ISSUES IN TAXATION OF RECONSTITUTION OF FIRMS

RAMDEV BHUTADA

PAST HISTORY

- Reconstitution of firm was not defined either u/s 2 or u/s Sec' 45 (4)
- Sec' 45 (4) was introduced first by Finance Act 1964 wef 01-04-1964 later omitted wef 01-04-1966 and subsequently Inserted by Finance Act, 1987 wef 01-04-1988

R.D.B. 1

This sub sec' (4) provided that Profits /gains arising on transfer of CAPITAL ASSETS by way of DISTRIBUTION OF CAPITAL ASSETS on the DISS0LUTION OF FIRM ……

……OR OTHERWISE is chargeable to tax as income of the FIRM ……... in the PY in which such transfer occurred and for purposes of Sec' 48 FMV of such asset shall be deemed to be the full value of consideration ……..

R.D.B. 2

- Explanatory circular No 477 dr. 01/01/87 states that as a part of exercise to control tax avoidance subsec' (4) to Sec 45 is introduced.

- Sec' 2 (47) defines transfer to include sale, exchange relinquishment or extinguishment of rights but it does not specifically include distribution of capital assets on dissolution of firm

R.D.B 3.

- Sec 4 is charging section which prescribes that income tax Shall be charged on total income of the PY of every person.

- Sec' 39 of Indian Partnership Act, 1932 specifies that dissolution of Partnership between ALL PARTIES is dissolution of firm i.e firm ceases to exist

- In

1) CIT vs Dewas cine Corporation (1968) 68ITR 240 (SC)
2) C1T VS Ban Keylal Vaidya (1971) 79 17R 594 (SC)
3) Malabar Fisheries Vs C3T (1979) 120 ITR 49 (SC)

it was held that there is no Sale / transfer of assets on dissolution of firm but it is merely a mutual adjustment and since firm ceases prior to distribution of assets tax can not be charged on entity which is ceased and extint.

R.D.B. 5

POSITION ON OR AFTER 01-04-2021

- Finance Act, 2021 has brought in two critical amendments both wef 01-04-2021
- First is introduction of Sec' 9B
- Second is replacing subsec' (4) of sec' 45
- Both these changes are impacting taxation on reconstitution of firms
- Circular No 14 of 2021 dt. 02/07/2021 is issued relating to guide lines u/s 9B and Rule 8AB

SALIENT FEATURES OF SEC 45(4) WEF 01-04-2021

- a) Specified person receives MONEY OR CAPITAL ASSET OR BOTH from specified entity
- b) in connection with "reconstitution" of specified entity
- (c) Profits / gains arising thereof is taxable as income of specified entity.

R.D.B. 7

- d) NOT WITH STANDING anything contrary contained in the Act, profits/ gains shall be determined as under:

$$A = B+C-D$$

Where :

A ⇒ income of specified entity chargeable as Capital Gains

B ⇒Value of MONEY received by specified person

C ⇒ FMV of CAPITAL ASSET received by specified person

D ⇒ Balance of CAPITAL of specified person at the time of reconstitution.

- e) If value of A is negative then it shall be deemed to be ZERO
- f) Balance of capital of specified person shall exclude increase in capital due to REVALUATION of assets OR due to SELF GENERATED GOOD WILL or any other SELF GENERATED ASSET

- h) The terms "reconstitution", “specified entity' and "Specified person shall have the meanings respectively assigned to them in sec’9B

- i) Self generated goodwill/ any other asset means these are acquired / Purchased without incurring any cost and are self generated in the course of business/profession

- j) Provisions of Sec' 45(4) operate in addition to provisions of Sec’ 9B and the taxation under the said provisions there of shall be worked out independently.

R.D.B. 11

- **Salient Features of Sec' 9B**

- a) Specified person receives from any CAPITAL ASSET OR STOCK IN TRADE OR BOTH from a specified entity .
- b) In connection with dissolution" or "reconstitution " of specified entity.
- c) It will be deemed as ‘transfer’ by Specified entity.

- d) Profit/ gains arising from such deemed transfer will be deemed income of specified entity and chargeable to tax under the head ‘Profits & gains of business or profession’ OR "Capital Gains’’ in accordance with the provisions of Act.

- e) FMV of capital asset / stock in trade shall be deemed to be full value of consideration received or accruing
- f) CBDT may issue Guide lines for purpose of removing difficulty. - circular No. 14 of 2021 dt. 02/07/2021

g) Reconstitution of specified entity means:

i)one or more Partners/members of specified entity ceases to be partners/members.

OR

ii) one or more new partners/members are admitted In Specified entity WITH existing partners/members continuing.

OR

iii)change in share of one or more of existing partners/members

h) Specified entity means a firm/Aop/ BOI not being a company or a coop: society

i) Specified person means partner of a firm / member of AOP or BOI in the the PY

R.D.B. 16

- Salient features of Rule 8AB (introduced by Eighteenth Amd mt. Rule 2021) wef 02-07-2021

a) Relate to 'attribution' of income taxable 45(4) to the capital assets remaining with the specified entity.

b) Attribution is given only for purposes of computing Capital Gains us 48 (iii) in the hands of specified entity in respect of transfer of remaining assets at a future date.

c) Attribution is to be done only in case revaluation/valuation of capital assets / self generated goodwill (asset) is carried out at the time of reconstitution of firm.

d) Where taxable income u/s 45 (4) does not relate to the revaluation/valuation then attribution is not allowed.

e) Where taxable income u/s 45 (4) relates only to the Capital asset which is received by the specified person then attribution is not allowed.

f) Details of attributed amount shall be furnished in Form No.5C with in the due date specified in Expin: 2 to sec' 139(1)

g) Form No. 5C to be furnished electronically under digital signature or through EVC by a person authorised to sign u/s 140

h) Necessary to obtain Valuation report from a registered Valuer as defined in clause (9) of rule 11U

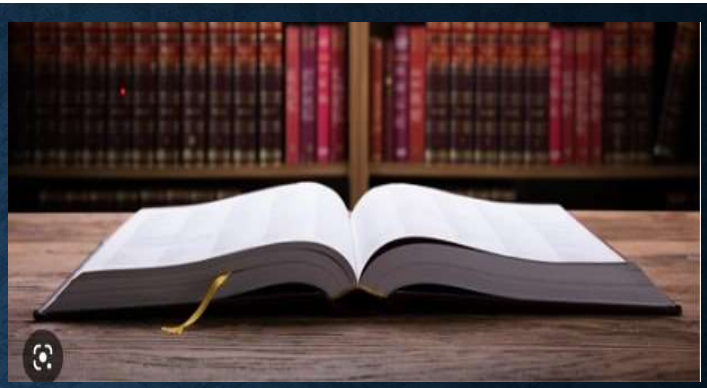
i) Revaluation/valuation of capital asset / self generated goodwill or asset does not entitle the specified entity to claim depreciation on such increased value.

j)Circular No. 14/2021 dt. 02/07/2021 prescribes Guidelines for working Capital Gains and attribution.

R.D.B. 21

SPECIAL PROVISIONS APPLICABLE TO FIRMS

CHAPTER XVI



- Sec' 184 specifies that :

a) Partnership shall be evidenced by an instrument and individual shares of partners shall be specified there in

b) Certified copy of instrument of Partnership shall accompany the return of Income of firm for the PY in which it is first sought itself as a firm.

c) Certification is by all the major partners.

R.D.B. 22

d) For change in constitution, certified copy of revised instrument shall be furnished.

e) where a firm fails to comply with various provisions as detailed in Sec' 144 then any payment to partner (s) in the form of salary, interest, commission, remuneration etc, is not deductible while computing income of the firm under the head profits & gains of business or profession but is taxable under the head other sources in the hands of the Partner.

Sec 185 → Provides for treatment of salary interest, commission, remuneration etc, to partner(s) in same way as in See' 184 (5) for failure to comply with sec' 184

Sec 186 → There is no section with this number since substitution of sections 184, 185 & 186 with sec 184 & 185 by Finance Act, 1992 wef 01-04-1993

- Sec 187 specifies that

a) while making assessment u/s 143 or u/s sec 144 if it is found that a change has occurred in the Constitution of the firm, the assessment shall be made on the firm as constituted at the time of making the assessment

b) where the firm is dissolved on death of partner it will not be deemed to be change in constitution due to retirement /admittance

- Sec' 188 provides that in case of Succession of a firm by another firm (not the same as specified in sec'187) then Separate assessments shall be made on the predecessor firm and successor firm as per sec' 170

- Sec' 188A specifies that for tax, penalty or other sum payable by the firm the partners or LR of deceased partner is jointly and severally liable.

➢Sec 189 specifies that:

a) where a firm is dissolved or business is discontinued the AO shall make assessment as if no dissolution/discontinuance has occurred and all provisions of the Act apply there of.

b) where dissolution / discontinuance occurred after commencement of any proceeding, all partners /LRs are subject to such proceedings

c) Liability of LR is Limited to the extent of estate of deceased devolved on him/her.

INTERESTING CASE LAWS

1)Credit of amount to the capital accounts of the partners on revaluation of the assets of assessee firm after introduction of some new partners can be said to be "transfer" which fall in the category of "Otherwise" mentioned in sec' 45 (4) and therefore provisions of sec'45(4) are applicable.

- CIT Vs Mansukh Dyeing & Printing Mills (2022) 329CTR(SC) 673

- 2) No profit arises on revaluation of assets by a company as no profit can be derived from one's own self

- Kikabhai Premchand VS CIT (Central) (1953) 24-ITR 506 (SC)
- CIT Vs Hind Construction Ltd. (1972) 83 ITR 211 (SC)

3) Expenditure on purchase of good will is a capital expenditure but however expenditure incurred for use of good will is allowable as revenue expenditure. Hence payment made to the widow of deceased partner for use of goodwill of the firm is allowable as business expenditure.

- Devi Das Vithal Das & Co; Vs CIT (1972) 84 ITR 277 (SC)

4) Firm have no seperate personality apart from its' members hence provisions of Sec' 269SS/269T would not apply to a firm in respect of loan transactions with partners.

- Dulichand Lakshminarain Vs CLT (1956) 29 ITR (555) SC

EXAMPLE AS PER GUIDELINES VIDE CIRCULAR NO.14 OF 2021

Partners	A	B	C
Profit sharing ratio	1/3rd	1/3rd	1/3rd
Capital as on 31/03	10 Lakhs	10 Lakhs	10 Lakhs

BALANCE SHEET OF FIRM AS ON 31/03

LIABILITIES			ASSETS		
Capital			LAND		
A	10		X	10	
B	10		Y	10	
C	10	30	Z	10	30
		30			30

PARTNER A RETIRES ON 01/04 ON FOLLOWING TERMS

- He is to be paid Rs 11 Lakhs
- He is to be given land Z
- All assets are to be revalued i.e FMV to be determined vide rule 11U

- FMV of Land X is 70 Lakhs

  FMV of Land Y is 70 Lakhs

  FMV of Land Z is 50 Lakhs

COMPUTATION OF INCOME U/S 9B

- Deemed transfer of capital asset i.e land Z to A
- FMV of land Z is consideration i.e Rs. 50 lakhs
- Presumed that land Z is acquired more than two years ago and whose indexed cost is 15 lakhs

- Chargeable income u/s 9B i.e LTCG is Rs 35 Lakhs
- Presumed tax at Rs. 7 Lakhs/=

- Amount to be allocated as on transfer of land Z is Rs 3300000/= i.e FMV of land Z i.e Rs 50 lakhs less actual cost of Rs 10 Lakhs less tax of Rs 7 lakhs.
- This allocation in profit sharing ratio works out to Rs 1100000/= in the capital of each partner i.e A,B and C

- After allocation of above sum the outstanding balance in a/c of each partner stands at Rs 21 Lakhs each

COMPUTATION OF INCOME U/S 45(4)

- Partner A is receiving 11 lakhs cash and 50 lakhs worth of land Z. Thus total value received by him is Rs. 61 lakhs

- By applying formula A = B+C-D as specified in Sec'45(4) the LTCG is 40 Lakhs where:

A is income chargeable i.e 40 lakhs

=

B is value of money received i.e 11 lakhs

+

C is FMV of capital asset received i.e 50 lakhs

-

D is o/s balance in capital A/c i.e 21 lakhs

ATTRIBUTION OF LTCG TO REMAINING ASSETS

- Attribution of 40 lakhs on remaining assets i.e land X and Y whose values increased in equal proportion i.e Rs 60 lakhs each

- Land X and land Y cost will be Rs 30 lakhs each i.e Rs 10 lakhs original cost plus Rs 20 lakhs of attribution

- This cost after attribution will be considered for purpose of Sec'48(iii) only to determine capital gains in future on sale/transfer of these lands

Ramdev Bhutada

A professional is a person who can do his best at a time when he doesn't particularly feel like it.

THANK YOU

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
Hyderabad Branch (SIRC)

A2Z of Income Tax Act

Structured CPE Hours 14 Hrs

1. POEM

2. Merger

3. Demerger

Draft for discussion

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Tax Residency of Foreign Company :POEM - Section 6(3)

- Under Indian tax laws, a foreign company resident in India in any year, is taxable on its global income.

- Under India law, a company is resident in India in any year, if
  - it is an Indian company (i.e. incorporated in India); **OR**
  - its **POEM**, in that year, is in India.

- POEM concept borrowed from Tax Treaties

- POEM generally means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made.

- While each country, may explain and apply the concept POEM differently, in substance the objective is the same.

POEM CBDT Guidelines – Circular No. 6/2017

Key Principles

- The POEM concept is one of substance over form and determination of the POEM depends on the facts and circumstances of the company
- It may be noted that an entity may have more than one place of management, but it can have only one POEM at any point of time
- Since "residence" is to be determined for each year, POEM will also be required to be determined on year-to-year basis
- For determining the POEM of a Company, companies can be classified into the 2 categories viz.,
  - Companies engaged in Active Business Outside India ('**ABO**I'); or
  - Other Companies.

As per CBDT circulate, POEM provisions shall not apply to a company having turnover or gross receipts of Rs 50 crore or less in a financial year.

POEM – Guiding Principles

Companies having ABOI

- POEM is presumed to be outside India, if the majority meetings of the board of directors of the company are held outside India.
- A company shall be said to be engaged in *"**active business outside India**"*, if :
  - the passive income is not more than 50% of its total income ('**Income Test**'); and
  - less than 50% of its total assets are situated in India (**Asset Test**); and
  - less than 50% of total number of employees are situated in India or are resident in India (**Employee Test**); and
  - the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure (**Payroll Test**).

Other Companies

Determination of POEM would be a two-stage process, namely:

- **First stage** would be identification or ascertaining the person or persons who actually make the key management and commercial decision for conduct of the company's business as a whole.
- **Second stage** would be determination of place where these decisions are in fact being made.

Secondary factors for identification of POEM:

- Place where main and substantial activity of the company is carried out;
- Place where the accounting records of the company are kept;
- Location of the Head office.

POEM – Commentary

OECD Guidelines

- Place where decisions are made,
- Where the actions are determined,
- Where is the decision-making function performed
- Where is the place of incorporation, where are corporate documents kept / stored / maintained
- Place where CEO, office staff, senior executives reside to carry out activities.

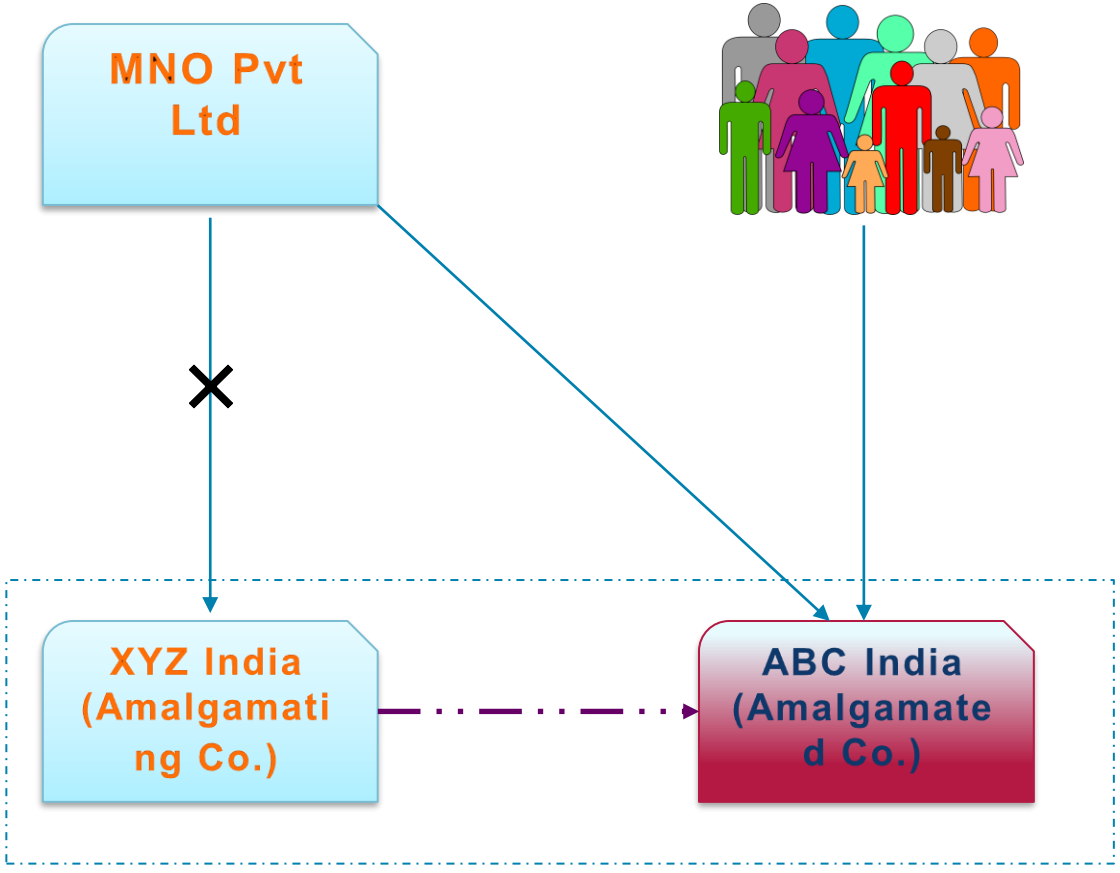
UN DTAA Directive Principles

- Where company is managed and controlled
- Place from where decisions are taken by the top management which are essential for the company
- Contribution of a place in the management of the company from an economic and functional point of view

The head and seat and directing power of a company's affairs is situated at the place where the directors meetings are held (who manage and control the business)

Merger

- In the context of a merger, tax implications can arise for various stakeholders involved, including
  - Amalgamating Company;
  - Amalgamated Company; and
  - Shareholders of the Amalgamating Company;
- The nature and extent of the tax implications depend on the type of entities involved (domestic or cross-border) and the nature of the assets being transferred.



Amalgamation – Section 2(1B)

- *Amalgamation, in relation to companies, means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the **amalgamating company** or companies and the company with which they merge or which is formed as a result of the merger, as the **amalgamated company**) in such a manner that—*

  *i. All the **property** of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation;*

  *ii. All the **liabilities** of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation;*

  ***iii.** **Shareholders** holding not less than **three-fourths in value of the shares** in the amalgamating company or companies (**other than shares already held therein** immediately before the amalgamation **by**, or by a nominee for, **the amalgamated company or its subsidiary**) become shareholders of the amalgamated company by virtue of the amalgamation,*

  otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of the distribution of such property to the other company after the winding up of the first-mentioned company

Tax Neutrality for Mergers – Section 47(vi) & (vii)

- ***(vi)*** *Any transfer, in a scheme of amalgamation, of a* ***capital asset by the amalgamating company*** *to the amalgamated company if the amalgamated company is an Indian company.*
- ***(vii)*** *Any transfer* ***by a shareholder****, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company, if—*

  (a) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company except where the shareholder itself is the amalgamated company, and

  (b) the amalgamated company is an Indian company;

- Clause (vi) provides tax neutrality to the **amalgamating company**, provided that the amalgamated company is an Indian company.
- Clause (vii) provides tax neutrality to the **shareholder of the amalgamating company (shareholder)**, for transfer of shares in case of a merger. In addition to amalgamated company being an Indian company, the shareholders should receive consideration in form of shares of the amalgamated company (except where the shareholder is the amalgamated company itself).

Tax on Amalgamated Company – Section 56(2)(x)

- Section 56(2)(x) provides of taxation of certain receipts from another person without consideration or for a consideration, which is less than FMV of the property received (exception for low value property < Rs 50K).
- The proviso to the section provides that the clause shall not apply to inter alia to an amalgamation under Section 47(vii)
- There is also a view that in case of merger, the amalgamated company receives a business undertaking of the amalgamating company. A business undertaking cannot be equated to property and hence should not be taxable in the hands of the amalgamated company.
- Irrespective, if the merger satisfies conditions of Section 47(vii) viz., the amalgamated company is any Indian company and shareholders receive consideration in form of shares of the amalgamated company (except where the shareholder is the amalgamated company itself), taxation under Section 56(2)(x) does not apply.

Tax Neutrality on Transfer of Shares in Indian Company on account of Overseas Mergers –Sec 47(via) & (viab)

- ***(via)*** *any transfer, in a scheme of amalgamation, of a capital asset being a share or shares held in an Indian company, by the amalgamating foreign company to the amalgamated foreign company, if—*

  *a) at least **twenty-five per cent of the shareholders** of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company, and*

  *b) such transfer **does not attract tax on capital gains in the country**, in which the amalgamating company is incorporated.*

- ***(viab)*** *any transfer, in a scheme of amalgamation, of a capital asset, being a share of a foreign company, referred to in the Explanation 5 to clause (i) of sub-section (1) of section 9, which derives, directly or indirectly, its value substantially from the share or shares of an Indian company, held by the amalgamating foreign company to the amalgamated foreign company, if—*

  *A. at least **twenty-five per cent** of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company; and*

  B. such transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated;

Merger - Carry forward and set off of accumulated loss and unabsorbed depreciation allowance – Section 72A

Amalgamating company—

i. has been engaged in the business, in which the accumulated loss occurred or depreciation remains unabsorbed, for three or more years;

ii. has held continuously as on the date of the amalgamation at least three-fourths of the book value of fixed assets held by it two years prior to the date of amalgamation;

Amalgamated company—

i. holds continuously for a minimum period of five years from the date of amalgamation at least three-fourths of the book value of fixed assets of the amalgamating company acquired in a scheme of amalgamation

ii. continues the business of the amalgamating company for a minimum period of 5 years from the date of amalgamation

iii. fulfils such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose.

Restricted to Specified Industrial undertakings, Banking company, power companies, mining, certain infrastructure companies, telecommunication services companies

Demerger – Section 2(19AA)

demerger, in relation to companies, means the transfer, pursuant to a scheme of arrangement u/s 391 to 394 of the Companies Act, 1956, by a demerged company of its one or more undertakings to any resulting company in such a manner that—

i. *all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;*

ii. *all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;*

iii. *the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;*……

iv. *the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis except where the resulting company itself is a shareholder of the demerged company;*

v. *the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;*

vi. *the transfer of the undertaking is on a going concern basis;*

vii. *the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A by the Central Government in this behalf.*

Tax Neutrality for Demergers – Section 47(vib) & (vid)

- ***(vib) any transfer, in a demerger, of a capital asset by the demerged company to the resulting company, if the resulting company is an Indian company;***

- (vid) any transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company if the transfer or issue is made in consideration of demerger of the undertaking;

- Clause (vib) provides tax neutrality to the **demerged company**, provided that the resulting company is an Indian company.
- Clause (vid) provides tax neutrality to the **shareholder of the demerged company**, for transfer or issue of shares by the resulting company.

Tax Neutrality for transfer of Shares in Indian company by Demerged Foreign company – Section 47(vic) & (vicc)

- ***(vic)*** *any transfer in a demerger, of a capital asset, being a share or shares held in an Indian company, by the* ***demerged foreign company*** *to the resulting foreign company, if—*

  a) the shareholders holding not less than three-fourths in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; and

  b) such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated:

- ***(vicc)*** *any transfer in a demerger, of a capital asset, being a share of a foreign company, referred to in the Explanation 5 to clause (i) of sub-section (1) of section 9, which derives, directly or indirectly, its value substantially from the share or shares of an Indian company, held by the* ***demerged foreign company*** *to the resulting foreign company, if—*

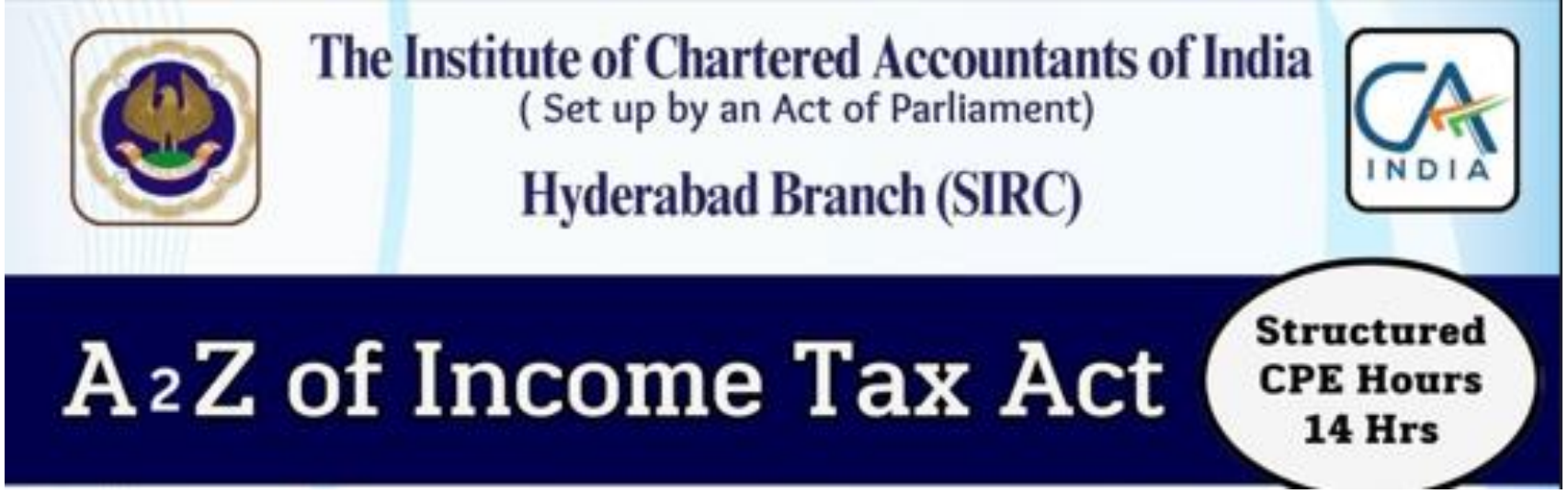
  a) the shareholders, holding not less than three-fourths in value of the shares of the demerged foreign company, continue to remain shareholders of the resulting foreign company; and

  b) such transfer does not attract tax on capital gains in the country in which the demerged foreign company is incorporated:

- *Provided that the provisions of sections 391 to 39487 of the Companies Act, 1956 shall not apply in case of demergers referred to in the above clause.*

Demerger - Carry forward and set off of accumulated loss and unabsorbed depreciation allowance – Section 72A

- where such loss or unabsorbed depreciation is **directly relatable** to the undertakings transferred to the resulting company, be allowed to be carried forward and set off in the hands of the resulting company;
- where such loss or unabsorbed depreciation is **not directly relatable** to the undertakings transferred to the resulting company, be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company, and be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be.



Thank You

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Draft for discussion

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