Conversion of Company into LLP, Sole Proprietorship/ Partnership Firm into Company

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This article discusses the nuances related to the conversion of the company into LLP. We shall first understand the rationale for converting a company into LLP, followed by the relevant provisions of the LLP law dealing with conversion of company into LLP and thereafter the implications under the income-tax law relating to the conversion in the hands of the company, LLP and shareholders.

1. Rationale for Conversion - Why select LLP over a Company?

1.1 In this article we are mainly going to discuss on the conversion of a company into a Limited Liability Partnership ('LLP'). Before we get into our discussion on the key aspects related to the conversion and the tax implications thereof, it is imperative to consider the rationale for conversion of a company into LLP particularly considering the case that the tax rates applicable to companies have been extensively slashed. As we are aware that with the introduction of the new corporate tax regimes under the framework of section 115BAA and section 115BAB of the Income-tax Act, 1961 ('IT Act') the base tax rates applicable to a company have been reduced to 22% and 15% respectively, though this comes with some conditions and restrictions which require a taxpayer company to forego various deductions. Considering that the tax rates have been reduced for a company, whether the LLP framework still proves to be effective and attractive enough? Let us examine this through a simple illustration:

Taxation in hands of Company				
Particulars	**Normal**	**Turnover less than 400 crs**	**115BAA**	**115BAB**
Total income	100.00	100.00	100.00	100.00
Base Tax rates	30.00%	25.00%	22.00%	15.00%
Tax rates	34.94%	29.12%	25.17%	17.16%
Tax liability of Co. (A)	**34.94**	**29.12**	**25.168**	**17.16**
Surplus	65.06	70.88	74.83	82.84
Surplus distributed by way of Dividend	65.06	70.88	74.83	82.84
Balance	-	-	-	-

Taxation in hands of Shareholders					
		Dividend Model			
Taxable Income		65.06	70.88	74.83	82.84
Tax liability of shareholders (B)	**35.88%**	**23.34**	**25.43**	**26.85**	**29.72**
Total tax liability (A+B)		**58.29**	**54.55**	**52.02**	**46.88**
Effective tax rate		**58.29%**	**54.55%**	**52.02%**	**46.88%**
		Buy Back Model			
Distributable Surplus		65.06	70.88	74.83	82.84
Buy back tax rate (C)	**23.30%**	**12.29**	**13.39**	**14.14**	**15.65**
Effective Buy back tax rate		18.89%	18.89%	18.89%	18.89%
Buy back proceeds received (exempt in hands of shareholders)		52.76	57.49	60.69	67.19
Total tax liability (A+C)		**47.24**	**42.51**	**39.31**	**32.81**
Effective tax rate		**47.24%**	**42.51%**	**39.31%**	**32.81%**

Taxation in hands of LLP	
Particulars	Amount
Total income	100.00
Base Tax rates	30.00%
Tax rates	34.94%
Tax liability of LLP (D)	**34.94**
Surplus	65.06
Surplus distributed as Share of	
Profit	65.06
Balance	-

Taxation in hands of Partners	
Particulars	Amount
Total income – exempt	100.00
Tax liability of Partner (E)	**0.00**
Total tax liability (D+E)	**34.94**
Effective tax rate	**34.94%**

Entities with low tax rate – Company v. LLP:

Co. vs. LLP	Normal	Turnover less than 400 crs	115BAA	115BAB
Dividend Model	LLP	LLP	LLP	LLP
Buy Back Model	LLP	LLP	LLP	Co.

1.2 From above illustration it can be seen that in a case where the funds are not needed to be reinvested and deployed for purposes of business and are instead distributed to the stakeholders either by way of dividend or buy back model, then the aggregate tax liability in hands of the company and the shareholder works out higher than that the aggregate tax liability applicable to a LLP and its partners, except in a case where the company has opted for section 115BAB regime and funds are distributed by way of buy-back. However, it is to be noted that the buy-back model comes with the restriction on the amount that can be bought back annually. Hence, considering the above parameters, LLP framework may prove to be more tax effective as compared to a company and thus warranting us to explore the route for conversion of a company into LLP.

1.3 One may also keep in mind that in some cases especially a business owned by a single family, they may prefer not to distribute dividends over a longer period of time in which case a company may still be a preferred option. Further, company structure would be more effective and workable in cases where funding is sought to be raised from banks and financial institutions, raising funds from private equity investors, issuing debentures, listing on stock exchanges is to be undertaken, etc.

1.4 One of the key features that score well over the company is the ability of LLP to grant loans or accept loans/deposits from the partners and other parties. The LLP can easily accept loans and advances from any person, unlike a company that is required to comply with Companies (Acceptance of Deposit) Rules, 2014 which permits borrowings from only specific sources. Also, the provisions of deemed dividend contained in the IT Act do not apply to LLP, unlike a company.

1.5 Apart from the above tax and deposit rules consideration, incorporating LLP requires lesser legal compliances. Further, an LLP agreement offers more operational flexibility in structuring and managing LLP compared to a company bound by the memorandum of association and its articles of association. A company also has to undertake several statutory compliances such as holding general meetings, board meetings, maintaining registers, and much more which are not required in the case of LLPs. Unlike the shareholders in the case of a company, the partners of an LLP have the right to manage the business directly.

Having briefly discussed the advantages of the LLP, we shall now discuss the route of conversion of a company into an LLP and its tax implications in the hands of the company, LLP, and shareholders.

2. Conversion of Company into LLP – Provisions of the LLP Act:

2.1 The Limited Liability Partnership Act, 2008 ('LLP Act') permits the conversion of a private company and unlisted public company into LLP. The enabling provisions permitting the conversion into LLP are contained in section 55 of the LLP Act. Further, the framework for the conversion of a private company and unlisted public company into the LLP is contained in section 56 and 57 of the LLP Act read along with the Third and Fourth Schedules to the LLP Act, respectively. Section 58 of the LLP Act deals with the provisions relating to the registration of the LLP and the effect of conversion of an entity into LLP.

2.2 LLP Act permits conversion of a private company into LLP. Following are some of the key aspect of the LLP Act related to the conversion of company in to LLP:

- There is no security interest created in its assets and which is subsisting or in force at the time of application.
- The partners of the LLP to which it converts comprise all the shareholders of the company and **no one else.**
- Upon conversion, the shareholders of the private company, the LLP to which such company has converted, and the partners of LLP shall be bound by the provisions of the LLP Act read with rules.
- An application along with the specified documents is required to be filed with the Registrar of Companies ('ROC').
- The ROC on satisfying that a private company has complied with the provisions of the LLP Act read with relevant rules, shall register the documents submitted and issue a certificate of registration.
- From the date of registration specified in the certificate of registration:
  - o There shall be LLP by the name specified in the registration certificate;
  - o All tangible (movable or immovable) and intangible property vested in the company, all assets, rights, interests, privileges, liabilities, obligations relating to the company, and the whole of the undertaking of the company shall be transferred to and vest in LLP without further assurance, act or deed;
- The company shall be deemed to be dissolved and removed from the records of ROC.

- All deeds, contracts, bonds, agreements, applications, instruments, and arrangements subsisting immediately before the date of registration relating to the company **shall continue in force** as if they relate to the LLP and shall be enforceable by or against the LLP.

- Every contract of employment shall continue in force on or after the date of registration as if the LLP were a party instead of the company.

- Any approvals, licenses issued to the company under any other Act, which is in force immediately before the LLP is registered shall also continue in force as if they relate to the LLP. However, this is subject to the provisions of the respective Act under which such approval or license has been issued. It is sometimes observed that some government contracts or approvals are granted with the conditions that the tender applicant is a company and that there is specific debarring for the LLP. In such a case, extreme care should be taken at the time of deciding the conversion of the company into LLP.

- As the assets are vested in LLP on conversion, the transfer of the assets and liabilities is at book value.

3. Implications of stamp duty on the conversion of a company to LLP

The LLP Act does not expressly contain any provision relating to stamp duty. As per the provisions of the LLP Act on conversion the assets and liabilities of the company vest in and stand transferred to the LLP without any further assurance, act, or deed. Hence, given that there is no instrument, or a conveyance deed required for the transfer of assets from the company to the LLP and that the assets stand transferred pursuant to the framework of the LLP Act it may be a good case to argue that the stamp duty shall not apply on the conversion of company into LLP.

4. Conversion – Approach/ Alternative:

The conversion of a company into LLP can be undertaken through the following two approaches:

- Conversion under LLP Act carried out in accordance with section 47(xiiib) of the IT Act (tax compliant conversion)

- Conversion under LLP Act carried out without compliance of conditions prescribed in section 47(xiiib) of the IT Act (non-tax compliant conversion)

4.1 Approach 1: Conversion carried out in accordance with section 47(xiii b) of the IT Act (tax compliant conversion)

- The Finance Act, 2010 has inserted special provisions by way of section 47(xiiib) of the IT Act to incentivize the conversion of smaller companies into LLP. Subject to compliance with the conditions laid down, the provisions of section 47(xiiib) of the IT Act provide an exemption from taxation of capital gains both in the hands of the company and its share holders on account of the conversion of the company to LLP.

- The non-compliance of the conditions of section 47(xiiib) of the IT Act would trigger the taxability of the gain so treated as exempt at the time of conversion both in the hands of the successor LLP and the partners (shareholders) in the year in which such condition/s are not fulfilled.

- Compliance with each of the conditions of section 47(xiiib) of the IT Act is mandatory to avail exemption. There are overall six conditions, of which two conditions require compliance both at the time of conversion and for a further specified period.

- The conditions laid down under section 47(xiiib) of the IT Act are as under:

Conditions of Section 47(xiiib) of the IT Act and their Analysis

Condition 1: All the assets and liabilities of the company immediately before the conversion become the assets and liabilities of the LLP

Analysis:

The conversion of a company into LLP is in terms of the provisions of the LLP Act. In terms of the conversion framework specified in the LLP Act all assets and liabilities of the company automatically become the assets and liabilities of the LLP. Thus, compliance with this condition is relatively easy. However, if some asset/s are sought to be kept out of LLP, then before the conversion the same can be transferred out of the company. This condition requires to be fulfilled only at the time of conversion.

Notably, section 47(xiiib) of the IT Act provides for the conversion of a company into LLP, unlike section 47(xiii) and 47(xiv) of the IT Act which provides for succession by company in the business of the erstwhile partnership firm and sole proprietorship concern, respectively. Consequent to the requirement of conversion under section 47(xiiib) of the IT Act all the assets of the company are required to be transferred, whereas for cases covered by section 47(xiii) and 47(xiv) of the IT Act there is flexibility in this regard as the requirement is to only transfer the assets relating to the business of the firm immediately before the succession by the company.

While converting a company into LLP, care needs to be taken to ensure that soon after the conversion of the company into LLP, all the assets in the name of the company are effectively transferred in the name of LLP. Any follow-up required to achieve this ought to be undertaken. In a few cases where the assets are not transferred in the name of the LLP, one may be able to argue that by virtue of the process enshrined under the law, such transfer is deemed to have taken place. However, this may result into avoidable litigation and hence proactive compliance is preferable.

Condition 2: This condition lays down two requirements, namely:

1. all the shareholders of the company immediately before conversion become the partners of the LLP; and
2. capital contribution and Profit-Sharing Ratio ('PSR') in the LLP are in the same proportion as their shareholding in the company on the date of conversion

Analysis of sub-condition 1:

As per the conversion framework of the LLP Act, partners of the LLP shall be all the shareholders of the company and no one else. Hence, this condition of section 47(xiiib) of the IT Act shall be easy to comply with.

However, the important factor to keep in mind is that '*all the shareholders of the company shall become partners of LLP*' thereby requiring both equity and preference shareholders to become the partners in the LLP. This may not be of concern, where the equity and preference shareholders are the same parties. However, this could be of concern if the preference shareholders are parties different from equity shareholders. The company in such a case can evaluate redeeming the preference share capital before undertaking conversion.

Further, as per section 5 of the LLP Act, only individuals or body corporate may become a partner in LLP. Hence a HUF through its Karta cannot become a partner in the LLP. In a scenario where the shares of the company are held by the HUF, then before conversion, the shareholding of HUF in the company should be aligned to ensure compliance with the requirement of the LLP Act as well as section 47(xiiib) of the IT Act.

Analysis of sub-condition 2:

As per this condition, the capital contribution and PSR of the shareholders in the LLP (upon becoming the partner on conversion) shall be in the same proportion as their shareholding in the company. There may arise some difficulty in complying with this condition if the company has issued both equity as well as preference shares to different parties or where the equity and preference shares are issued in different proportions. There could be different approaches to look at the compliance of this condition, namely:

Approach 1: Since only equity shareholders have voting rights in the company, subject to exceptional cases, therefore on conversion into LLP the PSR shall also be in line with the equity capital of the company. The preference shareholders may be passed on returns by way of fixed coupon interest proportionate to their entitlement to the dividend as preference shareholders. However, this interpretation does not flow from the literal reading of the provisions of section 47(xiiib) of the IT Act. Since there is no ambiguity in the language of section 47(xiiib) of the IT Act this approach may not stand the compliance test.

Approach 2: The PSR, as well as capital contribution, could be decided by aggregating the equity and preference share capital of the company before the conversion. This could be a simple approach however this will put both the equity and the preference shareholders at par and hence may not be equitable. Nevertheless, it shall ensure compliance with the condition.

Approach 3: If possible, the preference shares may be redeemed before the conversion or be acquired by the equity shareholders.

Condition 3: Shareholders do not receive any consideration or benefit, directly or indirectly, in any form or manner other than by way of share in profit and capital contribution of LLP

Analysis:

- The purpose of this condition is to ensure that the shareholders under the style of conversion do not end up monetizing their shareholding. Hence, it is imperative that no consideration is passed on to the shareholders/ partners other than by way of capital contribution or share in profit.
- There is no specific requirement for complying with this condition for a continuous period. Further, the condition puts a restriction on the shareholder to not receive any other form of consideration. The status of shareholders is only up to the stage of conversion and that thereafter there is no shareholder but a partner. Hence, it could be possible to contend that this condition is to be complied with only at the time of conversion and that on and for conversion the shareholder should not receive any other consideration. However, out of abundant caution, one may exercise restraint and ensure that there is no questionable consideration passed on to the shareholders/ partners in the near period after conversion.
- However, this shall not restrict LLP to pay a justifiable amount of remuneration to the working (designated) partners. It could be also noted that the remuneration is allowable as per section 40(b) of the IT Act and that as per section 40(b) of the IT Act the remuneration is paid out of the profit of the LLP. Thus, if the profit is allowed to be paid to the partners, then the remuneration paid out of the profits of the LLP shall also be permitted to be given without being treated as in violation of the provisions of section 47(xiiib) of the IT Act. A similar principle should apply also to interest paid on partners' capital. Further, if the condition is to apply only at the time of conversion, then in such case the remuneration and interest paid after conversion should not be subject to limitation.

Condition 4: Aggregate of PSR of the shareholders of the company in the LLP shall not be less than 50% at any time during the period of 5 years from the date of conversion

Analysis:

- The rationale of this condition appears to ensure that for a period of five years the majority control over the LLP through PSR remains with the persons who were controlling the company immediately before the conversion and that they should not make a complete exit before 5 years.
- One may admit new partners, however, the admission shall not have the effect of reducing the aggregate PSR of all the existing partners in the LLP below 50%. In case the partners wish to admit new partners with PSR of such partner being in excess of 50%, then in such case, their admission as nominal shareholder/s in the company immediately before the conversion could be explored.
- It should be possible to forcefully argue that changes amongst the existing (shareholders) partners shall not have an impact on the compliance of this condition so long as on an aggregate basis the 50% threshold is always met. In other words, partners can undertake realignment of their existing PSR and that would not be violative of this condition.

- The condition requires that the aggregate PSR of the partners being the shareholders of the company is at least 50%. As discussed above, if the rationale of the condition is to ensure that control over the converted entity (LLP) remains with the (shareholders) partners for five years such that 50% of the profit get passed on to the shareholder partners, then it shall be sufficient compliance if at-least 50% of PSR of LLP is with any one or more of the (shareholders) partners but not necessarily all the shareholders of the company. Further, in this regard, one can also refer to the provisions of the General Clauses Act, 1897, wherein section 13 provides that the words in the singular shall include the plural and vice versa i.e., the plural shall include singular. Basis this provision of the General Clauses Act 1897 it can be contended that if singular can be interpreted to include many, and similarly if many (plural) can be read to mean singular, then the usage of the term 'shareholders' in section 47(xiiib) of the IT Act should not be strictly read as multiple shareholders. Even a single shareholder continuing to be a partner in LLP with PSR of 50% should suffice with the compliance of this condition. Alternatively, a safer view could be to ensure that all the shareholders of the company at the time of conversion continue to remain partner for said period of 5 years.
- Though the Supreme Court in the case of CIT v. Vegetable Products Ltd held that where two interpretations are possible, then the one which is beneficial to the assessee ought to be adopted. However, again the Supreme Court in the case of Commissioner of Customs (Import), Mumbai v. Dilip Kumar & Company [2018] 95 taxmann.com 327 (SC) held that the eligibility condition of the exemption/ incentive provision should primarily be interpreted in a strict manner. Though this ruling is in the context of the indirect tax law, the principle shall apply to the provisions of alike nature under the IT Act as well. Therefore, considering that the exemption is at stake, any position should be undertaken with utmost care and consideration.
- It is possible to argue that non-compliance of this condition owing to involuntary events such as the death of a partner may not be regarded as a violation of this condition. Impossibility in performance of condition cannot be read as a violation of condition.
- This condition is required to be fulfilled for a continuous period of five years from the date of conversion. It is to be ensured that at no point in time i.e., not even for a single day or moment this condition is breached.
- Further, as the conditions are required to be fulfilled for a period of five years, therefore it should be ensured that the LLP continues to exist during this period.

<u>Condition 5:</u>Total sales, turnover, or gross receipts in the <u>business</u> of the company in <u>any of the 3 previous years preceding the previous year</u> in which the conversion takes place does not exceed Rs. 60 lakhs

<u>Analysis</u>:

- Total sales, turnover, or gross receipts "in the business" are to be considered. Hence if some receipts like dividends, capital gains, etc. do not form part of the business, then they could be excluded in computing the limit of Rs. 60 lakhs. Further as per the CBDT circular No. 1/2011 [F. No. 142/1/2011-SO(TPL)], dated 6-4-2011 total sales, turnover, or gross receipts in the business of the company which are taxable under the head "Profits and gains of the business or profession" should be seen for testing the condition of Rs. 60 lakhs.

- Further, the turnover of the preceding three previous years is to be seen. Thus, if the turnover of the company in the year of conversion is more than Rs. 60 lakhs, then that should not disqualify such a company from seeking conversion as per section 47(xiiib) of the IT Act.
- If a company is in existence for a period of only two years, then it may be possible to argue that this test should be seen from the period since the company is in existence. The fact that three previous years have not been completed may not disqualify the company to avail benefit under section 47(xiiib) of the IT Act. Impossibility of performance of condition should not be regarded as case of breach of condition. A condition should be seen purposefully and objectively.

Condition 6: Total value of assets as appearing in the books of account of the company in any of the three previous years preceding the previous year in which the conversion takes place does not exceed five crore rupees

Analysis:

- This condition applies to all the assets including the current assets. Further, the amount of five crores rupees is to be seen qua gross value of assets i.e., without netting off the current liabilities.
- One should take care that the value of assets should not exceed five crores rupees at any point in time during this period of three years.
- Further, the value of assets of the preceding three previous years is to be seen. Thus, if the value of assets in the year of conversion is more than five crores, then that shall not disqualify such a company from seeking conversion as per section 47(xiiib) of the IT Act.
- While the section has used the term 'value' however since it is followed by the words 'as appearing in the books' have been used, it is the book value that ought to be considered. It is understood that the term 'as appearing in the books' is qua value of assets and not qua assets appearing in books.
- Where the assets are upward or downward revalued, should the revaluation impact be ignored? Section 47(xiiib) of the IT Act only uses the term 'book value', it nowhere provides for making an adjustment to exclude the revaluation impact. Unlike in section 50B of the IT Act where the assets where the proviso to Explanation 1 provides for ignoring the revaluation while working out the 'net worth'. Hence on a plane reading of the provisions, it may be possible to argue that in cases where the assets have been revalued, the value as appearing in the books should be considered. It goes without saying that where such revaluation may be the subject matter of questions, hence revaluation if any, should be adequately backed and justifiable.

Condition 7: No amount is paid, either directly or indirectly, to any partner out of the balance of accumulated profit standing in the accounts of the company on the date of conversion, for the period of 3 years from the date of conversion

Analysis:

- This condition requires that the accumulated profit standing in the accounts of the company should not be passed on to any partner/s directly or indirectly by the LLP. This puts restriction on all the partners i.e., even partners that would have been admitted after conversion. The rationale of this condition is that the accumulated profits of the company which were so far locked in the company and were subject to dividend taxation, should not be allowed to be withdrawn for a specified period.

- This condition needs to be complied with not just at the time of conversion but for a period of three years from the date of conversion.
- Out of abundant caution, the accumulated profits standing in the books of the company on the date of conversion can be parked and recorded in a separate account under separate nomenclature in the books of LLP for a period of three years during which this condition is required to be complied with. To this effect, suitable terms may also be recorded in the LLP agreement which would provide for restriction on withdrawal of said accumulated profits for the specified period. Further, the LLP agreement can also provide the manner of distribution of this amount amongst the partners upon the completion of the compliance period.
- Another notable point is that this provision puts restriction only on the withdrawal of accumulated profits. Hence a better view is that the amount of share capital, securities premium, etc. are not subjected to this restriction.
- Whether capitalization of the accumulated profits by the issue of bonus shares and subsequent withdrawal of such capitalized profits post-conversion is impacted by this condition? On a literal reading, where the accumulated profits are capitalized into share capital just before the date of conversion, such that there are no or nominal accumulated profits on the date of conversion then only such accumulated profits on the date of conversion only should be tested for this condition.
- However, this may be against the spirit of the provisions of section 47(xiiib) of the IT Act. Further, the term accumulated profit has not been defined under section 47(xiiib) of the IT Act, however in section 2(22) of the IT Act the term accumulated profits is at places suffixed with the terminology '*capitalized or not*', hence support may also be drawn from the same by tax authorities to treat this as a colorable transaction. Further, the conditions in section 47(xiiib) of the IT Act provides that the accumulated profits of the company should not be paid '*directly or indirectly*', in this context the tax authorities may argue that by capitalizing the profits before conversion the accumulated profits have been indirectly passed on and paid to the (shareholders) partners through a colorable route. Further, this approach may also be subject to huge litigation. Therefore, it seems advisable to avoid such an approach and comply with the language in its true spirit as the entire exemption under section 47(xiiib) of the IT Act is at stake.
- Whether the money can be advanced by the LLP to the partners by way of loan? The Income-tax Appellate Tribunal ('Tribunal') at Kolkata in the case of Aravali Polymers LLP v. JCIT [2014] 47 taxmann.com 335 (Kolkata) had the opportunity to deal with this issue. In said case, the Tribunal held that granting of a loan to the partners from the accumulated profits of the company amounted to a violation of this condition of section 47(xiiib) of the IT Act. Thus, considering this peculiar ruling it should be ensured that where any advances or loans are sought to be advanced to any partner then a suitable trail shall be maintained which demonstrates that the loans are given out of current profits of LLP or from borrowing made by LLP, and suitable evidence should be maintained to prove that accumulated profits of the company before conversion are not touched and used for granting such loans.

4.2 Other provisions that stand attracted in case of conversion in terms of section 47(xiii b) of the IT Act:

- **No step-up in cost of assets**: As per Explanation 2C to section 43(6) of the IT Act the actual cost of the block of assets transferred to LLP on conversion shall be the WDV of the block of assets in the hands of the company on the date of such conversion. Similarly, as per section 49 of the IT Act, the cost of non-depreciable assets in the hands of the LLP shall be deemed to be the cost for which the company had acquired such asset.

- **Depreciation in the year of conversion**: In the year of conversion, the depreciation allowance on the assets transferred on conversion to the LLP is allowed both to the company and the LLP based on the number of days for which such assets were used by the company and the LLP.

- **Carry forward of losses**: Where the conversion is undertaken in compliance with the conditions listed in section 47(xiiib) of the IT Act, the tax losses and unabsorbed depreciation allowance of the company stand transferred to and become losses of the LLP. Further from the construct of the language of section 72A(6A) of the IT Act it could be possible to say that the losses stand to review on conversion i.e., they get a fresh lease of life for carry forward and set off, from the year of conversion. However, if the conditions laid down in section 47(xiiib) of the IT Act are not complied with then in such case the loss shall not be allowed to be carried forward, and where any loss is set off then such loss shall be deemed to be the income of LLP in the year in which conditions of section 49(xiii b) of the Act.

- **Transfer of MAT Credit**: Section 115JAA(7) of the IT Act clearly provides that in case of conversion of company into LLP, the provisions of section 115JAA of the IT Act allowing carry forward and set-off of MAT credit shall not apply to successor LLP. In other words, the MAT Credit of the company shall stand lapsed and will not be available to the LLP for carry forward or set-off.

- **Allow ability of deduction linked to Undertaking**: The deduction or exemption say under section 80-IA, 10AA, etc., attaches to "the undertaking". The Board vide its letter F. No. 15/5/63 dated 12.5.1963 has clarified that the deduction under section 84 of the IT Act was available to the undertaking and not to the owner thereof. The said position of the Board has also been made applicable to other sections wherein the deduction is linked to the undertaking. Hence on the transfer of the undertaking as a going concern, the benefit of the deduction will be available to the transferee. Similarly, on conversion, the undertaking identity remains intact and the incentives, deduction, etc linked to the undertaking continue to attach. Therefore, upon conversion, the LLP shall be entitled to claim the deduction, incentives, etc., as are linked to eligible undertaking received upon conversion.

- **Dividend Implication**: Whether on the transfer of assets on conversion, will there be any deemed dividend implications under section 2(22)(a) of the IT Act? In case of conversion, the assets of the company are transferred to and vest in LLP, there is no distribution to the shareholders. Thus, the transfer and vesting of the assets to the LLP cannot be regarded as a distribution to the shareholders. Hence there should not be any deemed dividend implication under section 2(22)(a) of the IT Act.

4.3 Implication on violation of the conditions of section 47(xiii b) of the IT Act:

- Where any of the conditions specified in section 47(xiiib) of the IT Act is not complied with then gain arising to the company and its shareholders on conversion into LLP shall be taxable under section 45 of the IT Act. However, where initially the company has been converted into LLP in compliance with the condition of section 47(xiiib) of the IT Act and subsequently either of the condition is not complied with, then in terms of section 47A(4) of IT Act the gain on conversion that was treated as exempt in hands of company as well as shareholders under section 47(xiiib) of the IT Act shall be taxable as income of the successor LLP and the shareholders in the year in which such condition/s are violated.

- **<u>In the hands of Company</u>**: Since under the LLP Act, the transfer of the assets on conversion is to be done at the respective book values, therefore, it may be reasonable to contend that the sale consideration to be adopted in the case of the company shall be taken as the book value of assets at which they have been transferred on conversion. In the case of Aravali (*supra*) the AO treating the conversion as non-tax compliant conversion, computed the capital gains in the hands of the company by adopting the fair market value of the assets (being investments in that case) transferred as the sale consideration. The Tribunal however struck down such basis of imputing the sales consideration on the ground that there is no provision to deem fair market value of the assets (being investments) as the sales consideration arising on conversion. The Tribunal considering that the assets were transferred at book value held that capital gain was to be computed by adopting such book values. However, this principle may not hold good for all cases, and in cases where the immovable property gets transferred to LLP in a non-tax compliant conversion, the AO may consider imputing the stamp duty ready reckoner value of such immovable property in terms of section 50C of the IT Act.

- Thus, where a company seeks conversion in terms of section 47(xiiib) of the IT Act and claims exemption thereof in accordance with provisions of section 47(xiiib) of the IT Act, then upon violation of the conditions of section 47(xiii b) of the IT Act the provisions of section 47A of the IT Act shall stand attracted. Alternatively, it may be possible to argue that the conversion of company into LLP is a case of statutory vesting and shall not be construed as 'transfer' under section 2(47) read with section 45 of the IT Act (discussed in detail in Approach 2 below) and as a back-up comply with the provisions of section 47(xiiib) of the IT Act to secure exemption for shareholders.

- **<u>In the hands of the shareholders</u>**: This is discussed in detail in the latter part of this note along with Approach 2.

4.4 Approach 2: Conversion carried out in terms of LLP Act and without compliance of conditions prescribed in section 47(xiiib) framework (non-tax compliant conversion)

- In cases where the condition under section 47(xiiib) of the IT Act cannot be complied with or for any other reason, the parties may explore the conversion of a company into LLP without compliance with the provisions of section 47(xiiib) of the IT Act. In the case of a non-tax compliant conversion, there would be potential implications both in the hands of the company and the shareholders.

- In the case of non-tax compliant conversion, provisions of section 72A(6A) of the IT Act enabling carry forward of losses of the company to LLP shall not apply. Consequently, losses of the company will not stand transferred to the LLP.

Tax implications in the hands of the company:

- In case of conversion of a company into LLP, all the assets, liabilities, and the undertaking of the company would stand transferred to the LLP. Whether such transfer is taxable as capital gains in the hands of the company? If one were to consider the provisions of section 56 of the LLP Act pursuant to which such conversion is sought to be undertaken, then it could be argued that the transfer and vesting of assets are consequent to the conversion of the company into LLP. The relevant provisions of section 56 of LLP Act are as under:

  > "*S. 56. Conversion from private company into limited liability partnership. – A private company may* ***convert*** *into a limited liability partnership in accordance with the provisions of this Chapter and the Third Schedule*."

  [Emphasis supplied]

- Thus, the enabling provision of the LLP Act i.e., section 56, section 57, **provides for conversion** of a company into LLP. The process of conversion however has been spelled out in the Third Schedule. Also, the framework for conversion of company into LLP under the LLP Act ensures that all the assets, liabilities, and the undertaking of the company vests in the LLP without any assurance, act, or deed. Hence in substance, the statute provides for the conversion of one of form of entity into another form.

- The term 'conversion' as referred in section 56 and 57 of the LLP Act is a verb and is to be understood as an act of 'change'. Further, it is defined in various dictionaries as under:

  Cambridge Dictionary: "to (cause something or someone to) change in form or character"

- Thus, the term 'conversion' means transformation or change in the form, of a company into LLP. Whereas the term 'transfer' in its general sense means to pass or give. Hence in the case of conversion, the basic test of transfer i.e., to pass or to give, from one person to another is not satisfied. In case of conversion, the transferor and transferee are the same person, and one cannot transfer to himself (unless the provisions specifically deems so like section 45(2) of the IT Act).Thus, the test of 'transfer' is not fulfilled. Consequently, it may be argued that conversion of company into LLP pursuant to the statutory provisions of the LLP Act does not constitute a transfer for purposes of IT Act and consequently there shall be no capital gain in the hands of the company.

- Further, the High Court of Bombay in the case of CIT v. Texspin Engg. & Mfg. Works [2003] 129 Taxman 1 (Bombay) in context of conversion of a firm into a company as per Part IX provisions of the Companies Act, 1956, held that transfer of assets, etc. was pursuance to the statutory vesting under the Companies Act, 1956 and that same did not tantamount to transfer under the IT Act. Further, while coming to the said conclusion, the High Court stated that for a transfer to take place there shall be a transferor as well as a transferee, both existing at the same point in time i.e., together/ simultaneously. However, in the peculiar case of conversion, the transferor and the transferee do not exist together and at the same point in time. It is a case of conversion of the transferor into transferee. In other words, only when the transferor ceases to exist that the transferee comes into existence. Thus, the fundamental test of having the transferor and transferee for the purposes of transfer is not achieved under the conversion framework. Thus, it was held that the statutory vesting of assets on conversion was not to be regarded as transfer and consequently no capital gain arose on such conversion.

- The conversion of the company into LLP under the LLP Act is similar to the conversion framework prescribed under the Part IX provisions of the Companies Act, 1956. Hence the ruling in the case of Texspin Engg. & Mfg. Works (*supra*) shall equally apply in case of conversion of company into LLP. Thus, basis the above proposition it could be argued that even if the conversion of the company into LLP is not in compliance with section 47(xiiib) of the IT Act, there still should not be taxable capital gains.

- **No consideration received by the company:** Furthermore, on conversion, the company dissolves, and that it does not receive any consideration. Thus, even if one were to say that there is conversion, it can be argued that as consideration is absent, therefore the computation mechanism, laid down under section 45 read with section 48 of the IT Act, fails. This proposition has been affirmed by various courts including the High Court of Bombay in the case of Texspin Engg. & Mfg. Works (*supra*). Further, the Supreme Court in the case of Sunil Siddharth bhai v.CIT [1985] 156 ITR 509 (SC) held that even where a transaction may involve a transfer [i.e., within the meaning of section 2(47) of IT Act], however, if there is no consideration for such transfer, then no profits or gains can be said to arise for the purpose of the IT Act.

Analysis of the recent ruling of the Tribunal in case of Celerity Power LLP:

- At this stage, it is relevant to discuss the ruling of the Tribunal at Mumbai in the case of ACIT v. Celerity Power LLP [2018] 174 ITD 433 (Mumbai), wherein the Tribunal has disregarded the proposition of statutory vesting in the context of conversion of company into LLP and held that the non-tax compliant conversion was a transfer and gain there from was chargeable to tax.

- The Tribunal has disregarded the contention of no transfer owing to statutory vesting as well as distinguished the ratio of the High Court of Bombay in the case of Texspin Engg. & Mfg. Works (*supra*) on the ground that the term 'convert' means 'transfer'. The emphasis of the Tribunal has been predominantly on the definition of the term 'convert'. The term 'convert' is to be read contextually and in accordance with the scheme of things. While it is important to give weightage to the words used in the definition, but such words are to be read together with other words surrounding it and in the context of the purpose for which such provisions are enacted. The Third Schedule of the LLP Act provides that a company can convert into LLP. As part of this process the assets which were so far held in the entity operated in the form and style of a company will now be held in an entity which is to exist in the form and style of the LLP. Thus, consequently on account of the change in form and structure of the entity from company to LLP, the assets, liabilities, contracts, litigations, etc., shall also belong to and vest in the LLP and to give effect to the same law provides that such assets shall be reckoned to have been transferred to the LLP. It is a framework which gives force to the process of conversion and to give effect to this conversion under various laws it is imperative to state and provide that the assets of the company now belong to the LLP. It is important to note that the definition nowhere uses that the assets shall be transferred **by the company to the LLP**, instead it provides that convert means transfer **of assets of the company to the LLP**. From the definition, it could be clearly seen that it provides for 'transfer of assets' and not 'transfer by company of assets'. There is huge difference in both the phrases, the first phrase simply talks of assets getting transferred to LLP (on conversion of company into LLP), whereas the second phrase talks of transfer of assets by one person being a company to another person being an LLP. The second phrase pre-requires the existence of both the parties i.e., the transferor (company) and the transferee (LLP). However, as evident from the LLP Act on conversion and upon the issue of the registration certificate the company ceases to exist, and the LLP is registered. Thus, under the LLP Act, both the company and LLP do not simultaneously exist. If put simply, then LLP is an altered form of a company and for that reason, there can be no situation where both the company and LLP can co-exist.

- Further, without prejudice to the above discussion, if at one instance the view of the Tribunal in case of Celerity Power LLP (*supra*) was to be accepted, even then the definition of the term 'convert' is only restricted to the Third Schedule. The definition cannot stand extended to and apply to the term 'convert' used in the main provisions of section 56 of the LLP Act. The term 'convert' used in enabling provisions of section 56 of the LLP Act has to be given its natural meaning and cannot be read to mean a transfer from one person to another. While interpreting in the manner it is done, the Tribunal has failed to appreciate that the substantive provisions of section 56 of the LLP Act that provide that the company may get converted into LLP. The Third Schedule of the LLP Act only provides the mechanism for giving effect to the conversion. However, the Tribunal without giving enough weight to the substantive and enabling provision has proceeded to deny the benefit by resting the analysis purely on the words used in the procedural provisions of the Third Schedule of the LLP Act. Furthermore, the Tribunal has not considered or discussed upon the term '*transferred to and shall vest in limited liability partnership without further assurance, act or deed*'. These phrase as used in the Third Schedule of the LLP Act clearly demonstrate that the transfer and vesting are pursuant to the statutory provision of the LLP Act providing for the conversion of company into LLP.

- Further, the Tribunal has invoked the provisions of the Transfer of Property Act, 1892 ('TOPA') to contend that in terms of the provisions of the TOPA also vesting of assets on conversion to oneself also constitutes transfer. The relevant provisions of section 5 of TOPA as referred to by the Tribunal are as under:

  In the following sections "transfer of property" means an act by which a living person conveys property, in present or in future, ***to one or more other living persons, or to himself, 1[or to himself] and one or more other living persons****; and "to transfer property" is to perform such act.*

- The Tribunal has by reading the above provisions along with the definition of 'convert' in Third Schedule of the LLP Act, held that on the conversion of company into LLP there is transfer. The provision of the TOPA provides that there shall be a transfer of property where (i) one living person transfers to another; and (ii) one living person transfers to himself and one or more other living persons. Now in the case of conversion, neither of these two situations get covered. Firstly, there is no transfer of assets by a living person (say company) to any other living person. As the LLP does not exist at the time when the company exists, thus there is no living person to whom the assets are transferred by the company. Further, the second limb of section 5 of TOPA provides that a living person can transfer to 'himself and one or more other living persons. Again, as on conversion the company ceases to exist, there is no transfer to himself. However, if it was to be argued that the company exist in a new form (i.e., LLP), even then section 5 of the TOPA provides for the transfer of assets which was singularly held (or owned) to group of persons including the transferor. Thus, second limb of section 5 of the TOPA provides for a scenario of transfer of assets to common or joint holding (or ownership) of asset where transferor is one of the parties, *and not the sole party*. Thus, the case of vesting of assets on account of conversion of the form of an entity is not covered within the ambit of the provisions of section 5 of the TOPA.

- Further the provisions of section 5 of the TOPA envisage an 'act' of transfer on the part of the transferor. Now in the case of the conversion under the LLP Act, on conversion the assets stand vested into LLP **without** further assurance, ***act***, deed. Thus, even this condition of section 5 of TOPA is not satisfied. Thus, it shall be safe to say that the conversion does not tantamount to transfer even under the provisions of TOPA.

- Another notable point is that similar words were used in Part IX of the Companies Act, 1956 which were tested by the High Court of Bombay in the case of Texspin Engg. & Mfg. Works (*supra*). The Part IX provisions contained the phrase 'pass to and vest in' as against the phrase 'transferred to and shall vest in' as used in the Third Schedule of the LLP Act. The relevant provision of section 575 of the Companies Act, 1956 reads as under:

  "575. ……..Vesting of property on registration: All property, movable and immovable (including actionable claims), belonging to or vested in a company at the date of its registration in pursuance of this Part, shall, on such registration ***pass to and vest in*** *the company as incorporated under this Act for all the estate and interest of the company therein."*

  [Emphasis supplied]

- Thus, the only difference between is the use of words 'pass' in the Companies Act, 1956 and 'transferred' in the LLP Act. However, in general parlance, both these words i.e., pass and transfer should have a similar meaning and that therefore the law as laid down by the High Court of Bombay in the case of Texspin Engg. & Mfg. Works (supra) shall equally apply to conversion of company into LLP in terms of the LLP Act. Thus, with all due respect in my humble opinion the principle laid down by the Tribunal in the case of Celerity Power LLP (*supra*). Having said so, the litigation on this approach is likely and it is advisable to obtain an opinion of senior counsel on this matter so as to safeguard from the penal exposures if any.

- The Tribunal in Celerity Power LLP (*supra*) while dealing with the manner of computation of the gain arising to the company on the conversion held that on conversion the assets vest into LLP at their book value. Hence, the full value of the consideration of assets transferred was held to be taken as their book value. The Tribunal observed that while imputing the full value of consideration one cannot impute the market value of assets on the date of transfer and that as the assets stood transferred at book value, that was the amount which became due from the LLP on account of transfer of assets on conversion.

Tax implications in the hands of the shareholders:

- **Whether transfer test satisfied?** On conversion of the company into LLP, the shareholders of the company cease to be shareholders and become partners in the LLP entitled to bundle of rights including right to (i) share in the profit,(ii) manage of operation of LLP, (iii) capital contribution in their name, etc. The definition of transfer under section 2(47) of the IT Act is wide enough and includes the sale, exchange, or relinquishment of the asset. It also includes the extinguishment of any rights in an asset. On conversion of the company into LLP the shares held by the shareholders in the company cease to exist and so the rights therein are extinguished. Further, the receipt of the partnership interest in the LLP is consequent to the partner holding shares in the company. Thus, there is nexus between the extinguishment of rights in shares and receipt of the partnership interest in the LLP. Furthermore, the Supreme Court in the of case Grace Collis - 248 ITR 323 [SC] involving the amalgamation of a company where shareholder receives shares in the amalgamated company in place of his shareholding in the amalgamating company, held that the term "the extinguishment of any rights therein" can be either on account of transfer of rights or otherwise i.e., even on extinguishment of the asset. The Supreme Court thus held that on amalgamation there was a transfer so as to be liable to capital gains. Hence, on the conversion of company into LLP, there shall be an extinguishment of the rights of the shareholder in the shares held in the company and the same shall constitute a transfer.

- In this regard and in the context of conversion of company into LLP, the AAR in its recent ruling in the case Domino Printing Science Plc [AAR No. 1290 of 2012] also held that as the shareholding of the shareholders in the company stands extinguished on the conversion of company into LLP, such extinguishment of shares shall be regarded as transfer under the provisions of the IT Act.

- **What shall be the consideration?** Even, if there is a transfer, in order that such extinguishment is taxable as capital gains, there has to be a consideration for such transfer. What is the consideration that accrues in the hands of the shareholder? The Supreme Court in the case of Sunil Sidharthbhai - 156 ITR 509 (SC) held the amount credited to the capital account of a partner is not the full and final consideration that accrues to the partner, the amount will constantly undergo change on account of share of profit and loss getting credited to partners' capital account. Hence the consideration arising to the partner was not ascertainable at the stage of contribution, thereby causing the computation mechanism to fail. The principles laid down by the Supreme Court in the case of Sunil Sidharthbhai - 156 ITR 509 (SC) could have equally applied to the case of conversion of company into LLP. However, to overcome such scenarios, section 50D has been introduced in the IT Act.

- As per the provisions of section 50D of the IT Act in the case where consideration is not ascertainable or cannot be determined, then for the purpose of computing the capital gains, the fair market value of the asset transferred on the date of transfer shall be deemed to be the full value of consideration received or accruing as a result of such transfer.

- The term fair market value is not defined under section 50D of the IT Act however section 2(22B) of the IT Act defines the fair market value to mean the price that the capital asset will ordinarily fetch on sale in the open market on the relevant date. If such price is not ascertainable, then one may determine the price in accordance with the methods prescribed under the IT Act or IT Rules in the context of different provisions. In the case of the shares of private limited company which are not marketable or freely transferable, the popular methodology is to adopt the mechanism laid down in Rule 11UA of IT Rules. Alternatively, one may adopt the amount that is credited by LLP to the partners' capital account (including therein reserves and surplus of the company as on date of conversion). The AAR in the case of Dominos Printing Science Plc (*supra*) was also posed with the question regarding the quantification of the sale consideration accruing to the shareholders in the case where the conversion is a taxable conversion. In this regard, the AAR held that the full value of the consideration accrued to each shareholder on account of relinquishment of shares will be the value of the capital in the newly formed LLP. It further observed that if any of the shareholders receive any extra consideration or benefit, directly or indirectly, in any form or manner, then the full value of the consideration received shall be enhanced accordingly for the purpose of computation of capital gains under section 48 of the IT Act. The AAR gave a finding that even if the assets of the company were transferred to LLP at their book value, the value of partnership interest in LLP will be certainly more than the face value of the shares foregone by the applicant considering the reserves and surpluses transferred. Thus, the AAR held that on non-compliance of provisions of section 47(xiiib) of the IT Act the transaction involving extinguishment of shares was a transfer, and that gain on such transaction was chargeable to tax on the lines as discussed above. For computing the gain, the cost paid for acquisition of the shares shall be allowed as deduction from the sales consideration so determined.

4.5 GAAR implication

- The LLP Act was enacted to provide a separate legal form of entity to the businessmen, taxpayers, etc. to operate from. Though one of the reasons for having LLP was to have a regulated framework for the partnership firms which are not so well regulated till date and at the same time provide the benefit of the limited liability to the partners, etc. The scope of the LLP Act was not just to cover the partnership firms, but even the companies that wished to operate under the partnership framework. Accordingly, the LLP Act provided the framework for the conversion of the company into LLP. Further, to encourage the companies to convert themselves into LLP even the provisions of the IT Act were amended by the insertion of section 47(xiiib) of the IT Act vide Finance Act 2010 to provide that transfer of assets on the conversion of a company into an LLP in accordance with section 56 and section 57 of the LLP Act shall not be regarded as a transfer for the purposes of capital gains tax under section 45 of the IT Act, subject to certain conditions. Also, the Finance Minister in his Budget Speech relating to Finance Bill, 2010 which inserted the provisions of section 47(xiiib) of the IT Act, stated that the measure is intended to facilitate the tax-neutral conversion of small companies.

"To facilitate the conversion of small companies into LLPs, I propose that this will not be subject to capital gains tax".

- Thus, the conversion of the existing company into LLP has been acknowledged by the IT Act, and that there is a separate provision inserted to provide an exemption to such transfer. Thus, there has been a clear intent from the Government to allow the taxpayers to exercise such route and avail exemption if they are able to satisfy the conditions that are laid down under section 47(xiiib) of the IT Act. Thus, there exist Specific Anti-Abuse provisions (SAAR) which seek to confer exemption only to entities fulfilling the conditions. Further, section 47(xiiib) of the IT Act has continued to remain on statute even after the introduction of the GAAR provisions. Though CBDT has vide Circular no. 7 of 2017 dated 27 January 2017 provided that GAAR provisions are in addition to the SAAR provisions and shall apply even if the SAAR test was satisfied. However, the same being circular it shall not have any binding effect on the assesses and the courts. Further, such circular is to be read purposively and reasonably so that due merit is served to the current provisions of section 47(xiiib) of the IT Act.

- Additionally, selection between the form of entity (company, firm, LLP, etc.) ought not to be the subject matter of GAAR provisions. It is for the taxpayer to decide which entity it wants to operate through. The right and freedom to choose an entity should not be questioned and neither should the taxpayer be directed to select one form of entity over other. Hence, it may be a good case to argue that GAAR provision ought not to apply in such cases. However, it is advisable, to back the conversion with some sound commercial rationale as well, rather than solely justifying on the tax grounds. This will add more safeguards and build a strong case in favor of the taxpayer.

4.6 Conclusion:

- The LLP as an entity framework is attractive as it provides various benefits including the benefits of limited liability in a partnership structure and lesser compliances burden. The LLP operates through the terms agreed in the LLP Agreement and thus provides immense flexibility to parties in arranging their inter-se relationships i.e., between the partners, also between partners, and the LLP. However, the law on LLP is relatively new and recent and thus the jurisprudence thereon remains limited, but with the passage of time it should get settled. Basis the facts and requirements of each case one should evaluate the feasibility of operating through the LLP structure and plan out the approach in an effective and efficient manner.