Navigating the New Era of Partnership Taxation

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Part A

Section 9B & Section 45(4): Partnership Reconstitution Tax Framework

The Finance Act 2021 introduced transformative provisions governing taxation of partnership reconstitutions, fundamentally altering how capital gains are recognized and attributed when partners exit or entities restructure.

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Legislative Context and Scope

The Language of the New Law:

Section 9B Overview

Establishes deemed transfer taxation when specified persons receive capital assets or stock-in-trade from specified entities during dissolution or reconstitution. Applies to firms, associations of persons, and bodies of individuals.

Section 45(4) Framework

Imposes additional capital gains tax on excess distributions to exiting partners. Uses formula **A = B + C - D** to calculate taxable gains based on money received, capital asset fair market value, and capital account balance.

Effective Date

Both provisions became operative for assessment year 2021-22 and subsequent years, representing significant expansion of partnership taxation principles.

Crucial Clarification: "the provisions of sub-section (4) of section 45 of the Act shall operate in addition to the provisions of section 9B of the Act and the taxation under the said provisions thereof shall be worked out independently."

Key Definitions and Terminology

Specified Entity

Firm, association of persons, or body of individuals—excluding companies and cooperative societies. The transferor entity subject to deemed transfer provisions.

Specified Person

Any partner in a firm or member of an association/body of individuals during the relevant previous year. The recipient of distributed assets.

Reconstitution Events

1. Exit of one or more partners/members
2. Admission of new partners with continuity of existing partners
3. **Change in profit-sharing ratios among continuing partners**

Self-Generated Assets

Goodwill or assets acquired without purchase cost or generated through business operations. Excluded from capital account calculations.

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Section 9B: Deemed Transfer Mechanics

1

Transfer Recognition

Entity deemed to transfer assets at fair market value on receipt by specified person, regardless of actual consideration structure.

2

Income Characterization

Profits taxed under **"Capital gains"** or **"Business profits"** head depending on asset nature and holding period.

3

Valuation Standard

Fair market value on receipt date constitutes full consideration for computing taxable gains under deemed transfer provisions.

2(22B)- FMV means open-market value of capital asset

The deemed transfer occurs in the previous year when the specified person receives the capital asset or stock-in-trade, establishing the taxation year and triggering compliance obligations for the specified entity.

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Section 45(4): Excess Distribution Taxation Formula

$$A = B + C - D$$

Component A: Taxable Gain

Total income chargeable under capital gains head. If calculation yields negative value, deemed zero per statutory proviso.

Component B: Cash Received

Value of money received by specified person from entity on distribution date. Includes all monetary transfers during reconstitution.

Component C: Asset Value

Fair market value of capital assets received on distribution date. Determined through registered valuer assessment.

Component D: Capital Balance

Partner's capital account balance at reconstitution, excluding revaluation increases and self-generated goodwill/assets.

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The Integrated Application: A Step-by-Step View

1 Apply Section 9B

If an asset is transferred out, calculate the firm's capital gain based on its FMV (`FMV - Indexed Cost`).

↓

2 Update Capital Accounts

The book profit arising from the Section 9B transaction is credited to the capital accounts of all partners in their profit-sharing ratio.

↓

3 Apply Section 45(4)

Using the *updated* capital account balance, calculate the firm's gain using the formula `A = (B + C) - D`.

↓

Outcome: The firm is liable for tax on gains calculated under both sections, independently.

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Cumulative Taxation Mechanism

Independent Operation

Section 9B and Section 45(4) operate concurrently and independently. Both provisions must be applied when capital assets are distributed during reconstitution.

Cumulative Taxation

Entity faces potential cumulative tax liability: deemed transfer gains under Section 9B plus excess distribution gains under Section 45(4). Tax calculations proceed separately.

Critical Planning Consideration: The cumulative tax burden under both sections can significantly exceed traditional partnership dissolution taxation, requiring careful structuring of exit transactions and asset distributions.

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Attribution Framework: Rule 8AB Application

Circular No. 14 of 2021 dated 02.07.2021 clarifies that amounts taxed under Section 45(4) must be attributed to remaining capital assets, preventing double taxation on subsequent transfers.

01

Revaluation Requirement

Obtain registered valuer report establishing fair market values for all remaining capital assets and identifying self-generated goodwill or assets.

02

Attribution Calculation

Allocate taxed amount proportionally based on increase in asset values per valuation report. Self-generated assets included in attribution base. No attribution may be permissible for stock-in-trade.

03

Block Asset Treatment

For depreciable assets forming block, attributed amounts reduce consideration in future transfers but do not increase written down value or generate depreciation.

04

Gain Reduction

On subsequent asset transfer, attributed amount deducted from sale consideration under Section 48(iii) (or Section 43(6)(c) and Section 50 for block assets).

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Block Assets and Self-Generated Assets Treatment

Depreciation Prohibition

Attributed amounts under Section 45(4) do not increase written down value of block assets. No depreciation allowable on revaluation increments or attributed amounts per Explanation 2 to Section 32(1) and Section 43(1).

Future Transfer Mechanism

Upon subsequent transfer of block asset, attributed amount reduces gross consideration before applying Section 43(6)(c) for WDV reduction or Section 50 for capital gains computation, preventing double taxation.

Self-Generated Assets

Goodwill and self-generated assets participate in attribution calculations despite zero actual cost. Recognition in valuation report enables attribution but generates no depreciation benefit. Section 32 explicitly prohibits goodwill depreciation.

Comprehensive Example: Asset Distribution Scenario

Setup	
Firm	'FR' with 3 partners (A, B, C), 1/3rd share each.
Capital	₹10 lakh each.
Assets	Land 'S', 'T', 'U' (Book Value ₹10 lakh). Land 'U' has an indexed cost of ₹15 lakh.
Transaction	Partner 'A' exits, receiving Land 'U' (FMV ₹50 lakh) + Cash (₹11 lakh).

Tax Calculation 1: Section 9B (Deemed Transfer of Land 'U')

Fair Market Value (Consideration):	₹50 lakh
Less: Indexed Cost of Acquisition:	(₹15 lakh)
Capital Gain (for Firm FR):	**₹35 lakh**

Tax Calculation 2: Section 45(4) (Excess Receipt)

A's Updated Capital = ₹10 lakh (initial) + ₹11 lakh (1/3rd share of ₹33 lakh book profit from 9B gain) = **₹21 lakh.**

Applying formula: A = (₹11 lakh Money + ₹50 lakh Asset FMV) - ₹21 lakh Capital

Capital Gain (for Firm FR): ₹40 lakh

Result: The firm faces two separate capital gains tax liabilities on this single exit: **₹35 lakh** (under 9B) and **₹40 lakh** (under 45(4)).

Post-Transaction: Attributing the Sec 45(4) Gain

To prevent the same value from being taxed again, the gain calculated under Section 45(4) 45(4) is attributed to the firm's remaining appreciated capital assets.

Attribution is proportional

Future Impact:

Future Impact: When Land "S" is sold in the future, the attributed amount of ₹20 lakh will be **reduced from the full value of the consideration** received, lowering the subsequent capital gain.

Strategic Implications for Tax Planning

Valuation Criticality

Engage registered valuers early in reconstitution planning. Valuation reports drive attribution calculations and directly impact cumulative taxation under both provisions. Conservative valuations may minimize Section 45(4) exposure.

Capital Account Management

Exclude revaluation increments and self-generated assets from capital accounts per statutory mandate. Maintain detailed documentation distinguishing purchased versus self-generated goodwill to support Component D calculations.

Distribution Structuring

Consider timing of asset distributions versus cash settlements. Cash-only distributions may avoid Section 9B deemed transfer but still trigger Section 45(4) if exceeding capital balance. Model alternative scenarios before finalizing terms.

Attribution Documentation

Meticulously document attribution of Section 45(4) taxed amounts to specific remaining assets. Maintain valuation reports and attribution schedules to substantiate future consideration reductions and defend against double taxation challenges.

The coordinated application of Section 9B and Section 45(4) requires sophisticated tax planning to minimize cumulative liability while ensuring full compliance with attribution and characterization requirements established by Circular No. 14 of 2021.

Part B

Section 45(3) vs Section 50C/56(2)(x): Contribution of immovable property as capital

Position prior to introduction of section 45(3) & 50C

- **Section 45(1) r.w.s 2(47)- Apex Court** in the case of **Sunil Siddharthbhai and Kartikeya V. Sarabhai vs CIT, Ahmedabad [1985] 156 ITR 509 dated 27.09.1985** held that contribution of property in a partnership firm amounts to transfer.
- **Computation mechanism fails-** Consideration for transfer of capital asset is the 'right' of the partner to receive share of profits in subsequent years and net assets on dissolution/ retirement, which cannot be quantified in monetary terms as on the date of transfer. Applying **CIT v. B.C. Srinivasa Setty [1981] 128 ITR 294 (SC),** no tax liability arose

s.t. para 20- lifting of veil and testing the genuineness of firm as well as contribution made

"20. We have decided these appeals on the assumption that the partnership firm in question is a genuine firm and not the result of a sham or unreal transaction, and that the transfer by the partner of his personal asset to the partnership firm represents a genuine intention to contribute to the share capital of the firm for the purpose of carrying on the partnership business. ***If the transfer of the personal asset by the assessee to a partnership in which he is or becomes a partner is merely a device or ruse for converting the asset into money which would substantially remain available for his benefit without liability to income-tax on a capital gain, it will be open to the income-tax authorities to go behind the transaction and examine whether the transaction of creating the partnership is a genuine or a sham transaction and, even where the partnership is genuine, the transaction of transferring the personal asset to the partnership firm represents a real attempt to contribute to the share capital of the partnership firm for the purpose of carrying on the partnership business or is nothing but a device or ruse to convert the personal asset into money substantially for the benefit of the assessee while evading tax on a capital gain.*** *The ITO will be entitled to consider all the relevant indicia in this regard,* ***whether the partnership is formed between the assessee and his wife and children or substantially limited to them, whether the personal asset is sold by the partnership firm soon after it is transferred by the assessee to it, whether the partnership firm has no substantial or real business or the record shows that there was no real need of the partnership firm for such capital contribution from the assessee.*** *All these and other pertinent considerations may be taken into regard when the ITO enters upon a scrutiny of the transaction, for in the task of determining whether a transaction is a sham or illusory transaction or a device or ruse he is entitled to penetrate the veil covering it and ascertain the truth."*

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Introduction of section 45(3)

Finance Act, 1987 w.e.f 01.04.1988

Section 45(3):

(3) The profits or gains arising from the transfer of a capital asset by a person to a firm or other association of persons or body of individuals (not being a company or a co-operative society) in which he is or becomes a partner or member, by way of capital contribution or otherwise, shall be chargeable to tax as his income of the previous year in which such transfer takes place and, ***for the purposes of section 48, the amount recorded in the books of account of the firm, association or body as the value of the capital asset shall be <u>deemed</u> to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.”***

CBDT Circular No. 495 dated 22.09.1987

“24.1 One of the devices used by assessees to evade tax on capital gains is to convert an asset held individually into an asset of the firm in which the individual is a partner. ***The decision of the Supreme Court in Kartikeya V. Sarabhai v. CIT [1985] 156 ITR 509 has set at rest the controversy as to whether such a conversion amounts to transfer. The Court held that such conversion fell outside the scope of capital gain taxation. The rationale advanced by the Court is, that the consideration for the transfer of the personal asset is indeterminate, being the right which arises or accrues to the partner during the subsistence of the partnership to get his share of the profits from time to time and on dissolution of the partnership to get the value of his share from the net partnership assets.***

24.2 With a view to blocking this escape route for avoiding capital gains tax, the Finance Act, 1987 has inserted new sub-section (3) in section 45. The effect of this amendment is that profits and gains arising from the transfer of a capital asset by a partner to a firm shall be chargeable as the partners income of the previous year in which the transfer took place. For purposes of computing the capital gains, the value of the asset recorded in the books of the firm on the date of the transfer shall be deemed to be the full value of the consideration received or accrued as a result of the transfer of the capital asset.”

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Introduction of section 50C

Finance Act, 2002 w.e.f 01.04.2003

Section 50C:

*(1) Where the **consideration received or accruing** as a result of the transfer by an assessee of a capital asset, being land or building or both, is less than the value adopted or assessed or assessable by any authority of a State Government (hereafter in this section referred to as the "stamp valuation authority") for the purpose of payment of stamp duty in respect of such transfer, **the value so adopted or assessed or assessable <u>shall</u>, for the purposes of section 48, be deemed to be the full value of the consideration received or accruing as a result of such transfer.”***

- **Both section 45(3) and 50C are deeming provisions.**
- The said deeming fiction extends to section 48 of the Act only.
- **None of them contain non-obstante clause.**
- section 45(3) is specific to ‘mode of transaction’ (i.e. capital contribution in a partnership firm) and general w.r.t ‘nature of asset’; section 50C is specific to ‘nature of asset’ (i.e. immovable property) and general w.r.t ‘mode of transaction’.

Fate of deeming fictions:

Supreme Court in its yet another judgment in the case of **Bhuwalka Steel Industries Ltd. & Another vs Union of India dated 24.03.2017**

*“The words “shall be deemed to be” occurring in both Section 3A(2) and Rule 5 appear to create a fiction. **But in our opinion, on a true and proper construction (as rightly argued by the respondent) they do not create a legal fiction**. **In Consolidated Coffee Ltd. & Another v. Coffee Board, Bangalore, (1980) 3 SCC 358 = 1980 (4) TMI 278 - SUPREME COURT OF INDIA**, it was held: (page371, para 11) “… **the word “deemed” is used a great deal in modern legislation in different senses and it is not that a deeming provision is every time made for the purpose of creating a fiction. A deeming provision might be made to include what is obvious or what is uncertain or to impose for the purpose of a statute an artificial construction of a word or phrase that would not otherwise prevail, but in each case it would be a question as to with what object the legislature has made such a deeming provision.** In St. Aubyn v. Attorney-General, 1952 AC 15, 53 : (1951) 2 All ER 473,498, Lord Radcliffe observed thus:*

“The word “deemed” is used a great deal in modern legislation. Sometimes it is used to impose for the purposes of a statute an artificial construction of a word or phrase that would not otherwise prevail. Sometimes it is used to put beyond doubt a particular construction that might otherwise be uncertain. Sometimes it is used to give a comprehensive description that includes what is obvious, what is uncertain and what is, in the ordinary sense, impossible.” ***Thereafter, The Apex Court also observed that a fiction always conflicts with reality.”***

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Section 50C to override where genuineness is in doubt

SLP dismissed by Supreme Court in Carlton Hotel Pvt. Ltd. vs CIT-1, Lucknow 2017 (11) TMI 808 dated 06.11.2017. Extracts of Allahabad High Court rulig in CIT-1 vs M/s Carlton Hotel Pvt. Ltd. [2017] 399 ITR 611 dated 31.01.2017:

*"78. …………………….**In normal course, therefore, the case in hand could have been dealt by Section 45 (3) of Act, 1961 itself, unless other things as apprehended by AICT and CIT(A) would not have been existing.** These facts were brought to the notice of Tribunal also but unfortunately it has completely ignored the same.*
79. In Shiv Mohan Lal and others Vs. CIT, 1998 144 CTR 6 (Allahabad), this Court held, if transfer of personal asset by Assessee to a partnership, in which he is or becomes a partner, is merely a device or ruse for converting the asset into money, which would substantially remain available for his benefit without liability to Income Tax on a capital gain, it will be open to Income Tax authorities to go behind the transaction and examine whether transaction of creating partnership is genuine or a sham transaction. Even where partnership is genuine, whether transaction of transferring personal asset to the partnership firm represents a real attempt to contribute to the share capital of partnership firm for the purpose of carrying on partnership business or is nothing but a device or ruse to convert personal asset into money, substantially for the benefit of Assessee, while evading tax on a capital gain is the cardinal issue, which has to be considered.
80. In this case we find that this point was specifically appreciated by ACIT and CIT(A) and also raised before Tribunal but they have not recorded any finding thereon.
……………….
*84. …………………In Sunil Siddharthbhai Vs. CIT (supra), Court also observed that transfer of personal asset to partnership firm need not result in capital gains to such partner within the contemplation of Section 48 of Act, 1961 so as to attract Section 45 of Act, 1961. **This is why Section 45 of Act, 1961 stood amended in 1987 by insertion of sub-section 3, but yet this aspect will depend on the fact that partnership firm is genuine, there is no sham or unreal transaction, and assets of the Firm represents a genuine intention to contribute to the share capital of the firm for the purpose of carrying on the partnership business.***
……………
86. In the present case as we have already discussed, entire consideration for free-hold was paid by M/s SICCL but in what capacity, is not known. A part of land was transferred by sale to M/s SICCL at a consideration which has a vast difference than that was acquired by Assessee after execution of free-hold deed. For the purpose of contributing to partnership firm and applying book value, Tribunal failed to appreciate that the entire land came to be acquired by Assessee only on 31st March, 2002. Prior thereto, it had no lawful right or interest in the property in dispute which belonged to State of U.P. Even as per book value, cost of land determined and share profits determined between the parties and their capital contribution is so negligible, as it did not conform to even any normal business transaction entered into by a person of ordinary prudence, and, therefore, there existed all the facts and circumstances to show prima facie that entire transaction of contribution to partnership is a sham and fictitious transaction and an attempt to device a method to avoid tax. Even the terms and conditions of partnership fortify the above inference.
……………
91. However, we find that the Tribunal has not looked into the matter with regard to colorable device and sham transaction of partnership, which was an issue directly raised by Revenue right from the stage of ACIT and onwards, and for that purpose matter requires to be remanded to Tribunal.
92. At this stage we propose to answer question no.1 in favor of Revenue and against Assessee……………….

Section 45(3) to override where genuineness is not in doubt

Where no dispute has been brought on record by the Assessing Officer regarding the genuineness of capital contribution in the partnership firm so as to expand the business of the firm, a favorable view has been endorsed in a host of judicial precedents laid down by the Tribunals, holding that section 45(3) of the Act, being a more specific provision shall prevail over section 50C, otherwise the same shall be rendered otiose and infructuous:

- **Mumbai Bench of ITAT** in the case of **DCIT -9(1)(1) vs M/s Amartara Pvt. Ltd. 2017 (12) TMI 1677 dated 29.12.2017**
- **Mumbai Bench of ITAT** in the case of **ACIT, Range-16(1) vs Moti Ramanand Sagar 2019 (3) TMI dated 28.02.2019**
- **Mumbai Bench of ITAT** in the case of **ACIT, 16(1) vs Shri Prem Sagar 2019 (10) TMI 1453 dated 16.10.2019**
- **Mumbai Bench of ITAT** in the case of **C. Bhansali Developers Pvt. Ltd. vs ACIT, Ward 15(1)(2) 2022 (9) TMI 1231**
- **Chennai ITAT** in the case of **Shri Sarrangan Ashok vs ITO, Non-Corporate Ward-15(1) 2019 (8) TMI 1527 dated 19.08.2019**
- **Surat Bench of ITAT** in the case of **Ashesh Nanalal Doshi vs Pr. CIT-1 2022 (2) TMI 861 dated 07.02.2022**
- **Special Bench of Delhi ITAT** in the case of **DLF Universal Ltd. vs DCIT, Special Range (Cent)-1 [2010] 36 SOT 1**
- **Bombay High Court** in the case of **Jamnalal Sons vs CIT 2016 (10) TMI 59**

Possible view on section 56(2)(x)

It is not quantifiable how to compare SDV of land against share of partner in future profits/losses. Hence, practical invocation of section 5(2)(x)(b) may be challenging.

Further, Hyderabad Bench of ITAT in its decision in the case of **ITO, Ward-4(5) vs M/s Shrilekha Business Consultancy Pvt. Ltd. 2020 (11) TMI 263 dated 04.11.2020** dealt with a case of contribution of shares by a partner as his capital contribution, and held that (i) the consideration is not quantifiable, and also (ii) the capital contribution in kind is not a receipt by the partnership firm from **'any person':**

"18.1. The crucial word mentioned in the aforesaid Section is "consideration". In the instant case, we find that SOT had merely brought in capital contribution in the form of shares at a particular value in terms of Section 45(3) of the Act. The said value had been duly credited in the books of the assessee firm as partner's capital contribution. The term "consideration" represents amount lying at the disposal of the assessee firm to do whatever it wants and is not repayable to any person in any manner whatsoever. Whereas the amount lying to the credit of capital account of partner is repayable by the firm to the said partner as and when the partner retires, resigns or at the time of dissolution of the firm.

On this aspect itself, it could be safely concluded that what has been received by the partner in the form of capital contribution cannot be equated with the term "consideration" within the meaning of Section 56(2)(viia) of the Act. *Admittedly, the receipt of capital contribution from a partner either in cash or in kind would be "transaction in the capital field and not in the revenue field" at all, for the simple reason that the said capital is always repayable at the time of retirement / resignation of the partners or at the time of dissolution of the firm.*

…..contd

18.2. We find that the other key words in the Section 56(2)(viia) are "firm" , "receives" and "any person". It contemplates a contract / transaction between the "firm" and "any person" who transferred shares for consideration. In any contract, consideration pre-supposes an enforceable right to recover money due from one party by the other. As there is no contract / transaction between the partner and the firm in respect of capital contribution, the partner cannot sue the firm for recovery of the same. In case of capital contribution, the partner cannot claim / recover the capital balance from the firm as long as he continues as a partner. ***In the case of capital contribution made by a partner, there is no consideration involved from the firm until retirement of partner from the firm or dissolution of the firm and as such, there cannot be any issue of recovery much less enforceable right to recover the credit balance in its capital account.***
18.3. The most excruciating fact which needs to be understood is when a partner retires from the firm, he does not walk away with the credit balance in his capital account alone, instead he would be entitled to the share of the profits / losses besides assets of the firm. ***The provisions of the Section 56(2)(viia) deals with transaction / contract between the existing 'firm' and 'any person' which are not in the nature of capital contribution. Hence, "any person" mentioned in section 56(2)(viia) of the Act, in our considered opinion, does not cover the partner in respect of his capital contribution.*** *Yet another crucial point which needs to be understood is whether any contract exists between firm and partner in the case of capital contribution. We find that there is no contract between the firm and the partner in the case of capital contribution. "Firm" is a concern created consequent to a contract of partnership deed among partners to contribute capital, to carry on business and share profits and assets in pre-determined ratio.* ***Pursuant to the capital contribution made by the partners only, the partnership firm comes into existence and becomes capable of entering into all the transactions / contracts thereafter****. The provisions of Section 56(2)(viia) covers both firms as well as companies. A company cannot enter into any transaction / contract before its incorporation even with its promoter/prospective shareholder.*

However, the promoters of the prospective company need to make payments of various kinds viz: ROC fees, preparation of articles and memorandum of association, professional charges, travelling etc., before its incorporation. Accounting entries regarding all such contributions are made in the books of the company after incorporation. ***Similarly, firm also cannot enter into any transaction with its prospective partner before coming into existence. Partner's capital contribution is an event that happens before the firm comes into existence rather firm comes into existence with the help of capital contribution. There cannot be any consideration from the firm to the partner in respect of capital contribution as long as the firm subsists. Capital contribution happens before firm comes into existence and consideration for partner arises after dissolution of the firm or retirement or resignation of partner. Hence, it could be safely concluded that the term "person" mentioned in Section 56(2)(viia) of the Act does not cover "partner" in respect of capital contribution and accordingly, Section 56(2)(viia) of the Act cannot be made applicable in the case of capital contribution made by a partner to the firm.***

…..contd

18.4. We are inclined to accept the arguments advanced by the ld. AR by placing reliance on the decision of the Hon'ble Supreme Court in the case of Kartikeya V Sarabhai vs. CIT reported in 228 ITR 163 (SC) and Sunil Sidharthbai vs.CIT reported in 156 ITR 509 (SC), wherein the Hon'ble Supreme Court had held that part of the ownership rights in the property gets transferred to other partners and hence, such contribution amounts to transfer of capital asset u/s.45 of the Act ; Consideration for capital contribution is share in the profits of the firm during its subsistence and share in assets after its dissolution ; 'Consideration' is 'indeterminate' and as such the computation provisions of Section 48 of the Act would fail and hence, no capital gain would arise thereon. The relevant observations of the Hon'ble Supreme Court in para 15 of the said order would also be crucial for understanding and relating to the facts of the instant case before us, wherein it was observed that the credit entry made in the partners capital account does not represent the true value of the consideration and that it is only a notional entry intended to be taken into account at the time of determining value of partners share in net assets of the firm at the time of dissolution of the firm. Hence, in these circumstances, the Hon'ble Supreme Court held that consideration which a partner acquires on making over his personal asset to the partnership firm as his contribution to its capital account does not fall within the terms of Section 48 of the Act. ***The aforesaid reasoning and observations of the Hon'ble Supreme Court could be made applicable to the facts of the instant case in as much as "consideration" in respect of capital contribution made by a partner is "indeterminate" for the purpose of Section 56(2)(viia) of the Act also. When consideration is indeterminate, computation provisions of Section 56(2)(viia) of the Act to determine inadequacy or otherwise of 'such consideration' also fail. Hence, on this count also, provisions of Section 56(2)(viia) of the Act cannot be made applicable to capital contribution of a partner made in the firm.***

18.5. The CBDT vide its circular No.495 dated 22/09/1987 had explained rationale behind introduction of Section 45(3) of the Act by specifically stating that consideration was made deemed to be "determinate" at the discretion of the parties for the purpose of Section 48 of the Act. Hence, unless the consideration was made 'determinate' specifically u/s.56(2)(viia) of the Act like it was done u/s.45(3) of the Act for the purpose of Section 48, it cannot be extended to any other provision.

Needless to mention that when Section 56(2)(viia) of the Act was introduced in the statute in the year 2010, the Parliament was well aware of the existing decision of the Hon'ble Supreme Court in the case of Sunil Sidharthbai referred to supra holding the consideration as "indeterminate" and also existence of Section 45(3) of the Act in the statute. Still the legislature in its wisdom did not deem it fit to make it "determinate" for the purpose of Section 56(2)(viia) of the Act consciously unlike it was done for Section 45(3) of the Act.

……………..

Reliance in this regard is placed on the decision of the Hon'ble Madras High Court in the case of ACIT vs. Dr. D. Ramamurthy reported in 410 ITR 236. ***In view of the aforesaid observations, we have no hesitation to hold that the provision of Section 56(2)(viia) of the Act could not be made applicable at all in the case of capital contribution made by a partner in the form in kind.*** *Accordingly, we do not find any infirmity in the order of the ld. CIT(A) granting relief to the assessee and the grounds raised by the revenue in this regard are dismissed."*

Part C

Section 47(xiiib): Conversion of company into LLP

Exemption under section 47(xiiib)

"Transactions not regarded as transfer.

47. *Nothing contained in section 45 shall apply to the following transfers :—*

(i)……..

……….

(xiiib) ***any transfer of a capital asset or intangible asset by a private company*** *or unlisted public company (hereafter in this clause referred to as the company)* ***to a limited liability partnership*** *or* ***any transfer of a share or shares held in the company by a shareholder as a result of conversion of the company into a limited liability partnership in accordance with the provisions of section 56 or section 57 of the Limited Liability Partnership Act, 2008*** *(6 of 2009):*

Provided *that—*

(a) all the assets and liabilities of the company immediately before the conversion become the assets and liabilities of the limited liability partnership;

(b) all the shareholders of the company immediately before the conversion become the partners of the limited liability partnership and their capital contribution and profit-sharing ratio in the limited liability partnership are in the same proportion as their shareholding in the company on the date of conversion;

(c) the shareholders of the company 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 limited liability partnership;

(d) the aggregate of the profit-sharing ratio of the shareholders of the company in the limited liability partnership shall not be less than fifty per cent at any time during the period of five years from the date of conversion;

(e) ***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;***

(ea) 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

(f) 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.

Explanation.—For the purposes of this clause, the expressions "private company" and "unlisted public company" shall have the meanings respectively assigned to them in the Limited Liability Partnership Act, 2008 (6 of 2009);"

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Transfer when conditions u/s 47(xiiib) are not satisfied

Conversion of company into LLP should be regarded as transfer and should attract capital gain tax.

Mumbai Bench of the ITAT in the case of **ACIT vs M/s Celerity Power LLP (ITA No. 3637/Mum/2015 and C.O. No. 2/Mum/2016),**

“10…….
It is discernible from a cursory glance of Sec. 47, that the 'transfers' referred to in the said statutory provision would not be chargeable to income-tax under the head “Capital gains” under Sec. 45 of the Act. In other words, though the transactions referred to in Sec. 47 are 'transfers', however, the same subject to cumulative satisfaction of the conditions contemplated in the respective sub-sections would fall beyond the sweep of chargeability to income-tax as 'Capital gains' under Sec. 45 of the Act.
11. We thus are of the considered view that the transaction involving conversion of a private limited company or unlisted public company to a LLP as contemplated in Sec. 47(xiiib) would though be a 'transfer', however, the same on cumulative satisfaction of conditions (a) to (f) of the proviso to Sec. 47(xiiib) would not be chargeable to 'capital gains' under Sec. 45 of the Act. Our aforesaid view stands fortified from a perusal of the 'Memorandum' explaining the Finance Act, 2010, which reads as under (relevant extract) :
……
15. We are of the considered view that in terms of our aforesaid observations, the transaction involving conversion of the private limited company to the assessee LLP de hors compliance of the conditions contemplated in the proviso to Sec. 47(xiiib), would thus involve 'transfer' of the capital assets. *However, as we have ousted the applicability of the provisions of Sec. 47A(4) to the facts of the case before us, therefore, the 'deeming fiction' therein facilitating assessing of the profits and gains arising from the transfer of the capital assets in the hands of the transferee i.e the assessee LLP would also meet the same fate and thus, would not be principally applicable in the case before us. In the backdrop of the aforesaid facts, the issue involved in the present case boils down to the chargeability of the profits and gains arising from the 'transfer' of the capital assets in pursuance to conversion of a private limited company to the assessee LLP.*

…..contd

We are of the considered view that as per Sec. 45 r.w Sec. 5 of the Act, the profits or gains arising from the 'transfer' of the capital assets effected in the previous year shall be principally chargeable to income-tax under the head "Capital gains" in the hands of the 'transferor', as its income of the previous year in which the transfer took place. ***In the backdrop of our aforesaid deliberations, we are of the considered view that the "Capital gains", if any, arising from the 'transfer' of the capital assets on conversion of the private limited company to the assessee LLP, de hors the applicability of Sec. 47A(4), could not have been principally brought to tax under Sec. 45 as 'Capital gains' in the hands of the assessee LLP. Further, we find that as per Sec. 170(1)(b) of the Act, a 'successor entity' which continues to carry on the business of the person who has been succeeded (hereinafter referred to as "predecessor") shall be liable to be assessed only in respect of the income of the previous year after the date of succession. However, the said liability of a successor entity is subject to an exception carved out in Sec. 170(2), as per which, where the predecessor cannot be found, there the assessment of the income of the previous year in which the succession took place up to the date of succession, and of the previous year preceding that year shall be made on the successor in the like manner and to the same extent as it would have been made on the predecessor, and all the provisions of this Act shall, so far as may be, apply accordingly. In so far, the term 'Income' is concerned, the same as per the Explanation to Sec. 170 includes any gain accruing from the transfer, in any manner whatsoever, of the business or profession as a result of the succession. We thus in terms of our aforesaid observations are of the considered view that though the "Capital gains", if any, involved in the transfer of the capital assets on conversion of the private limited company to the assessee LLP, de hors applicability of Sec. 47A(4) to the facts of the case, would not be liable to be assessed in the hands of the assessee LLP as per Sec. 45 r.w Sec. 5 of the Act, however, the same would be subject to the liability of the assessee LLP (as a successor entity) under Sec. 170 of the Act.*** *The "Cross Objection No. I" of the assessee is disposed off in terms of our aforesaid observations.*

…..contd

16. We shall now advert to the issue that as to whether the conversion of a company into a LLP involves any 'capital gain', or not. *We may herein observe that the exemption under Sec. 47(xiiib) which contemplates that certain transactions on satisfaction of the conditions therein provided are not to be regarded as a 'transfer', cannot be construed as a fiction to the effect that the income which is not liable to be taxed under the other provisions of the chapter of 'capital gains' can be deemed to be capital gains, if the conditions contemplated in Sec. 47(xiiib) are not satisfied. In so far, for determining that as to whether on the failure to satisfy the conditions provided in Sec. 47(xiiib), the conversion of the company into a LLP would involve any 'capital gain', the charging provision in Sec. 45 has to be looked into.* ***Admittedly, the conversion of the assets and liabilities of the erstwhile company to the assessee LLP in the case before us took place as per the Limited Liability Partnership Act, 2008 at the 'book value' itself. Rather, as the entire undertaking of the erstwhile company got vested into the LLP, therefore, no separate cost other than the 'book value' was attributable to the individual assets and liabilities.*** *As per the settled position of law, the provisions of Section 48 which provides for the mode of computation of the capital gains has to be read as an integral part of the charging provision in Section 45 of the Act. The* ***Hon'ble High Court of Bombay in the case of CIT v. Texspin Engg. & Mfg. Works [2003] 263 ITR 345 (Bom),*** *has observed that the said two sections viz. Sec. 45 and Sec. 48 are to be read together, as the charging section and the computation section constitute one package. Also,* ***the Hon'ble Supreme Court in the case of CIT v. B.C Srinivasa Setty [1981] 128 ITR 294 (SC) and Navin Jindal & Ors. v. ACIT [2010] 320 ITR 708 (SC)*** *had observed that for the purposes of Sec. 48 of the Act, one must keep in mind an important principle, namely, that chargeability and computation has to go hand in hand. In other words, computation is an integral part of chargeability under the Act.* ***Now, under Sec. 48 it is laid down, inter alia, that the income chargeable under the head 'capital gains' shall be computed by deducting from the 'full value of consideration received or accrued' as a result of the transfer, the cost of acquisition of the asset and the expenditure incurred in connection with the transfer. The expression "full value of consideration" used in Sec. 48 cannot be construed as the 'market value' of the asset on the date of transfer. As observed by the Hon'ble High Court of Bombay in the case of Texspin Engg. & Mfg. Works (supra), the consideration for the transfer of a capital asset is what the transferor receives in lieu of the assets he parts with, viz. money or money's worth, and, therefore, the asset transferred or parted with cannot be the consideration for the transfer. It was further observed that the expression "full value of the consideration" cannot be construed as having a reference to the 'market value' of the asset transferred, and that the said expression only means the full value of the things received by the transferor in exchange for the capital asset transferred by him****. Our aforesaid view that 'full value of consideration' used in Sec. 48 cannot be construed as the 'market value' of the asset on the date of transfer is fortified by two judgments of the Hon'ble Supreme Court viz. (i). CIT v. George Henderson and Co. Ltd. [1967] 66 ITR 622 (SC) and (ii). CIT v. Gilanders Arbuthnot and Co. [1973] 87 ITR 407 (SC). The Hon'ble Apex Court in the said judgments had observed that the expression 'full value of the consideration' does not mean the 'market value' of the asset transferred, but it shall mean the price bargained for by the parties to the transaction.* ***We thus in terms of our aforesaid observations are persuaded to subscribe to the view of the CIT(A), that as the assets and liabilities of the erstwhile private limited company had got vested in the assessee LLP at their 'book values', a fact which has not been negated, hence such 'book value' could only be regarded as the 'full value of consideration' for the purpose of computation of 'capital gains' under Sec. 48 of the Act****. The Grounds of appeal Nos. 1 and 2 raised by the revenue are dismissed.*

…..contd

17. In so far, the cost of acquisition of the assets of the erstwhile company are concerned, as per Sec. 49(1)(iii), where the capital assets becomes the property of the assessee by succession, inheritance or devolution, the cost of acquisition of the assets shall be deemed to be the cost for which the previous owner of the property had acquired the same. *Our aforesaid view is fortified by the judgment of the Hon'ble High Court of Bombay in the case of CIT v. Manjula J. Shah [2013] 355 ITR 474 (Bom). In the said order, it was observed by the Hon'ble High Court in context of a capital asset that was acquired by the assessee by way of a gift from her daughter [one of the mode of acquisition under Sec. 49(1)], that if one reads Explanation 1(i)(b) to Sec. 2(42A) together with ss. 48 and 49, it becomes absolutely clear that the object of the statute is not merely to tax the 'capital gains' arising on transfer of a capital asset acquired by an assessee by incurring the cost of acquisition, but also to tax the gains arising on transfer of a capital asset inter alia acquired by an assessee under a gift or will as provided under s. 49, by deeming the assessee to have incurred the cost of acquisition. Further, the Hon'ble High Court of Calcutta has in the case of CIT v. Delta Jute Mills [1986] 159 ITR 215 (Cal) and in CIT v. Budge Budge Amalgamated Mills Ltd. [1980]122 ITR 561 (Cal), observed that in case of an amalgamation where the assessee became the owner of the capital asset of the amalgamating company by way of devolution, the cost of acquisition of the amalgamating company was to be considered as the cost of acquisition for computing the capital gains.* ***We thus in terms of our aforesaid observations are in agreement with the view taken by the CIT(A), that though there was a transfer of capital assets from the erstwhile private limited company to the assessee LLP by virtue of the provisions of Sec. 47(xiiib), however, as the difference between the transfer value and the cost of acquisition was Nil, therefore, while computing the 'capital gains' the machinery provision was rendered as unworkable.*** *The Cross-Objection No III is disposed off in terms of our aforesaid observations.”*

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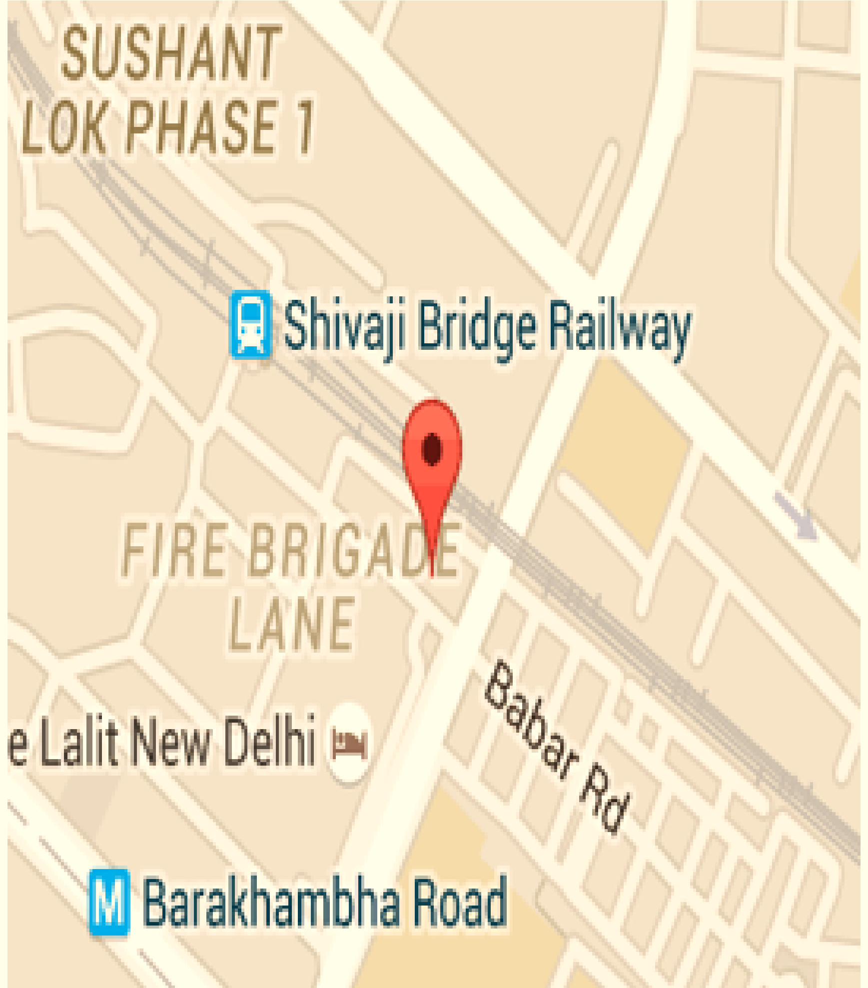

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