Partnership Firm and LLP - Tax Considerations

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Contents

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Taxation of LLP

Basic Tax Provisions

- Alimited liability partnership and a partnership firm will be accorded the same tax treatment under the provisions of Income-tax Act, 1961 ('IT Act')
  - (Excerpts from Explanatory Memorandum to Finance Bill No. 2 of 2009. Reiterated also in CBDT Circular 5 / 2010 dated 3rd June 2010)

- The term 'firm' and 'partnership' as defined under section 2(23) of IT Act includes the term 'LLP' as well.

- All provisions of IT Act as applicable to firm and its partners shall equally apply to LLP and its partners

- General tax rate applicable to an LLP is as under–

  Income ≤ 1crore : 31.20% (including education cess @ 4%)

  Income > 1 crore : 34.944% (including surcharge @ 12% and education cess @ 4%)

- No double taxation – Share of profit is exempt in the hands of partners under section 10(2A) of IT Act

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LLP – Key Tax Provisions (1/3)

Remuneration & interest on partner's capital shall be allowed as deduction in the hands of LLP subject to following conditions as prescribed under section 40(b) of the IT Act:

Remuneration	Interest
• In accordance with LLP Agreement	• In accordance with LLP Agreement
• Relating to the period post date of execution of LLP Agreement	• Relating to the period post date of execution of LLP Agreement
• Not exceeding the prescribed limit a) Upto INR 3 lakhs of book profit – higher of INR 1.5 lakhs or 90% of book profit b) Balance book profits – 60% of book profits	• Not exceeding 12% per annum
• Paid to individual working partner	• Interest paid to a person who is acting as a partner in a representative capacity shall also be considered to calculate the prescribed limit. However, interest paid to the said person otherwise than in representative capacity shall not be considered for the purpose of the above limits.

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LLP – Key Tax Provisions (2/3)

- **Interest deduction under section 36(1)(iii) of IT Act:**
  - Capital contribution of partners is capital borrowed for the purposes of business or profession and for allowance of deduction of interest payments, requirement of section 36(1)(iii) needs to be fulfilled -
    - *Munjal Sales Corp vs. CIT [2008] 168 Taxman 43 (SC)*
    - *ACIT vs. Pahilajrai Jaikishin [2016] 66 taxmann.com 30 (Mumbai)*
- **Section 40(b) vs. section 40A(2) of IT Act:**
  - No disallowance under section 40A(2) is warranted if the conditions as specified in section 40(b) are complied with –
    - *CIT vs. Great City Manufacturing Co. [2013] 33 taxmann.com 258 (Allahabad)*
    - *Chhajed Steel Corp. vs. Asst. CIT [2001] 116 Taxman 37 (Ahmedabad - ITAT)*
    - *ACIT vs. Budhalal & Co. [2011] 10 taxmann.com 52 (Ahmedabad - ITAT)*

LLP – Key Tax Provisions (3/3)

Section 115JC & section 115JD - Alternate Minimum Tax (AMT)

- AMT Rate is as under

  If Income ≤ 1 crore - 19.24% *
  If income > 1 crore - 21.58%*#

- Adjusted Total Income = Net Taxable Income + Deduction under part C of Chapter VI A (other than section 80P) + deduction under section 10AA (SEZ Units) + deduction under section 35AD (net of notional depreciation otherwise allowed)
- Unlike MAT for companies which is computed on **Book Profits**
- Credit of amount allowed to be carried forward for 15 Assessment Years
- Credit limited to excess of normal tax over AMT liability

* including 4% health and education cess
\# Including 12 % surcharge

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Other tax benefits and limitations

Tax benefits to LLP

- Certain provisions not applicable to LLP such as:
  - Section 2(22) does not apply to LLP;
  - Section 2(24)(iv) - perquisites in the hands of directors / substantial shareholder or their relatives
  - Explanation to Section 73 - treating of income as income earned from speculation business to the extent to which the business consists of the purchase and sale of such shares;

Tax limitations:

- LLP is not eligible for certain tax benefits such as:
  - Deduction in relation to scientific expenditure or in-house research under section 35(2AB)
  - Tax neutrality for business re-organization (merger, demerger etc.)
  - Benefit of lower tax rate applicable to companies (for e.g. 15% / 22% / 25%)

01 Reconstitution of Firm / LLP

Section 9B and Section 45(4) – New Tax Regime

Section 9B of IT Act:

Genesis:

- Receipt of capital asset or stock-in-trade or both by a specified person (i.e. partner of a firm/ LLP) from a specified entity (i.e. a firm /LLP) in connection with **dissolution or reconstitution** of firm shall be regarded as deemed transfer of such capital asset or stock-in-trade or both
- Provides for taxation of gains arising on such transfer in the hands of the firm
- Chargeable as capital gains or business income in accordance with provisions of IT Act

Section 45(4) of IT Act:

Genesis:

- In case a specified person (i.e. partner) receives a capital asset or money or both from a specified entity (i.e. a firm /LLP) in connection with **reconstitution** of firm, any gains arising on such receipt shall be taxable in the hands of the firm as capital gains
- Levies capital gains tax on realization in excess of partner's capital account balance in connection with reconstitution – **Gains computed from partner's perspective but taxable in the hands of firm**
- The capital gains shall be computed based on the mechanism specified in section 45(4) of the IT Act

Section 9B and Section 45(4) – New Tax Regime

- The term ‘**reconstitution**’ is defined under section 9B of IT Act to mean:
  - one or more partners of firm ceases to be partners; or
  - one or more new partners are admitted in such firm in such circumstances that one or more of the persons who were partners of the firm, before the change, continue as partner or partners after the change; or
  - all the partners of such firm continue with a change in their respective share or in the shares of some of them;
- The term ‘specified entity’ means firm / LLP / AOP / BOI - not being a company or a cooperative society
- The term ‘specified person’ means a person, who is a partner of firm / LLP or member of AOP/BOI in any previous year
- In case where capital asset is received by a partner from a firm in connection with reconstitution of firm, section 45(4) shall operate in addition to section 9B

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Section 9B and Section 45(4) – Comparative Analysis

Parameters	Section 9B	Section 45(4)
Taxable Entity	• Firm	• Firm
Trigger of taxability	• It would apply upon receipt of **capital asset or stock-in-trade or both** by a partner • Upon **dissolution or reconstitution** of a firm	• It would apply upon receipt of **capital asset or cash or both** by a partner • Upon **reconstitution** of a firm
Year of taxability	• In the year of receipt by partner	• In the year of receipt by partner
Head of Income	• In case of capital asset – Capital Gains • In case of stock-in-trade – Business Income	• Capital gains
Determining Consideration	• Fair Market Value ('FMV') of capital asset or stock in trade or both on date of receipt by partner	• Value of money + FMV of capital asset on date of receipt by partner

Section 9B and Section 45(4) – Comparative Analysis

Parameters	Section 9B	Section 45(4)
Cost of acquisition	• As determined under section 48 / 49 in respect of capital asset transferred	• Partner's capital account balance (determined in specified manner*) at the time of reconstitution
Computation of Gains	• Computed as per the provisions of IT Act under the head 'Profits and gains of business or profession' or under 'Capital gains', as the case may be	• Computed as follows: **A = B + C - D** *A is capital gains* *B is value of money received C is FMV of the capital asset received* *D is the amount of balance in the capital account determined in specified manner* • In case the computation results in capital loss, the value shall be deemed to be zero

** Without taking into account increase due to revaluation of any asset or due to self-generated goodwill/asset*

Rule 8AA – Determination of Period of Holding

As per Rule 8AA of Income-tax Rules, 1962 (‘IT Rules), in case of capital gains chargeable under section 45(4), the amount of such capital gains (whole or part of it) shall de deemed to be from transfer of short term / long term capital asset based on the criteria discussed below:

Where capital gain can be attributed to:	Nature of capital gains
Capital asset which is short-term under the IT Act, at the time of taxation of capital gains under section 45(4)	Short term capital gains
Capital asset forming part of block of assets	Short term capital gains
Self-generated goodwill/asset	Short term capital gains
Any other capital asset not covered above and, which is long-term capital asset under the IT Act, at the time of taxation of capital gains under section 45(4)	Long term capital gains

Rule 8AB - Attribution Rules

- Rule 8AB of IT Rules provides the manner of attribution of capital gains chargeable under section 45(4) in the hands of specified entity, to the remaining capital assets of the specified entity

- Following table summarizes the attribution Rules:

Capital gains relate to	Capital gains to be attributed to remaining capital assets of the specified entity
Capital asset received by the partner from the specified entity	No attribution
Relates to revaluation of any capital asset of specified entity or Relates to valuation of self-generated goodwill/asset of specified entity	Amount charged under section 45(4) basis the same proportion as the increase in, or recognition of, value of that asset that bears to the aggregate of increase in, or recognition of, value of all assets because of the revaluation or valuation
Does not relate to any of the above categories	No attribution

Revaluation to be based on a valuation report obtained from a registered valuer
Firm / LLP to furnish details in prescribed form on or before the due date of filing of return

Capital Contributions - Tax Implications

Contribution of capital asset in partnership firm / LLP

For partner

- Section 45(3) of Income -tax Act, 1961 ('IT Act')- Value recorded in the books of firm / LLP shall be deemed to be full value of consideration in hands of partner for determining capital gains
  - In case of contribution of immovable property, where the value recorded by firm / LLP is less than the ready reckoner value of property, can the difference be taxed as per provision of section 50C of IT Act in the hands of partner?
- Section 32 of Limited Liability Partnership Act, 2008 ('LLP Act') - Monetary value of contribution to be accounted and disclosed in the prescribed manner based on valuation report of an approved valuer
- Possibility of tax authorities challenging the valuation and amount recorded by firm / LLP

For firm / LLP

- In case of mis-match in the fair value of capital asset vis-à-vis value of capital asset recorded by firm / LLP - Whether implication under section 56(2)(x) of IT Act may arise on LLP ?
  - Whether the value of stake / interest issued by firm / LLP is adequate consideration for receipt of contribution from the partner?

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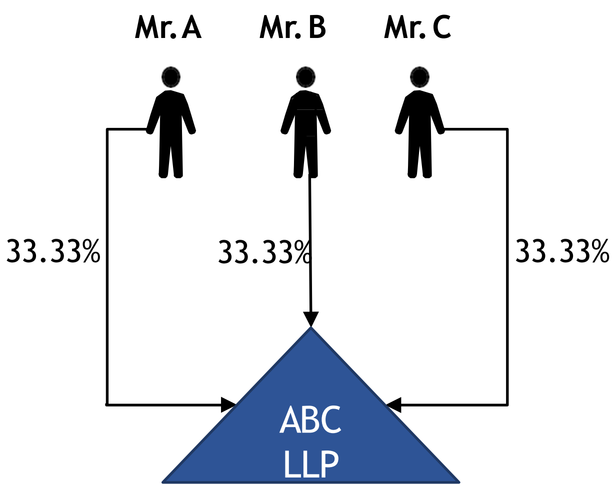
1A Case Studies

Case Study – 1 (1/4)



Facts

- Mr. A, Mr. B and Mr. C are partners of ABC LLP in equal ratio
- BAC LLP holds multiple land parcels. All the land parcels are held as long-term capital assets
- Partner A wishes to retire from the firm.
- Partner A's account is proposed to be settled as under:-
  - Cash payment - 11
  - Distribution of land parcel Z – FMV 50
- The balance sheet of LLP is provided below:

Liability	Amount	Asset	Amount
Partners Capital	30	Land parcel X (FMV 70)	10
Mr. A – 10		Land parcel Y (FMV 70)	10
Mr. B – 10		Land parcel Z (FMV 50)	10
Mr. C – 10			
Total	**30**	**Total**	**30**

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Case Study – 1 (2/4)

- Implications under section 9B of the IT Act – Capital Gains shall be chargeable to tax in the hands of firm

Particulars	Amount
Sale consideration (FMV of land parcel Z)	50
Less:- Indexed cost of acquisition of land (assumed)	15
Long term capital gains chargeable u/s 9B in hands of firm	35
Capital gains tax payable by the firm @ 20% (without applying surcharge and education cess for simplicity)	7

- Capital account of partners on account of this transaction shall be as under:-

Particulars	Amount
Sale consideration (FMV of land parcel Z)	50
Less:- Cost of land for the LLP (as per books)	10
Profit of the firm (before tax)	40
Capital gains tax paid by the firm	7
Post-tax profit of the firm (this amount will be equally distributed to all 3 partners)	33
Capital Balance of each of the partners (Old Balance 10 + Profit 11)	21

Case Study – 1 (3/4)

- Implications under section 45(4) of the IT Act – Capital Gains shall be chargeable to tax in the hands of firm

Particulars	Description	Amount
Sale consideration	Value of any money received by partner from firm on the date of such receipt (A)	11
	FMV of the capital asset received by partner from firm on the date of such receipt (B)	50
Cost of acquisition	Balance in the capital account of partner in the books of account of the firm at the time of reconstitution (C)	(21)
Capital Gains	**A + B - C**	**40**

- For the firm, capital gains of 40 shall be chargeable under section 45(4), in addition to 35 which is chargeable under section 9B.

- The cost of acquisition of land parcel Z in the hands of Mr. A shall be 50

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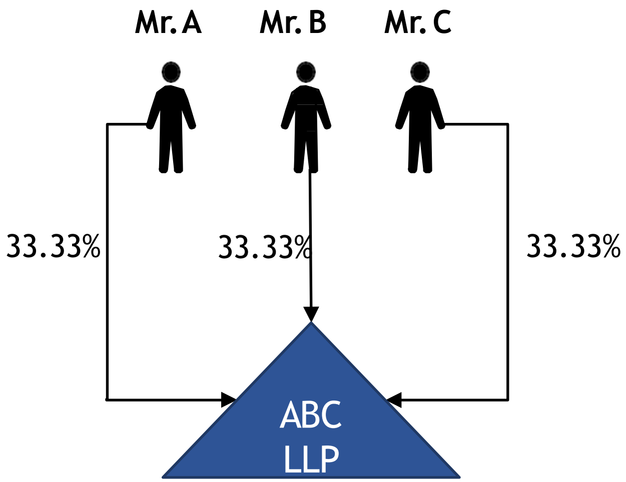
Case Study – 1 (4/4)

- Attribution of capital gains under section 45(4) read with Rule 8AB to remaining capital assets of firm:

Particulars	Cost	FMV	Increase in value	Proportion	Attribution of capital gains charged u/s 45(4)
Land parcel X	10	70	60	50%	20
Land parcel Y	10	70	60	50%	20
Total			**120**		**40**

- The amount of 20 each shall be attributed to land parcel X and land parcel Y. When either of land parcel is sold by the LLP in the future, 20 as attributed at the time of taxation under section 45(4), shall be reduced from sale consideration while computing capital gains on sale of such land.
- Since capital gains of 40 gets attributed to land parcel X and land parcel Y being long term capital asset, such capital gains of 40 shall be chargeable as long-term capital gains.

Case Study – 2 (1/2)



Facts:

- Mr. A, Mr. B and Mr. C are partners of ABC LLP
- The partner's profit-sharing ratio ('PSR') and capital contribution is equal in ratio
- The partner's aggregate contribution is INR 12 lakhs (INR 4 lakhs by each partner)
- ABC LLP acquired listed shares out of capital contributed by partners
- The current FMV of shares is INR 24 lakhs and they are held as long term capital asset
- Mr. A intends to retire from the LLP and it has been decided to settle his account by paying cash considering FMV of shares held by LLP
- Mr. A is paid INR 8 lakhs on overall basis :
  - INR 4 lakhs pertaining to capital contribution; and
  - INR 4 lakhs as 1/3rd share in value appreciation of shares by INR 12 lakhs

Question

1. What are the tax implications in the hands of LLP?

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Case Study – 2 (2/2)

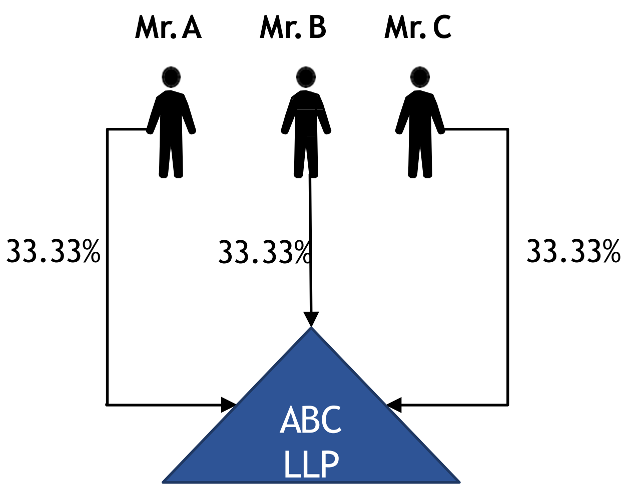
Tax implications under new regime

- Section 9B – No tax implication considering there is no transfer of capital asset or stock-in-trade by LLP
- Section 45(4):
  - Money received (INR 8 lakhs) in excess of capital balance (INR 4 lakhs) shall be taxable as capital gains in the hands of LLP. Therefore, INR 4 lakhs taxable as capital gains in case of LLP
  - INR 4 lakhs (attributable to Mr. A's share in value appreciation) to be reduced from sales consideration on transfer of such shares in future by LLP

Tax implications under old regime

- Erstwhile section 45(4) of IT Act provided for taxation of capital gains on transfer of 'capital asset' by the LLP
- In case of payment of cash by the LLP, there is no transfer of capital asset and hence no tax implications in the hands of LLP
- Further, no tax implications in the hands of Mr. A as he received the amount to the extent of his right in the firm

Case Study - 3 (1/4)



Facts

- Mr. A, Mr. B and Mr. C are partners of ABC LLP in equal ratio
- Land parcel 'S' is a long-term capital assets and Patent 'T' is a short-term capital asset
- Partner A wishes to retire from the firm.
- Partner A's account is proposed to be settled as under
  - Cash Payment - 75
  - Distribution of land parcel 'S' – FMV 45
- The balance sheet of LLP is provided below

Liability	Amount	Asset	Amount
Partners Capital	300	Land parcel 'S' (FMV 45)	30
Mr. A – 100		Patent 'T' (FMV 60)	45
Mr. B – 100		Cash	225
Mr. C – 100		Self generated Goodwill (FMV 30)	0
Total	**300**	**Total**	**30**

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Case Study - 3 (2/4)

- Implications under section 9B of the IT Act - Capital Gains shall be chargeable to tax in the hands of firm

Particulars	Amount
Sale consideration (FMV of land parcel S)	45
Less:- Assumed cost of indexation of land	45
Long term capital gains chargeable u/s 9B in hands of firm	0
Capital gains tax payable by the firm @ 20% (without surcharge and education cess, for simplicity)	0

- Capital account of partners on account of this transaction shall be as under:-

Particulars	Amount
Sale consideration (FMV of land parcel S)	45
Less:- Cost of land for the firm (as per books)	30
Profit of the firm (pre-tax)	15
Tax paid by the firm	0
Post-tax profit of the firm (this amount will be equally distributed to all 3 partners)	15
Capital Balance of each of the partners (Old Balance 100 + Profit 5)	**105**

Case Study - 3 (3/4)

- Implications under section 45(4) of the IT Act – Capital Gains shall be chargeable to tax in the hands of LLP

Particulars	Description	Amount
Sale consideration	Value of any money received by partner from LLP on the date of such receipt (A)	75
	FMV of the capital asset received by partner from LLP on the date of such receipt (B)	45
Cost of acquisition	Balance in the capital account of partner in the books of account of the firm at the time of reconstitution (C)	(105)
Capital Gains	**A + B - C**	**15**

- Capital gains of 15 shall be chargeable under section 45(4) in the hands of LLP
- The cost of acquisition of land parcel S in the hands of Mr. A shall be 45

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Case Study – 3 (4/4)

- Attributing of capital gains under section 45(4) to remaining capital assets of firm:

Particulars	Cost	FMV	Increase in value	Proportion	Attribution of capital gains charged u/s 45(4)
Patent T	45	60	15	33.33%	5
Self Generated Goodwill	0	30	30	66.66%	10
Total			45		15

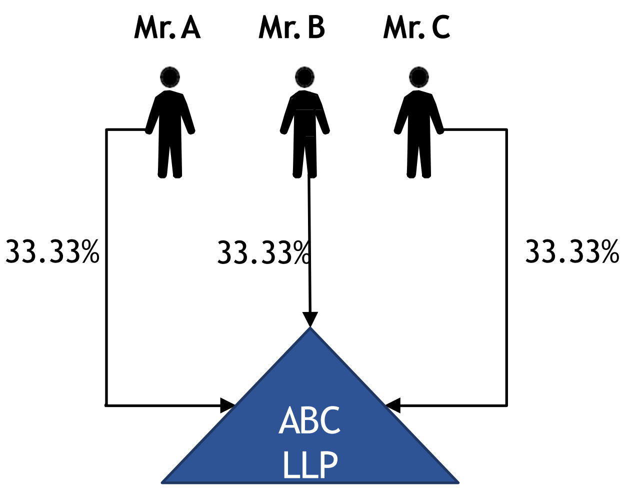
- 5 shall be attributed to Patent T and 10 shall be attributable to self generated goodwill

- No depreciation shall be available on 5 which is attributed to Patent T and on 10 which is attributed to self-generated goodwill.

- When Patent T gets sold subsequently, 5 shall be reduced from sale consideration and net consideration shall be reduced from WDV of block of intangible assets. Assuming Patent T is sold for 25, 5 shall be reduced from 25 and only net consideration of 20 shall be reduced from WDV of block of intangible assets. Similarly, when goodwill gets sold subsequently, 10 shall be reduced from sale consideration and only such reduced consideration shall be chargeable to capital gains tax.

- Since capital gains of 15 gets attributed as 5 to asset forming part of block of assets (Patent T) and 10 to self-generated goodwill, such capital gains of 15 shall be chargeable as short-term capital gains.

Case Study - 4 (1/2)



Facts

- Capital balance and profit-sharing ratio of Mr. A, Mr. B and Mr. C is as under:
  - Mr. A - Cap Balance - Rs. 100 ; Profit Sharing – 33.33%
  - Mr. B - Cap Balance - Rs. 100 ; Profit Sharing – 33.33%
  - Mr. C - Cap Balance - Rs. 100 ; Profit Sharing – 33.33%
- Mr. C is contemplating to retire without any consideration and resultantly his capital balance shall be ascribed to Mr. A and Mr. B equally
- Post retirement of Mr. C, revised capital balance and profit-sharing ratio of Mr. A and Mr. B would be as under:-
  - Mr. A - Cap Balance - Rs. 150 ; Profit Sharing – 50%
  - Mr. B - Cap Balance - Rs. 150 ; Profit Sharing – 50%

Question

What would be the tax implications in case Mr. A makes a withdrawal of Rs. 125 from his capital account post retirement of Mr. C as partner of the LLP?

Case Study – 4 (2/2)

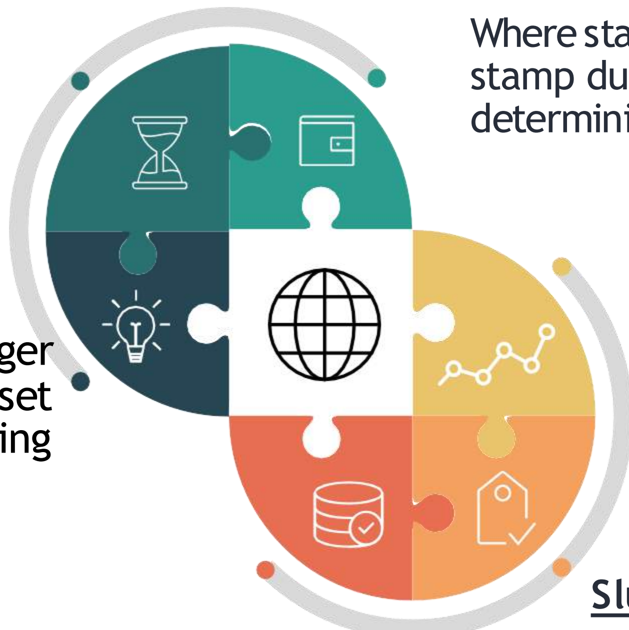
Proposed : Computation of capital gains in the hands of firm under section 45(4)	
Full value of consideratio n	• Value of any money or the FMV of capital asset on the date of receipt of such money or capital asset
Cost of acquisition	• Balance in the capital account of the partner in the books of accounts of the firm at the time of reconstitution **without taking into account increase in the capital account of the partner due to revaluation of any asset or due to self-generated goodwill or any other self-generated asset**

- For the purpose of computation of cost of acquisition, only increase in the capital account of the partner due to revaluation of any asset or due to self-generated goodwill or any other self-generated asset is to be excluded

- In the instant case there may not be any tax implications in the hands of firm on Mr. A withdrawing sum of Rs. 125 from his capital balance

1B Key Considerations

Key Points to Ponder



Retirement considering book value

Whether tax implication arises when **partner retires by withdrawing capital balance at book value** inspite the **fair value** of partnership interest being higher

Receipt by legal representative

Whether section 45(4) would trigger when **legal heir** receives the capital asset / money from the firm considering definition of '**specified person**'?

Self-generated goodwill

In case of **value appreciation of self-generated goodwill**, the specified entity would get **benefit of attributed amount** at the time of sale of such goodwill in future – Practically an **unlikely** event.

Tax paid by specified entity on such value appreciation may practically become cost for the specified entity.

Stamp duty value v/s FMV for Section 9B

Where stamp duty value exceeds FMV of asset, can stamp duty value be substituted for the FMV for determining gains under section 9B

No depreciation on asset

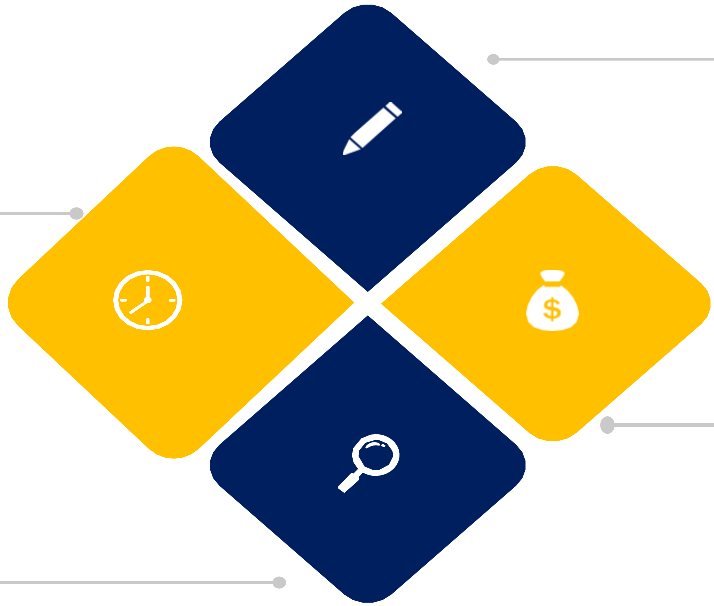
Attribution amount does not inflate the 'actual cost', hence the **benefit of depreciation would not be available** to the specified person

Slump Sale

In case of **slump sale**, since the subject matter of transfer is an undertaking and not a particular asset, it is **unclear as to whether the benefit of amount attributed to the assets forming part of the undertaking would be allowed or not.**

Forward Looking Considerations

Re-visiting partnership deed and terms in relation to retirement, manner of settlement etc.



To have a re-look at previous revaluation exercise done and its impact on capital balance of partners.

Whether capital asset should be converted into stock-in-trade prior to distribution in order to avoid dual taxation under section 9B as well as section 45(4)

Evaluate mode of transfer of assets i.e. slump sale or itemized sale – Considering deduction impact as per section 48(iii)

02 Conversion of Company into LLP

Key Comparatives - Company vs LLP (1/3)

Particular	Company	Limited Liability Partnership
Company Law/ LLP Law		
Governing Act	• Companies Act, 2013	• Limited Liability Partnership Act, 2008 ('LLP Act 2008')
Charter	• Memorandum of Association and Articles of Association	• Limited Liability Partnership Agreement
Members	• Minimum - 2 Members • Maximum- 200 Members (Private Company)	• Minimum- 2 Partners • Maximum - No Limit
Meetings	• Four (4) board meetings each year to be held and each board meeting shall be held at the gap of 120 days	• No statutory requirement to hold meetings
Compliance	• Higher reporting/ compliance requirements like minimum number of board meetings, appointment of auditors	• Relatively lower reporting/ compliance requirements as compared to Company
Corporate Social Responsibility ('CSR')	• Mandatory spend of 2% of net profits as per provisions of section 135 of Companies Act, 2013	• No CSR Obligations
Related Party Transactions	• Restrictions/ approvals required for several related party transactions, inter company loans etc.	• No restriction/ approvals required

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Key Comparatives - Company vs LLP (2/3)

Particular	Company	Limited Liability Partnership
Regulatory Implications		
NBFC exposure in case of investment activity	• High - where financial assets are more than 50% of total assets and financial income is more than 50% of total income	• As per literal reading of definition, only a company is regarded as NBFC. • In practice, advisable not to have pure holding LLP as MCA insist for operating LLP
Foreign Direct Investment	• Foreign Investment permitted under automatic and approval route	• Foreign Investment permitted under automatic route in sectors which allow 100% FDI under automatic route and where there are no FDI linked performance conditions
External Commercial Borrowings ('ECB')	• Debt funding through ECB route under exchange control regulation available	• Not permitted to access ECB route for raising funds subject to specific exception

Key Comparatives - Company vs LLP (3/3)

Particular	Company	Limited Liability Partnership
Taxation		
Applicable Tax Rate	• 34.94% / 29.12% • If company opts for section 115BAA benefit- 25.17% • If a newly incorporated company is engaged in business of manufacturing and opts for section 115BAB benefit - 17.16%	• 34.94%
Cash upstreamin g	• Possible by way of dividend only if there are profits / reserves • Also, possible by way of buy-back and capital reduction which are subject to certain conditions and procedures	• Partners can freely withdraw cash from the LLP - No restrictive conditions applicable
Tax liability on cash extraction	• Dividend - taxable for shareholder @ 35.88% • Buy-back - company liable to pay tax @ 23.3%	• Share of profit not taxable in hands of partner
Deemed Dividen d	• Loans and advances by shareholders to company attracts deemed dividend	• No deemed dividend implications

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Why convert to LLP ?

Tax Benefits	Operational Benefits	Regulatory Benefits
• Facilitates tax efficient cash extraction – ideal for owners who anticipate profit upstreaming at regular intervals • No alternate minimum tax ('AMT') subject to certain conditions • Deemed dividend provisions not applicable	• Ideal for small to medium scale businesses • Advisable where inter-se Promoter's relationship is cordial and doesn't warrant strict legal bindings • Gives utmost flexibility and freedom to partners to manage business affairs as per LLP Deed	• Easy to set up, re-organize and wind up • Far less compliances to be undertaken as compared to a company • No mandatory audit if turnover $\leq$ INR 40 lakhs or contribution $\leq$ INR 25 lakhs

2A Key Provisions

Section 47(xiiib) – Conditions for tax neutral conversion of company into LLP

Conversion of company into LLP shall be tax exempt for company and its shareholders provided following conditions are satisfied:

- **All the assets and liabilities** immediately before the conversion become the assets and liabilities of LLP
- All the **shareholders to become partners** of LLP; and
  Contribution and profit-sharing ratio (**'PSR'**) to be in same proportion as their shareholding in company
- **Aggregate of PSR** of the shareholders of the company in the LLP shall be **atleast 50%** at any time during the period of **5 years** from the date of conversion
- In any of the **3 preceding years**:
  Total **sales** or **turnover** or **gross receipts** of the company ≤ INR **60 lakhs**; and
  Total value of **assets** of the company ≤ INR **5 crore**
- **No other consideration** is paid to the shareholders except by way of PSR and capital contribution
- **No amount is paid** to the partners of LLP , directly or indirectly, **out of accumulated profit** of the company as on the date of conversion for a period of **3 years** from the date of conversion.

Other Key Tax Provisions (1/2)

For Company

- Capital gains exempt from tax on fulfilment of conditions u/s 47(xiiib) of the Income tax Act, 1961 ('IT Act').

For LLP

- The actual cost of the block of assets in the case of LLP shall be the written down value of the block of assets in the hands of company on the date of conversion.
- In the year of conversion, the aggregate depreciation allowable to the company and LLP shall not exceed the depreciation calculated at the prescribed rates as if the conversion had not taken place.
- The cost of acquisition of the capital asset for the LLP shall be equal to be the cost for which the company acquired it.

For Partners of LLP

- Capital gains exempt from tax on fulfilment of conditions u/s 47(xiiib) of the IT Act.
- The cost of acquisition of a capital asset being rights of a partner in successor LLP, shall be equal to be the cost of acquisition of the shares in the company immediately before its conversion.

Other Key Tax Provisions (2/2)

Section 72A

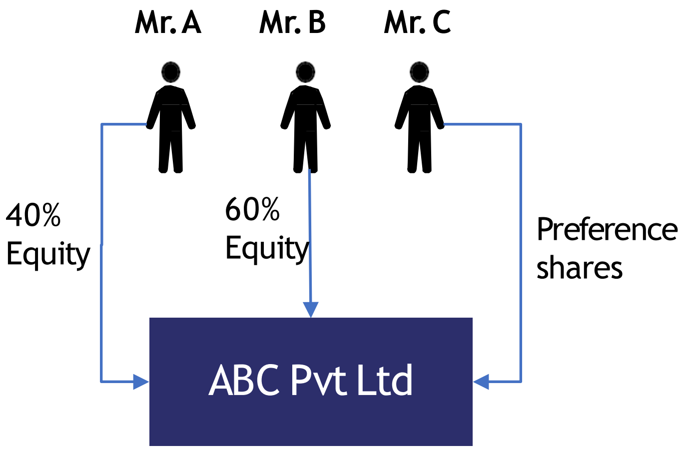
- Subject to fulfillment of conditions prescribed under section 47(xiiib) of the IT Act, the accumulated loss and the unabsorbed depreciation of the company, shall be deemed to be the loss or allowance for depreciation of the LLP for the purpose of the previous year in which company was converted into LLP.
- 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 as prescribed under section 47(xiiib) of the IT Act are not complied with, any accumulated loss or unabsorbed depreciation utilized in any previous year by the LLP, shall be deemed to be the income of the LLP and chargeable to tax in the year in which such conditions are violated.

Section 47A

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

2B Case Studies

Case Study - 1



Facts:

- Mr. A and Mr. B are equity shareholders of ABC Pvt Ltd
- Mr. C is a preference shareholder of ABC Pvt Ltd
- The total investment by shareholders is as follows:

  Mr. A - INR 40 lakhs;

  Mr. B - INR 60 lakhs; and

  Mr. C - INR 1 crore
- ABC Pvt Ltd is to be converted into LLP

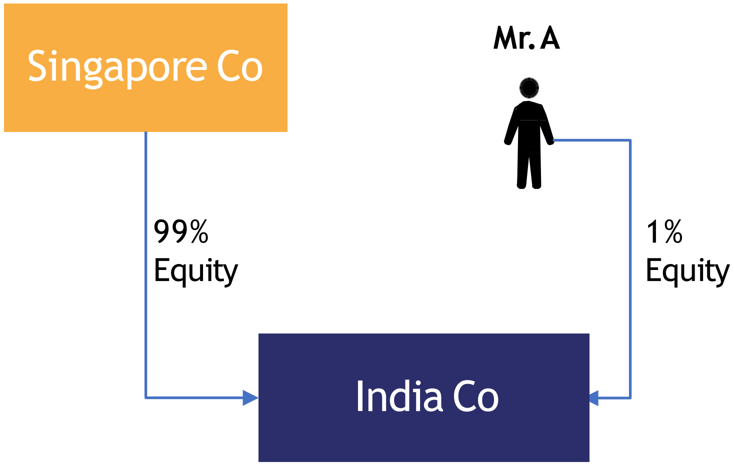
Question

1. Whether a preference shareholder shall also become a partner in LLP for tax neutral conversion?
2. What shall be the capital contribution ratio ('CCR') and PSR of partners in LLP for tax neutral conversion?

Q1 - Yes, preference shareholder shall become partner in LLP

Q2- The CCR and PSR amongst Mr. A, Mr. B and Mr. C shall be in the ratio of 20:30:50 respectively

Case Study - 2



Facts:

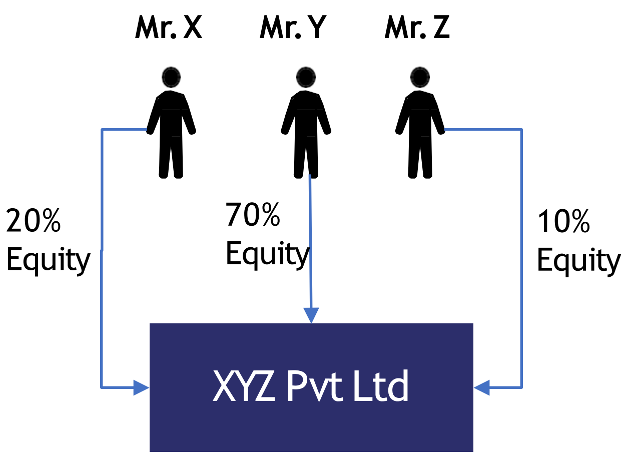
- A company incorporated in Singapore ('Singapore Co') and also a tax resident of Singapore, acquired 99% equity stake in India Co in 2015
- Mr. A, an Indian resident, holds 1% equity stake in India Co
- India Co is engaged in manufacturing business and for year ending March 2021, its turnover was INR 75 crore and the value of total assets was INR 125 crore
- India Co is contemplating to convert itself into LLP in FY 2021-22
- Singapore Co proposes to claim exemption benefit available under Article 13 (Capital Gains) of India-Singapore tax treaty

Question

- Whether Singapore Co would be eligible to claim treaty benefit considering it was a non-tax neutral conversion?

Any gains arising on transfer of shares of India Co shall be taxable in India. However, as per provisions of India-Singapore tax treaty, such gains shall be taxable only in Singapore as per Article 13 and subject to fulfilment of limitation of benefit ('LOB') conditions as per Article 24A of India-Singapore tax treaty

Case Study - 3



Facts:

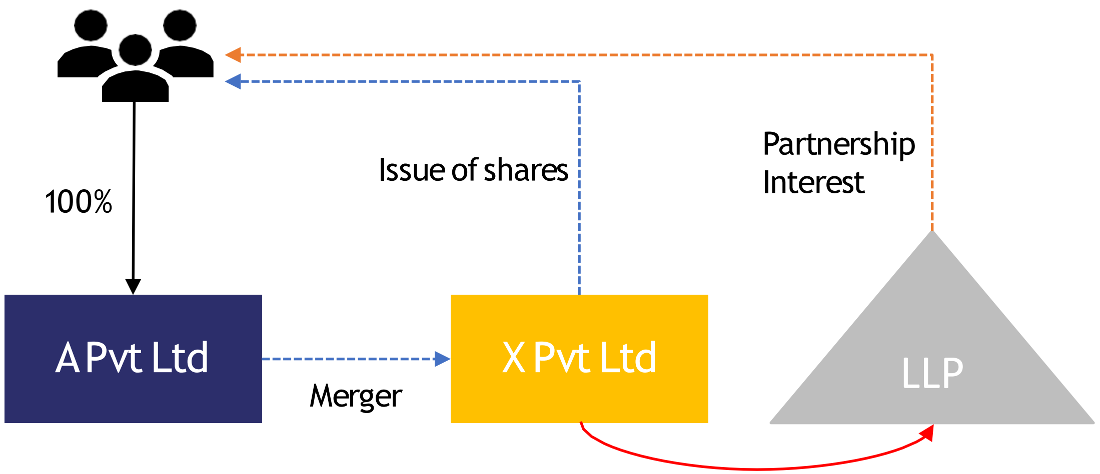
- Mr. X, Mr. Y and Mr. Z are equity shareholders of XYZ Pvt Ltd
- XYZ Pvt Ltd has accumulated profits. The entire balance of accumulated profits is utilized to issue bonus shares to the shareholders prior to conversion into LLP
- Upon conversion, the stake held by the shareholders gets converted and credited as capital contribution in LLP
- In 2nd year post conversion, all the partners withdraw an amount equal to the value of accumulated profits that were utilized for issue of bonus shares

Question

- Whether withdrawal of capital tantamount to withdrawal of 'accumulated profits' as contemplated in section 47(xiiib) ?

No, considering that there were no accumulated profits as on the date of conversion into LLP. However, the same shall be subject to the provisions of General Anti-Avoidance Rules ('GAAR')

Case Study - 4



Facts:

- A Pvt Ltd is proposing to merge with X Pvt Ltd with Appointed Date of 1 April 2021. The merger shall be tax neutral
- As on 31 March 2021, the turnover of A Pvt Ltd is INR 20 crore
- The turnover and assets of X Pvt Ltd has never exceeded limits prescribed under section 47(xiiib) of IT Act
- Post merger, X Pvt Ltd shall be converted into LLP prior to 31 March 2022

Question

- Whether such conversion into LLP violate the condition of ‘turnover’ as prescribed under section 47(xiiib) of the IT Act ?

No, considering that the turnover of the entity being converted i.e. X Pvt Ltd does not exceed the limits prescribed under section 47(xiiib) in any of the 3 preceding years prior to the year of conversion. However, the tax neutrality shall be subject to GAAR provisions

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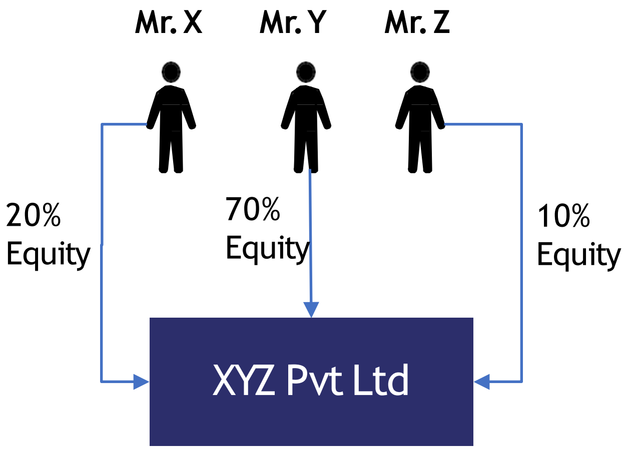
Case Study - 5 (1/3)



Facts:

- Mr. X, Mr. Y and Mr. Z are equity shareholders of XYZ Pvt Ltd
- The turnover of XYZ Pvt as on 31 March 2021 is INR 10 crores and the value of total assets is INR 25 crores
- XYZ Pvt Ltd is proposing to convert itself into LLP in FY 2021-22

Question

1. What are the tax implications in case of a) shareholders; b) XYZ Pvt Ltd; and 3) LLP

Case Study – 5 (2/3)

In case of XYZ Pvt Ltd

View 1-

- Considering the definition of term 'convert' as per Third Schedule of LLP Act, 2008, the assets of the company are 'transferred' and vested into LLP pursuant to conversion[1].
- Therefore, any gains arising on transfer shall be subject to tax as per section 45 of the IT Act.
- In case where the assets of the company are transferred and vested at book value, the sales consideration for the purpose of section 45 read with section 48 of the IT Act shall be the book value of assets[1]. Since the sales consideration and cost of acquisition of net assets shall be equal, no capital gains arises in the hands of the company.

View 2-

- Based on principles discussed in judicial precedents[2], it is possible to argue that pursuant to conversion, all the assets and liabilities vest in the LLP pursuant to succession and therefore the same shall not tantamount to 'transfer'.
- Without prejudice to the above, even if it is considered as 'transfer', it is possible to contend that the company has not received any consideration for statutory vesting of such assets in LLP.
- In absence of consideration, being a key element for the purpose of determining capital gains, the computation mechanism fails.

[1] *Celerity Power LLP (100 taxmann.com 129 [Mumbai Tribunal])*
[2] *Texspin Engg & Mfg Works – (129 taxmann 1 [Bombay])*

Case Study – 5 (3/3)

In case of shareholders

- Based on principles discussed in Advance Authority Ruling (AAR)[1], the shares held in the company are exchanged for interest in LLP and also the rights in the shares of company are extinguished pursuant to deemed dissolution of the company. Therefore, there is a 'transfer' of capital asset for the purpose of section 45 of the IT Act.
- The value of partnership interest received from LLP shall be full value of consideration for the purpose of section 45 read with section 48 of the IT Act.
  - In case value of partnership stake cannot be determined, fair market value of shares of XYZ Pvt Ltd may be considered as full value of consideration pursuant to provisions of section 50D of the IT Act.
- The cost of acquisition of shares shall be available as deduction against sales consideration for the purpose of computation of capital gain.

In case of LLP

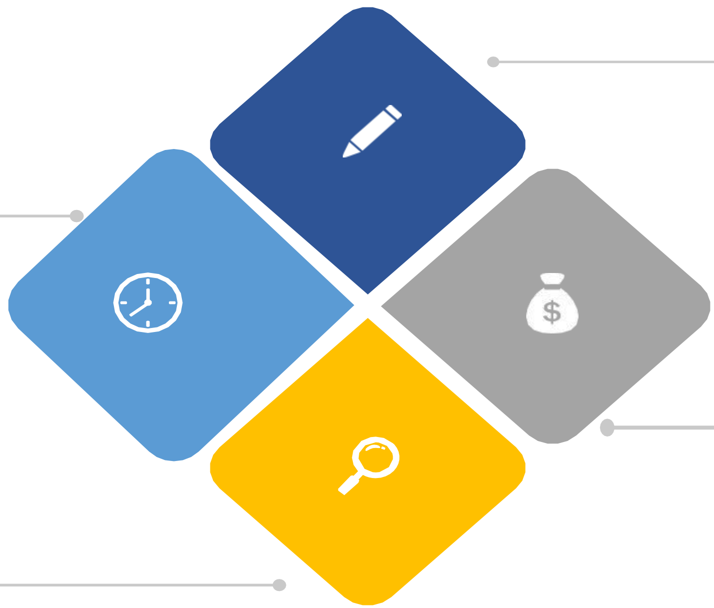
- The LLP shall receive net assets from the company and discharge consideration by giving partnership interest in LLP to the shareholders of the XYZ Pvt Ltd.
- Therefore, it is possible to contend that LLP has discharged adequate consideration for receipt of net assets and hence no tax implication arises under section 56 of the IT Act.
- Further, in case where the assets received by the Successor LLP does not contain any asset which is considered a 'property' as defined in section 56 of the IT Act, there is no tax implication under section 56 of the IT Act in the hands of LLP.

AURTUS

[1] *Domino Printing Science Plc (124 taxmann.com 187 [AAR])*

2C Key Consideration

Points to Ponder



Period of Holding ?

Whether period of holding of shares prior to conversion be included in the period of holding of partnership interest?

Deemed taxation?

In case of non-tax neutral conversion at book value, whether provisions of section 50C, 50CA and 56(2)(x) of IT Act can get attracted?

LLP as a holding company ?

Whether 47(iv) exemption will continue if the holding company (which has claimed 47(iv) exemption in the past) is converted into LLP?

Cost of acquisition ?

Whether LLP shall be eligible to claim cost of acquisition of listed shares as per section 55(2)(ac) of IT Act?

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Key Considerations

What constitutes turnover /sales /gross receipts for the purpose of section 47(xiiib).

As per CBDT Circular 1/2011 the sales / gross receipts / turnover of the business which is taxable under the head 'Profits and gains of business or profession' shall be considered

Whether MAT credit of company can be utilized by the LLP post conversion

LLP cannot utilize accumulated MAT credit of company post conversion (Section 115JAA of IT Act)

Whether is it necessary to remove charge on the assets of the company prior to conversion into LLP

Yes, as per Third Schedule to LLP Act, 2008 a company may apply for conversion provided no security interest in its asset is subsisting or in force at the time of application

Whether LLP has to re-negotiate existing contracts with customers and vendors

No, as per Third Schedule to LLP Act, 2008 the reference to the company shall be substituted with reference to the LLP as if such LLP was a party to the agreement

AURTUS

2D Key Judicial Precedents

Domino Printing Science Plc (AAR No 1290 of 2012)

Facts

- Domino Printech India Private Limited ('Domino India') was converted into LLP pursuant to approval of the FIPB
- The turnover of Domino India exceeded the threshold prescribed under section 47(xiiib) of the IT Act
- Key questions raised before the AAR:
  - Whether conversion of equity shares into partnership interest in an LLP amounts to a transfer under the IT Act?
  - On such conversion, whether the capital gains tax computation mechanism fails?
  - Whether there is a taxable capital gains as the value of partners' interest in LLP cannot be more than the value of shareholders' interest in the company?

Key Contentions by Assessee

- Transfer of shares pursuant to conversion does not tantamount to transfer as per section 2(47) of IT Act
- This is not a case of extinguishment wherein a right in one is merged or consolidated with the other. In this case, there was no merger or consolidation but conversion of a company into an LLP.
- The Bombay High Court in the case of Texspin[1] has held that the vesting of properties in the company (under the erstwhile Part IX conversion) was a statutory vesting which did not constitute a transfer.

[1] *Texspin Engg & Mfg Works – (129 taxmann 1 [Bombay])*

Domino Printing Science Plc (AAR No 1290 of 2012)

AAR's Ruling

With regards to 'transfer':

- The definition of transfer under section 2(47) is an inclusive definition and it therefore covers extinguishment of shareholder's interest on conversion of company into LLP.
- The facts in Texspin are completely different from the facts of the present case and hence the same is distinguishable.

•Extinguishment of shares in the company was 'transfer' as per provisions of section 2(47) of the IT Act.

With regards to computation mechanism:

- For computing capital gains, the value of the interest in the newly formed LLP will be the full value of consideration and the cost of acquisition would be the amount paid by the applicant shareholder at the time of purchase of shares.
- In case the value of partnership interest cannot be determined, then the fair market value of the shares of the company would be deemed as consideration as per section 50D of the IT Act.

With regards to absence of capital gains:

- The value of the shareholder's interest in the company which may be equal to the total interest in the LLP is not relevant in determining the impact of capital gains in the hands of shareholders.
- The specific asset of the shareholder which is extinguished is the shares held in the company, which is different from shareholder's funds appearing in the books of the company and therefore capital gains arises in the hands of the shareholder.

Celerity Power LLP (ITA No. 3637 / Mum / 2015)

Facts

- Celerity Power LLP (‘Celerity’ or ‘Assessee’), earlier a private company was converted into LLP
- During assessment proceedings, the tax authority (‘TA’) argued that since the sales of company exceeded the threshold prescribed under section 47(xiiib) of the IT Act, such conversion is a taxable transfer and provisions of section 47A shall apply.
- The TA considered the fair market value of assets transferred as full value of consideration in the hands of company
- Key issues before ITAT:
  - Whether the conversion of company into LLP would be a ‘transfer’ chargeable to tax considering that the conditions for tax neutrality were not complied with?
  - What will be the value of consideration for determining capital gains, if any?

Key Contentions by Assessee

- Pursuant to conversion, all the assets and liabilities of the company stands vested in the LLP without any further assurance, act or deed.
- Thus, the term ‘transfer’ used in the definition of the term ‘convert’ in Third Schedule as per the LLP Act 2008 cannot be read as ‘transfer’ under the Transfer of Property Act, 1882.
- In absence of charging mechanism, mere ineligibility to claim exemption under section 47(xiiib) cannot lead to the chargeability under section 45 of the IT Act

Celerity Power LLP (ITA No. 3637 / Mum / 2015)

ITAT's Ruling

With regards to 'transfer':

- Based on Memorandum to Finance Act, 2010, the conversion of a company into an LLP qualified as 'transfer' chargeable to tax and attracted levy of capital gains tax prior to insertion of tax neutral provisions.
- Such conversion involves the transfer of property, assets, etc. based on the definition of the term 'convert' as per the LLP Act, 2008 as against the Companies Act, 1956 in case of conversion of a firm into company.

•Therefore, conversion of company into LLP is a 'transfer' as per section 2(47) of the IT Act

With regards to value of consideration:

- In one of the judgements[1], Supreme Court has held that the expression "full value of consideration" could not be construed as the market value of the asset, but it shall mean the price bargained for by the parties to the transactions.
- In the instant case, the price at which the assets and liabilities were vested in the LLP was the book value. Therefore, such book value could only be regarded as the full value of consideration
- Although there was a transfer of capital asset, since the difference between the consideration and the cost of acquisition was nil, the machinery provision is rendered unworkable while computing the capital gains

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03 Conversion of Firm into Company

Key Comparatives - Company vs Firm (1/3)

Particular	Company	Partnership Firm
Company Law/ Partnership Law		
Governing Act	• Companies Act, 2013	• Indian Partnership Act, 1932
Charter	• Memorandum of Association and Articles of Association	• Partnership Deed
Members	• Minimum - 2 Members • Maximum- 200 Members (Private Company)	• Minimum- 2 Partners • Maximum - 50 Partners
Liability of Members	• Limited to the extent of share capital	• Unlimited
Meetings	• Four (4) board meetings each year to be held and each board meeting shall be held at the gap of 120 days	• No statutory requirement to hold meetings
Compliance	• Higher reporting/ compliance requirements like minimum number of board meetings, appointment of auditors	• Relatively lower reporting/ compliance requirements as compared to Company
Corporate Social Responsibility ('CSR')	• Mandatory spend of 2% of net profits as per provisions of section 135 of Companies Act, 2013	• No CSR Obligations
Related Party Transactions	• Restrictions/ approvals required for several related party transactions, inter company loans etc.	• No restriction/ approvals required

Key Comparatives - Company vs Firm (2/3)

Particular	Company	Partnership Firm
Regulatory Implications		
NBFC exposure in case of investment activity	• High - where financial assets are more than 50% of total assets and financial income is more than 50% of total income	• As per literal reading of definition, only a company is regarded as NBFC.
Foreign Direct Investment	• Foreign Investment permitted under automatic and approval route	• Foreign investment in a partnership firm is not permissible under automatic route except for investment by NRI and OCI subject to certain conditions
External Commercial Borrowings ('ECB')	• Debt funding through ECB route under exchange control regulation available	• Not permitted to access ECB route for raising funds

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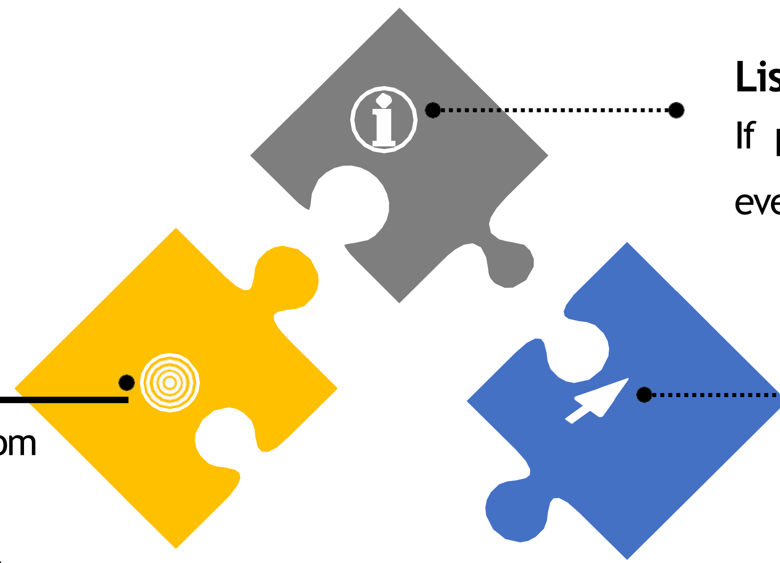
Key Comparatives - Company vs Firm (3/3)

Particular	Company	Partnership Firm
Taxation		
Applicable Tax Rate	• 34.94% / 29.12% • If company opts for section 115BAA benefit- 25.17% • If a newly incorporated company is engaged in business of manufacturing and opts for section 115BAB benefit - 17.16%	• 34.94%
Ease in cash upstreamin g	• Possible by way of dividend only if there are profits / reserves • Also, possible by way of buy-back and capital reduction which are subject to certain conditions and procedures	• Partners can freely withdraw cash from the firm - no restrictive conditions applicable
Tax liability on cash extraction	• Dividend - taxable for shareholder @ 35.88% • Buy-back - company liable to pay tax @ 23.3%	• Share of profit not taxable in hands of partner
Deemed Dividen d	• Loans and advances by shareholders to company attracts deemed dividend	• No deemed dividend implications

Why convert to Company ?



Listing Objective

If promoters are eyeing to unlock value by eventually listing its shares on stock exchanges

Funding

- Ease of fund raising from multiple investors
- Issue of hybrid instruments possible
- Access to External Commercial Borrowings ('ECB')
- Attract Foreign Direct Investment ('FDI')

Tax Benefits

Take advantage of benefits available under IT Act:

- Lower corporate tax rate
- Non-applicability of Minimum Alternate Tax ('MAT') to certain companies
- Specified tax exemptions for M&A

3A Key Provisions

Section 47(xiii) – Conditions for tax neutral conversion of Partnership Firm ('PF') into Company

Conversion of a partnership firm into company shall be tax exempt for the firm provided following conditions are satisfied:

First Condition
All the assets and liabilities of the firm relating to the business immediately before the succession become the assets and liabilities of the company

Second Condition
All the partners of the firm become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the succession

Third Condition
The partners of the firm do 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

Fourth Condition
The aggregate of the shareholding of the partners is atleast 50% of the total voting power in the company and their shareholding continues to be as such for a period of 5 years post conversion

Other Key Tax Provisions (1/2)

For Company

- The aggregate depreciation allowable to the firm and company shall not exceed, in any previous year, the depreciation calculated at the prescribed rates as if the conversion had not taken place.
- The cost of acquisition of the capital asset for the company shall be deemed to be the cost for which the firm acquired it.

For partners

- No specific provision has been included with regards to determining cost of acquisition of shares of the company
- No specific provision has been included with regards to determining the period of holding of capital asset being shares of the company.

Other Key Tax Provisions (2/2)

Section 72A

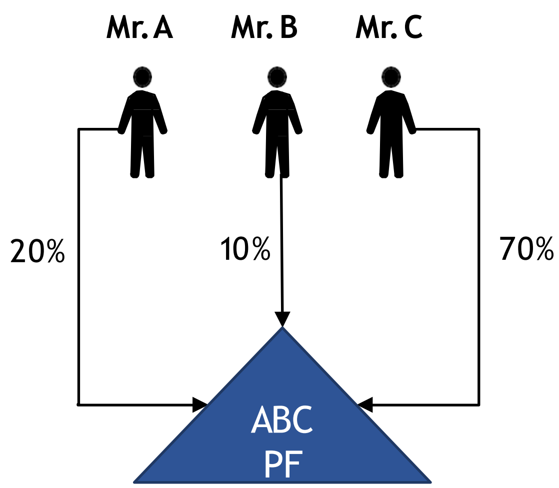
- Subject to fulfillment of conditions prescribed under section 47(xiii) of the IT Act, the accumulated loss and the unabsorbed depreciation of the firm shall be deemed to be the loss or allowance for depreciation of the company for the purpose of previous year in which conversion was effected.
- Further, 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 as prescribed under section 47(xiii) of the IT Act are not complied with, any accumulated loss or unabsorbed depreciation utilized in any previous year 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.

Section 47A

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

3A Case Studies

Case Study – 1



Facts:

- Mr. A, Mr. B and Mr. C are partners of ABC PF
- The partner's aggregate contribution is INR 10 lakhs
- ABC PF is to be converted into company viz. ABC Pvt Ltd
- Pursuant to conversion, ABC Pvt Ltd shall issue shares in following manner:

  Mr. A – 20,000 equity shares of INR 10 each;

  Mr. B – 10,000 equity shares of INR 10 each; and

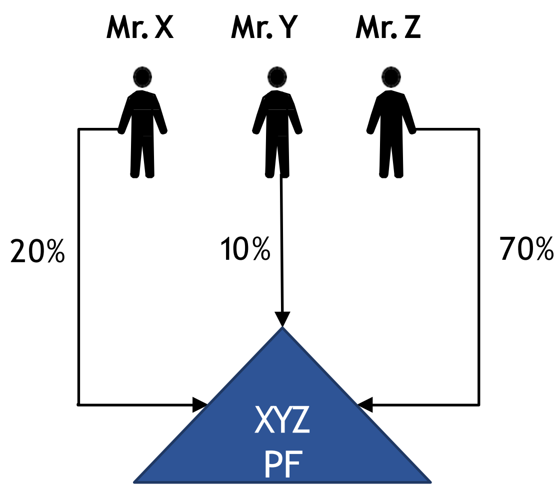
  Mr. C – 70,000 preference shares of INR 10 each
- The preference shares carry equal voting rights as equity

Question

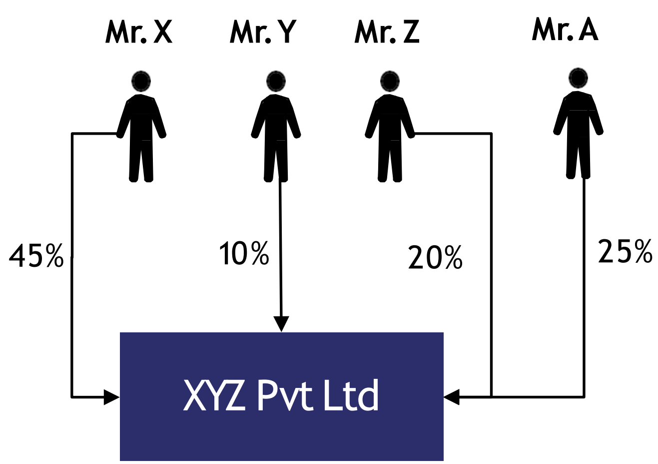
1. Whether issue of preference would impact tax neutral conversion of firm into company?

No, considering that all the partners became shareholders of the company in the proportion of their capital contribution and their aggregate shareholding in the company is greater than 50% of total voting power

Case Study - 2



<u>Resultant Structure</u>



Facts:

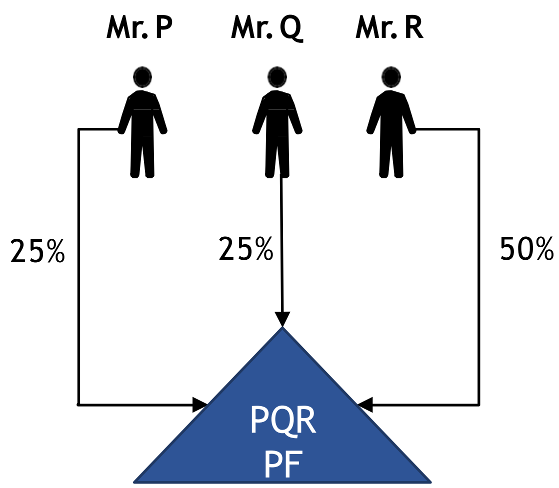
- Mr. X, Mr. Y and Mr. Z are partners of XYZ PF
- XYZ PF is to be converted into company viz. XYZ Pvt Ltd
- XYZ Pvt Ltd shall issue shares to the partners of PF in the ratio of their capital contribution
- Post conversion, Mr. Z transfers 25% stake each to Mr. X and a new investor viz. Mr. A

Question

1. Whether tax neutral conversion of XYZ PF is impacted ?

No, considering that the aggregate shareholding of the partners of XYZ PF is greater than 50% of total voting power in the company

Case Study - 3 (1/3)



Facts:

- Mr. P, Mr. Q and Mr. R are partners of PQR LLP
- The capital contribution and PSR between P, Q and R is 25:25:50
- PQR PF is to be converted into company viz. PQR Pvt Ltd
- Pursuant to conversion, PQR Pvt Ltd shall issue shares to the P, Q and R in the ratio of 50:25:25

Question

- What are the tax implications in case of a) PQR PF; 2) Partners; and 3) Company

Case Study - 3 (2/3)

In case of PQR PF

- Based on principles discussed in judicial precedents[1], it is possible to argue that all the assets and liabilities statutorily vest in the company pursuant to succession and therefore the same shall not tantamount to 'transfer'.
- Without prejudice to the above, even if it is considered as 'transfer', it is possible to contend that the firm has not received any consideration for statutory vesting of such assets in company.
- In absence of consideration, being a key element for the purpose of determining capital gains, the computation mechanism fails
- Similar view has also been upheld in case of Umicore Finance Luxembourg (76 taxmann.com 32 [Bombay HC])
- Further, provisions of section 45(4) of the IT Act shall not apply to the firm on following grounds:
  – In case of conversion of firm into company, the assets of the firm vest with the company by way of statutory force
  – Section 45(4) deals with distribution of assets upon dissolution which is difference than vesting of assets in company

[1] *Texspin Engg & Mfg Works – (129 taxmann 1 [Bombay])*

Case Study - 3 (3/3)

In case of Partners

- Partner's share in the capital / profit of the firm shall be capital asset as per section 2(14) of the IT Act
- Pursuant to conversion of firm into company, the firm shall stand dissolved resulting in extinguishment of right in a partnership firm i.e. capital asset
- Therefore, any capital gains on extinguishment of right in partnership firm shall be subject to tax
- The fair value of shares received shall be full value of consideration for the purpose of section 45 read with section 48 of the IT Act
- Actual capital contribution to the firm may be considered as cost of acquisition for the purpose of determining capital gains

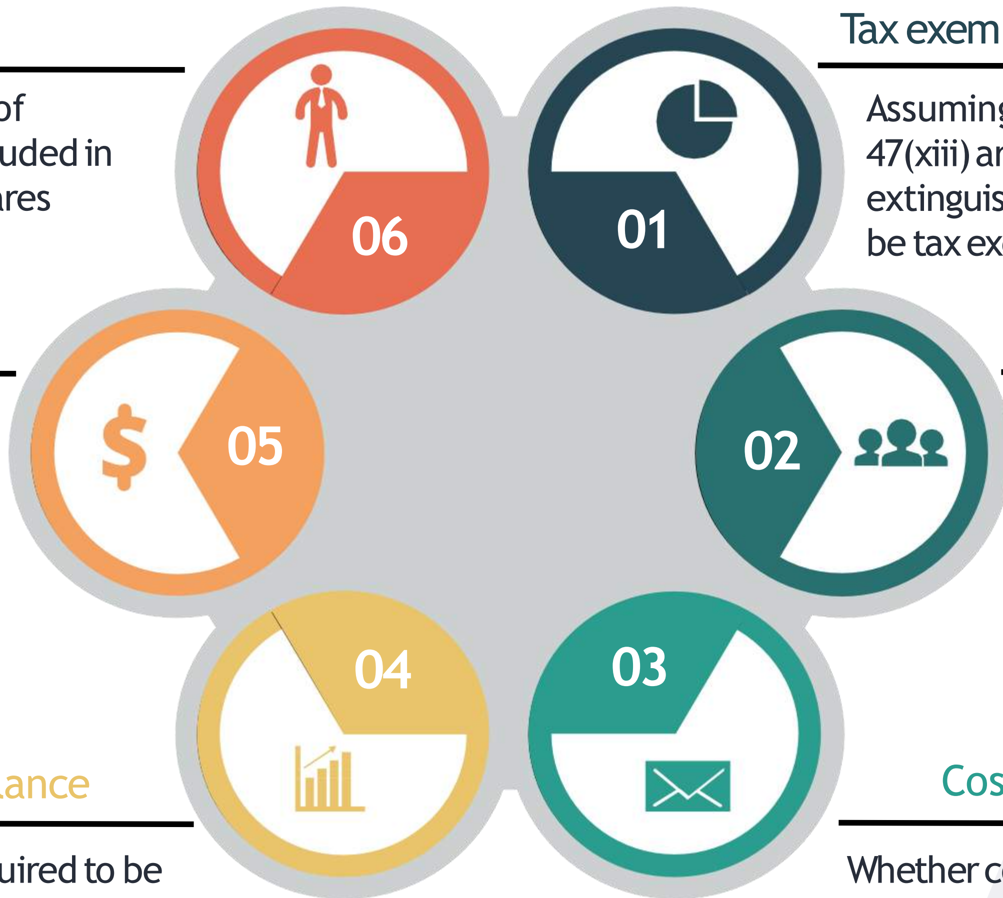
In case of Company

- The Company shall receive net assets from the firm and discharge consideration by way of issue of shares to the partners of the firm
- Therefore, it is possible to contend that Company has discharged adequate consideration for receipt of net assets and hence no tax implication arises under section 56 of the IT Act
- Further, in case where the assets received by the Company does not contain any asset which is considered a 'property' as defined in section 56 of the IT Act, there is no tax implication under section 56 of the IT Act in the hands of Company

[1] *Domino Printing Science Plc (124 taxmann.com 187 [AAR])*

3B Key Considerations

Points to Ponder



Tax exempt 'transfer' for Partners?

Assuming all the conditions of section 47(xiii) are satisfied, whether extinguishment of right in firm would be tax exempt for partners

Loan to Director

Whether provisions of section 185 of the Companies Act, 2013 shall apply in case a partner (who has taken loan from the firm) becomes director of the company pursuant to conversion

Cost of acquisition

Whether company shall be eligible to claim cost of acquisition of listed shares as per section 55(2)(ac)

Negative Capital Balance

Whether shares are required to be issued even in case when partner's capital account is negative or has a debit balance

Restructuring

Post conversion:
1. Converted company merges with another company; or
2. Another company merges with converted company

Whether tax neutrality can be challenged

Period of Holding

Whether period of holding of partnership interest be included in the period of holding of shares

3C Key Judicial Precedent

Texspin Engg. & Mfg. Works [129 Taxman 1 (Bombay)]

Facts

- A partnership firm ('Firm') was converted into limited company. The conversion was made under Part IX of the Companies Act, 1956
- The firm did not disclose any capital gain on the ground that since there was no dissolution of the firm, there was no transfer as such and therefore section 45(4) of the IT Act was not attracted.
- The TA held that it was a transfer of capital assets by way of distribution and such transfer was on the dissolution of the firm and therefore profits or gains from such transfer became chargeable to tax under section 45.

Key Contentions by Revenue

- Pursuant to conversion, the erstwhile firm stood dissolved.
- On such vesting, every asset of the firm was taken over by the company. Further, as a result of vesting, the company became the owner of all the properties of the firm and in lieu thereof, shares were allotted to the partners by the company. Therefore, in this case, section 45(4) was applicable.
- Alternatively, on dissolution of the firm, there was extinguishment of all the rights of the firm in the capital assets and, therefore, there was a transfer as contemplated under section 2(47) read with section 45(1) of the IT Act

Texspin Engg. & Mfg. Works [129 Taxman 1 (Bombay)]

High Court's Ruling

- The firm had been treated as a limited company by virtue of section 575 of the Companies Act, 1956. and the firm became a company under Part IX of the Companies Act, 1956
- Under Part IX, when a partnership firm is treated as a company, the properties of the erstwhile firm vests in the limited company. There is a difference between vesting of the property and distribution of the property.
- On vesting in the company under Part IX, the properties vest in the company as they exist. On the other hand, distribution on dissolution presupposes division, realisation, encashment of assets and appropriation of the realised amount
- Generally, in the case of a transfer of a capital asset, two important ingredients are existence of a party and a counter-party and, secondly, incoming consideration qua the transferor. When a firm is treated as a company, the said two conditions are not attracted.
- All properties of the firm vest in the company pursuant to conversion but that vesting is not consequent or incidental to a transfer. It is a statutory vesting of properties in the company as the firm is treated as a limited company.
- Assuming it is a 'transfer', the liability to pay capital gains would not arise because section 45(1) is required to be read with section 48 wherein the term 'full value of consideration' is what the transferor receives in lieu of the assets he parts with, viz., money or money's worth and, therefore, the very asset transferred or parted with cannot be the consideration for the transfer and, therefore, the expression 'full value of the consideration' cannot be construed as having a reference to the market value of the asset transferred. In the instant case, the firm did not receive any consideration.

04 Restructuring of LLP

4A Merger / Demerger

Merger of LLPs (1/2)

Tax Implications under IT Act

- The IT Act does not contain tax neutral provisions covering such merger of LLPs – Unlike merger of companies
- Considering absence of specific exemption provisions, the tax implications may arise as under:
- **<u>In the hands of the amalgamating LLP</u>**
  - Tax authorities may argue that capital gains has arisen in the hands of the amalgamating LLP pursuant to transfer of capital asset pursuant to merger
  - Possible to argue that capital gains does not arise in the hands of LLP considering the Bombay High Court judgement in case of *CIT vs Texspin Engg. & Mfg. Works [2003] 129 Taxman 1 (Bombay)P*
  - Based on the principles discussed in judicial precedents, possible to argue on following grounds:
    - ✓ All the assets and liabilities statutorily vest in the LLP pursuant to succession and therefore, the same shall not tantamount to 'transfer'
    - ✓ LLP does not receive any consideration pursuant to such merger – Computation mechanism fails
    - ✓ At the time of merger, the transferor LLP ceases – for "transfer" of capital asset – there should be existence of party and counter party

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Merger of LLPs (2/2)

- **<u>In the hands of the partners</u>**
  - Right in the LLP shall be treated as a capital asset as per section 2(14) of the IT Act
  - Extinguishment of right in the LLP shall be regarded as 'transfer' of capital asset
  - Determining capital gains on such transfer of interest in the LLP
    - ➢ Tax authorities may argue that the value of interest received in amalgamated LLP is full value of consideration
    - ➢ Since consideration is not ascertainable, recourse to section 50D may be possible. However, difficulty in determining "FMV" of the interest in LLP given up would arise.
    - ➢ Cost of acquisition of interest given up in amalgamating LLP – Whether initial capital contribution or closing capital balance.
    - ➢ In case consideration or cost of acquisition is not determinable, whether ratio laid down in **BC Srinivasa Shetty** [21 CTR (SC) 138] can be applied to argue that since computation mechanism fails, capital gains cannot be determined and hence not taxable.
- **<u>In the hands of amalgamated LLP</u>**
  - Possible to argue that no tax implications should arise considering that amalgamated LLP has issued adequate consideration to the partners of amalgamating LLP

De-merger from LLP

Tax Implications under IT Act

- The IT Act does not contain tax neutral provisions covering demerger from LLPs – Unlike demerger of companies
- Considering absence of specific exemption provisions, the tax implications may arise as under:
- **<u>In the hands of the partners of demerged LLP</u>**
  - No tax implication should arise considering that the partners continue to hold interest in the demerged LLP
- **<u>In the hands of demerged LLP</u>**
  - Tax authorities may argue that capital gains has arisen in the hands of the demerged LLP pursuant to transfer of capital asset pursuant to merger
  - Based on judicial precedents, possible to argue that capital gains does not arise in the hands of demerged LLP considering absence of any consideration and hence computation mechanism fails
- **<u>In the hands of resulting LLP</u>**
  - Possible to argue that no tax implications should arise considering that resulting LLP has issued adequate consideration to the partners of demerged LLP

4B Transfer of stake in LLP

Transfer of Partner’s rights in LLP / Firm (1/3)

Section 42 of LLP Act

- Assignment / transfer of partner’s interest is possible:
  - To share profits and losses;
  - To receive distribution in accordance with LLP agreement
  - Such a transfer does not cause the disassociation of the partner or dissolution of LLP
- Based on the provisions of section 43 of LLP Act, it may be possible to separately assign the right to share profit / loss and right to receive distribution from the LLP
- The transfer of right does not entitle the assignee / transferee to participate in the management or conduct of activities
  - The LLP deed may be required to be amended to recognize and induct transferee as a partner of the LLP in order to legally enjoy the rights of a partner

Transfer of Partner's rights in LLP / Firm (2/3)

Section 29 of Indian Partnership Act, 1932

- A partner may transfer his / her interest in the firm such that the transferee shall be entitled to the following:
  - Share profits and losses; and
  - Receive distribution of assets on dissolution / retirement.
- The transfer of right does not entitle the transferee to participate in the management or conduct of activities of the firm
  - The partnership deed may be required to be amended to recognize and induct transferee as a partner in firm in order to legally enjoy the rights of a partner

Transfer of Partner's rights in LLP / Firm (3/3)

Tax implications

- **Whether partner's right in firm / LLP is a capital asset?**
  - Nature of rights of a partner – 'capital asset' or personal privilege
  - By virtue of section 42 of the LLP Act and section 29 of Indian Partnership Act, 2008 – the right of partner is separately assignable
  - Therefore, partner's right in LLP shall be regarded as 'capital asset' under section 2(14) of IT Act
- **What is the cost of acquisition of such right?**
  - Whether it is initial contribution or latest capital account balance
  - Possible to apply ratio laid down in case of *BC Srinivasa Shetty [21 CTR (SC) 138]* to contend that since computation mechanism fails, capital gains cannot be determined and hence not taxable
  - Tax authorities may argue that the right in firm /LLP should be regarded as right to carry on business and hence the cost of acquisition should be NIL – However, possible to defend that the right in firm / LLP cannot be equated with a right to carry on business
- **Applicability of section 50CA or 56(2)(x)?**
  - Provisions of section 50CA of IT Act should not apply
  - Since interest in LLP does not get covered in the definition of 'property' as defined under section 56 of IT Act, section 56(2)(x) should not be attracted

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05 Cross Border Taxation of Firm / LLP

5A Key Provisions

Key Provisions – IT Act

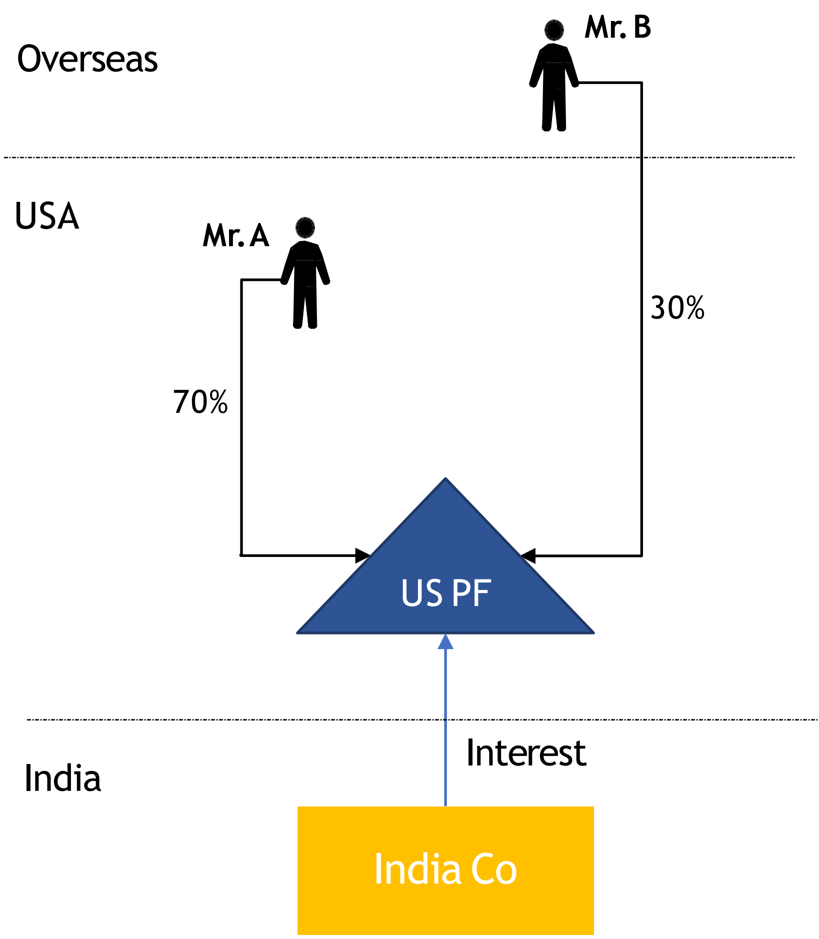
- Section 2(23) of IT Act defines 'firm' to mean a partnership constituted under the Indian Partnership Act, 1932. Further, the term 'firm' shall also include a LLP as defined under LLP Act, 2008
- The term 'LLP' is defined under LLP Act, 2008 to mean partnership formed and registered under LLP Act, 2008
- Section 2(17) of IT Act defines the term 'company' to include any body corporate incorporated by or under the laws of a country outside India
- As per section 6 of IT Act, a firm is said to be resident in India in every case except where the control and management of its affairs is situated wholly outside India during that year.
- Since a firm / LLP is treated as a separate taxable person under the provisions of IT Act, income of such firm / LLP is taxed in its own hands at applicable rates.
- As per section 10 of IT Act, any the share of income of partner received from the firm / LLP is exempt from tax in the hands of such partner
- In case a partnership is not organized within the meaning of the Indian Partnership Act, 1932 or fails to fulfil the conditions prescribed under section 184 of the IT Act, it is likely that it may be treated as an association of persons ('AOP')

Tax Treaty Provisions

- The tax treaty generally provides that the provisions of tax treaty shall apply only to the ‘persons’ who are ‘residents’ of either India or other contracting country
- Pertinent to ascertain whether foreign firm / LLP would be eligible to claim benefit under provisions of tax treaty considering its characterization under domestic tax law
- Characterization of firm / LLP as per domestic law in select overseas jurisdiction has been discussed below for reference:
  - Under domestic law of UK, LLP is regarded as a body corporate. However, it is regarded as a fiscally transparent entity for tax purposes
  - Partnership firms / LLP in US are generally treated as transparent / pass through entity for tax purposes. The tax is levied on partners of the firm and there is no entity level taxation on the firm / LLP
  - In case of Singapore, firm / LLP is not regarded as a separate legal entity for tax purposes. Firm / LLP is not subject to tax and the partners are liable to pay tax on its share of income
- Where it is possible to establish that a foreign partnership has same primary features and characteristics as that of an Indian partnership firm, it should be regarded as a ‘firm’ under IT Act. In case it is regarded as a body corporate, tax authorities might accord the status of a ‘company’ for the purpose of IT Act.

5B Case Studies

Case Study - 1 (1/2)



Facts:

- Mr. A and Mr. B partners of US partnership firm
- Mr. A is a tax resident of US
- Mr. B is a tax resident of overseas jurisdiction and is not subject to any income-tax in US
- US partnership firm is a fiscally transparent entity for US tax purposes
- India Co pays interest to US partnership firm
- US partnership firm does not have permanent establishment in India

Question

1. Whether US partnership firm would be eligible to claim benefit under US-India tax treaty?

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Case Study – 1 (2/2)

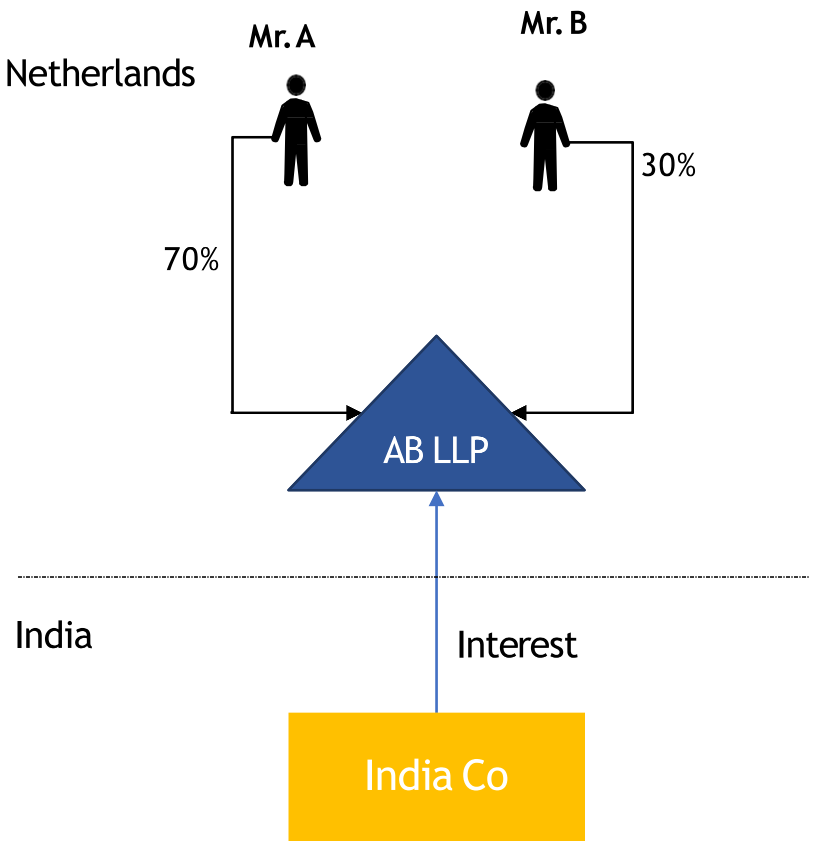
Key Points

- Under Article 3 of the India-USA tax treaty, partnerships are specifically included under the definition of the term 'person'.
- Article 4 of India-USA tax treaty provides that the term 'resident of a contracting State' in relation to a partnership firm applies only to the extent that the income derived by such partnership is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners.
- Considering the above, income received by a partnership will be treated as received by US resident only to the extent such income is subject to tax in the US as the income of a US resident.
- Therefore, the residency of the partners rather than the partnership firm is important in determining whether the income is received by a resident of US for availing tax treaty benefit
- In the given case, Mr. A being a tax resident of USA, interest income to the extent of 70% being subject to tax in USA will be eligible for benefit under India-US tax treaty

Similar view of claiming treaty benefit can be adopted in case of partnerships under India-UK* and India-Canada tax treaty

* Calcutta High Court in case of P&O Nedllyod Ltd [2014] 52 taxmann.com 468

Case Study - 2 (1/2)



Facts:

- Mr. A and Mr. B partners of AB LLP
- Mr. A and Mr. B are tax resident of Netherlands
- It is assumed that AB LLP is treated as a fiscally transparent entity for tax purposes in Netherlands
- India Co pays interest to AB LLP
- AB LLP does not have permanent establishment in India
- The benefit of lower taxation as per provision of section 115A read with section 194LC is not available

Question

1. Whether AB LLP would be eligible to claim benefit under tax treaty between India and Netherlands?

Case Study - 2 (2/2)

Key Points

- Article 3 of the India-Netherland tax treaty defined ‘person’ to include an individual, a company, a body of persons and any other entity which is treated as a taxable unit under the taxation laws of a country
- The term ‘person’ does not include partnership firm except for Indian partnership or LLP which is treated as a taxable unit under the IT Act
- Article 4 of India-Netherlands tax treaty defines ‘resident of a contracting state’ to mean any person who under the laws of a state is **liable to tax** therein by reason of his domicile, residence, place of management or any other criteria of a similar nature
- AB LLP is a fiscally transparent entity for tax purposes in Netherlands and hence it is not liable to tax as per its domestic tax law
- Considering the above, it may be difficult for AB LLP to claim benefit under India-Netherlands tax treaty since it may not be regarded as a ‘resident’ of UK for treaty purposes*.

* Similar view has been taken by AAR in case of ABC, In re [2021] 125 taxmann.com 293