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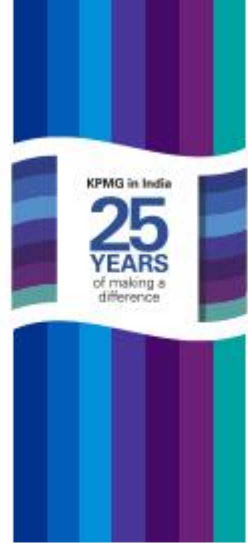

The Mumbai Tribunal decision on taxation aspects of conversion of a private limited company into a limited liability partnership

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Celerity Power LLP[1] (the taxpayer) has dealt with the taxation aspects of conversion of a private limited company into a Limited Liability Partnership (LLP).

During the year, a private limited company was converted into an LLP (the taxpayer) under the LLP Act, 2008 (LLP Act). The taxpayer claimed that the conversion of a company into an LLP did not involve any transfer of the property, assets, liabilities, etc. The Assessing Officer (AO) observed that the conversion did not satisfy one of the conditions of the exemption provisions[2] under the Income-tax Act, 1961 (the Act). Accordingly, the conversion resulted into transfer of capital assets and capital gains on the same liable to tax in the hands of the taxpayer (LLP) as per the provisions of Section 47A(4)[3] of the Act. Further, the claim of the taxpayer with respect to carry forward losses of the erstwhile company was also rejected. Similarly, the deduction claimed by the taxpayer under Section 80-IA of the Act was also rejected on account of failure to file the 'audit report'.

The Commissioner of Income-tax (Appeals) [CIT(A)] observed that since the taxpayer did not fulfil the conditions laid down in exemption provisions, the conversion was treated as a transfer. However, the CIT(A) was in agreement with the claim of the taxpayer, that as there was absence of any consideration involved in the transaction of conversion of the private limited company into an LLP, the machinery for computation of 'capital gain' contemplated in Section 48 of the Act was rendered as unworkable. The CIT(A) also denied carry forward losses of the erstwhile company. However, the CIT(A) observed that as the profit-linked deduction is attached to the 'undertaking' and not to the 'owner of the undertaking', the taxpayer was eligible to claim such deduction. The CIT(A) admitted the audit report as an 'additional evidence' to allow the claim of deduction under Section 80-IA of the Act.

Tribunal's decision

Whether the conversion was resulted into 'transfer' of capital assets

It is evident from Section 47 of the Act that the 'transfers' referred to in the said statutory provision would not be chargeable to income-tax under the head capital gains under Section 45 of the Act. In other words, though the transactions referred to in exemption provisions are 'transfers', however, the same subject to cumulative satisfaction of the conditions contemplated in the respective sub-sections would fall beyond the sweep of chargeability to income-tax as capital gains.

A perusal of the memorandum explaining the purpose and intent behind the enactment of exemption provisions suggests that prior to its insertion, the 'transfer' of assets on conversion of a company into an LLP attracted levy of capital gains tax. The legislature vide the Finance Act, 2010 made Section 47(xiiib) (exemption provisions) available on the statute, with the purpose that the transfer of assets on conversion of a company into an LLP in accordance with the LLP Act, subject to fulfillment of the conditions contemplated therein, shall not be regarded as 'transfer'.

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[1] ACIT v. Celerity Power LLP (ITA No. 3637/Mum/2015) – Taxsutra.com
[2] Section 47(xiiib) of the Act – conversion of a company into an LLP shall not be regarded as transfer
[3] Section 47A(4) of the Act deals with withdrawal of exemption availed under Section 47(xiiib) on non-fulfillment of conditions under such exemption provisions

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The reliance placed by the taxpayer on the decision of the Bombay High Court in the case of Texspin Engg. & Mfg. Works[4] was distinguishable on facts. The High Court had observed that the case before it was of a succession of a firm by a company. On a firm being treated as a company under Part IX of the Companies Act, there was statutory vesting of the properties in the company as the firm is treated as a limited company and it was not a case of transfer. When a firm is treated as a company under Part IX, it is a case similar to the transmission of assets[5].

However, in the instant case, the issue was with respect to the conversion of a private limited company to an LLP. As per Section 56 of the LLP Act, a private limited company may 'convert' into an LLP in accordance with the provisions of Chapter X of the LLP Act. On a perusal of the definition of the term 'convert', the Tribunal observed that the conversion of a private company into an LLP involves the transfer of the property, assets, etc.

The Tribunal observed that the 'transfer' of the property by the company to an LLP under the LLP Act[6] would in itself satisfy the requirement of Transfer of Property Act, 1882 (TOPA). The scope of the term transfer has to be read in the context of the Act and cannot be narrowed down to that defined in TOPA.

Therefore, conversion of a company into an LLP which does not satisfy the conditions of exemption was to be treated as 'transfer' of capital assets. Since the taxpayer failed to satisfy the conditions of exemption provisions, the transaction was treated as 'transfer' of capital assets.

Withdrawal of exemption under Section 47A(4) of the Act

Section 47A(4) of the Act dealing with the withdrawal of exemption comes into play only for the purpose of withdrawing an exemption earlier availed by the taxpayer under the exemption provisions of the Act dealing with conversion of company into LLP. In the instant case, the taxpayer failed to satisfy the conditions provided in 'exemption provisions' itself. Thus, the issue in the present case does not relate to withdrawing of an exemption earlier availed by the taxpayer.

[4] CIT v. Texspin Engg. & Mfg. Works [2003] 263 ITR 345 (Bom)
[5] CIT v. Umicore Finance Luxmeborg [2017] 244 Taxman 43 (Bom), Umicore Finance Luxembourg [2010] 323 ITR 25 (AAR)
[6] As per Clause 6(b) of the 'Third Schedule' of LLP Act

The lower authorities had failed to appreciate that withdrawal provisions which could come into play only for revoking an exemption earlier availed by the taxpayer. It could not have been pressed into for concluding that capital gains arising from the conversion of company into an LLP is taxable in the hands of successor, i.e., LLP.

Liability of successor LLP

As per Section 170(1)(b) of the Act, a 'successor entity' which continues to carry on the business of the person who has been succeeded shall be liable to be assessed only in respect of the income of the previous year after the date of succession. However, the said liability of a successor entity is subject to an exception carved out in Section 170(2) of the Act. It provides that where the predecessor cannot be found, the assessment of the income of the previous year in which the succession took place up to the date of succession, and of the previous year preceding that year shall be made on the successor in the like manner and to the same extent as it would have been made on the predecessor. Since, on conversion, the company stood dissolved, if there is any capital gains arising to the predecessor company on conversion of company into an LLP, it would be taxable in the hands of the successor LLP i.e. the taxpayer.

Capital gain computation on conversion

The conversion of the assets and liabilities of the erstwhile company to the taxpayer LLP took place as per the LLP Act at the 'book value' itself. The entire undertaking of the erstwhile company got vested into the LLP, and hence no separate cost other than the 'book value' was attributable to the individual assets and liabilities. The provisions of Section 48 of the Act which provides for the mode of computation of the capital gains have to be read as an integral part of the charging provision in Section 45 of the Act. The expression full value of consideration used in Section 48 of the Act cannot be construed as the 'market value' of the asset on the date of transfer[7]. Since assets and liabilities of the erstwhile private limited company had taken over at book value, 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. The Tribunal observed that

[7] CIT v. George Henderson and Co. Ltd. [1967] 66 ITR 622 (SC), CIT v. Gilanders Arbuthnot and Co. [1973] 87 ITR 407 (SC)

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the difference between the transfer value and the cost of acquisition was nil, therefore, while computing the 'capital gains' the machinery provision was rendered as unworkable.

Carry forward losses of erstwhile company

Section 72A(6A) of the Act which allows an LLP, carry forward losses of the erstwhile private limited company, is in clear terms preconditioned by a statutory requirement that the taxpayer should have complied with the exemption provisions of the Act. Since the taxpayer had failed to satisfy the conditions of such provisions, the lower authorities had rightly declined the carry forward losses.

The taxpayer relying on the provisions of LLP Act stated that conversion of LLP in the present case stood vested the right of carry forward losses of erstwhile private limited company. However, provisions of LLP Act are only in the context of the tangible and intangible property, interests, rights, etc., and has nothing to do with the carry forward losses.

Benefit of Section 80-IA of the Act

The Tribunal was in agreement with the order of the CIT(A). The taxpayer was under bonafide belief that it was eligible to set-off the losses of the erstwhile private limited company and therefore, upon setting off of such losses its total income was nil. Thus for the said reason it had not raised a claim of deduction under Section 80-IA in its 'return of income' for the year under consideration. Further the taxpayer was under a bonafide belief that non-filing of the audit report would not jeopardise its entitlement towards the claim of deduction under Section 80-IA of the Act. The taxpayer had in the course of the appellate proceedings before the CIT(A) had filed the audit report. The Tribunal observed that filing of an audit report is procedural and directory in nature and the same could also be validly filed by the taxpayer at the appellate stage[8]. Accordingly, the Tribunal allowed the claim of deduction raised by the taxpayer under Section 80-IA of the Act.

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[8] CIT v. Medicaps Ltd. [2010] 323 ITR 554 (MP), CIT v. Gujarat Oil and Allied Industries [1993] 201 ITR 325 (Guj), CIT v. Jaideep Industries [1989]180 ITR 81 (P&H)

Our comments

This is an important decision of the Mumbai Tribunal dealing with the taxation aspects of the conversion of a company into an LLP. In the instant case, the Tribunal distinguished the Bombay High Court decision in the case of Texspin Engg. & Mfg. Works where it was held that the conversion of a partnership firm into a company does not amount to 'transfer'. However, in the instant case, the Tribunal treated the conversion of a company into an LLP as a 'transfer'.

This decision will have a far-reaching impact. The AO may apply this decision to pending proceedings. Further, they may reopen assessments and revise the earlier orders on the basis of this decision. It may have a significant impact on the future action course of corporates as substantial liability will arise on the company when assets are transferred at higher than the book value.

The observations of the Tribunal with respect to taxability in the hands of a successor on a conversion of a company into an LLP, since the company is dissolved, may also impact the successor LLP adversely. Further, the taxpayer may not be eligible for carry forward losses and unabsorbed depreciation of the erstwhile company on non-fulfillment of the exemption provisions.

However, there is some respite for taxpayers where conversion happens at book value. In such cases, no capital gain would arise. However, it has been seen that many corporates convert into LLP by valuing the assets higher than the book value to strengthen the balance sheet of the LLP.

Further, the observations with respect to the availability of deductions like Section 80-IA, etc. in the hands of successor LLP will help the taxpayers to avail such benefits more effectively.

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