SUCCESSION OF PROPRIETARY FIRM INTO COMPANY – SECTION 47(XIV)

CA Khyati Thapa
Email : khyati@cgca.india.com

Choosing between a Sole Proprietorship and a Private Limited Company involves various factors, including legal, financial, and operational considerations. This article deliberates the nuances in relation to succession of a proprietary firm into Company. Let us first delve into the rationale for such conversion and then explore the relevant provisions of the Income Tax Act.

Initial Opting for Sole Proprietorship:

1. **Ease of Setup:** Sole Proprietorships are simple to establish, requiring minimal legal formalities, thereby appealing to individuals looking to start small businesses quickly with minimal overhead.
2. **Control:** As the sole owner, the proprietor has full control over business decisions and operations. This level of autonomy attracts entrepreneurs wanting complete authority over their ventures.
3. **Lower Costs:** Operating as a Sole Proprietorship typically involves fewer administrative costs and compliance requirements compared to incorporating a company.
4. **Tax Simplicity:** Business profits are taxed at the individual owner's personal tax rate. This can result in simpler tax filings and potentially lower overall tax liabilities.
5. **Flexibility:** Sole Proprietorships offer flexibility in terms of decision-making, business structure, and operations. Entrepreneurs can adapt quickly to changing market conditions and pivot their business strategies as needed.

As business develops, the demands of business world and downsides of sole ownership could constrain its growth. Converting into a company is a significant step for entrepreneurs seeking to expand their business and reap the benefits of a corporate structure. While a proprietorship offers simplicity and easy setup, transitioning to a company provides many advantages highlighted below.

Reasons for Converting Sole Proprietary Business into Company:

1. **Limited Liability:** Companies are distinct legal entities, meaning the owners (shareholders) have limited liability for the company's debts and obligations. This separation protects personal assets from business-related liabilities, which becomes increasingly important as the business grows.
2. **Access to Capital:** Companies have better access to external funding sources, such as venture capital, angel investors, and bank loans. Investors often prefer investing in companies with a formal corporate structure as it provides transparency, governance and accountability.
3. **Public Perception:** A corporate structure can enhance the business's credibility and perceived stability in the eyes of customers, suppliers, and partners. It signals a level of commitment and professionalism that can facilitate business relationships and attract higher-caliber employees.

4. **Expansion and Growth Opportunities:** Corporate structure offer greater scalability and expansion opportunities as it allows for the issuance of additional shares, bringing in new investors, and facilitating mergers and acquisitions, all of which can fuel growth and expansion initiatives.

5. **Perpetual Succession:** Converting to a Company enables better succession planning and continuity of the business beyond the owner's lifespan. With clear corporate governance structures and the ability to transfer ownership through share transfers, the business can continue operating smoothly even in the owner's absence.

Disadvantages on Conversion:

Yet, the decision is not without its complexities. Shift to a corporate structure introduces a few disadvantages as under:-

1. **Diffusion of power** and a potential **loss of independence** for the business owner
2. **Statutory Compliance:** Because the laws, regulations, and guidelines under the Companies Act, 2013 govern the operation of a company, compliance formalities are a lot higher
3. T**ax on Withdrawal of Profits:** Dividend Tax on distribution of profits
4. **Data Exposure to Public:** Financial Data available in public domain
5. Difficulty in **Winding up** the Company

One Person Company:

Another option that can be explored by a sole proprietor who intends to attain a corporate structure without any intention of bringing in other members or investors is to get it's business converted into One Person Company (OPC). Companies Act 2013 defines OPC as a company which has only one person as a member. OPC in India presents various advantages, such as

1. Limited liability
2. Separate Legal Entity
3. Perpetual Succession (subject to nominee chooses to become its sole member on death of the promoter member)
4. Easy transferability of Ownership by transfer of shares
5. Fewer Compliance Requirements as compared to a Company
6. Enhanced credibility
7. Improved Funding Opportunities
8. Professional Image
9. Ease of ownership transfer

Having briefly discussed the pros and cons of a corporate structure, we shall now discuss the route of conversion of a proprietorship firm into a company and its tax implications.

Process of Conversion:

Section 366 to 374 of Part I of Chapter XXI of Companies Act, 2013 deals with Companies that are capable of being registered under the Companies Act. As per Section 366(1) of the Companies Act, the word **"company" includes any partnership firm, limited liability partnership, cooperative society, society or any other business entity formed under any other law for the time being in force** which applies for registration under this Part. Since proprietary concerns are not formed, registered or governed by any law or statute, the same will not get covered under Chapter XXI of the Companies Act.

Section 368 of the Companies Act, 2013 states that **all property, movable and immovable** (including actionable claims), **belonging to or vested in the predecessor entity** in pursuance of this Part, **shall, on such registration, pass to and vest in the company as incorporated under this Act.** Since the proprietary concern, not being governed by any statute, cannot be converted into a Company under Chapter 21 of the Companies Act, it can be inferred that the property belonging to the proprietary concern **shall not vest but gets transferred to the Company.** As a normal practice, the proprietary concern firm can be taken over by a new or existing company by outright sale of the business as a going concern. Below are the broad steps for conversion of a proprietary concern into a company:

1. **Company Formation:** The process involves first forming a company and then taking over the sole proprietorship by transferring its benefits and liabilities through a Memorandum of Association (MoA). The MoA needs to carry the object **"The takeover of a sole proprietorship".**

2. **Agreement:** A formal **slump sale agreement or business takeover agreement** to be documented between the sole proprietor and the company post Company Registration. The agreement outlines the terms and conditions of the transition and how to transfer the Capital in the way of subscriber to MOA, agreement should also specify the effective transition date for smooth conversion.

3. **Shareholding Structure:** The shareholding structure is a critical aspect. The proprietor's shareholding in the company should not be less than 50% of the voting power, and this ownership structure to be maintained for a period of 5 years in order to claim the exemption u/s 47(xiv) of the Income Tax Act which is discussed later in this Article.

4. **Transfer of assets and liabilities:** All properties, assets, and liabilities of the sole proprietorship to be meticulously transferred to the company subject to agreed terms along with cash at bank / hand. This ensures a comprehensive transfer of ownership and control. The sole proprietor should ensure that he closes old bank accounts tied to the sole proprietary business, opens new accounts in the name of the Company and redirect all financial transactions to the new accounts.

5. **Surrender all associated registration certificates and licenses by the proprietor:** The proprietor should intimate all relevant authorities where business has been registered, surrender all associated registration certificates and subsequently reapply for licenses and permits in the name of the Company. This ensures transparency and a seamless transition to the regulatory bodies.

6. **Contracts / Leases:** All contracts, service agreements, and leases to be updated or re-signed under the company.

Tax Implications:

Section 2(47) of Income Tax Act suggests that for an event to be considered a **transfer**, there must be **simultaneous existence of a "transferor"** (person relinquishing the property) **and a "transferee"** (person acquiring the property). Both parties must exist concurrently for the transaction to be considered a transfer. **Conversion under Part I of the Companies Act** mentions about statutory vesting of the assets and hence **cannot be considered as transfer** as the predecessor stands converted and dissolved i.e. it ceases to exist and the newly incorporated company comes into existence. This is also supported by the H'ble High Court of Bombay in the case of **Texspin Engg. & Mfg. Works** where it has been held that succession of a partnership firm (which is akin to an LLP for income-tax purposes) by company was not taxable transfer as it was a case of statutory 'vesting' of property upon the converted company.

Since conversion of sole proprietary concern is out of purview of Part I conversion under Companies Act, **transfer of Sole Proprietorship business to Company triggers capital gains tax in the hands of the Sole Proprietorship owner for the transfer of assets.** However, within the tangle of tax regulations lies a beacon of opportunity: **Section 47(xiv) of the Income Tax Act.** This provision was introduced by the Finance (No. 2) Act, 1998 w.e.f. 1.4.1999 with a view to provide incentives and to promote corporatisation of proprietorship business. It offers a vital lifeline for individuals navigating the transition from a Sole Proprietorship to a Company, potentially granting them tax exemptions on transfer of assets.

Nonetheless, such a transfer will involve payment of stamp duty on the transfer of assets which will depend on whether it is an itemized sale or a slump sale unlike Part I conversion where stamp duty would not have been payable since it is a statutory vesting of assets.
Intention:

The intention behind introducing the provisions of Sec 47(xiv) has been explained in the Explanatory Notes

on the provisions of Finance (No. 2) Act, 1998 vide CBDT circular no. 772 dated 23.12.1998. These are summarized as under:

1. Business reorganizations have specific tax implications including levy of capital gains. Transfer of assets attracts levy of capital gains tax;
2. Similarly carry forward of losses and depreciation is not available to successor business entities;
3. In the case of amalgamation, capital gains is not levied and unabsorbed business losses and depreciation is available subject to certain conditions;
4. The expert group has recognized the need to encourage business reorganization when they are in consonance with economic development and not merely the devices to secure tax advantages.

Section 47(xiv):

For the sake of reference the provisions of S. 47(xiv) are reproduced herein:

S. 47 (xiv)-" where a sole proprietary concern is succeeded by a company in the business carried on by it as a result of which the sole proprietary concern sells or otherwise transfers any capital asset or intangible asset to the company:

Provided that—

(a) all the assets and liabilities of the sole proprietary concern relating to the business immediately before the succession become the assets and liabilities of the company;

(b) the shareholding of the sole proprietor in the company is not less than fifty per cent of the total voting power in the company and his shareholding continues to remain as such for a period of five years from the date of the succession; and

(c) the sole proprietor does not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company;"

Section 47(xiv) provides exemption from the applicability of capital gains u/s 45 by holding that the **transactions specified in sec 47(xiv) will not be regarded as transfer on satisfaction of the conditions** mentioned therein. The presence of a "transfer" is indeed a prerequisite for the taxability of capital gains. Accordingly, **when the transaction is not considered a "transfer," capital gains tax liability will not arise.**

Furthermore, since conversion u/s 47(xiv) takes the transaction out of the purview of section 45 which is the charging section for capital gains, corresponding sections like section 50 (capital gain on sale of depreciable asset), section 50B (capital gain on slump sale) and section 50C (capital gain on sale of land or building or both) will also not get triggered.

Scope of Section 47(xiv):

For Section 47(xiv) to trigger following events needs to occur:-

1. There has to be a conversion from proprietary concern to a company;
2. The succession has to be in the business carried on by the proprietary concern and
3. As a result of the succession / conversion, there has to be a transfer of capital asset or intangible asset from the proprietary concern to the company

Interpretation:

- **Transfer** would be as per definition of transfer u/s 2(47) of Income Tax Act
- **Capital Asset** would be as per definition of capital asset u/s 2(14) of the Act. The term capital asset has a wide meaning and includes every kind of property as generally understood except those that are expressly excluded in the definition.

  "A **business undertaking as a whole** would constitute a capital asset" - Syndicate Bank Ltd. v. Addl. CIT [1985] 155 ITR 681/[1986] 29 Taxman 32(Kar.)

  "A business as a going concern would constitute a capital asset" – CIT v. F.X. Periera & Sons (Travancore)(P.) Ltd. [1990] 184 ITR 461/[1991] 55 Taxman 242 (Ker.).

- Succession by the Company has to be in respect of the business carried on by the proprietary concern. In cases, where the sole proprietary concern has different and independent businesses, there is a possibility to claim exemption u/s 47(xiv) in respect of one of the business which is transferred to the Company and the other business can be continued by the proprietary concern. However, the Assessee should be able to substantiate that the two businesses are distinct and not dependent on each other in terms of operations and finance. Also it would be difficult in claiming exemption u/s 47(xiv) in case of succession in respect of profession.

- There is a potential possibility to transfer each capital asset or intangible asset by way of itemized sale instead of slump sale. However, in that case since stock has been specifically excluded from the definition of capital asset, it would be difficult to transfer stock separately and hence should be recommended to transfer the business as a whole in its entirety.

Conditions for claiming exemption u/s 47(xiv):

1st Condition – 47(xiv)(a): all the assets and liabilities of the sole proprietary concern relating to the business immediately before the succession become the assets and liabilities of the company

- No individual asset or liability can be omitted or excluded. Each asset and liability must be accounted for and compulsorily transferred.
- Only assets and liabilities directly associated with the business should transit to the company. Assets or liabilities unrelated to the business, such as investments made from surplus funds, may not be required to transfer. However, it's the responsibility of the assessee to demonstrate that such assets or liabilities are indeed unrelated to the business.
- In case certain assets relating to the business like immovable property are not intended to be transferred, its advisable to handle these matters prior to conversion. This could involve transferring the asset to another party and settling the liability beforehand.

2nd Condition – 47(xiv)(b): the shareholding of the sole proprietor in the company is not less than fifty per cent of the total voting power in the company and his shareholding continues to remain as such for a period of five years from the date of the succession

First Part – Initial Fulfillment: This part of the condition must be met either during the succession of the business or immediately thereafter when shares are allotted as per condition 2.

- Reference is given to voting power and not number of shares. In scenarios where shares with differential voting power are issued, the number of shares held may not directly correlate with the voting power.
- The requirement does not specify that the 50% ownership must be issued solely due to succession. Therefore, if the sole proprietor already held shares in the company before additional shares are allotted to him upon succession, the requirement could be considered fulfilled. The primary intent is to ensure that provisions such as S. 47(xiv) are not utilized to transfer ownership to a different set of shareholders other than the proprietor.
- The condition does not specify the timing for fulfilling the 50% ownership requirement. It should be ensured that compliance with this requirement is made either on the date of succession or, at the very least, at the time shares are allotted in consideration of succession. This approach ensures clarity and minimizes any potential ambiguity regarding compliance with regulatory requirements.

  In the case of IT0 Vs. Shri Sanjay Singh (ITAT Delhi) it was held that “as entire consideration was shown as share application money and shares were issued against the same and same was continued to be held for more than 5 years, the condition prescribed in Section 47(xiv)(b) is also satisfied. Merely because there is a delay in the allotment of shares against the share application money, it cannot be said that there is a violation of clause (b) of Section 47(xiv) of the Act”.

Second Part – Ongoing Compliance: The second part of the condition must be fulfilled continuously for a period of five years following the conversion.

- The requirement for maintaining the 50% shareholding serves a critical purpose to prevent any change in economic control post conversion and to ensure that the benefits provided by legislation aren't exploited to transfer ownership to a different set of shareholders for the purpose of tax avoidance. By maintaining the majority ownership with the proprietor, the intended tax benefits are appropriately directed to those who are genuinely continuing the business operations; thereby safeguarding against any misuse of tax provisions.
- Corporate actions involving restructuring of business, such as mergers, demergers, or sale of business assets, require careful scrutiny to ensure compliance with the conditions outlined in S. 47(xiv). Failure to adhere to these conditions could result in the withdrawal of exemptions under S. 47A. If the company merges with another entity within the five-year period, it may violate the conditions of S. 47(xiv) unless the shareholding of the proprietor is maintained.

3rd Condition – 47(xiv)(c): the sole proprietor does not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company

This condition implicitly implies that he solely receive shares in the company and no other form of consideration whatsoever. Any arrangements, such as appointing the proprietor as working director and providing him with remuneration or renting property owned personally by the proprietor, cannot be construed as a "benefit" flowing to the proprietor resulting from the succession.

The Hon'ble ITAT in the case of Asst. CIT v. Nayan L. Mepani (Mum) (2012) 49 SOT 641 (Mumbai) held that the intangibles arising on the transfer u/s 47(xiv) does not violate the provisions and resultantly the amounts considered under the transfer needs to be taken as the cost of acquisition for the purposes of depreciation. **Exemption u/s 47(xiv) cannot be denied on receipt of higher number of shares by sole proprietor on conversion into corporate entity because of revaluation of assets and cannot be treated as consideration or benefit received other than by allotment of shares.**

The Mumbai High Court in the case of Kantilal Gopalji Kotecha held that **goodwill that was not recorded in the books of a sole proprietary concern, but which arose on conversion of the proprietary concern into a company, was not exempt u/s 47(xiv)** of the Income-tax Act, 1961 (the Act), but would be taxable in the hands of the sole proprietor under the head, "Capital Gains".

Violation of Conditions – Withdrawal of Exemption – Sec 47A(3):

- In case any of the conditions laid down in sec 47 (xiv) are not complied with, the amount of profits or gains arising from transfer of such capital asset or intangible assets shall be chargeable to tax.
- Further, such amount shall be deemed to be profits and gains chargeable to tax in the hands of company for the previous year in which the conditions prescribed u/s 47(xiv) of IT Act are violated.

Other Key Tax Provisions:

- **Pro-rata Depreciation:** The aggregate depreciation allowable to the proprietary concern and company shall not exceed the depreciation calculated at the prescribed rates as if the conversion had not taken place. Which means in the year of succession, the depreciation on the assets held by the proprietary concern and transferred to the Company would be available to both based on no. of days for which the said assets were used by the proprietor and the company.

- **Accumulated Losses and Unabsorbed Depreciation Section 72A(6):**
  - Subject to fulfillment of conditions u/s 47(xiv), the accumulated loss and unabsorbed depreciation of the proprietary concern shall be deemed to be the loss or depreciation allowance of the company for the purpose of previous year in which conversion was effected.
  - Further, other provisions of the IT Act relating to set off and carry forward of loss and unabsorbed depreciation shall apply accordingly.
  - In case any of the conditions prescribed u/s 47(xiv) are not complied with, any accumulated loss or unabsorbed depreciation utilized by the company, shall be deemed to be the income of the company and chargeable to tax in the year in which such conditions are violated.
  - The term "accumulated losses" has been defined to refer to business losses, which the proprietary concern was entitled to carry forward. Hence, lapsed losses of the concern cannot be transferred.
- **Cost of Assets on which depreciation has not been claimed:**
  - When non-depreciable assets like land are transferred from a sole proprietorship to a company, the price paid by the successor company would be considered the cost for the purpose of computing capital gains.
  - Provision of section 49(1)((iii)(a) states that where the capital asset became the property of the assessee by succession, inheritance or devolution, the cost of acquisition of the asset in the hands of the predecessor becomes the cost in the hands of the successor.
  - Correspondingly as per Explanation 1(b) of section 2(42A), the period of holding of the predecessor shall become the period of holding of the successor.
  - Question arises whether succession would mean succession only on death or would cover succession on transfer of business. The scope of terms such as "succession," "inheritance," and "devolution," traditionally refer to the passing of property upon the death of an individual or through other legally recognized mechanisms such as inheritance laws or estate planning arrangements. If such normal sale of business involving succession to business are covered within the scope of S. 49(1)(iii)(a) then it would create tremendous hardships. The acquirer having paid the price would not be entitled to claim the cost as deduction. According to the principle of noscitur a sociis, when two or more words that are capable of analogous meanings are used together in a statute or legal provision, the words can influence or "take color" from each other. There are various supreme court judgements that have laid down the same analogy in different contexts. Hence it can be strongly argued that the term succession should be limited to succession arising due to death, liquidation or winding up or by other process of law.
- **Cost of Acquisition of shares in the hands of the proprietor:**
  - No specific provision has been included to determine the cost of acquisition of shares of the company. In most cases, the succession u/s. 47(xiv) would be by way of sale or assignment agreed to at a specified price / amount – either by way of itemized sale or slump sale. The proprietor would be allotted specified number of shares at a specified price. This would be the cost of in his hands for the purpose of onward sale in future.

- **Period of Holding of shares in the hands of the proprietor:**
  - No specific provision has been included to determine the period of holding of capital asset being shares of the company. However, one may consider period of holding from the date when shares were issued and received by the shareholder.
- **Whether section 56(2)(x) can be invoked to the buyer of the business undertaking (Company in case of conversion) under slump sale u/s 50B?**
  - Deeming fiction of section 56(2)(x) is applicable to sum of money, capital asset being movable and immovable property. "Property" has been exhaustively defined to include various asset but has not specifically covered "business undertaking" acquired under slump sale.
  - The distinctive feature of a slump sale is that individual values are not assigned to the assets and liabilities being transferred. The transaction is treated as a whole, with a single consideration amount agreed upon for the entire undertaking.
  - Where the Company purchases the business for a lumpsum consideration and records the value in its books as per purchase price allocation, whether section 56(2)(x) can be invoked if value of property (as per the Rules) is more than the value assigned pursuant to purchase price allocation?
  - Explanation 2 to section 2(42C) ensures that valuation of assets and liabilities for stamp duty or registration fees does not affect its treatment as a slump sale for income tax purposes.
  - Proviso to clause 56(2)(x) provides that the section will not be applicable in case of transfer of asset from company to its subsidiary or in cases of amalgamation, scheme of demerger, etc. Conversion u/s 47(xiv) has not been included in the proviso.
  - Absence of the term "undertaking" in the definition of "property" limits the applicability of the deeming provisions of Section 56(2)(x) to transactions involving assets such as immovable property and would not apply to transfer of an undertaking in slump sale u/s 50B.
  - In the context of a slump sale, where entire undertaking is transferred for a lump sum consideration without assigning individual values to assets and liabilities, the argument posits that the computation mechanism prescribed u/s 56(2) fails. This is because there's no feasible way to determine the FMV of individual assets in such a transaction.

Conclusion:

As India experiences an economic boom over the coming decades, there's a prevailing expectation that the corporate form of business will rise in popularity. This trend is driven by the corporate structure's inherent ability to scale up and facilitate growth effectively. In this context, the process of corporatisation plays a crucial role.