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TAX TRIBUNAL RULES THAT CONVERSION OF A COMPANY INTO LLP CONSTITUTES "TRANSFER"

4 December 2018

Recently, the Mumbai bench of the Income Tax Appellate Tribunal (Tribunal) has ruled that the conversion of a private company into a limited liability partnership (LLP) shall be considered as a taxable "transfer" attracting capital gains tax under the Income-tax Act, 1961 (IT Act), unless certain specified conditions are satisfied (Ruling). One such essential condition is that the total sales, turnover or gross receipts in the business of the company in any of the three financial years preceding the financial year in which the conversion takes place, does not exceed INR 60,00,000. However, in the present instance, since the transfer (on account of conversion) was undertaken at 'book-value', no capital gains tax was payable in this case.

Facts

- M/s Celerity Power LLP (Taxpayer) was the erstwhile company which converted into an LLP in the financial year 2010-2011 (Conversion Event). The Conversion Event took place in accordance with the provisions of the Limited Liability Partnership Act, 2008 (LLP Act) and the transfer of assets from the company to the LLP happened at 'book-value'

- In its tax return, the Taxpayer took a position that the Conversion Event was not subject to capital gains tax, despite not satisfying the aforesaid INR 60,00,000 turnover test stipulated for a tax neutral conversion. For this purpose, the Taxpayer placed reliance on the decision of the High Court of Bombay (High Court) in the case of Texspin Engg. & Mfg. Works (Texspin Case). In the Texspin Case, the High Court held that succession of a partnership firm (which is akin to an LLP for income-tax purposes) by a company was not a taxable transfer as it was a case of statutory 'vesting' of property upon the converted company.

- The income-tax authority (Tax Officer) disputed the Taxpayer's position and levied capital gains tax on the Taxpayer for the Conversion Event by imputing the fair values of the assets received by the LLP as sale consideration received. While the first level appellate authority (CIT(A)) held that Conversion Event is a taxable event; since the transfer took place at 'book-value', it held that no capital gains tax was payable by the Taxpayer.

- Both, the Taxpayer as well as the Tax Officer appealed before the Tribunal, being the second level appellate authority.

Decision

Re: Whether the Conversion Event is subject to capital gains tax

The Tribunal ruled that the Conversion Event is subject to capital gains tax as the aforesaid INR 60,00,000 turnover test was not met. The Tribunal distinguished the aforesaid Texspin Case, as in the Texspin Case, there was a statutory vesting of property upon the converted company; whereas, the instant case dealt with conversion of a company into an LLP in which the LLP Act itself uses the word 'transfer'.

Re: Computation of capital gains

- The Tribunal noted that as the transfer of all assets and liabilities of the erstwhile company took place at 'book-value', as per the provisions of the LLP Act, no separate cost other than 'book-value' could be attributable to the assets and liabilities.

- In the absence of any specific provision as per which the 'full value of consideration' could be deemed as the market value of the assets transferred, the consideration received for transfer of the assets, would be its 'book-value' itself.

Therefore, while the Conversion Event was held as a taxable event, since the difference between the cost of acquisition and sale consideration was nil, no taxable gains would arise on such conversion.

Comments

This is an important decision dealing with the taxability of conversion of a company into an LLP. The Ruling also assumes significance as it states that in case of a conversion wherein the conditions for tax neutrality are not met in the year of conversion itself, the capital gains tax liability of the erstwhile company can still be fastened upon the successor LLP.

Interestingly, the Ruling does not deal with implications in the hands of the shareholders at the time of conversion of their shares in the company for an interest in the LLP. Implications in the hands of the shareholders, would therefore need to be evaluated.

Further, it is important to note that the IT Act has certain deeming provisions, as per which, in case of a transfer of certain specified assets (such as land or shares), the fair market value of such assets shall be deemed as the sale consideration for the purpose of computing the capital gains arising to the transferor. The applicability of such deeming provisions in a case where the conditions stipulated for a tax neutral conversion are not met or breached would also need to be examined.

Apart from this, there was another ancillary issue which was also dealt with in this Ruling – i.e. whether tax holiday benefit which was available to the erstwhile company for its power generation business, would continue to be available to the Taxpayer, post conversion. Though the Tribunal has not dealt with this aspect, it was noteworthy that the CIT(A) had held that the tax holiday benefit was unaffected by a past amendment to the IT Act which had debarred the continuance of such benefits in case of amalgamation, demerger.

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