

# *Tribunal decides on taxability of conversion of company into an LLP*

December 12, 2018

## *In brief*

In a recent ruling,<sup>1</sup> the Mumbai bench of the Income-tax Appellate Tribunal (Tribunal) held the following:

- Conversion of a company/ private limited company (PLC) into a limited liability partnership (LLP) results in “transfer” of capital assets and is subject to capital gains tax in India in the hands of the PLC unless covered by the specific exemption under the Income-tax Act, 1961 (the Act). Further, due to conversion, the PLC ceases to exist and hence such gains will be taxable in the hands of the converted LLP.
- However, such capital gain arising on conversion of a PLC to a LLP tantamount to ‘nil’ as book value of the assets/ liabilities transferred is to be considered as full value of consideration received or accrued to the PLC which is same as cost of acquisition.
- Further, the Tribunal also made observations on the permissibility of carry forward of losses of the PLC in the hands of the successor LLP.

## *In detail*

- The taxpayer, an LLP, was a tax resident of India and engaged in the business of power generation. The taxpayer, earlier a PLC, was converted into an LLP with effect from September 2010.
- During the course of assessment proceedings, the tax officer (TO) argued that conversion from PLC to LLP was a “taxable transfer” and that capital gains arising thereon were taxable in the hands of the successor LLP. Therefore, the TO invoked the provisions of section 47A(4) of the Act to withdraw the tax exemption availed by the PLC and deemed such gains as profits and gains of the successor LLP.
- For determining the gains taxable due to such conversion, the TO considered, fair market value (FMV) of the assets transferred as full value of consideration.
- Further, the claim of the taxpayer LLP with regard to “carry forward” of depreciation loss of the erstwhile company was also rejected by the TO.
- The taxpayer also raised the claim of deduction under section 80-IA of the Act (tax holiday specific to power generation) during the assessment filing relevant audit report to justify the claim, which was also rejected by the TO on the basis that the said report was not filed with the return of income.
- On appeal the First Appellate Authority (FAA) agreed with the TO’s contention and held that such conversion was a “taxable transfer.” FAA observed that the taxpayer was not eligible to claim tax exemption provided under section 47(xiiib) of the Act on conversion from PLC to LLP, as the sales of the erstwhile company were more than INR 6 million.
- However, the FAA agreed with the taxpayer’s claim that in the absence of any consideration involved in the conversion of the PLC

<sup>1</sup> ITA No. 3637/ Mum/ 2015

into an LLP, the machinery for computation of “capital gain” would be rendered unworkable.

- With regard to carry forward of depreciation loss, the FAA observed that the taxpayer was not eligible to carry forward the losses incurred by the erstwhile PLC.
- The FAA allowed the taxpayer’s tax holiday claim even though the same was not claimed in the return of income filed.
- Aggrieved by the observations of the FAA, the Revenue appealed before the Tribunal.

#### **Issues before Tribunal**

- Whether the conversion of PLC into LLP would be a transfer chargeable to tax, as the conditions laid down for tax neutrality were not complied with?
- Whether the full value of consideration with respect to such transfer would be ‘book value’ or ‘FMV’ as computed by the TO?
- Whether such gain, if any are liable to be taxed under section 47A(4) of the Act (i.e. if exemption conditions are not fulfilled) in the hands of LLP in the year of conversion?
- Whether the losses incurred by the PLC can be carried forward by the successor LLP, although such conversion is not in accordance with the tax neutral provisions?

#### **Taxpayer’s contention**

- On conversion of PLC into LLP and grant of registration as LLP under the LLP Act, 2008, all the tangible and intangible

property, including assets, interests, etc., stands vested in the LLP without any further assurance, act or deed.<sup>2</sup> Thus the term – transfer used in the definition of the term ‘convert’ in clause 1(b) of the – Third Schedule as per the LLP Act 2008 cannot be read as ‘transfer’ under the Transfer of Property Act, 1882.

- The conversion of a PLC into LLP involved only a change of cloak, and by no means could be construed as a “transfer” under the Transfer of Property Act, 1882 or the Act.
- If there was a transfer, it was of the undertaking, which had no determinable cost of acquisition, and hence, no capital gain was chargeable in the hands of the taxpayer.<sup>3</sup>
- In absence of appropriate charging and computation sections, mere ineligibility for claim of exemption under section 47(xiiib) of the Act cannot lead to the creation of a charge.<sup>4</sup>
- As no consideration was involved in the conversion, the machinery provision for computing the capital gains tends to be unworkable.
- Since the taxpayer claimed no exemption under section 47(xiiib) of the Act, the issue of its withdrawal by invoking section 47A of the Act would not arise.
- Section 47(xiiib) read with section 47A of the Act cannot be construed to read a fiction, to the effect that the income not liable to be taxed as capital gains can be deemed as capital gains.<sup>5</sup>

#### **Department’s contentions**

- The sales of the erstwhile company in the prescribed period was more than INR 6 million. Since the condition is not fulfilled, hence it leads to a taxable transfer.
- Conversion of the PLC into an LLP involved two separate and distinct entities. Thus, it was incorrect to state that in the absence of co-existence of the “transferor” and “transferee” the transaction was not taxable as “capital gains.”

#### **Tribunal’s ruling**

##### **Whether conversion from PLC to LLP is a taxable transfer**

- The Tribunal observed that the conversion of a PLC or unlisted public company into an LLP qualified as ‘transfer’ chargeable to tax and attracted levy of capital gains tax prior to insertion of tax neutral provisions (section 47(xiiib) of the Act).<sup>6</sup> The Legislature enacted the said provision in a way that such transfers, subject to fulfilment of conditions, shall not be regarded as ‘transfer’ for the purpose of section 45 of the Act.
- The Tribunal distinguished the landmark Bombay High Court (HC)<sup>3</sup> decision on this issue, which dealt with the conversion of a partnership firm into a company. While analysing so, the Tribunal observed the subsequent decision of the Bombay HC<sup>5</sup>, whereby it was observed that there was no express opinion on the point of ‘transfer’ based on part IX of the Companies Act, 1956.

<sup>2</sup> Section 58(4) of the Limited Liability Partnership Act, 2008 read with clause 4 and clause 6(b) of the Third Schedule to the of the Limited Liability Partnership Act, 2008

<sup>3</sup> CIT v. Taxspin Engg. & Mfg. Works [2003] 263 ITR 345 (Bom) and DCIT v. R. L. Kalathia & Co. [2016] 381 ITR 0180 (Guj)

<sup>4</sup> Elphinstone Spg. & Weaving Mills v. CIT [1955] 28 ITR 811 (Bom) and The Deccan

Cements Product Company 8 STC 100 (Bom)

<sup>5</sup> CIT v. Umicore Finance Luxembourg [2017] 291 CTR 174 (Bom)

<sup>6</sup> Memorandum to Finance Act, 2010

- It also noted that such conversion involves the transfer of property, assets, etc., based on the definition of the term “convert,” as per the LLP Act, 2008 as against the Companies Act, 1956.
- In light of the above, conversion of PLC into LLP qualifies as ‘transfer’ under the Act.

*Whether capital gains were leviable on conversion from a company into LLP*

- Various courts have held that sections 45 and 48 of the Act are to be read together, as the charging section and computation section constitutes one package.<sup>7</sup>
- Further, relying on the Supreme Court’s decisions,<sup>8</sup> the Tribunal also observed that the expression “full value of consideration” could not be construed as the market value of the asset on the date of transfer, but it shall mean the price bargained for by the parties to the transactions. In the instant case, the price at which the assets and liabilities were vested in the LLP was the book value. Such book value could only be regarded as the full transfer value of the undertaking.
- With regard to the cost of acquisition of the undertaking, the Tribunal states that when the capital assets became the property of the taxpayer by succession, inheritance or devolution, the cost of acquisition of the assets should have been deemed to be the cost for which the previous owner of the property

had acquired them. Various judicial precedents also support this principle.<sup>9</sup>

- Thus, the Tribunal held that although there was a transfer of capital asset from the erstwhile PLC to the LLP, as the difference between the transfer value and the cost of acquisition was nil, the machinery provision was rendered unworkable while computing the capital gains.

*Whether such gain, if any are liable to be taxed under section 47A(4) of the Act (i.e. if exemption conditions are not fulfilled) in hands of LLP, at time of conversion itself?*

- The Tribunal held that section 47A(4) of the Act can only be invoked to withdraw an exemption already availed by the taxpayer, and hence, since no exemption under section 47(xiiib) was claimed, there was no question of its withdrawal.
- The deeming fiction therein, facilitating the assessing of profits and gains arising from the transfer of capital assets in the hands of the LLP would also not be applicable as per section 47A(4) of the Act.
- However, considering the succession provisions<sup>10</sup>, the successor LLP which carries on business of the predecessor company was liable to tax in respect of the profits and gains of the predecessor company, including the gains arising on succession of the company into an LLP. Since, on conversion, the company stood dissolved, the capital gains arising to the predecessor

company on conversion was taxable in the hands of the successor LLP/ taxpayer.

*Whether carry forward of losses will be permissible under section 72A(6) of the Act if exemption under section 47(xiiib) of the Act is not available due to non-satisfaction of the conditions*

The Tribunal held that there was a statutory pre-condition that the tax neutral provisions should be complied with for availing the accumulated losses as well as unabsorbed depreciation. As the taxpayer did not satisfy the conditions for purpose of exemption owing to the non-fulfilment of the sales threshold condition, the carry forward of losses incurred by the erstwhile PLC was not permissible in the hands of the successor LLP.

*Allowability of tax holiday on the claim put forth during the assessment proceedings*

The Tribunal agreed with the observations of the FAA to hold that filing of audit report to claim tax holiday was procedural and directory in nature, and allowed the tax holiday claim.

**The takeaways**

The ruling comments on various litigative areas relating to the taxability of conversion of PLC to LLP in case the conditions prescribed under section 47(xiiib) of the Act are not complied with. This ruling clarifies that even if there is conversion of PLC into LLP which is not tax neutral due to non-satisfaction of prescribed conditions, such transfer happened at book value, and hence, the computation mechanism for capital gains fails, and the tax liability becomes nil.

<sup>7</sup> CIT v. Taxspin Engg. & Mfg. Works [2003] 263 ITR 345 (Bom), CIT v. B. C. Srinivas Setty [1981] 128 ITR 294 (SC), Navin Jindal v. ACIT [2010] 320 ITR 708 (SC)

<sup>8</sup> CIT v. George Henderson & Co. Limited [1967] 66 ITR 622 (SC) and CIT v. Gillanders Arbuthnot & Company [1973] 87 ITR 407 (SC)

<sup>9</sup> CIT v. Manjula J Shah [2013] 355 ITR 474 (Bom), Hindustan Aluminium

Corporation Limited v. CIT [1986] 159 ITR 673 (Cal), CIT v. Budge Budge Amalgamated Mills Limited [1980] 122 ITR 561 (Calcutta )

<sup>10</sup> Section 170(1)(b) of the Act

One needs to consider this ruling in light of subsequent provisions introduced in the income-tax law which requires the determination

of FMV of the asset in case the consideration is unascertainable for any transfer of assets.

***Let's talk***

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

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