

# ***Bombay High Court rules that non compliance with conditions prescribed under section 47(xiii) does not give rise to capital gains***

December 7, 2016

## ***In brief***

In a recent decision, the Bombay High Court (HC) upheld the ruling of the Authority for Advance Ruling (AAR) wherein it had ruled that violation of the conditions prescribed under clause (d) of proviso to section 47(xiii) of the Income-tax Act, 1961 (the Act) does not give rise to capital gains since no profit or gain was arising at the time of conversion of a partnership firm into a company.

## ***In detail***

### ***Facts***

- The taxpayer<sup>1</sup> along with its nominees acquired 100% of the equity shares of Z Limited in August 2008.
- Z Limited was incorporated as a private limited company succeeding erstwhile partnership firm “Z” whose conversion into a company was effected under section 565 (Part IX) of the Companies Act, 1956 in September 2005.
- Pursuant to the above conversion, all the assets and liabilities of the partnership firm were vested in Z Limited. The partners of erstwhile firm continued as shareholders with their respective shareholding in Z Limited

being identical to the profit-sharing ratio in Z.

- The aggregate of shareholding of erstwhile partners continued to be more than 50% of the total voting power until the taxpayer acquired equity shares of Z Limited in August 2008
- Section 47(xiii) of the Act states that transfer of capital assets pursuant to conversion of a firm into a company will be exempt from capital gains tax provided conditions prescribed thereunder are complied with.
- Clause (d) of proviso to section 47(xiii) of the Act requires partners of erstwhile firm to hold at least 50% of total voting power in the company for a minimum period of five

years from the date of succession.

### ***AAR Ruling***

- The taxpayer, a non-resident entity had applied to AAR in order to determine the following:
  - (a) whether conversion of firm into a company can be regarded as a “transfer” within the meaning of section 2(47) of the Act.
  - (b) if yes, whether it would give rise to capital gains upon acquisition of shares in Z Limited by the taxpayer.
- AAR ruled that no capital gains accrued or arose at the time of conversion of the firm into company. Hence, deeming provisions under section 47A(3) of the Act cannot be invoked.

<sup>1</sup> [2016] 76 taxmann.com 32 (Bombay)

- However, aggrieved by the ruling, Revenue filed a writ petition with the Bombay HC on this matter.

### ***Issues before the High Court***

Whether any capital gains can be said to have accrued on account of the so-called transfer of capital assets of the firm to the company in a case where conditions prescribed under section 47(xiii) of the Act are violated.

### ***Key contentions of the taxpayer***

- Registration of the firm as a company under Part IX of the Companies Act, 1956 and consequent vesting of assets and liabilities did not amount to transfer and nor had any capital gains arisen within the meaning of section 45 read with section 48 of the Act. Therefore, irrespective of the violation of the condition laid down in section 47(xiii) of the Act, the liability cannot be fastened on the taxpayer.
- The taxpayer also contended that the net worth of the company as on the date of conversion was the same as it was in the hands of the erstwhile firm, and no gain or benefit was derived on account of conversion.

### ***Key contentions of the Revenue***

- The condition of maintaining at least 50% of the total voting power was violated, and hence, exemption from capital gains enjoyed by the firm upon conversion into company ceased to be in force.

- The Revenue also contended that section 2(47) of the Act is an “inclusive provision” and transfer by modes other than those that are presently listed can also be included in the definition of transfer.

### ***High Court’s ruling***

- The Bombay HC in upholding the ruling, reiterated the following observations of:
  - a. what is deemed to be profit and gains of the successor company is the amount of profit or gains arising from transfer not charged earlier. If no profit arose earlier when conversion took place or if there was no transfer at all of capital assets of the firm, the deeming provision under section 47A(3) of the Act cannot be invoked to levy capital gains tax.
  - b. in case of such reconstitution of the firm as a company under Part IX of the Companies Act, 1956, the assets automatically vest in the newly registered company as per statutory mandate contained in the provisions of law.
  - c. on violation of conditions prescribed under section 47(xiii) of the Act, exemption from capital gains enjoyed by the firm upon conversion ceases to be in force cannot be accepted.
  - d. no capital gains accrued at the time of conversion of the firm into company.

Accordingly, the HC held that notwithstanding the non-compliance with clause (d) of section 47(xiii) of the Act by premature transfer of shares, the said company was not liable to pay capital gains tax.

- The HC also observed that even if capital gains are sought to be taxed in the hands of erstwhile partners/shareholders, it would not affect the decision passed by the AAR, while coming to the conclusion that there were no capital gains at the time of conversion of the firm into company.

### ***The takeaways***

- The HC has re-iterated and confirmed that no capital gains arose or accrued upon conversion of firm into a company and subsequent violation of any prescribed condition cannot bring the transfer under the scope of capital gains tax.
- However, the tax implications in the hands of the partners of the erstwhile firm continues to remain unresolved.

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For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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