<u>Circular No. 14 of 2021</u>

F. No.370142/22/2021-TPL
Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes (TPL Division)

Dated: 02nd July, 2021

Sub.: Guidelines under section 9B and sub-section (4) of section 45 of the Income-tax Act, 1961 - reg.

Finance Act, 2021 inserted a new section 9B in the Income-tax Act 1961 (hereinafter referred to as "the Act"). This section mandates that whenever a specified person receives any capital asset or stock in trade or both from a specified entity, during the previous year, in connection with the dissolution or reconstitution of such specified entity, then it shall be deemed that the specified entity have transferred such capital asset or stock in trade or both, as the case may be, to the specified person (hereinafter referred to as "deemed transfer"). This deemed transfer would be in the year in which such capital asset or stock in trade or both are received by the specified person. Any profits and gains arising from such deemed transfer is deemed to be the income of such specified entity of the previous year in which such capital asset or stock in trade or both were received by the specified person. Further, it is chargeable to income-tax as income of such specified entity under the head "Profits and gains of business or profession" or under the head "Capital gains", in accordance with the provisions of this Act. It has also been provided that the fair market value of the capital asset or stock in trade or both, on the date of its receipt by the specified person, shall be deemed to be the full value of the consideration received or accruing as a result of such deemed transfer. The definitions of terms "reconstitution of the specified entity", "specified entity" and "specified person" are provided in section 9B of the Act.

2. Similarly the Finance Act 2021 substituted sub-section (4) of section 45 of the Act. This newly substituted sub-section (4) now provides that where a specified person receives any money or capital asset or both from a specified entity, during the previous year, in connection with the reconstitution of such specified entity, then any profits or gains arising from receipt of such receipt by the specified person shall be chargeable to income-tax as income of the specified entity under the head "Capital gains". It has been further deemed that this income shall be the income of the specified entity of the previous year in which such money or capital asset or both were received by the

specified person. A formula to calculate such profits and gains has also been provided in this sub-section. The definitions of terms "reconstitution of the specified entity", "specified entity" and "specified person" shall be as provided in section 9B of the Act while the terms "self-generated goodwill" and "self-generated asset" have been defined in this sub-section. It has been further 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 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. Both, the new section 9B and substituted sub-section (4) of section 45 are applicable for the assessment year 2021-22 and subsequent assessment years.

3. Sub-section (4) of section 9B of the Act provides that if any difficulty arises in giving effect to the provisions of this section and sub-section (4) of section 45 of the Act, the Board may, with the approval of the Central Government, issue guidelines for the purposes of removing the difficulty. For this purpose, the Central Board of Direct Taxes, with the approval of the Central Government, hereby issues the following guidelines.

Guidelines

4. It is noticed that the amount taxed under sub-section (4) of section 45 of the Act is required to be attributed to the remaining capital assets of the specified entity, so that when such capital assets get transferred in the future, the amount attributed to such capital assets gets reduced from the full value of the consideration and to that extent the specified entity does not pay tax again on the same amount. It is further noticed that this attribution is given in the Act only for the purposes of section 48 of the Act. It may be seen that section 48 of the Act only applies to capital assets which are not forming block of assets. For capital assets forming block of assets there is sub-clause (c) of clause (6) of section 43 of the Act to determine written down value of the block of asset and section 50 of the Act to determine the capital gains arising on transfer of such assets. However, the Act has not yet provided that amount taxed under sub-section (4) of section 45 of the Act can also be attributed to capital assets forming part of block of assets and which are covered by these two provisions. To remove difficulty, it is clarified that rule 8AB of the Income Tax Rules, 1962 (hereinafter referred to as "the Rules") notified vide notification no. 76 dated 02.07.2021 also applies to capital assets forming part of block of assets. Wherever the terms capital asset is appearing in the rule 8AB of the Rules, it refers to capital asset whose capital gains is computed under section 48 of the Act as well as capital asset forming part of block of assets. Further, wherever reference is made for the purposes of

section 48 of the Act, such reference may be deemed to include reference for the purposes of sub-clause (c) of clause (6) of section 43 of the Act and section 50 of the Act.

5. For the removal of doubt it is further clarified that in case the capital asset remaining with the specified entity is forming part of a block of asset, the amount attributed to such capital asset under rule 8AB of the Rules shall be reduced from the full value of the consideration received or accruing as a result of subsequent transfer of such asset by the specified entity, and the net value of such consideration shall be considered for reduction from the written down value of such block under sub-clause (c) of clause (6) of section 43 of the Act or for calculation of capital gains, as the case may be, under section 50 of the Act.

6. For the purposes of understanding and for removing difficulties, if any, the application of section 9B of the Act and sub-section (4) of section 45 of the Act is explained with the help of the following examples:

Example 1: There are three partners "A", "B" and "C" in a firm "FR", having one third share each. Each partner has a capital balance of ₹10 lakh in the firm. There are three pieces of lands "S", "T" and "U" in that firm and there is no other capital asset in that firm. Book value of each of the land is ₹10 lakh. All these three lands were acquired by the firm more than two years ago.

Partner "A" wishes to exit. The firm revalues its lands based on valuation report from a registered valuer, as defined in rule 11U of the Rules, and as per that valuation report fair market value of lands "S" and "T" is Rs 70 lakh each, while fair market value of land "U" is ₹50 lakh. On the exit of partner "A", the firm decides to give him ₹11 lakh of money and land "U" to settle his capital balance.

In accordance with the provisions of section 9B of the Act, it would be deemed that the firm "FR" has transferred land "U" to the partner "A" at its fair market value of ₹50 lakh. Let us assume that the indexed cost of acquisition of land "U" is ₹15 lakh.

Now on account of the deeming provisions of section 9B of the Act, it is deemed that the firm "FR" has transferred land "U" to partner "A". Thus, an amount of ₹50 lakh less ₹15 lakh would be charged to tax in the hands of firm "FR" under the head "Capital gains". For partner "A", the cost of acquisition of this land would be ₹50 lakh. Hence, the amount of ₹ 35 lakh is charged to long term

capital gains and let us assume that the tax is ₹7 lakh(assume no surcharge or cess just for ease of calculation and illustration purposes).

This, net book profit after tax of ₹33 lakh (capital gains of ₹40 lakh without indexation less tax of ₹7 lakh) is to be credited in the capital account of each of the three partners, i.e. ₹11 lakh each. Thus partner "A" capital account would increase to ₹21 lakh. This exercise is required to be carried out since section 9B of the Act mandates that it is to be deemed that the firm "FR" has transferred the land "U" to partner "A" and the long term capital gains of ₹35 lakh is chargeable to tax in the hands of the firm "FR".

As against capital balance of ₹21 lakh, partner "A" has received ₹61 lakh (₹11 lakh of money plus land "U" of fair market value of ₹50 lakh). Thus ₹40 lakh is required to be charged to tax under sub-section (4) of section 45 of the Act. This shall be in addition to an amount of ₹35 lakh charged to tax under section 9B of the Act.

On account of clause (iii) of section 48 of the Act, read with rule 8AB of the Rules, this ₹40 lakh is to be attributed to the remaining assets of the firm "FR" on the basis of increase in their value due to revaluation based on the valuation report of registered valuer. In this case as per revaluation there are only two capital assets remaining; lands "S" and "T". In both cases the value has increased by ₹60 lakh each. Thus, out of ₹40 lakh, ₹20 lakh shall be attributed to land "S" and ₹20 lakh to land "T". When either of these lands gets sold, this amount attributed to them would be reduced from sales consideration under clause (iii) of section 48 of the Act.

The amount of ₹40 lakh which is charged to tax under sub-section (4) of section 45 of the Act shall be charged as long term capital gains in view of sub-rule (5) of rule 8AA of the Rules, since the amount of ₹40 lakh is attributed to land "S" and land "T" which are both long term capital assets at the time of taxation of ₹40 lakh under sub-section (4) of section 45 of the Act.

Example 2: There are three partners "A", "B" and "C" in a firm "FR", having one third share each. Each partner has a capital balance of ₹10 lakh in the firm. There are three pieces of lands "S", "T" and "U" in that firm and there is no other capital asset in that firm. All these three lands were acquired by the firm more than two years ago.

Book value of each of the land is ₹10 lakh. Partner "A" wishes to exit. The firm sells land "U" for its fair market value of ₹ 50 lakh. Let us assume that the indexed cost of acquisition of land "U" is ₹15 lakh. Thus, an amount of ₹50 lakh less ₹15 lakh would be charged to tax in the hands of firm "FR" under the head "Capital gains". Hence, the amount of ₹ 35 lakh is charged to long term capital gains and let us assume that the tax is ₹7 lakh(assume no surcharge or cess just for ease of calculation and illustration purposes).

This, net book profit after tax of ₹33 lakh (capital gains of ₹40 lakh without indexation less tax of ₹7 lakh) is to be credited in the capital account of each of the three partners, i.e. ₹11 lakh each. Thus partner "A" capital account would increase to ₹21 lakh.

Partner "A" decides to exit the firm "FR". The firm revalue its lands "S" and "T" based on valuation report from a registered valuer, as defined in rule 11U of the Rules, and as per that valuation report fair market value of lands "S" and "T" is ₹70 lakh each On the exit of partner "A", the firm decides to give him ₹ 61 lakh of money to settle his capital balance. Thus, as against capital balance of ₹21 lakh, partner "A" has received ₹61 lakh of money. Thus ₹40 lakh is required to be charged to tax under sub-section (4) of section 45 of the Act. This will be in addition to ₹35 lakh already charged to capital gains.

On account of clause (iii) of section 48 of the Act, read with rule 8AB of the Rules, this ₹40 lakh is to be attributed to the remaining assets of the firm "FR" on the basis of increase in their value due to revaluation based on the valuation report of registered valuer. In this case as per revaluation there are only two capital assets remaining; lands "S" and "T". In both cases the value has increased by ₹60 lakh each. Thus, out of ₹40 lakh, ₹20 lakh shall be attributed to land "S" and ₹20 Lakh to land "T". When either of these lands gets sold, this amount attributed to them would be reduced from sales consideration under clause (iii) of section 48 of the Act.

The amount of ₹40 lakh which is charged to tax under sub-section (4) of section 45 of the Act shall be charged as long term capital gains in view of sub-rule (5) of rule 8AA of the Rules, since the amount of ₹40 lakh is attributed to land "S" and land "T" which are both long term capital assets at the time of taxation of ₹40 lakh under sub-section (4) of section 45 of the Act.

Note: The final result in both example 1 and 2 is same due to the operation of section 9B of the Act.

Example 3:

There are three partners "A", "B" and "C" in a firm "FR", having one third share each. Each partner has a capital balance of ₹100 lakh in the firm. There is a piece of land "S" of book value of ₹30 lakh. There is patent "T" of written down value of ₹45 lakh. And there is cash of ₹225 lakh. The land was acquired by the firm more than two years ago. The patent was acquired/developed/registered one year back.

Partner "A" wishes to exit. The firm revalue its land and patent based on valuation report from a registered valuer, as defined in rule 11U of the Rules, and as per that valuation report fair market value of land "S" is ₹45 lakh and fair market value of patent "T" is ₹60 lakh. As per the valuation report there is also self-generated goodwill of ₹30 lakh. On the exit of partner "A", the firm decides to give him ₹75 lakh in money and land "S" to settle his capital balance.

In accordance with the provisions of section 9B of the Act, it would be deemed that the firm "FR" has transferred land "S" to the partner "A" at its fair market value of ₹45 lakh. Let us assume that the indexed cost of acquisition of land "S" is ₹45 lakh.

Now on account of the deeming provisions of section 9B of the Act, it is deemed that the firm "FR" has transferred land "S" to partner "A". However, since the sale consideration is equal to indexed cost of acquisition, there will not be any capital gains tax. For partner "A", the cost of acquisition of this land would be ₹45 lakh.

The net book profit of ₹15 lakh (capital gains of ₹15 lakh without indexation) is to be credited in the capital account of each of the three partners, i.e. ₹5 lakh each. Thus partner "A" capital account would increase to ₹105 lakh. This exercise is required to be carried out since section 9B of the Act mandates that it is to be deemed that the firm "FR" has transferred the land "S" to partner "A". Thus, any gain in the books is to be apportioned to partners' capital accounts.

As against capital balance of ₹105 lakh, partner "A" has received ₹120 lakh (money of ₹75 Lakh plus land "S" of fair market value of ₹45 lakh). Thus ₹15 Lakh is required to be charged to tax under sub-section (4) of section 45 of the Act.

On account of clause (iii) of section 48 of the Act, read with rule 8AB of the Rules and this guidance note, this ₹15 lakh is to be attributed to the remaining capital assets of the firm "FR" on the basis of

increase in the value due to revaluation of existing capital assets, or due to recognition of the value of self-generated goodwill, based on the valuation report of registered valuer. In this case as per this report the value of patent "T" has increased by ₹15 lakh and the self-generated goodwill value has been recognised at ₹30 lakh. Thus one third of ₹15 lakh (i.e. ₹5 lakh) would be attributed to patent "T", while two third of ₹15 lakh (i.e. ₹10 lakh) would be attributed to self-generated goodwill. ₹5 lakh attributed to patent "T" shall not be added to the block of the assets and no depreciation shall be available on the same. When patent "T" gets transferred subsequently, this ₹5 Lakh attributed shall be reduced from the full value of the consideration received or accruing as a result of transfer of patent "T" by the firm "FR", and the net value shall be considered for reduction from the written down value of the intangible block under sub-clause (c) of clause (6) of section 43 of the Act or for calculation of capital gains, as the case may be, under section 50 of the Act.(Refer guidance in paragraph 5 of this circular). Let us say that Patent T is sold for ₹25 lakh. ₹5 lakh shall be reduced from ₹25 lakh and only net amount of ₹20 lakh shall be considered for reduction from the written down value of the intangible block under sub-clause (c) of clause (6) of section 43 of the Act or for calculation of capital gains, as the case may be, under section 50 of the Act. Similarly when goodwill gets sold subsequently, ₹10 lakh would be reduced from its sales consideration under clause (iii) of section 48.

The amount of ₹15 lakh which is charged to tax under sub-section (4) of section 45 of the Act shall be charged as short term capital gains, as ₹5 lakh is attributed to the Patent "T" which is part of block of assets and ₹10 lakh is attributed to self-generated goodwill. In accordance with sub-rule (5) of Rule 8AA of the Rules, both of these are to be characterised as short term capital gains.

Note: For the purpose of calculation of depreciation under section 32 of the Act, the written down value of the block of asset "intangible" of which Patent "T" is part, would remain ₹45 lakh and would not be increased to ₹60 lakh due to revaluation during the year. In this regard it may be highlighted that the following provisions are relevant in determining the amount on which depreciation is allowable under the Act:

- Explanation 2 of sub-section (1) of section 32 of the Act provides that the term "written down value of the block of assets" shall have the same meaning as in clause (c) of sub-section (6) of section 43 of the Act.

- Clause (c) of sub-section (6) of section 43 of the Act, with respect to block of assets, inter-alia, provides that the aggregate of the written down values of all the assets falling within that block of assets at the beginning of the previous year is to be increased by the actual cost of any asset falling within that block, acquired during the previous year. This clause does not allow any increase on account of revaluation.
- Sub-section (1) of section 43 of the Act which defines "Actual cost" as actual cost of the assets to the assessee. In revaluation, there is no actual cost to the assessee

Further, section 32 of the Act does not allow depreciation on goodwill. If in the given example "self-generated goodwill" is replaced by "self-generated asset", even then the depreciation will not be admissible on the amount of ₹30 lakh recognised in valuation. In this regard it may be highlighted that the above mentioned provisions, in the immediate preceding paragraph, are also applicable to "self-generated asset" and since there is no actual cost to assessee in case of "self-generated asset", depreciation is not allowable under section 32 of the Act on an asset whose actual cost is nil.

02.07.2021

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