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Capital Gains on Transfer of Assets by a Partnership Firm to its Partners in India – Fishing in Troubled Waters

Sridhar Vemulapati[1]
Bindu Ronald[2]

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Abstract: *The Finance Act, 2021 introduced section 9B to the Income Tax Act, 1961 and substituted (4) 45(4) of the Act. These sections deal with the transfer of money, capital assets and other assets from a partnership firm to a partner. The amendments are stated to be made to clear the uncertainty that exists in the law. This article explores the history of taxation of partnership firms and their partners under the Indian Tax law and examines whether the said amendments meet the stated objective. The authors argue that the amendments have widened the uncertainty rather than minimise it let alone erase it. In the opinion of the authors, the entire amendment process is flawed, and the situation causes vexatious litigation of alarming proportions. Similar tax provisions in the USA, the UK and Australia, are compared.*

1. INTRODUCTION

The Finance Act, 2021 inter alia, made two significant amendments to the Indian Income Tax Act, 1961. These two amendments relate to the transfer of assets by a partnership firm to its partners. With these amendments, the erstwhile law relating to the taxation of partners and partnership firms has undergone a sea change, which is bound to lead to controversy as pointed out in this article.

According to the 2021 Budget Speech in the Indian Parliament, the change was apparently necessitated, to "*provide certainty*" (Memorandum Explaining the Provisions of Finance Bill, 2021, p. 62) on matters relating to taxability of surplus amounts received by partners. The whole issue revolves around the transfer of assets by a partnership firm to its partners and the provisions relating to the same are contained in section 45(4) of the Income Tax Act, 1961. The aim and object of the amendments as explained by the Finance Bill 2021, as placed before the Indian Parliament, was "*Rationalisation of provision of transfer of capital asset to partner on dissolution or reconstitution*". The rationalisation was proposed to be carried out by replacement of the existing subsection (4) of section 45 with a new subsection (4) and introduction of new subsection (4A) in section 45.

By this amendment, the existing subsection (4) is replaced. An altogether new section 9B, which had no presence in the tabled Bill, is introduced under Chapter II of the Act, - Basis of Charge. This appears to be contrary to the established parliamentary procedure. The subsection (4A) originally in the Bill was totally dropped.

1 Symbiosis International (Deemed University), Symbiosis Law School, Survey No. 227, Plot No. 11, Rohan Mithila, Opp. Pune Airport, Symbiosis Road, Viman Nagar, Pune - 411014, Maharashtra, India
2 Symbiosis International (Deemed University), Symbiosis Centre for Advanced Legal Studies and Research, Symbiosis Law School, Pune, Survey No. 227, Plot No.11, Rohan Mithila, Opp. Pune Airport, Symbiosis Road, Viman Nagar, Pune - 411014, Maharashtra, India

This Article traces the genesis and history of the controversy surrounding the taxation of the transfers of assets by a partnership firm to its partners and concludes that the whole exercise is contrary to the established principles of partnerships which do not, in law, have a separate legal status. The article also analyses the legality of the new provisions viz., the new subsection 45(4) and the new section 9B and controversies that are bound to arise which undermine the object of the amendment i.e., "Rationalisation of provision of transfer of capital asset to partner on dissolution or reconstitution".

2. NATURE OF PARTNERSHIPS, RELATION BETWEEN PARTNERS AND LEVY OF TAX ON THEIR INCOME

The partnership is a convenient way of carrying on business and is one of the most common forms of commercial entities in India. The law relating to partnership firms and partners is contained in the Indian Partnership Act, 1932. Section 4 of the Act defines partnership as '*the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. Persons who have entered into partnership with one another are called individually, "partners" and collectively "a firm", and the name under which their business is carried on is called the "firm-name".'* Section 5 declares that partnership is not created by status but by a contract between partners. This means that a partnership does not have a separate legal status. It is neither a person nor a legal entity (Mahabir Cold Storage v. Commissioner of Income-tax, [1991] 188 ITR 91 (SC))[3] like a company incorporated under the Indian Companies Act, 1956 (now 2013). A firm is a collective name given to an individual group or persons (Mahabir Cold Storage v. Commissioner of Income-tax, [1991] 188 ITR 91 (SC)).

It is clear from the definition itself that a partnership is a "*relation*" between persons who have agreed to become partners. The legal status of a partnership and the contractual relationship between the partners constituting the group called '*the firm'*, and the position that firm is not different from its partners, but is a collective group of partners coming together to share losses or profits of a business carried on by all or one or more of them acting for all, brings one to a logical conclusion that the income/property of the firm is not separate from that of the partners. Therefore, there should not be any tax on the earnings of the firm, instead, the partners should be taxed in proportion to their respective shares. Alternatively, if the firm is taxed then partners should not be taxed again on their share, because it is they, as a collective group who have already paid the taxes.

The dealings between partners and the firm and the concept of the partnership firm are a sensitive and highly difficult ones. This is evident from the explanation[4] of section 4 of the Partnership Act, 1932 that '*This clause contains the difficult definition of "partnership" and the ones of "partner", "firm" and "firm name*" (Bharika, 2021).

Despite the challenges in clearly specifying the independent status of the partners, and *vice versa*, the Income Tax Act has introduced provisions to bring about taxation of transactions between the partners and the firm. However, the real difficulty arose in the interpretation of the transactions between the partners and the firm and more so when such transactions were sought to be taxed. This is particularly so because in practical reality and as per the principles of partnership, these

[3] The position of a firm under Income Tax law explained.

[4] Given in the Statement of Objects and Reasons which is a part of the Report of the Special Committee appointed by the Government of India to examine and report on the provisions of the Bill which became the Indian Partnership Act, of which Sir Brojendra Mitra was Chairman and Sir Dinshaw Mulla was a member.

transactions are literally from one hand to the other and the taxation provisions disregard the general principle of partnership as a "relation" between partners.

The Indian Partnership Act 1932 came into force on 1st October 1932. At that time Indian Income Tax Act, 1922 was in force.

2.1. Taxation of Partnership and Partners Under the 1922 Act.

The transfer of assets between a partner and the firm is when a partner transfers an asset to the firm and *vice versa*. Both these types of transfers have come under tax scrutiny and have become subject matter of debate before courts under the Indian Income Tax Act, 1922 as well as the Income Tax Act, 1961.

Section 2(9) of the Indian Income Tax Act, 1922 (the 1922 Act), defines "person" as including a Hindu undivided family and a local authority. The definition did not include a 'firm' as a distinct taxable entity or a 'person'. The 1922 Act did not separately define the terms "firm" "partnership" and "partner" but simply said, the terms shall have the meaning respectively assigned to them under the Indian Partnership Act, 1932 (Section 2(6B) of the Indian Income Tax Act, 1922).

Though the definition of "person" under the 1922 Act, did not cover a partnership firm in its ambit, the chargeability of income of a partnership firm to tax was indirectly covered under section 3, the charging section of the Act which included the words "*of every firm*", while the firm is not included in "person". (A taxable unit under the Indian Income Tax law).

The capital gains arising from transactions relating to capital assets were sought to be taxed by section 12B (1) of the 1922 Act. Though the section incorporates the word transfer, the term 'transfer' itself was not defined under the 1922 Act. Thus, from the plain reading of the section, the first impression and understanding would be that the transfer of a capital asset by a partner to a firm is covered by the section and as such the gains would be taxable. However, in relation to the transfers of a capital asset by a partner to a firm (mostly as a contribution towards capital) courts have held that no gain arises therefrom to the partner and as such there is no tax liability.

In holding that no gain arises, the Supreme Court (Commissioner of Income-tax v. Hind Construction Ltd, [1972] 83 ITR 211 (SC)), observed and held:

> *"The machinery that fell to the share of the assessee was never sold. Therefore, there was no question of the assessee making any profit out of them. No one can sell his goods to himself. A sale contemplates a seller and a purchaser. If a person revalues his goods and shows a higher value for them in his books, he cannot be considered as having sold these goods and made profits therefrom. Nor can a person by handing over his goods to a partnership of which he is a partner and that as his share of capital be considered as having sold the goods to the partnership."*

The basic rationale behind the decision was that partners and partnership firms are not separate legal entities distinct from one another and the relationship *inter se* does not arise from status but from contractual understanding (Sections 4 & 5 of the Partnership Act, 1932). On several occasions the Supreme Court has explained the relations between partners and partnership firms – that a firm is only a compendious description of individuals who compose the firm (Supra n. 5, citing

Munshiram v. Municipal Committee, (1979) 3 SCC 83, para 17; CIT v. RM Chidambaram Pillai, (1977) 1 SCC 431, para 5, and other cases, p. 36), a partnership is nothing but a collective form of all its partners (Supra n. 5, citing MVV Satyanarayana v. Engineer- in – Chief (R & B), 2007 SCC Online AP 911, p. 37), a partnership firm is not an independent legal entity (Supra n. 5, citing Indian Oil Corporation Limited v. Shree Nivas Ramgopal, 2018 SCC Online Cal 4383, p. 37), rather merely a convenient name to carryout business by partners (Supra n. 5, citing Sanjay Suganchand Kasliwal v Jugalkishor Chhaganlal Tapadia, 2013 SCC Online Bom 1470, p. 37). However, time and again issues relating to taxation of transactions under the 1922 Act have been taken to the courts and repeatedly courts have held that there arises no profit to the partner nor the firm.[5]

The other instance of transfer between a partnership firm and the partners is that of a transfer of an asset from a firm to a partner. This could be during the existence of a firm or at the time of its dissolution. According to section 12B(3) of the 1922 Act, "*in computing the capital gains of an assessee, where the property became the property of the assessee on dissolution of a firm or an association of persons, the actual cost to the firm or the association of persons shall be taken as the cost of acquisition in the hands of the assessee*". This essentially meant that no tax was levied in the hands of the firm on its dissolution. This is because if tax were to be levied then the value on the date of the transfer to the partner (which is the date of dissolution) would be considered in computing the gains and such gains would have been taxed in the hands of the firm. In such a case the value having been taxed in the hands of the firm on the date of dissolution would be the cost of acquisition in the hands of the partner consequent to such transfer.

One other way of looking at it is that no tax was leviable in the hands of the partner (as he only realised his interest in the assets of the firm) therefore the actual cost to the firm will continue to be actual cost to the partner in relation to such asset. Yet another way to interpret the issue is that there is no sale, exchange, transfer, or relinquishment of asset at all on dissolution of a partnership firm[6].

This contentious issue was finally set to rest by the Supreme Court,[7] which observed that "*The expressions "sale" and "sold" are not defined in the Act: those expressions are used in section 10(2)(vii) in their ordinary meaning. "Sale", according to its ordinary meaning, is a transfer of property for a price, and adjustment of the rights of the partners in a dissolved firm is not a transfer, nor it is for a price. A partner, might, in an action for dissolution insist that the assets of the partnership be realised by sale of its assets, but where in satisfaction of the claim of the partner to his share in the value of the residue determined on the footing of an actual or notional sale property was allotted, the property so allotted to him could not be deemed in law to be sold to him."*

In a large number of cases on the subject of retirement and dissolution of a partnership firm and also in cases of transactions, *inter se*, between a partnership firm and its partners, reliance was placed on the decision of the Apex Court in the case of Addanki Narayanappa v. Bhaskara Krishtappa (1966) 3 SCR 400; AIR 1966 SC 1300, where it was held that during the subsistence of the partnership a partner has a right to get his share of the profits as per the agreed proportion and at the time of his retirement or dissolution, to get the value of his share in the net assets of the partnership, after deducting the liabilities and prior charges (Addanki Narayanappa v. Bhaskara Krishtappa, p. 407 of SCR).

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5 See for instance Commissioner of Income-tax v. Janab N. Hyath Batcha Sahib, [1969] 72 ITR 528 (MAD.).

6 Sale, exchange, transfer, or relinquishment of asset – the words used in section 12B.

7 See Commissioner of Income-tax v. Dewas Cine Corpn, [1968] 68 ITR 240 (SC). See also Commissioner of Income-tax *v.* Bankey Lal Vaidya [1971] 79 ITR 594 (SC).

From a plethora of judgments and in particular the decisions of Bankey Lal Vaidya, Dewas Cine Corporation and Addanki Narayanappa, it clearly surfaces that the 1922 Act, failed in bringing to tax the transfer of capital assets between the partners and the firm and *vice versa*.

2.2. Taxation of Partnership and Partners Under the 1961 Act

The legislative history of taxation of transfers between a partnership firm and its partners under the 1961 Act is intriguing and appears to have been driven into a legal quagmire, over time.

To begin with, section 47 of the 1961 Act, declares instances of transactions that are not regarded as transfers. According to clause (ii) of section 47, distribution of assets on liquidation of a firm or an association of persons is not regarded as a transfer. This meant that the intention of the legislature when it enacted the 1961 law, replacing the 1922 law, was not to tax the gains arising on distribution of capital assets on dissolution of a partnership firm.

The definition of transfer (Section 2(47) of Income Tax Act, 1961) as originally introduced stood as under *"transfer", in relation to a capital asset, includes the sale, exchange or relinquishment of the asset or the extinguishment of any rights therein or the compulsory acquisition thereof under any law;*

Whether there is a transfer of a capital asset, on dissolution of a partnership firm, within the meaning of section 2(47) of the 1961 Act, on account of extinguishment of rights of the firm in such assets came up before the Supreme Court in the case of Malabar Fisheries Co. v. Commissioner of Income-tax, [1979] 2 Taxman 409 (SC). The case covered four years, viz., Assessment Years 1960-61 to 1963-64 of which two years were covered by the 1922 Act and two years under 1961 Act. In that case, a firm Malabar Fisheries Co., consisted of few partners. The firm invested in plant and machinery and claimed a development rebate for two years under section 33 of the 1961 Act and for earlier two years under the 1922 Act. The firm dissolved on 31.03.1963. (relevant to AY 1963-64) and the assets were distributed among its partners. One of the conditions for allowance of development rebate was that the asset should not be sold or otherwise transferred within 8 years (Section 34(3)(b)). Since the assets were distributed to the partners on dissolution of the firm, within 8 years, the revenue proposed to withdraw the development rebate.

The issue before the Apex Court was "Whether, on the facts and in the circumstances of this case, there was a transfer of assets within the meaning of the words 'otherwise transferred' occurring in section 34(3)(b) of the Income-tax Act?" (Para 3 of Malabar Fisheries Co. judgment as reported in Taxman). Earlier to the case reaching the Apex Court the tribunal had held that there is no sale of the assets on dissolution of the firm and as such it was a mere adjustment of mutual rights amongst the partners and that the provisions relating to withdrawal of the benefit were not applicable.

The High Court overturned the view of the Tribunal on the ground that the assets were owned by the firm and that on distribution of assets on dissolution of the firm, the rights of the firm were extinguished and as such there is a transfer within the meaning of section 2(47) of the 1961 Act.

The Apex Court held that the distribution of assets on dissolution of the firm is not covered within the meaning of the term "otherwise transferred" appearing in section 34(3)(b) of the 1961 Act and accordingly the rebate cannot be withdrawn. The rationale was that a partnership under the Indian Partnership Act 1932, has no separate and distinct legal identity and does not have any rights of own in the assets of the firm and on dissolution it is only a mutual adjustment of rights amongst the partners and accordingly, there is no question of extinguishment of rights (Para 18 of Malabar Fisheries Co. judgment as reported in Taxman).

The peculiar aspect of the whole litigation, as observed by the authors is that starts from the Income Tax Officer to the Appellate Assistant Commissioner, to the Income Tax Appellate Tribunal, to the High Court and finally before the Supreme Court, nowhere section 47(ii), (which declares that distribution of the assets on dissolution of a firm does not amount to transfer) was brought up. The entire process went on without any mention of the said provision which specifically excludes the transactions in Malabar Fisheries Co.'s case, i.e., distribution of capital assets on dissolution of a firm, from the ambit of the term transfer. There was no necessity to dwell into section 2(47) or any limb of it at all, as the application of section 2(47) itself was excluded specifically by section 47(ii). If section 47(ii) was brought to the notice of the judiciary, then the outcome of the decision and the principles laid down therein would have been on a different footing and further course taken by legislature, different.

In the opinion of the authors, the above situation laid a wrong foundation for the subsequent amendments in the Act as explained and analysed hereafter.

An amendment was brought in by the Finance Act, 1987 with effect from 1st April 1988, i.e., from Assessment Year 1988-89. It was explained in the Memorandum explaining the provisions of Finance Bill, 1987 that the amendments are "Measures against tax avoidance." Further it is stated that these amendments are proposed "with a view to preventing misuse of entities such as partnership firms, etc., *as escape routes for avoiding capital gains tax*" (Para 36 of Memorandum Explaining the Provision of Finance Bill 1987).

Based on the above justification, two new subsections were introduced to section 45 of the Act. These were subsection (3)[8] dealing with transfer of asset by a partner to a firm and subsection (4) dealing with distribution of assets on dissolution of a firm.

It is perplexing to note that the object of amendment uses the word "*misuse*". Where is the question of misuse when distribution of assets on dissolution of a firm is expressly excluded from the scope of transfer and consequently from tax liability by section 47(ii).? Moreover, it has been declared by judicial authorities with solid reasoning that the transactions are not exigible to tax.

Both subsection (3) and (4) open with the words "*The profits or gains arising from the transfer of a capital asset"*. When such are the opening words of these two purportedly charging sections the definition of "transfer" remained unaltered. It is till date not amended to include the transfers between the firm and its partners and the authors find no plausible reason for not bringing in such an amendment. The argument of the revenue that the transaction is covered by the clause of extinguishment of rights in an asset has been shot down by the Apex Court in Malabar Fisheries Co., case and may such cases. The argument that the revenue that it is covered by "otherwise transferred" has also been rejected by the courts. Yet the definition of transfer remains unaltered.

It is not a case that the definition of transfer has never been amended before. Amendments have been made to section 2(47) to offset the decisions of Apex Court. For instance, the decision in the

8 Offsetting the decision in case of Sunil Siddharthbhai v. Commissioner of Income-tax, [1985] 156 ITR 509 (SC), where it was held that the transfer is not chargeable to tax.

case of Bai Shirinbhai K. Kooka (Commissioner of Income-tax v. Bai Shirinbai K. Kooka, [1962] 46 ITR 86 (SC)) the Supreme Court held that when a capital asset is converted by its owner into stock-in-trade of a business carried on by him, such conversion does not amount to transfer. Such conversion has been brought within the scope of transfer by an amendment to section 2(47). Yet another instance is the case of part performance of a contract of the nature specified in section 53A of the Transfer of Property Act, 1882. The Apex Court in the case of Alapati Venkataramiah v. Commissioner of Income-tax, [1965] 57 ITR 185 (SC) held that mere possession of property and a book entry does not result in gains as possession in itself does not amount to transfer. This triggered an amendment to section 2(47) by bringing in a clause to the effect that any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882, shall come within the scope of transfer.

Yet in the case of partnership firms, despite the judicial decisions no amendments have been made in section 2(47) of the Act. Conflicting decisions have been rendered by the Courts on the issue, for instance, the Madhya Pradesh High Court held that without corresponding amendment to the definition of transfer in section 2(47) gains cannot be brought to tax under section 45(4) (Commissioner of Income-tax v. Moped and Machines, [2006] 150 TAXMAN 98 (MP)). The Karnataka High Court (Suvardhan v. Commissioner of Income-tax, Karnataka, [2006] 156 Taxman 229 (Karnataka)) observed that "When the Parliament in its wisdom has chosen to remove a provision, which provided 'no transfer', there is no need for any further amendment to section 2(47)." On the contrary, the Bombay High Court (CIT v. A.N. Naik Associates, [2004] 265 ITR 346) held that the Finance Act, 1987, with effect from 1-4-1988, omitted clause 47(ii), instead of amending section 2(47), the effect of which is that distribution of capital assets on the dissolution of a firm would be regarded as transfer. The decision of the Bombay High Court was affirmed by the Supreme Court.[9]

The amendment and the wordings of the sections have come under frequent litigation as seen above. The wordings also came under severe criticism. Authors like Datar (2020) expressed strong reservations about the language of the section. According to Datar (2020), Parliament has provided that the firm shall pay capital gains tax as if there is a transfer (by legal fiction), even though there would be none under the general law of partnership. However, it has not amended the general law of partnership in India. Therefore, for every purpose other than for paying liability under section 45(4) of the Act, Malabar Fisheries remains good law. It is a different issue that the existence of section 47(ii) was never raised before any of the judicial authorities including the Supreme Court.

With the decisions rendered in favour of the revenue both in case of transfer by a partner to a firm as well as in case of firm to a partner both on dissolution or otherwise, the law is now settled that there is a transfer of asset and that the transactions are exigible to tax. But then an amendment was brought in by the Finance Act, 2021. The beginnings and the journey of this amendment appears to be, again, on a wrong footing as they oppose the very meaning and legal status of partnership.

The 2021 Budget Speech remained silent about the provision. The Annexure to the Budget listing the Direct Tax Proposals lists the proposal as "Taxability of Surplus amount received by partners" and the proposed amendment in brief as – "In order to provide certainty, it is proposed to rationalise the provisions relating to the taxation of the assets or amount received by partners from the partnership firm in excess of their capital contribution." (Item No 16, page 49 of Anex to Part B of Budget Speech 2021)

[9] See Commissioner of Income-tax v. Mansukh Dyeing and Printing Mills, [2022] 145 taxmann.com 151 (SC).

Clause 14 of the Finance Bill 2021 proposed amendments to section 45, which inter alia, consist of substitution of subsection (4) with a new subsection (4) and insertion of new subsection (4A).

The new subsection (4) covered only the transfer of capital assets from a firm to a partner on the dissolution of a firm or at the time of its reconstitution.

The main issue that will be open to interpretation in this section is the use of the words "*which represents the balance in his capital account in the books of accounts of such specified entity at the time of its dissolution or reconstitution.*" What happens if the balance in the capital account of a partner is debit balance? In the opinion of the authors, this beginning itself is ominous.

Subsection (4A) as originally tabled in the Parliament, proposed to bring to tax the gains arising out of monies or other assets (other than capital assets) on dissolution or reconstitution. These amounts received by a partner are connected to his capital balance in the books of the firm, whereby the amounts received by the specified person in excess of the capital balance are taxed. Capital balance for this purpose was explained to exclude any revaluation credits of any asset or goodwill other than purchased goodwill. Definitions are given to the terms specified entity, specified person and self-generated goodwill.

Both these subsections, if not for the transformation and omission, (as explained hereunder) could have opened a Pandora's box of litigation arising from the wordings of the provisions, from the accounts and accounting treatment of the transactions in the books of the specified entity, which is the partnership firm. There are various possibilities for these litigations, such as the balance in capital account being debit and the fact that the amendment was proposed to be effective from 01.04.2021 - AY 2021-22, i.e., with retrospective effect.

Subsection (4) underwent a sea change and is a combination of originally proposed subsection (4) and (4A). Subsection (4A) never came to light and never found its way into the statute. An altogether new section viz., Section 9B crept into the statute and that too under Chapter II – Basis of Charge.

These peculiar aspects of the introduction of these sections and the amendments by themselves could be a subject matter of vexatious litigation and possibly render the amendment itself as unconstitutional, because the make-over from the original Bill to the statute and the introduction of section 9B have not been explained anywhere.

Be that as it may, the provisions, which are now in statute books, by themselves are open to litigation and the law as amended appears to be against the cannons of taxation.

The new subsection (4) as it finally found its way into the statute books provides that capital gains shall be chargeable in accordance with the following formula:

"$A = B + C - D$

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."

The value of self-generated goodwill is to be taken as 'nil' and that purchase will be at actual cost.

The possible litigation from the wordings of the section can arise, firstly, the new section 45(4) that came into effect from 1-4-2021 and is declared to be effective from AY 2021-22. It is of retrospective effect. The section being a charging section means that the transactions that have taken place even before the provision was introduced in the Parliament (i.e., those that have taken place from April 1, 2020, till March 31, 2021) also come under the ambit of the section.

Secondly, the subsection prescribes a formula to arrive at income chargeable to tax under the head capital gains. The first proviso clarifies that in case 'A' is negative the same shall be taken as zero. The section deals with the transfer of capital assets on dissolution or reconstitution of a partnership firm. In the case of a dissolution the amount in 'A' is negative in case of one partner and the same may be positive in case of another partner when assets are given to more than one partner. In such a case one negative ought to be set off against another positive when both the negative and positive arise from same event which is dissolution. The zero, not only goes against the principles of equity in taxation but also in a way goes against the computation methodology of capital gains wherein it is clear that loss in one capital asset can be set off against gain from another capital asset under the same category.

Thirdly, application of the formula in literal sense hinges on a fallacy. It is common that when a balance in the capital account of a partner is a debit, such a balance is adjusted against the claims of the partner at the time of the dissolution or retirement. It is well established law that the partners realise their rights in the *net* assets of a firm on its dissolution after meeting liabilities and prior charges (Addanki Narayanappa v. Bhaskara Krishtappa (1966) 3 SCR 400; AIR 1966 SC 1300). Applying the formula, the debit balance in the capital account of the partner only enhances 'A', i.e., the income chargeable to tax under the head capital gains while the entity is in fact realising its dues from the partner.

Fourthly, the section specifies only reconstitution and not dissolution. It is pertinent to mention here that the section as originally introduced in the Parliament included both dissolution and reconstitution. The omission of the word dissolution is open to different interpretations. In section 45(4) reference to section 9B is drawn for meaning of 'specified person', 'specified entity' and 'reconstitution', which in turn lead to section 2(23) of the Act which states that a firm and a partner shall have the meanings respectively assigned to them under the Partnership Act, 1932.

Fifthly, '*dissolution'* and '*reconstitution'* are also not defined originally under the Act. Section 9B defines a reconstitution only, though both the words dissolution and reconstitution are used in the section. These two have different sections under the Partnership Act and are dealt with on different footing therein. One of the clauses of the definition of reconstitution given in Explanation to section 9B[10] covers an instance where one or more of its partners of such firm ceases to be partners. It could be argued that this clause of the definition covers dissolution. In the opinion of the authors, such an argument will not hold good for two reasons. Firstly, it is by mere implication that dissolution is said to be covered under 'reconstitution' in 9B, whereas under the Partnership

10 Explanation (i)(a) to section 9B.

Act, these are two different instances and secondly, taxation cannot be by implication, it should be by specific mention.

Sixthly, from a plain reading of the formula, it appears that the computation methodology fails in bringing the gains to tax. It will be a better thing to say that the income is sought to be taxed under the head capital gains while at the same time brushing aside the computation methodology prescribed in section 48 which is set aside.

It is a well-established law that if capital gains are not determined in accordance with the computation methodology prescribed in section 48 of the Act, the taxation of such gains fails. The formula A = B + C - D ignores the deduction of the cost of acquisition of a capital asset that is deemed to have been transferred by a specified entity the gains from which are deemed to be the income of the specified entity. This is because 'C' in the formula is the fair market value (FMV) of the capital asset that is received by the specified person. If 'A' is to be taxed under the head capital gains, then gains should be computed following the scheme of the Act and FMV in itself cannot be taxed as capital gain. It will be far-fetched if the revenue comes up with the argument that the capital balance of the specified person is the cost of the acquisition of the asset. Even then indexation is not factored into the same in the formula.

Coming to section 9B, it specifies that FMV on the date of receipt of an asset by the specified person is taken as the full value of consideration and the section also states that in case of stock in trade being received by the specified person, the gains will be charged to tax under profits and gains of business or profession. The section is introduced under Chapter II, Basis of Charge and therefore supposedly, forms a foundation to the taxability of the instances specified therein. However, without including the instances in the charging sections specifically provided for the said purpose may not be in line with the accepted principles of interpretation of taxing statutes.

Even otherwise assuming that the inclusion of section 9B in Chapter II is valid and correct, then it is logical to say that it partakes the character of a Basis of Charge and not a charging section by itself. In other words, other sections of the Act gain the authority to charge to tax the instances mentioned in section 9B. However, this does not appear to be the case. Explanation 2 to section 45(4) reads as under:

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.

The explanation abundantly makes it clear that section 9B is a charging section and not a basis of charge.

Again, assuming that section 9B is a basis of charge and not a charging section, then section 45(4) gains its authority from section 9B and the omission of the word dissolution in section 45(4) coupled with its presence in 9B vitiates the taxation of gains on dissolution of a firm. Further, under the authority of section 9B corresponding amendments in section 28 ought to have been made to bring under the scope of business income the transfer of stock-in-trade and assets other than capital assets.

The above is the result of the so-called "Rationalisation of provision of transfer of capital asset to partner on dissolution or reconstitution". The memorandum explaining the provisions of Finance

Act, 2021 states – *"it has been noticed that there is uncertainty regarding applicability of provisions of aforesaid sub-section to a situation where assets are revalued, or self-generated assets are recorded in the books of accounts and payment is made to partner or member which is in excess of his capital contribution. Hence, it is proposed to substitute the existing sub-section (4) of section 45 of the Act with a new sub-section (4)"*

3. POSITION IN USA, UK AND AUSTRALIA

The fundamental principle is that a partnership is a relation between partners and the business of a partnership is carried out solely based on such relation and understanding is universal. The definition of partnership itself is a complex one, the taxation of partnership becomes even more complex and complicated. This complexity is noted in the case of taxation of partnerships in other countries.

3.1. Position in the USA

The general principle that a partnership is not a separate legal entity is well accepted in the USA. The taxation principles in the USA relating to partnerships and their partners are that the partnerships are treated as passthrough entities, which means that the partnership firm per se does not pay the taxes. Instead, it is viewed as an entity through which the profits or losses are passed on to its partners. The ultimate tax liability on the share of each partner lies with the partner.

Just like India, the United States too, which implements a partnership tax regime through Subchapter K of Internal Revenue Code (IRC), has its share of problems and complexities in interpretation of the relationship between the partners and partnership. Commenting on the tax framework relating to taxation of partnerships and partners, Monroe (2016) observed "*In designing every rule, someone had to marry theory and practice in order to make partnership taxation work (pp. 194-195)"*.

3.2. Position in the UK

The Indian Tax law (like many other statutes) derives the principles from the UK due to the long history of colonisation. Surprisingly, the taxation of partners and partnership is opposite in India. The principle that a partnership is not a separate entity distinct from its partners is clearly applied in the UK taxation scheme. In the UK the firm does not pay tax on its income. Instead, the partners include the profits or the losses of the firm in proportion to their respective shares in their individual tax returns.

3.3. Position in Australia

The tax regime relating to partnerships and their partners in Australia is equally complex and has seen conflicting decisions requiring proposals for amendments (Breznik, 2023: Bradbrook, 1988).

In Australia too, as in India, the general principle that a partnership is not a separate legal entity, has been disregarded when it comes to taxation. Instead, partners are treated as holding a fractional interest in partnership assets. Several decisions have in the recent time held that partners hold no such interest, while the taxation regime is designed based on one decision of High Court that partners hold fractional interest in the assets. Authors such as Breznik (2023) recommend the UK model of taxation of partnerships in Australia.

4. CONCLUSION

From the said beginnings to the present, the entire exercise appears to have increased the uncertainty rather than give clarity on the matter. In the opinion of the authors, a new era of litigation appears to have been laid foundation. There was no uncertainty about self-generated goodwill. This was already taken care of by amending section 55 way back in 1987 itself. The Supreme Court has clarified that an amount above capital contribution is taxable as capital gains and it is also settled law. Why quote these as reasons in 2021, 27 years down the line?

One more thought. At the end of all these what is the status of the receipt of the asset or amounts in the hands of the partners? Are they taxable? In the opinion of the authors, there is every possibility that it will be argued that the same is taxable in the hands of the partner, as was done earlier. The memorandum or the notes on clauses are not clear on that aspect.

The provisions of the Income Tax law in India relating to transfers of assets between a firm and partners need not be made this complex. The related Rules (Rule 8AD of Income Tax Rules, 1962) are even more confusing.

In the opinion of the authors, the confusion and complexity can be avoided by

- amending section 2(47) to include the transfers from a partner to a firm and *vice versa*.
- On dissolution compute income in accordance with law as applicable to the firm but tax incidence should be in the hands of the partners because ultimately it is they that are realising the surplus in proportion to their share.
- In case of retirement (reconstitution) tax incidence is to be in the hands of the retiring partner (s).
- Define reconstitution and dissolution separately and clearly. For this purpose, make the definition in Indian Partnership Act 1932, as the base.

A partner invests money or money's worth into a common pool of partners and forms a partnership. The firm is governed by the general Partnership law applicable to it, which in turn is governed primarily by principles of Contract law. This position need not be disturbed and disturbing this position be counterproductive and a near impossible task. The best solution in this context would be to bring surplus, of whatever kind arising to a partner from his relationship with other partners in the partnership, to tax in the hands of the individual partners as his personal income. The head of income may be decided based on the nature of income. Remuneration may be taxed under the head salaries; profits can be taxed under the head business and gains from the sale of property (non-business assets) under capital gains.

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