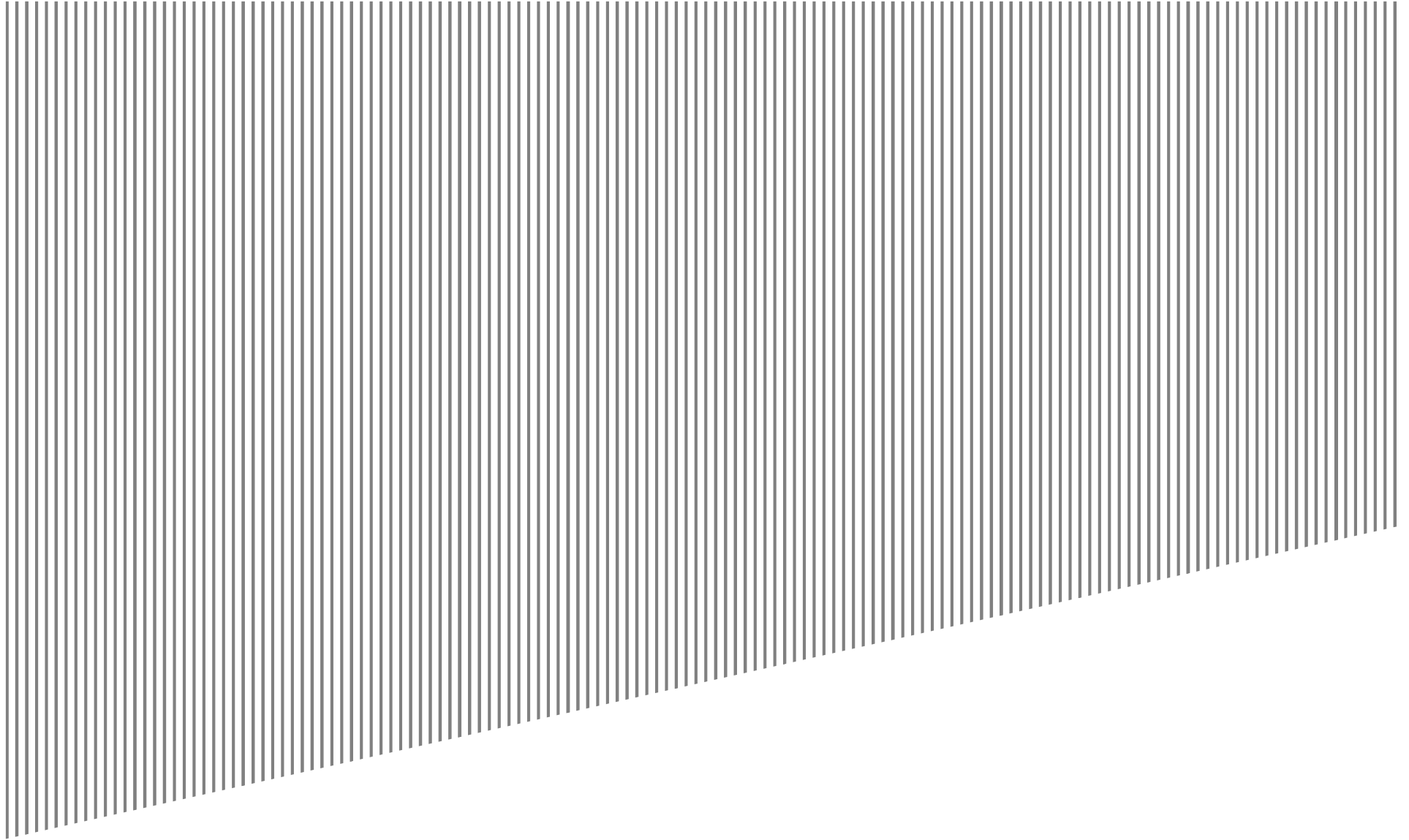
• **While the above table is based on partnership firm and partner, it will apply equally to AOP/BOI and their members*

*** Without taking into account increase (a) due to revaluation of any asset or (b) due to self-generated goodwill/asset)*

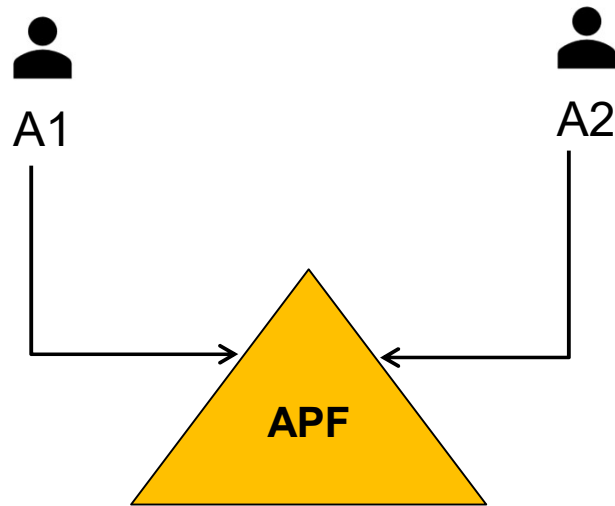
Comparative Analysis

S.N.	Parameters	Erstwhile s. 45(4)	New s. 9B	New s. 45(4)
7.	Treatment of loss	Loss admissible	Loss admissible	Not admissible
8.	Interplay between different provisions	Not applicable	Not specified	S.45(4) shall operate in addition to s.9B and both shall be worked out independently
9.	Reduction from sale consideration due to capital gains taxation in hands of firm	Not applicable as capital asset is no longer with firm	Not applicable	S.48 (iii) contemplates reduction from sale consideration on transfer of remaining capital assets, as per prescribed rules (refer later case studies)
10.	Cost of capital asset in hands of recipient partner	FMV based on general principles	FMV based on general principles	FMV based on general principles, also supported by CBDT guidelines
11.	Definition of 'reconstitution', 'specified entity' and 'specified person'	Not applicable - Refer back to judicial conflict on whether 'retirement' falls within scope of s.45(4)	Includes retirement, admission or change in profit sharing ratio	Borrowed from s.9B
12.	CBDT's power to issue guidelines to remove difficulties	Not applicable	Exists - Binding on both tax authority and taxpayers on placing before both Houses of Parliament	Exists - Provided in s.9B

Case studies to understand operation of s.9B and s.45(4)



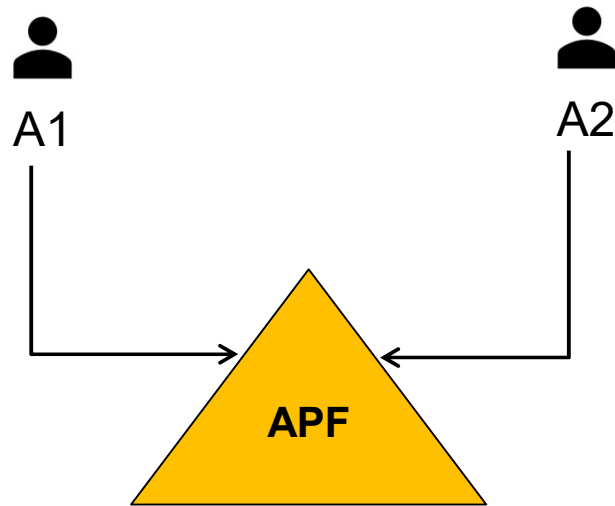
Case Study 1 – In-specie distribution on dissolution



Indicative balance sheet			
Capital		Land (FMV 1L)	10,000
A1	5,000		
A2	5,000		
Total	10,000	Total	10,000

- ▶ APF has two equal partners A1 and A2
- ▶ Capital of A1 and A2 is 5,000 each and is represented by land acquired by firm in past by investing capital of 10,000 contributed by partners
- ▶ Land is held as a long-term capital asset
- ▶ Firm is to be dissolved as its purpose is frustrated
- ▶ On dissolution, land is distributed equally between A1 and A2
- ▶ FMV of land as on the date of receipt is 1 L
- ▶ Tax implications u/s. 45(4) (under old regime)
 - ▶ FMV as on date of transfer adopted for taxation u/s. 45(4) in hands of firm
 - ▶ Capital gains is ₹ 90,000 [FMV of 1L (-) cost of acquisition of 10,000 (ignoring indexation)]
- ▶ See next slide for tax implications u/s. 9B and s.45(4) (new regime)

Case Study 1 – In-specie distribution on dissolution (Cont...)

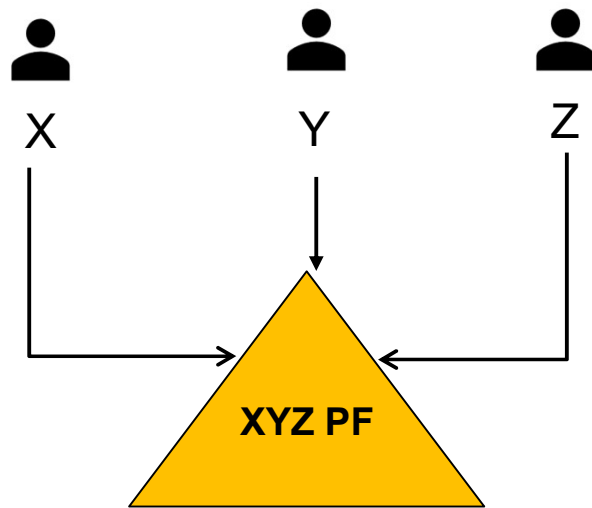


Indicative balance sheet			
Capital		Land (FMV 1L)	10,000
A1	5,000		
A2	5,000		
Total	10,000	Total	10,000

Particulars	S.9B	S.45(4)
FMV of land	1,00,000	N.A
Less:- Cost of acquisition (ignoring indexation)	10,000	N.A
LTCG in hands of firm	90,000	N.A

- ▶ S.45(4) not applicable to dissolution
- ▶ Effectively, no difference between old regime and new regime

Case Study 2 – Cash pay out on retirement



Indicative balance sheet			
X Capital	500	Land (FMV 2,100)	1,500
Y Capital	500		
Z Capital	500		
Total	1,500	Total	1,500

- ▶ XYZ PF has 3 partners having equal PSR and equal capital contribution
- ▶ XYZ PF has land acquired at cost of 1,500 whose FMV is 2,100
- ▶ Land is held as a long-term capital asset
- ▶ X retires from the firm and his account is settled in cash after taking into account FMV of land
- ▶ In order to settle X's share, continuing partners Y and Z bring in cash
- ▶ X is paid 700 against his capital balance of 500 (ignoring revaluation)
 - ▶ 700 is represented by capital of 500 plus 1/3rd share in value appreciation of 600
- ▶ Refer next slide for tax implications

Case Study 2 – Cash pay out on retirement (Cont...)

▶ Tax implications under old regime

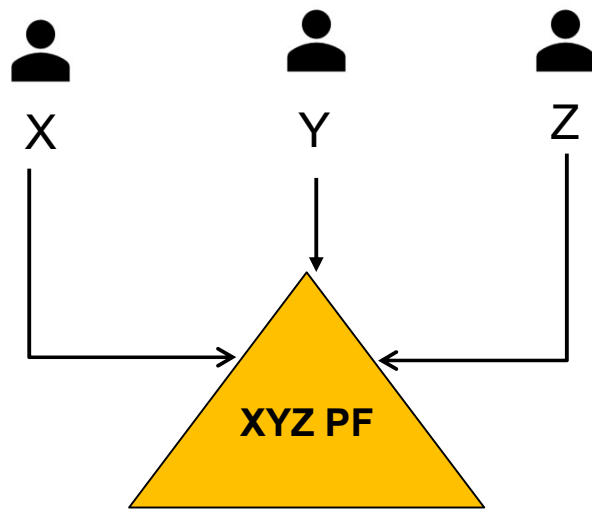
- ▶ Erstwhile s.45(4) provided for capital gains taxation in hands of firm, on transfer of capital asset to partners, by way of distribution, on dissolution or otherwise
- ▶ Cash payment to settle account of retiring partner does not result in transfer of capital asset by firm
- ▶ Cost of land continues to be historical cost of 1,500
- ▶ No taxation also in the hands of retiring partner as what he receives is always belonging to him

▶ Tax implications under new regime

Particulars	S.9B	S.45(4)
Money received (B)	N.A	700
FMV of capital asset received (C)	N.A	N.A.
Capital balance (D)	N.A	(500)
Capital gains in hands of firm (A)	N.A	200

- ▶ S.9B does not trigger as no capital asset/SIT is distributed to partner
- ▶ Amount of 200 is attributed to revaluation of land
 - ▶ S.48(iii) - Reduce 200 from sale consideration on transfer of land in future by firm
 - ▶ Say, if firm sells land for 2,100, cost of acquisition (ignoring indexation) is 1,500 and amount attributed is 200, net CG = 400

Case Study 3 – Distribution of capital asset on retirement



Indicative balance sheet			
X Capital	500	Land (FMV 2,100)	1,500
Y Capital	500		
Z Capital	500		
Total	1,500	Total	1,500

- ▶ Facts are same as #2, however, X's account is settled by distribution of one-third land against his capital balance of 500
- ▶ FMV of one-third land is 700 ($2,100 \times 1/3$), which is represented by capital of 500 plus 1/3rd share in value appreciation of 600
- ▶ **Tax implications under old regime**
 - ▶ Judicial conflict whether distribution of capital asset on retirement is covered by old s.45(4)
 - ▶ If old s.45(4) applies, firm pays tax on capital gains of 200 (ignoring indexation)
 - ▶ Cost of remaining two-third land continues to be historical cost of 1,000
 - ▶ No separate taxation in the hands of retiring partner.

Case Study 3 – Distribution of capital asset on retirement (Cont...)

Particulars	S.9B	S.45(4)
Money received	-	- [B]
FMV of capital asset received	700	700 [C]
Cost of one-third land	500	-
Partner's capital balance	-	566* [D]
Capital gains in hands of firm	200	134 [A = B + C – D]

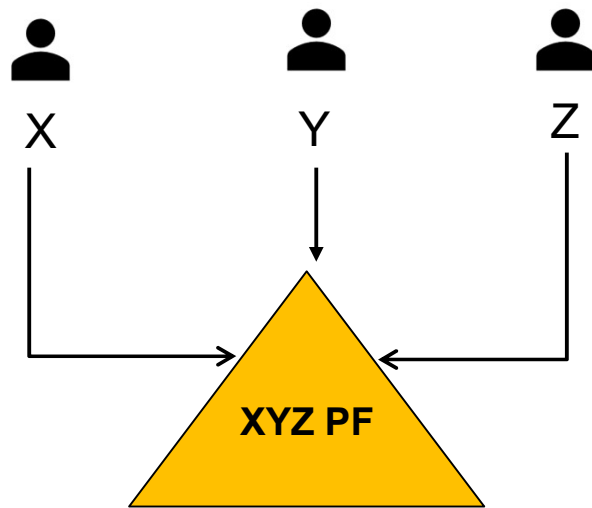
X's capital account			
Particulars	Debit	Particulars	Credit
Distribution of one-third land to X	700	Opening balance	500
Closing balance	-	X's share on revaluation of land (2,100–1,500x1/3)	200
Total	700	Total	700

Realised profit - 66
(700 - 500 x 1/3)

Unrealised profit – 134
(1,400 – 1,000 x 1/3)

- ▶ As per CBDT's guidelines, retiring partner's share of value appreciation in capital asset distributed to him (viz. 66) is includible in his capital account balance [D]
- ▶ S.48(iii) - Reduce 134 from sale consideration on transfer of two-third land in future by firm
- ▶ Say, if firm sells two-third land for 1,400, cost of acquisition (ignoring indexation) is 1,000 and amount attributed is 134, net CG = 266
- ▶ Thus, there is no double taxation; taxation u/s. 45(4) merely represents timing difference.

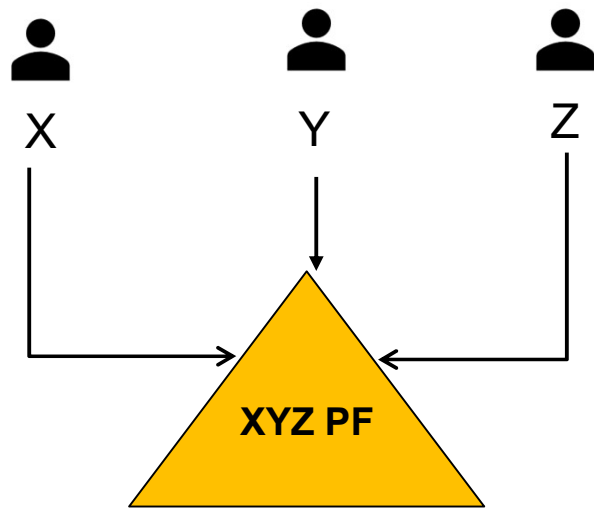
Case Study 4 – Distribution of stock in trade on retirement



Indicative balance sheet			
X Capital	500	Land (FMV 2,100)	1,500
Y Capital	500		
Z Capital	500		
Total	1,500	Total	1,500

- ▶ XYZ PF has 3 partners having equal PSR and equal capital contribution
- ▶ XYZ PF has land acquired at cost of 1,500 whose FMV is 2,100
- ▶ Land is held as a stock-in-trade
- ▶ X retires from the firm and his account is settled by distribution of one-third land as against his capital balance of 500
 - ▶ FMV of one-third land is 700 ($2,100 \times 1/3$), which is represented by capital of 500 plus 1/3rd share (200) in value appreciation of 600
- ▶ **Tax implications under old regime**
 - ▶ In absence of provision along the lines of s. 45(4), transfer of SIT on retirement does not amount to “transfer” from firm to partner. Arguably, firm not liable to business taxation
 - ▶ Partner also not liable. It is realisation of pre-existing right
 - ▶ ACIT v. Agrawal Timber and Bans Co. [1983] 144 ITR 46 (MP); and CIT v. Anant Narhar Nimkar (HUF) [1997] 224 ITR 221 (Gujarat)

Case Study 4 – Distribution of stock in trade on retirement (Cont....)



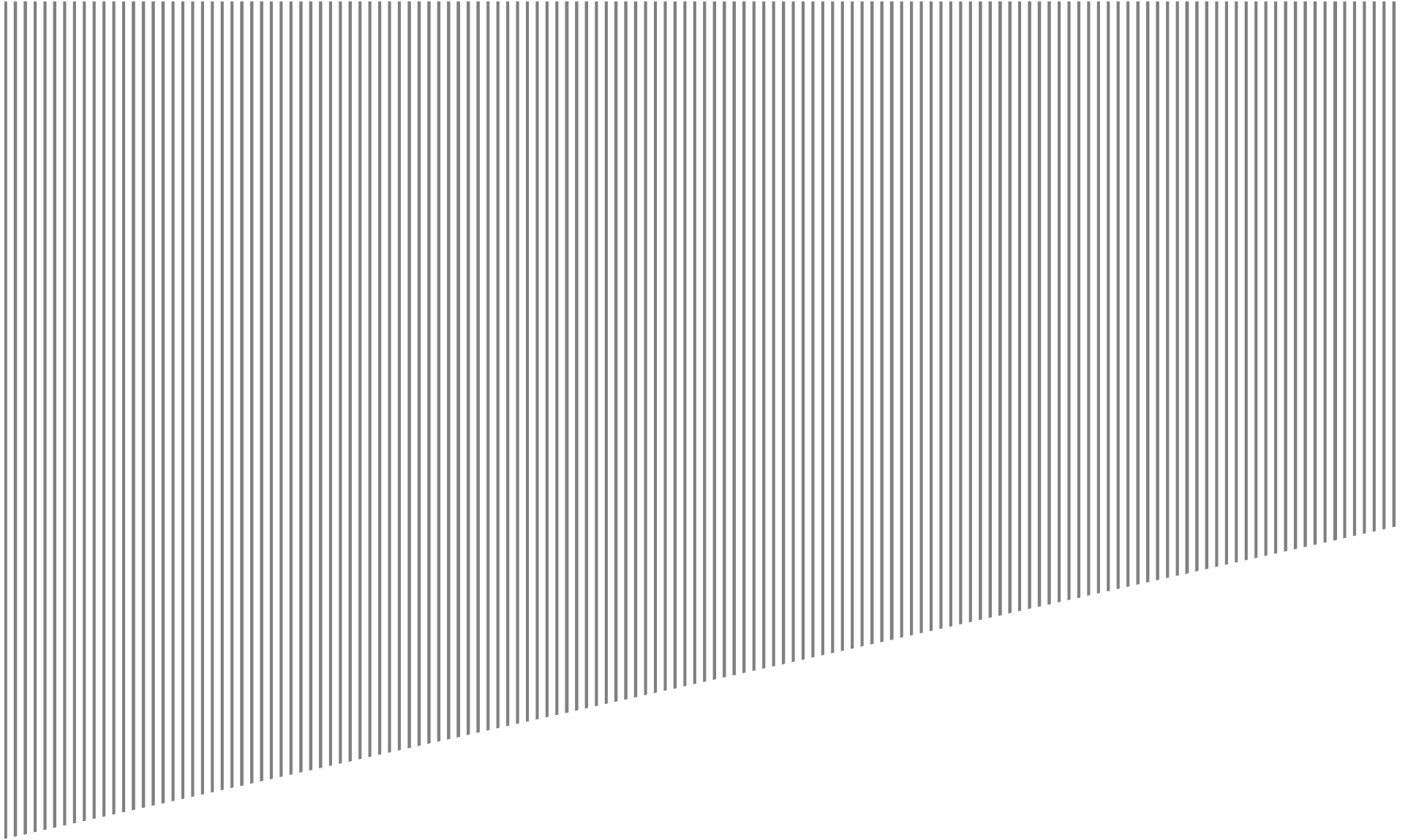
Indicative balance sheet			
X Capital	500	Land (FMV 2,100)	1,500
Y Capital	500		
Z Capital	500		
Total	1,500	Total	1,500

► Tax implications under new regime

Particulars	S.9B
FMV of SIT	700
Cost of land	(500)
Business income in hands of XYZ PF	200

- S.45(4) is inapplicable to case of distribution of SIT as its applicability is restricted to distribution of any money or capital asset.
- Consequently, s. 48(iii) will also not apply

Some illustrative issues



Issues

- ▶ Is tax u/s. 45(4) triggered upon partner retiring from the firm, or upon actual receipt from firm?
- ▶ Whether s.45(4) is prospective or retrospective?
- ▶ Whether s.9B is prospective or retrospective?
- ▶ Impact of retirement of partner at book value
- ▶ Impact of partner's capital account turning negative by ignoring revaluation
- ▶ Waiver of debit balance in partner's capital account on retirement
- ▶ Is s.45(4) applicable on receipt by legal representative of deceased partner?
- ▶ Impact of conversion u/s. 47(xiii) or Chapter XXI post retirement
- ▶ Withdrawal of firm's property by partners in their PSR
- ▶ Some illustrative issues

Issue 1: Is tax u/s. 45(4) triggered upon partner retiring from the firm, or upon actual receipt from firm?

- ▶ A partner retires in March 2021 whose account is settled in March 2022 by cash payment. Whether s.45(4) triggers in FY 2020-21 or FY 2021-22?
- ▶ **View 1:- Once a partner retires and entitlement is determinate as a creditor, charge u/s. 45(4) is triggered:-**
 - ▶ As per Indian Partnership Act, immediately upon retirement, a debt (viz. right to receive) is perfected in favour of retiring partner [Pamuru Vishnu Vinodh Reddy v. Chillakuru Chandrasekhara Reddy & Ors. C. A. No. 6519 of 1994, 17 February 2003]
 - ▶ Perfection of a debt in lieu of partnership interest is a constructive receipt by partner from firm
 - ▶ Word 'receipt' extends to credit to the account of the concerned person - Standard Triumph Motor Co. Ltd. v. CIT (1993)(67 Taxman 160)(SC)
 - ▶ Partner may enjoy interest on such debt, partner may monetise such debt by assignment in favour of bank
 - ▶ In many instances such as in the context of s.32AB(3)(ii)/(iii), the legislature itself uses the words "paid" and "payable" interchangeably
 - ▶ Specific references in ITL have been made to 'actual receipt' wherever the legislature intended the point of taxation to be as such, for instance, in s.43B and s.43D - S.45(4) refers to "received" and not "actually received"

Issue 1: Is tax u/s. 45(4) triggered upon partner retiring from the firm, or upon actual receipt from firm?

- ▶ **View 2:- Word ‘receives’ refers to actual receipt by the partner from the firm; acknowledgement of debt in favour of retiring partner is insufficient:-**
 - ▶ Clear reference is to ‘received’ in s.45(4) which is different than ‘receivable’
 - ▶ S.45(4) uses a phraseology which is aligned to other receipt-based taxation provisions like s.45(1A) or s.46(2) or s.45(5) - Delhi ITAT* held that taxation u/s. 45(1A) is in year of actual receipt
 - ▶ SC in Moon Mills Ltd. (1966) (59 ITR 574) drew clear distinction between ‘received’ and ‘receivable’ and upheld taxation in year of actual receipt in the context of balancing charge provision in 1922 Act which provided for taxation of insurance money “received”
 - ▶ SC decision in Standard Triumph is distinguishable on facts, as in that case, debtor was holding the money in India on behalf of creditor – in present case, amount is not at disposal of partner, his ability to assign such debt to a bank is not reflective of receipt from firm
 - ▶ SC in Toshoku Ltd. [1980] 125 ITR 525 (SC) held that mere credit entry would not suffice to answer to the requirement of receipt
 - ▶ Even old s.45(4) triggered charge only on distribution of CA and not on dissolution**

*Syndicate Printers Ltd. (2009) (27 SOT 404) **CIT v. Vijayalakshmi Metal Industries [2003] 132 TAXMAN 49;

Issue 2: Whether s.45(4) is prospective or retrospective?

- ▶ Partner retires in March 2020, but his account is settled in April 2020 by cash payment* – Is s.45(4) triggered, which is effective from AY 2021-22?
- ▶ **View 1:- S.45(4) applies**
 - ▶ It is deeming fiction of receipt-based taxation, like ss.45(1A) and 46(2) – Since receipt by partner from firm is post 1 April 2020, s.45(4) applies
 - ▶ No grandfathering of past reconstitution unlike s.2(22)(e) which applied to payments post 31 May 1987, s.43C applied only to sale of asset post 29 February 1988
 - ▶ S.46(2) was applied in respect of distributions by liquidator post 1 April 1961, while earlier distributions were exempt
 - ▶ Capital gains computed by deducting full cost of acquisition of shares against distributions post 1 April 1961 - CIT v. Inland Agencies (P.) Ltd. [1982] 11 Taxman 218 (Madras HC)**
 - ▶ Merely because determination of cost [viz. component D] is to relate back to pre-2020 date is not a good defence - even under a normal case, determination of cost is linked to FMV as on 1 April 2001

* Controversy applies equally to settlement by distribution of capital asset in April 2020

**See illustratively, CIT v. A. F. Harvey Ltd. [1990] 51 Taxman 238 (Mad), Cables & Wireless Ltd. [1977] 107 ITR 293 (Bom)

Issue 2: Whether s.45(4) is prospective or retrospective?

- ▶ **View 2:- S.45(4) does not apply**
 - ▶ 'Reconstitution' is defined as where a person "ceases" to be a partner of firm – where such cessation took place before introduction of law, it is not 'reconstitution'
 - ▶ S.45(4) only shifts timing of taxation to actual receipt – basis of taxation continues to be accrual – which, in the present case, happened in March 2020
 - ▶ Receipt as also its connection with reconstitution are twin requirements for satisfaction of charge, which is triggered only when both these events occur after April 2020
 - ▶ Very clear provisions (along the lines of Explanations 5 to 7 to s.9(1)(i) for indirect transfer) are needed to trigger charge in respect of past non-taxable events
 - ▶ Analogy of s.46(2) cannot be applied as liquidation of a company is a continuing event while the retirement / reconstitution is a snapshot event
 - ▶ While receipts pre April 2020 would go untaxed, entirety of partner's capital account balance may come up for deduction against receipts post April 2020, which may give rise to absurd results

Issue 3: Whether s.9B is prospective or retrospective?

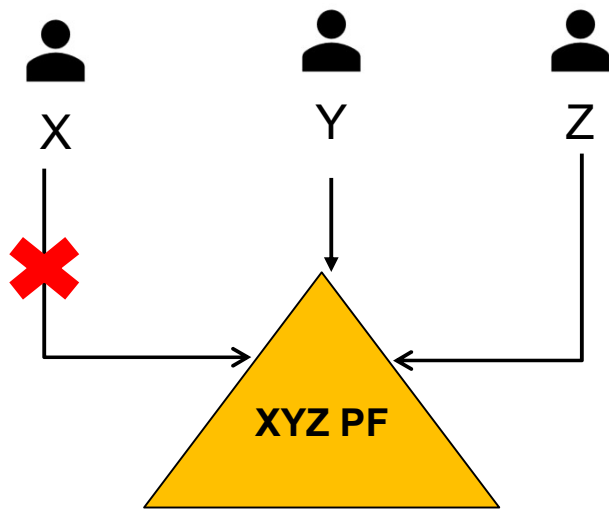
- ▶ Partner retires in March 2020, but his account is settled in April 2020 by distribution of capital asset – Is s.9B triggered, which is effective from AY 2021-22?
- ▶ **View 1:- S.9B applies**
 - ▶ S.9B concerns taxability on the part of the firm w. r. t. parting of CA or SIT
 - ▶ If retirement in March 2020 resulted into creation of a debt against firm, settlement of such debt by transfer of CA or SIT represents consideration accruing to firm
 - ▶ Distribution of CA or SIT is in lieu of sale in open market and payment of cash
 - ▶ There is repetitive emphasis in s.9B for treating event of receipt as “deemed transfer”; such deemed transfer occurs in year in which CA or SIT is received by partner from the firm
 - ▶ View 2 results in frustrating charge which already got created under old s.45(4) - legislative intent of s.9B is to expand the scope rather than to sacrifice the charge
- ▶ **View 2:- S.9B does not apply**
 - ▶ Retirement in March 2020 could not have resulted into creation of a debt against firm – legally, a partner can never be creditor of the firm; he is creditor of other partners
 - ▶ In absence of saving clause for past reconstitution, lacuna in legislation cannot justify the trigger of charge
 - ▶ View 1 may result in s.9B being applied even to dissolution pre 1 April 1987 (which was tax neutral) and create double whammy in absence of cost step-up to partner u/s. 49(1)(iii)(b)

Issue 4: Impact of retirement of partner at book value

- ▶ Settlement at an amount equivalent to partner's capital balance may not attract capital gains tax implications u/s. 45(4)
 - ▶ If such settlement is as per long standing terms of partnership deed, such settlement merely reflects working out of pre-existing rights
- ▶ In a different scenario, suppose, there is retirement and partner retires by withdrawing only capital balance at book value - despite there being higher entitlement basis partnership deed
 - ▶ Actual receipt by partner from firm is relevant - S.45(4) does not have any deeming fiction for taxation w. r. t. fair value of partnership interest
 - ▶ S.56(2)(x) implications in hands of continuing partners?
 - ▶ No transfer of specified property is effected by retired partner in favour of continuing partners
 - ▶ Settlement of retired partner without taking into account value of goodwill does not result in any transfer or settlement by such retired partner in favour of continuing partners under Gift-tax Act - assets and goodwill of firm continue to remain those of firm [CGT v T M Louiz [2000] 245 ITR 831 (SC)]
 - ▶ During subsistence of firm, no partner has any specific interest in any property of firm – while partners have certain rights on dissolution/retirement, properties remain that of firm and not of partners*

* *Addanki Narayanappa & Anr v. Bhaskara Krishtappa & Ors AIR 1966 SC 1300; S. V. Chandra Pandian and Ors. v. S. V. Sivalinga Nadar and Ors. [1993 SCR(1) 58*

Issue 5: Impact of partner's capital account turning negative by ignoring revaluation



Indicative balance sheet			
X Capital	1,000	Land (FMV 9,000)	3,000
Y Capital	1,000		
Z Capital	1,000		
Total	3,000	Total	3,000

- ▶ XYZ LLP has 3 partners having equal PSR and equal capital contribution
- ▶ In year 1, partner X desires to withdraw cash from his capital account for personal purposes
 - ▶ In year 1, land is revalued by firm and revaluation profit of 6,000 is credited in equal proportion to capital account of all three partners
 - ▶ Out of total credit balance in partner's capital account of 3,000 (viz. 1,000 capital contribution and 2,000 revaluation), partner X withdraws cash of 2,500 in year 1
- ▶ In year 2, partner X retires from LLP
- ▶ Amount payable to X on retirement is determined at 500, which is payable in cash in year 2
- ▶ Since retiring partner's account is settled in cash, s.9B does not trigger
- ▶ Refer next slide for s.45(4) implications

Issue 5: Impact of partner's capital account turning negative by ignoring revaluation

Particulars	If no withdrawal in year 1	Post withdrawal in year 1
Money received in connection with reconstitution	3,000 [B]	500 [B]
FMV of capital asset received	- [C]	- [C]
Partner's capital balance at the time of reconstitution	(1,000) [D]	(- 1,500*) [D]
Capital gains u/s. 45(4) in hands of firm	2,000 [A = B + C - D]	2,000 [A = B + C - D]

**Compute without taking into account increase due to revaluation of any asset*

X's capital account per books (post revaluation)			
Particulars	Debit	Particulars	Credit
Year 1			
To Withdrawal in year 1	2,500	By Opening b/f	1,000
To Closing c/f	500	By X's share on revaluation of land	2,000
Total	3,000	Total	3,000
Year 2			
		By Opening b/f	500

Memorandum capital a/c (ignoring revaluation)			
Particulars	Debit	Particulars	Credit
Year 1			
To Withdrawal in year 1	2,500	By Opening b/f	1,000
		By X's share on revaluation of land	Ignored *
		By Closing c/f	1,500
Total	2,500	Total	2,500
Year 2			
To Opening b/f	1,500		

Issue 6: Waiver of debit balance in partner's capital account on retirement

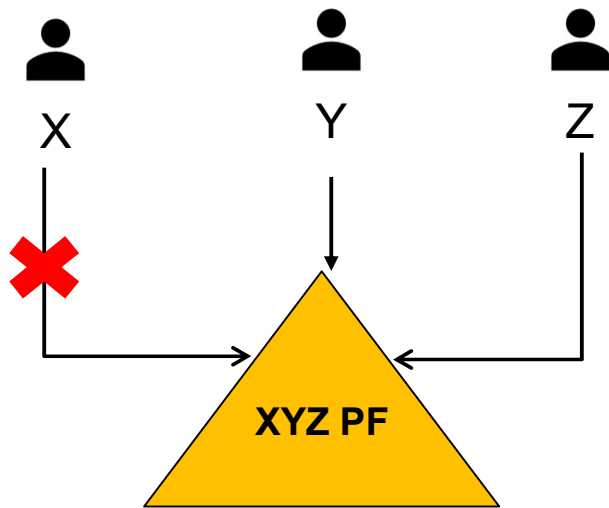
- ▶ In earlier case study, assume that partner X withdraws cash of 3,500 in year 1 for personal purposes, against his capital balance of 3,000 (post revaluation)
- ▶ Firm waives of 500 due from partner X and also, nothing further is paid to partner
 - ▶ CIT v. Mahindra And Mahindra Ltd. [2018] 93 taxmann.com 32 (SC): “waiver of loan by the creditor results in the debtor having extra cash in his hand. It is receipt in the hands of the debtor.”
- ▶ Hence, waiver of 500 by firm results in receipt of extra cash in hands of partner from firm

Particulars	Amount
Money received in connection with reconstitution	500 [B]
Partner's capital balance at the time of reconstitution	(2,000) [D]
Capital gains u/s. 45(4) in hands of firm	2,500 [A = B + C – D]

- ▶ Memorandum Capital Account of Partner X (ignoring revaluation) is as under:-

Memorandum Capital Account of Partner X			
Particulars	Debit	Particulars	Credit
Year 1			
To Withdrawal in year 1	3,500	By Opening b/f	1,000
		By X's share on revaluation of land	Ignored*
		By Closing c/f	2,500
Total	3,500	Total	3,500
Year 2			
To Opening b/f	2,500	By P&L account (waiver in year 2)	500
		By Closing c/f	2,000

Issue 7: Is s.45(4) applicable on receipt by legal representative of deceased partner?



Indicative balance sheet			
X Capital	1,000	Land (FMV 9,000)	3,000
Y Capital	1,000		
Z Capital	1,000		
Total	3,000	Total	3,000

- ▶ XYZ PF has 3 partners having equal PSR and equal capital contribution
- ▶ Partner X expires
- ▶ As per partnership deed, account of deceased partner X is to be settled at fair value in favour of his legal heir without admitting him as partner
- ▶ Continuing partners Y and Z bring in cash for payment to legal heir of X
- ▶ While there is no dispute that death of partner gives rise to reconstitution of the firm; limited issue is whether s.45(4) gets triggered when the legal heir receives settlement of deceased partner's capital account.
- ▶ S, 45(4) states 'where **a specified person receives** money.....from specified entity...'
- ▶ 'Specified person' is defined to mean **a person who is partner of a firm.....**

Issue 7: Is s.45(4) applicable on receipt by legal representative of deceased partner?

▶ View 1:- S.45(4) applies

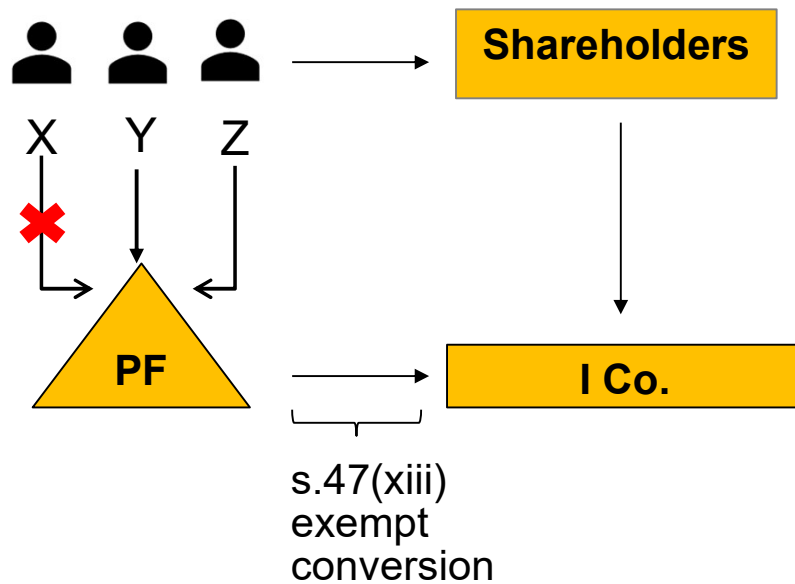
- ▶ Legal heir steps into shoes of deceased partner - payment is made to legal heir pursuant to right conferred on deceased partner in terms of partnership deed
- ▶ Concept of 'substituted assessee' enshrined in s.49(1) of ITL – to also be read into s.45(4)
- ▶ C.V. Ramanathan v. CIT [1980] 125 ITR 191 (Madras) – exemption u/s. 54 allowed to deceased taxpayer even where the investment in new house was made by son of deceased taxpayer

▶ View 2:- S.45(4) does not apply

- ▶ Legal heir was never admitted into partnership – hence, is not a 'specified person' – charge fails in absence of receipt by a 'specified person' –
- ▶ Being a charging provision, strict interpretation required
- ▶ S.159/168 provide taxing deceased person's income in hands of legal representatives/executor – such provisions are inapplicable to present case as taxation u/s. 45(4) is in hands of firm
- ▶ A specific provision along the lines of Explanation (iii) to s.45(5) is needed for taxing receipt by legal heir
- ▶ Interest paid by firm to estate of deceased partner administered by trustee, is not hit by s.40(b) as such trustee was never admitted as a partner in firm [Colombo Stores (1984)(17 Taxman 183)(Madras HC)]

Where firm having 2 partners is dissolved due to death of one partner, and business is continued by legal heir with surviving partner, there may be emergence of AOP/BOI

Issue 8: Impact of corporatisation of firm u/s. 47(xiii) or Chapter XXI post retirement



Indicative balance sheet			
X Capital	1,000	Land (FMV 9,000)	3,000
Y Capital	1,000		
Z Capital	1,000		
Total	3,000	Total	3,000

- ▶ XYZ LLP has 3 partners having equal PSR and equal capital contribution
- ▶ Partner X retires w. e. f. 1 January 2021
- ▶ Value of X's interest is determined at 3,000, which is payable in cash by LLP to X at the end of three years, i.e. on 31 December 2023
- ▶ X is recognized in books of LLP as a creditor
- ▶ Post retirement, remaining partners decide to carry on business in the form of a corporate structure
- ▶ On 31 March 2021, Y and Z form a company 'I Co.', infuse capital therein, and I Co. purchases business from LLP for a lump sum consideration – such conversion is exempt u/s. 47(xiii)
- ▶ On 31 December 2023, I Co. discharges the debt in favor of X by payment of cash
- ▶ Assuming charge u/s. 45(4) is triggered on actual receipt, can such charge trigger even where debt is repaid by I Co. and not by LLP?

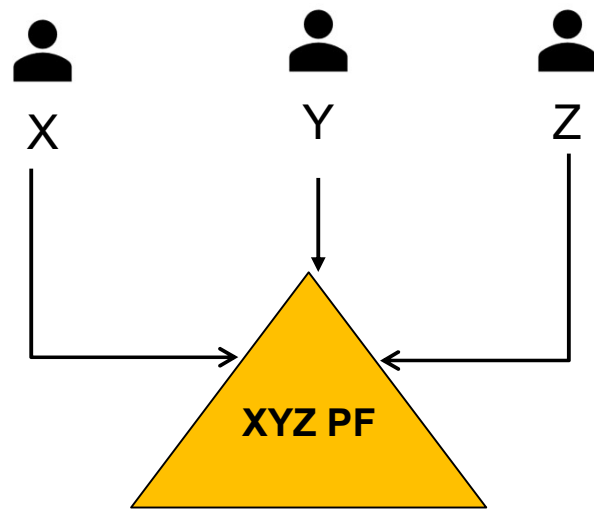
Issue 8: Impact of corporatisation of firm u/s. 47(xiii) or Chapter XXI post retirement

- ▶ S, 45(4) triggers charge “where specified person receives moneyfrom a specified entity.....”
- ▶ At the stage of conversion in year 1, retired partner receives debt owed by I Co. in lieu of debt owed by firm/LLP – retired partner does not receive any money from the firm/LLP
- ▶ At the stage of discharge of debt by I Co. in year 3, retired partner receives money from I Co. which is not a ‘specified entity’
- ▶ Charging provisions require strict construction – absence of receipt by partner from ‘specified person’ may frustrate the charge?

Additionally, corporatisation u/s. 47(xiii) involves novation of debt as inter-vivos transfer

- ▶ Novation involves discharge of original debt due by LLP and substitution by fresh debt due by ICo.
- ▶ Such discharge is not by way of repayment but by way of a mutual agreement

Issue 9: Withdrawal of firm's property by partners in their PSR



Indicative balance sheet			
X Capital	1,000	Business (FMV 6,000)	2,000
Y Capital	1,000	Land (FMV 3,000)	1,000
Z Capital	1,000		
Total	3,000	Total	3,000

- ▶ XYZ PF has 3 partners having equal PSR
- ▶ XYZ PF has two assets, one being business with book value of 2,000 (whose FMV is 6,000) and another being land with book value of 1,000 (whose FMV is 3,000)
- ▶ For diverse commercial and social considerations and for bona fide reasons of long-term sustenance of partnership relations, a decision is taken to distribute certain firm's properties
- ▶ Accordingly, Land B (having FMV of 3,000) is distributed to X against his entitlement of 3,000
- ▶ Firm debits book value of Land B against X's capital account balance
- ▶ In absence of any dissolution/reconstitution, s.45(4)/s.9B may not trigger in hands of PF
- ▶ Whether s.45(1) triggers in hands of firm? If yes, whether consideration is debit to partner's capital account? Whether s.50C applies?

Issue 9: Withdrawal of firm's property by partners in their PSR

▶ View 1:- S.45(1) may not trigger in hands of firm:-

- ▶ Despite s.14 and s.15 of Indian Partnership Act, firm is not a separate legal entity but a compendium of partners, firm cannot function without partners, and as a result, real owners of firm's property are partners who are effective co-owners in their profit sharing ratio
 - ▶ Upon distribution, co-owned property is converted into exclusive property
 - ▶ For determining whether an asset withdrawn from firm is long-term or short-term in hands of partner post such withdrawal, holding period of firm was considered [CIT v. Kamala Devi [1997] 227 ITR 701 (Madras HC) and Ratansi Narayan Patel v. CIT [1988] 173 ITR 547 (MP HC)]
- ▶ During subsistence of firm, there can be 'distribution' of property in profit sharing ratio, as contradistinguished from 'sale' of property for a specified consideration - [Burlingtons' Exports v. ACIT [1993] 45 ITD 424 (Mumbai ITAT)]

Issue 9: Withdrawal of firm's property by partners in their PSR

- ▶ **View 2:- Capital gains u/s. 45(1) r. w. s. 50C are attracted:-**
 - ▶ S.14 and s.15 of Indian Partnership Act provides that firm can acquire and own assets*
 - ▶ No partner has any specific or exclusive interest in any property of firm, even to the extent of his profit share; while partners have certain rights on dissolution/retirement, properties remain that of firm and not of partners
 - ▶ Once partner acquires exclusive rights in any property of firm, there is effective transfer or extinguishment of firm's interest in such property hitherto owned by firm**
 - ▶ Transfer of property to partners during subsistence of firm is different from distribution of property to partners on dissolution or retirement – also, in former case, debit to partner's capital balance may be regarded as consideration in hands of firm [B.T. Patil & Sons v. CGT [2001] 114 Taxman 301 (SC)]
- ▶ Partner can also face consequences u/s. 56(2)(x) if specified property such as land is withdrawn where debit to his capital account is less than stamp duty value

In case of withdrawal from LLP, View 2 becomes stronger as LLP Act regards LLP as a body corporate, capable of acquiring, owning, holding disposing of property

* *Addanki Narayanappa & Anr v. Bhaskara Krishtappa & Ors* AIR 1966 SC 1300; *S. V. Chandra Pandian and Ors. v. S. V. Sivalinga Nadar and Ors.* [1993 SCR(1) 58

** *A.S. Krishna Setty & Sons v. ACIT* [1975] 100 ITR 587 (Karnataka HC); *B.T. Patil & Sons v. CGT* [1996] 89 TAXMAN 598 (Karnataka HC); *CIT v. Bharani Pictures* (1980) 3 Taxman 478 (Madras HC)

Certain Additional points

- ▶ S.9B and s.45(4) are independent charging provisions; absence of back up amendment to definition of 'transfer' u/s. 2(47) or 'income' u/s. 2(24) may not frustrate the charge
- ▶ S.9B(3) deems FMV of capital asset or SIT as full value of consideration received or accruing as a result of deemed transfer - where stamp duty value is > FMV, whether the same substitutes FMV?
 - ▶ Arguably, no - S.9B(3) begins with the words "for the purposes of this section" – such a specific provision for ascertaining sale consideration shall prevail over all other general provisions such as s.43CA or s.50C
- ▶ As per s.45(4), partner's capital account can be "represented in any manner" in the books of the firm
 - ▶ In the context, both fixed capital and fluctuating capital account will be considered for s.45(4)
 - ▶ However, an account created due to loan is, strictly speaking, not a "capital account"

Certain Additional points

- ▶ If retiring partner is from a jurisdiction that has favourable capital gains article in tax treaty with India, can firm suggest that s.45(4) charge is not attracted as firm and partners are alternative taxpayers and if partner is treaty protected, there can be no taxation on firm?
 - ▶ For example, Article 13(5) of India-Netherlands treaty provides that “Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 shall be taxable only in the State of which the alienator is a resident”
- ▶ Firm may convert CA into SIT before distribution to partner upon reconstitution – such conversion may avoid duplicated taxation u/s. s.45(4) subject to GAAR
 - ▶ Upon distribution to partner, firm attracts taxation u/s. 45(2) w. r. t. FMV on date of conversion
 - ▶ S.9B impact is confined to appreciation beyond aforesaid FMV
 - ▶ Since receipt by partner is SIT which is neither money nor capital asset, s. 45(4) will not trigger.

Section 45(4)

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

$$A = B + C - D$$

Where,

A = income chargeable to income-tax under this subsection 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:

Provided that if the value of "A" in the above formula is negative, its value shall be deemed to be zero :

Provided further that the balance in the capital account of the specified person in the books of account of the specified entity is to be calculated without taking into account the increase in the capital account of the specified person due to revaluation of any asset or due to self-generated goodwill or any other self-generated asset.

Section 45(4) (Contd..)

45(4)

Explanation 1.—For the purposes of this sub-section,—

(i) the expressions "reconstitution of the specified entity", "specified entity" and "specified person" shall have the meanings respectively assigned to them in [section 9B](#);

(ii) "self-generated goodwill" and "self-generated asset" mean goodwill or asset, as the case may be, which has been acquired without incurring any cost for purchase or which has been generated during the course of the business or profession.

Explanation 2.—For the removal of doubts, 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 this sub-section shall operate in addition to the provisions of [section 9B](#) and the taxation under the said provisions thereof shall be worked out independently.]

Section 9B

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

(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.

Section 9B (Contd..)

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.]

Thank you

