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Conversion of Company into LLP – Tax Implications

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The concept of a Limited Liability Partnership ('LLP') as an alternate form of business entity was introduced in India through The Limited Liability Partnership Act, 2008 (the 'LLP Act'). An LLP is a hybrid form of an organization, which combines the benefits of a traditional partnership firm and a company. There is a unique amalgam of flexibility of ownership, management and control akin to a partnership firm, along with the benefits enjoyed by a corporate, like separate legal incorporated entity, limited liability and ability to raise equity funding from overseas.

Accordingly, many corporates nowadays are considering to alter their structure from a company form to an LLP form, in order to reap the above stated benefits.

In this regard, income tax implications arising pursuant to conversion of a company to an LLP need to be analyzed closely so as to achieve tax efficient conversion along with other commercial and regulatory benefits associated with an LLP structure.

Premise for taxability of capital gains on conversion of Company to LLP

Section 45 of the Income Tax Act ('IT Act') provides that any profits or gains arising from the **transfer** of a **capital asset** shall be chargeable to tax under the head 'Capital gains'.

Section 2(14) of the IT Act defines the term '**capital asset**' to include property of any kind held by an assessee, whether or not connected with his business or profession. Therefore, in context of a company, following would qualify as capital assets:

a. Assets of the company which are being transitioned to the LLP

b. Shares held in the company by its shareholders

Further, Section 2(47) of the IT Act defines '**transfer**' in an inclusive manner, so as to include sale, exchange, relinquishment of the asset or extinguishment of any rights therein. Given the wide definition of 'transfer', a view is taken that conversion of company should be covered within the ambit of 'transfer' and accordingly, any profits or gains arising on conversion of a company to an LLP should be chargeable to tax as capital gains on two accounts:

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- Transfer of capital assets from company to LLP upon conversion; and
- Transfer of a shares held in the company by a shareholder as a result of conversion of the company into an LLP

Furthermore, Section 48 of the IT Act provides the mode of computation of capital gains, wherein full value of consideration received/accrued pursuant to transfer is reduced by the cost of acquisition of the transferred asset to arrive at capital gains.

Accordingly, the gains derived on conversion of a company to an LLP may be subject to tax as per Section 45, computed in terms of Section 48 as follows:

Transfer	***Tax implications in the hands of***	***Computation of capital gains***
Transfer of capital assets from company to LLP	Successor LLP	Value of capital assets transferred *Less*: Cost of acquisition of capital assets
Transfer of shares in company	Shareholders of company	Value of partner's interest in LLP *Less:* Cost of acquisition of shares

Exemption provided under Section 47 from levy of capital gains tax

Section 47 (xiiib) of the IT Act provides an exemption from levy of capital gains tax on the abovementioned transfers pursuant to conversion of a company to LLP subject to fulfilment of below specified conditions:

a) **Transfer of all assets and liabilities**: All the assets and liabilities of the company immediately before conversion become the assets and liabilities of LLP.

b) **All shareholders to become partners in LLP**: All the shareholders of the company immediately before conversion become the partners of LLP and their capital contribution and profit-sharing ratio in the LLP are in the same proportion as their shareholding in the company as on the date of conversion.

c) **Consideration to shareholders**: The shareholders of the company does not receive any consideration or benefit, other than by way of share in profit and capital contribution in LLP.

d) **Profit sharing ratio of shareholders in LLP**: The aggregate of the profit-sharing ratio of the shareholders of the company in LLP should not be less than 50% at any time during a period of 5 years from the date of conversion.

e) **Total sales, turnover or gross receipts in the business of the company**: Must not exceed INR 60 lakhs in any of the 3 previous years preceding the previous year in which the conversion takes place.

f) **Total value of the assets as appearing in the books of account of the company**: Must not exceed INR 5 crores in any of the three previous years preceding the previous year in which the conversion takes place.

g) **No amount to be paid to any partner out of accumulated profits** of the company as appearing on conversion date for a period of 3 years from the date of conversion.

Moreover, Section 47A of the IT Act provides that if any of the conditions mentioned above are not complied with, then the amount of gains arising from the transfer pursuant to conversion to LLP which

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have not been charged to tax by virtue of fulfilment of above mentioned conditions, shall be deemed to be the gains chargeable to tax in the hands of the successor LLP or the shareholder of the predecessor company, as the case may be, for the previous year in which any of such condition is breached.

Litigation around taxability of conversion of Company into LLP

Even though specific provisions have been provided in the IT Act governing taxability of capital gains, as well as exemption from capital gains levy on conversion of company to LLP on fulfilment of prescribed conditions, it is pertinent to note that taxation of capital gains upon conversion of a company to an LLP has been a subject matter of litigation.

There have been multiple judicial precedents wherein the issue relating to incidence of tax in case of conversion of a partnership firm into a company have been discussed. Further in the said judicial precedents it has been discussed that these decisions should equally be applied in case of conversion of a company to an LLP as in both the cases, one form of an entity is being altered to form a different kind of an entity altogether i.e. to say that the dress is changing, with the soul remaining the same.**However, it is interesting to note that the intention of the lawmakers appears to be that the soul of the entity remains intact only if conditions mentioned in Section 47 are complied with and thus, exempt from tax.**

A few judicial precedents relating to conversion of a company to an LLP and conversion of partnership firm to company have been highlighted below.

In ***Domino Printing Science Plc***[1], the Authority for Advance Ruling (AAR) has held that shareholders of a company, which do not meet the specified conditions upon its conversion to an LLP, would be liable to capital gains tax on the difference between the full value of consideration and the cost of acquiring the shares. Some important points in the ruling are as follows:

1. **Conversion of a company into an LLP results in a 'transfer'** on account of the following:

- All tangible and intangible properties of the company stand 'transferred' to and vested in the LLP
- Upon such vesting, not only the share capital of the company but also the shareholders' interest in the shares of the company gets 'extinguished'.

2. **Sale consideration of 'transfer of shares' for computation of capital gains u/s 48** : The AAR held that the Applicant acquires partnership interest in consideration of relinquishment of shares in the company. Therefore, in the instant case, the full value of consideration for purposes of section 48 of the IT Act will be the value of partnership interest in LLP.

In case the value of consideration is not ascertainable, section 50D of the Act provides the fair market value to be deemed as the full value of consideration.

3. **Cost of acquisition of shares for computation of capital gains u/s 48** : Amount paid to purchase the shares is cost of acquisition for the shareholders of the company.

- In the case of ***Texspin Engg. & Mfg. Works***[2], a partnership firm got registered as a company and shares of the newly formed company were allotted to partners of the erstwhile firm and the question which arose was whether this gave rise to a taxable capital gain in their hands. The Bombay High Court held that vesting of properties in the Company under Chapter IX was a statutory vesting and was not consequent or incidental to a transfer. On such vesting, the cloak given to the firm was replaced by a different cloak and the same firm was now treated as a company, and that this did not constitute a transfer under section 45 of the IT Act read with section 2(47). Further, the Bombay High Court relied on two judgements of Supreme Court i.e. ***George Henderson & Co. Ltd.***[3] and ***Gillanders Arbuthnot & Co.***[4], wherein it was held that the expression "full value of the consideration" does not mean market value of the asset transferred, but it shall mean the price bargained for by parties to the transaction. Accordingly, the Bombay High Court held that even if they were to hold that it is a case of 'transfer', then also, the computation of capital gains under Section 48 is not possible because it has been laid down in the abovementioned Supreme Court judgements that full consideration cannot be construed to

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mean market value of the asset transferred.

- Mumbai ITAT in the case of ***Celerity Power LLP***[5] seems to have taken a different view in the matter of conversion of a company into an LLP (as opposed to registration of a partnership firm under Part IX of the Companies Act, 1956). Notwithstanding the provisions of section 58(4)(b) of the LLP Act, the Mumbai ITAT has made a distinction and has treated the conversion as 'transfer'. It was observed that the expression 'full value of the consideration' cannot be construed as having a reference to the 'market value' of the asset transferred, and that the said expression only means the full value of the things received by the transferor in exchange for the capital asset transferred by him. Thus, as the assets and liabilities of the erstwhile private limited company had got vested in the assessee LLP at their 'book values', a fact that has not been negated, hence such 'book value' could only be regarded as the 'full value of consideration' for the purpose of computation of 'capital gains' under section 48 of the Act.
- In case of ***Umicore Finance Luxembourg***[6], the issue was regarding capital gains arising on conversion of partnership firm into a company, wherein the condition that shareholding of 50% or more should continue for 5 years was not fulfilled. It was held by the AAR and later upheld by the Bombay High Court that no capital gains accrued at the time of conversion of the partnership firm into a private limited company and even if there was non-compliance with clause (d) of provision to Sec. 47(xii) by reason of premature transfer of shares, the said company was not liable to pay capital gains tax.
- In the case of ***CADD Centre***[7], the issue involved was conversion of partnership firm into company. It was observed by the Madras High Court that a company has an independent legal entity vis-à-vis its shareholders, whereas a firm has no such independent existence vis-à-vis the partners. Therefore, when a firm is transformed into a company with no change in number of partners and extent of property, there is no transfer of assets involved and hence, there is no liability to pay tax
- In the case of ***Unity Care and Health Services***[8], the ITAT held that the word 'transfer' presupposes existence of transferor and transferee simultaneously. Further, if the firm was held to be the transferor, then, the transferee company was not in existence on that date. On the other hand, if the transferee was the company which came into existence on certain date, then the firm i.e. the transferor was not in existence as on the said date. It was accordingly concluded that conversion of partnership firm into a company was not a case of transfer by one person to another and that it was a mere change under the relevant Act under which the persons are registered to carry on the business.

Conclusion

Though there could be divergent views on whether conversion of a company to an LLP constitutes a 'transfer' or not, but if we were to note the intent of the legislature to introduce Section 47 (xiiib) in Finance Bill 2010, we could gain some clarity on the taxability of the same. Section 47 (xiiib) was introduced to exempt transfer of assets and shares on conversion of a company into an LLP from capital gains tax under Section 45 of the IT Act, subject to fulfillment of certain stipulated conditions.

It is worthwhile to note that prior to Finance Bill 2010, conversion of a company into an LLP had definite tax implications and the transfer of assets on conversion attracted levy of capital gains tax.

Accordingly, a view may be taken that transfer of capital assets from a company to LLP and transfer of shares in company to partnership firm should be subject to tax in the hands of successor LLP and the shareholders respectively, if conditions specified in Section 47(xiiib) of the Act are not complied with.

It is likely that no capital gains would arise on transfer of capital assets in a situation where book value of assets (to be taken as sales consideration for computation of capital u/s 48) is equal to the cost of acquisition of such capital assets.

But, the incidence of capital gains tax in the hands of shareholders on transfer of shares, pursuant to conversion, cannot be ruled out.

However, there may be an exception to this, wherein the shares of the company have been acquired by Singapore/ Mauritius resident shareholders prior to 1 April 2017. As per Article 13 of India -Singapore DTAA and India – Mauritius DTAA, respectively, capital gains arising on transfer of shares in an Indian

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entity which have been acquired prior to 1 April, 2017, shall be taxable only in Singapore/ Mauritius and not in India. Therefore, possibility of availing benefit of grandfathering clause in DTAA with Singapore/Mauritius may be further explored in of Singapore/Mauritius resident shareholders of the company which is sought to be converted to LLP.

Thus, corporates need to assess whether the conditions laid out under Section 47(xiiib) could be complied with by them or not upon conversion of the company to an LLP. If not, then the tax cost accruing as a result of conversion needs to be weighed against other benefits that the corporate seeks to achieve through such structuring exercise in order to make a rational decision.

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[1] [TS-5005-AAR-2020-O]

[2] [TS-3-HC-2003(BOMBAY)-O]

[3] [TS-3-SC-1967-O]; [1967] 66 ITR 622 (SC)

[4] [TS-1-SC-1972-O]; [1973] 87 ITR 407 (SC)

[5] [TS-684-ITAT-2018(Mum)]

[6] [TS-644-HC-2016(BOM)]

[7] [TS-5670-HC-2015(MADRAS)-O]

[8] [TS-5367-ITAT-2005(BANGALORE)-O]

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