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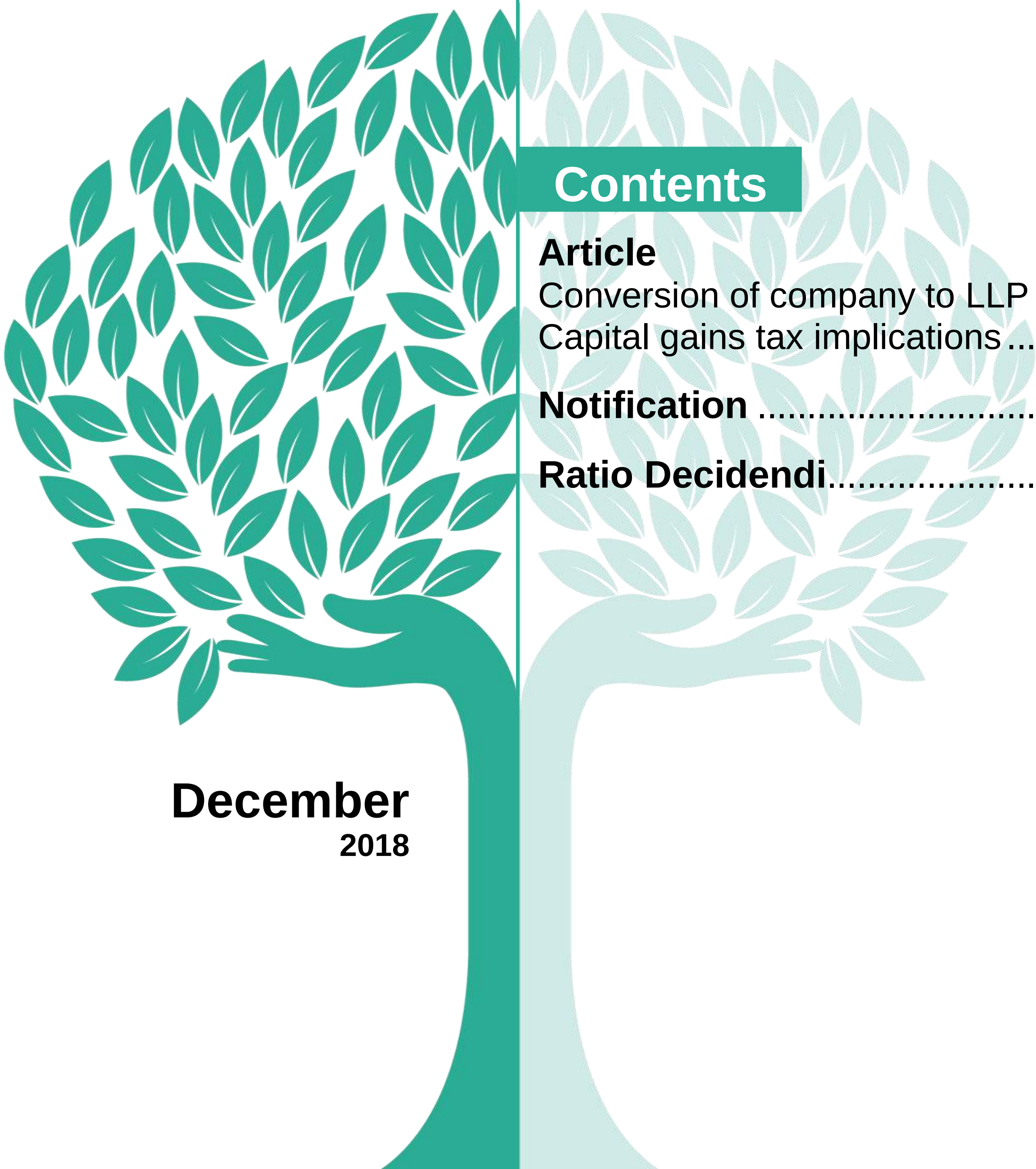

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Conversion of company to LLP - Capital gains tax implications

By **Prerana Priyanshu**

In the past few years, the corporate landscape has witnessed de-corporatisation of many companies, perhaps, because of the regulatory burden imposed on them under the erstwhile and present company laws. With the enactment of the Limited Liability Partnership Act, 2008, a viable option for such de-corporatising entities is to convert themselves into a Limited Liability Partnership ('LLP'). Conversion into LLP is becoming a popular choice for many existing companies for two broad reasons – (i) ease of conversion, for example, conversion of the assets and liabilities of the predecessor company into the successor LLP without any instrument of transfer, and hence, without any stamp duty liability; and (ii) other benefits after conversion, such as, lighter regulations, no limit to the number of partners in LLP, etc.

An aspect which needs to be looked into apart from examining the conversion from the viewpoint of corporate laws and stamp duty, is the implication under the income tax law. This article discusses a crucial aspect on taxability of conversion of company to LLP – *"Whether conversion of company into LLP amounts to 'transfer' for the purpose of 'capital gains' tax under Section 45 of the Income Tax Act, 1961?"*

ACIT v. Celerity Power LLP

The above question is analysed in light of the recent decision of ITAT Mumbai, in the case of *ACIT v. Celerity Power LLP* [2018] 100 taxmann.com 129 (Mum.-Trib.). The respondent-company converted itself to LLP on 28.09.2010 as per the LLP Act, 2008 as a consequence of which its business, assets and liabilities vested in the newly formed LLP. The AO questioned the failure of the assessee to pay tax on the 'transfer', which is as a result of the conversion, under the head 'Capital Gains'.

The primary contention of the respondent was that during the conversion of company to LLP, property, assets or liability of the company were only vested in the new LLP, and not 'transferred'. The backbone of this argument is Section 58(4) and Third Schedule of the LLP Act, 2008, which, when summarised, states that on conversion from private limited company to LLP, all tangible and intangible property of the company shall be transferred to and shall vest in the LLP without further assurance, act or deed. The assessee also relied on the decision of Bombay High Court in *CIT v. Texspin Engg. & Mfg. Works,* [2003] 263 ITR 345 (Bom.), where it was held that conversion of a partnership firm into private limited company would not amount to 'transfer' and further that such a conversion also did not involve 'consideration' for the purpose of taxation under Section 45 of the IT Act.

The Tribunal put forth that the meaning of 'transfer' is to be understood in terms of the IT Act, and not with reference to other Acts such as LLP Act or Transfer of Property Act. It was also observed that every form of conversion is distinct from the other, therefore, the Tribunal declined to follow *Texspin Engg. (Supra),* where it was a partnership firm to company conversion, and not company to LLP conversion, to decide whether it is a 'transfer' or not in the instant case. Thus, in this case, the Tribunal held that a company to LLP conversion is a 'transfer'.

The Tribunal also looked into Section 47(xiiib). Section 47(xiiib) provides that conversion from company to LLP shall not be transfer subject to fulfilment of certain conditions specified in clause (a) to (f) of the proviso to Section 47(xiiib). In this case, since the respondent-company had failed to satisfy clause (e) pertaining to total receipts or turnover in any of the three years preceding the previous year not exceeding Rs. 60 lakhs it was held that they could not avail the shield under Section 47(xiiib).

To put it simply, the ITAT ruled that conversion of a company to LLP is a 'transfer', and upon failure to fulfil conditions under clause (a) to (f) of the proviso to Section 47(xiiib), the newly formed LLP is chargeable to capital gains tax under Section 45 of the IT Act. After holding that the conversion is a 'transfer', the Tribunal finally ruled that there would be no capital gains tax payable as the assets are transferred to the assessee LLP at book value.

Analysis of the ITAT ruling

From an academic point of view, reading this order leaves the impression that the question of law before the tribunal was highly crucial, having large scale impact on corporates and other business entities, however, in the opinion of the author, the decision of the Tribunal was not as appositely reasoned as one might have hoped it to be.

The primary question before the Tribunal was whether conversion of company to LLP is a 'transfer' for the purposes of Section 45 or not? To decide whether a transaction is 'transfer', one may advert to the definition of transfer as is given in Section 2(47). According to the definition under Section 2(47), 'transfer' *qua* any capital asset includes, *inter alia,* 'the sale, exchange or relinquishment of the asset'. In context of the present case, the author is of the opinion, that there is no transfer upon conversion of a company to an LLP for two reasons. First, the conversion is by way of operation of law, whereby, the company, as per the LLP Act, changes its character to that of an LLP and there is no transfer of assets from one person to another. It is upon complying with the provisions under the LLP Act *qua* the conversion that the assets and liabilities of the company automatically vest in the LLP without any transfer taking place. Second, the aspect of sale or exchange or relinquishment primarily requires the existence of two parties, i.e. one who transfers and one in whose favour it is transferred. In case of conversion of company to LLP, there are no two counter parties as the process of conversion only alters the status and character of the existing company, which upon such conversion is treated differently under legal framework. This argument is supported by the decision of the Bombay High Court in in *Texspin Engg. & Mfg. Works (Supra).*

The conclusion of the Tribunal appears to be that that the company to LLP conversion is 'transfer' for reason that the exclusion provided under Section 47(xiiib) for such a transaction (conversion of company to LLP) leads a presumption that such conversions are *ipso facto* 'transfers'. The decision states *"…though the transactions referred to in Section 47 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' under Sec. 45 of the*

Act " (Para 10 of the order). In the opinion of the author, this reverse analogy does not have any concrete basis. The manner to determine whether a transaction is 'transfer' is through Section 2(47), and thereafter, once established as 'transfer', the second step is to see whether it falls under the exclusion provided under Section 47. The method cannot be vice-versa. It is pertinent to know that by using the words 'any transfer' in the opening part of Section 47(xiiib), the law implies only in scenarios where there is a 'transfer' in the first place, can one proceed to see if the conditions under proviso to Section 47(xiiib) are fulfilled. If there is no transfer, then, there is clearly no liability under capital gains tax.

The Tribunal also made a broad comparison of Part IX of Companies Act, 1956 with Section 58(4), read with Clause 6 of Third Schedule of LLP Act. The former talks about succession of a partnership firm by a company, wherein, there is a "vesting" of property of the firm in the company from the date of its registration under Section 575 of 1956 Act. Section 575 is extracted below,

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

Whereas, Section 58(4), read with Clause 6 of Third Schedule of LLP Act states something similar with respect to company to LLP conversion, as extracted below,

"(b) all tangible (movable or immovable) and intangible property vested in the firm or the company, as the case may be, all assets, interests, rights, privileges, liabilities, obligations relating to the firm or the company, as the case may be, and the whole of the undertaking of the firm or the 21 company, as the case may be, shall be transferred to ***and shall vest in the limited liability partnership without further assurance, act or deed;…"***

The conclusion of the Tribunal, after making the abovementioned comparison, is that both these sets of provisions are cumulatively distinct from each other, and therefore, while it is statutory "vesting" in case of Part IX succession, it is "transfer" in case of Section 58(4) read with Third Schedule of LLP Act. However, a close perusal of both these sets of provisions do not provide any basis to make such a distinction, mostly because the same principle flows through both, i.e. vesting of property by operation of law at the time of conversion. The decision does not provide any justification for making this distinction, and consequently labelling company to LLP under Section 58(4) and Third Schedule of LLP, as 'transfer'.

Celerity Power LLP case is the prevailing judicial precedent in the matter of conversion of company to LLP though, the author is of the view that the position taken in *Texspin Engg. & Mfg. Works (Supra)* is correct in law and the same principle should apply to transaction of conversion of company to LLP as well. Nevertheless, for all future conversion of company to LLP, the assessee has the uphill task of overcoming the observations made in *Celerity Power LLP case* in order to demonstrate that the transaction is not a taxable transfer.

[The author is an Associate, Direct Tax Team, Lakshmikumaran & Sridharan, Chennai]

Notifications

Conditions to be fulfilled for conversion of branch of foreign banks to Indian subsidiaries notified

By way of Notification No. 85/2018 and No. 86/2018 dated 6-12-2018 the conditions to be fulfilled by branches of foreign banks converting to a subsidiary company have been notified. AS per Section 115JG, branches of foreign banks converting to an Indian subsidiary company are eligible for certain benefits like capital gains arising on conversion not being taxable and certain exceptions, modifications in respect of treatment of unabsorbed depreciation and carry forward of losses. As per the notifications issued this month, the Indian branch of the banking company must amalgamate with the Indian subsidiary company as per the scheme of amalgamation approved by shareholders of foreign and Indian company as per the Framework for setting up of wholly owned subsidiaries by foreign banks in India issued by RBI. All assets and liabilities of the Indian branch should be transferred and vest in the Indian subsidiary and the foreign parent should continue to hold the whole to the share capital of Indian subsidiary till the end of the previous year from date of conversion and continue to hold not less than 51% of the voting power for period of five years thereafter. The foreign bank should not receive any benefit or consideration other than allotment of shares in the Indian subsidiary company. The Indian subsidiary will be eligible to claim depreciation apportioned on number of days for which the asset was used. As per Sub-rule 4 inserted in Rule 8AA by Notification No.86, the period of holding of a capital asset which become property of the Indian company on conversion, will include the period for which it was held by branch and by previous owner (if any) who acquired it under a will, gift, on liquidation etc.

CBDT issues a directive widening the scope of enquiry in limited scrutiny cases

On 28th November 2018, CBDT issued a directive *vide* F. No 225/402/2018/ITA.II regarding the scope of some limited scrutiny cases. In limited scrutiny cases, the Assessing Officer cannot examine additional issues and has to restrict his enquiry to the parameters which formed the basis of scrutiny i.e, the annual information report (AIR) or TDS statement data mismatch. Hence, even issues which may come to light on basis of information made available by law enforcement agencies or regulatory bodies could not be examined by the officer without approaching the higher authorities and would have led to the conversion of the limited scrutiny to a complete scrutiny. As per the latest directive where credible material or information has been or is provided by any law-enforcement agency, intelligence agency or regulatory authority cy regarding tax-evasion by an assessee, the assessing officer may examine the same without prior administrative approval by Principal Commissioner of Commissioner concerned. The directive shall be applicable from the date of issuance and would apply to the pending 'Limited Scrutiny' cases selected under Computer Aided Scrutiny Selection (CASS) 2017 and 2018 cycles.

Ratio Decidendi

Gain on sale of shares allotted under ESOP while assessee was a non-resident not be taxed as perquisite but as capital gain

The assessee had shares allotted in the ESOP (Employees Stock Option Plan) scheme during the earlier assessment years when the assessee was non-resident. In the instant case, the American company had floated an Indian subsidiary and devised a scheme to give encouragement and pecuniary incentive to the employees of the Indian company by offering to them an option to purchase its own shares at a predetermined price. In the earlier years the assessee was an employee of the foreign parent outside India, but during the year under consideration it was employed by the Indian subsidiary. The gains on sale of shares were realised when the assessee was resident but not ordinarily resident. The Assessing Officer and the CIT(A) treated the sum as perquisites, for the relevant assessment year, instead of capital gain. However, ITAT held that the assessee had already acquired the asset viz., "stock" from the employee's stock options scheme when he was serving abroad in the parent company and therefore during the beginning of the relevant assessment year, the asset was already vested. Any gain on sale arising out of such asset during the relevant assessment year when he is a resident but NOR has to be necessarily treated as capital gain in the hands of the assessee. [*Dr. Muthian Sivathanu* v. *Assistant Commissioner of Income Tax (ACIT)* - I.T. A.No.553/ CHNY/2018 (ITAT Chennai)]

Set-off allowed on administrative policy decision cannot be under taxable income

ITAT, Delhi has held that stipulated set-off of amount granted from the licence fee payable to Department of Telecommunications is out of the purview of Income tax. The Tribunal was of the view that the said amount is in the nature of a concession and could not be considered as a business income since the said sum had not resulted into any business transaction.

The spectrum fees in respect of certain licences was earlier paid by a different entity though part of the same group. The licences were cancelled, and fresh applications were invited, which was won by the assessee. The entity who had earlier won the licence (whose licences were cancelled) had paid license fee which was non-refundable. The assessee company later applied and was allotted licenses. It entered into an agreement with the erstwhile licensee to allow it to set off the license fee, (though the fee was non-refundable), by way of abundant caution. According to the Revenue department, the sum was to be brought to tax as short term capital gain.

The Tribunal held that appellant had not acquired any right from the other entity when that entity itself had no right, title, interest in the amount of non-refundable entry fee paid by it. Hence no capital gains arose. It also stated that transaction of set-off of entry fee is not independent but a composite transaction in respect of acquiring a business. [*Telenor (India) Communications Pvt. Ltd.* v. *ACIT* - I.T.A. No.7541/DEL/2017, decided on 26-11-2018, ITAT Delhi]

Advertising expenses incurred on own volition for purpose of business though as per group policy : Not international transaction

Incidental benefit to group concern is not a bar for deduction under Section 37(1)

At issue was the sponsorship fee for ICC cricket matches globally, reimbursed to an associated enterprise. The revenue authorities contended that sum entailed benefits to brand owned by the parent AE in USA and the resident assessee ought to have been compensated for all advertising promotion and marketing expenses (AMP) incurred by it. Further deduction under Section 37(1) was also denied stating that the expenditure was not wholly and exclusively for the purpose of business of the assessee and some benefit did flow to the group concerns. The ITAT held that on facts, the expenditure was incurred on the volition of the assessee to build brands of products sold in India and the decision to share in the expenses with a foreign AE not based on any agreement or arrangement as envisaged in Section 92B(1). Thus, the entire AMP expenses could not be brought under the ambit of an international transaction and the amount shared also did not constitute a separate international transaction. As regards deductibility under Section 37(1) the ITAT held that the analysis of benefit derived is relevant only under transfer pricing provisions and incidental benefit to group concern does not affect the eligibility to claim deduction and hence disallowance was deleted. [*Pepsico India Holdings P Ltd* v. *ACIT*, ITA No. 1334/Chandi/2010, Order dated 19-11-2018, ITAT Chandigarh]

TDS to be deducted on mark-up and not on reimbursement of salaries for manpower supply

ITAT, Delhi has dismissed the appeal of Revenue dept. and upheld the impugned order of the Commissioner (Appeals) deleting disallowance of project management expenses, certain interest expenses and software expenses.

In respect of project management expenses, assessee had paid certain amount for manpower supply to a foreign company and the department was of the view that assessee was liable to deduct TDS on the entire amount of manpower supply charges, including the salaries. The Tribunal however reiterated that before thrusting the liability to deduct taxes, three points must be seen (a) there must be income element in the hands of the recipient, (b) the income must be earned or derived in India and (c) in case the payment is made to a non-resident, the relevant DTAA must be examined. It was thus held that only the mark-up is liable to withholding tax under Section 195 of the Income Tax Act. It held that no TDS deduction on actual cost component which is reimbursement of salaries, was required, further because the non-resident company had deducted TDS under Section 192 while making payments to seconded employees. [*DCIT, Circle 1(1)* v. *DLF projects Ltd.* - ITA No. 5178/Del/2014, decided on 27-11-2018, ITAT New Delhi]

Accrual of income in respect of services – Proportionate completion method to be followed

Delhi High Court has held that the amount received on sale of prepaid cards to the extent of unutilized talk time will not accrue as income in the year of sale of the card, but in the subsequent year when the talk time was actually used or was exhausted when the card lapsed on expiry of the stipulated time. It observed that contention of the Revenue department that income should accrue in the year of sale, even if accepted, would be revenue neutral, since the addition made in the first year will result in corresponding reduction in the revenue of the next year.

Further, observing that the pre-paid amount was liable to be refunded if the assessee failed to perform the services, the court held that appropriation of prepaid amount was contingent upon the respondent-assessee performing its obligation. Revenue's appeal was dismissed by the court while it relied upon the Accounting Standards and the percentage of completion method which tries to attain periodic recognition of income in order to reflect current performance. [*Commissioner* v. *Shyam Telelink Ltd.* - Income Tax Appeal No. 70/2013, dated 15-11-2018, Delhi High Court]

Interest on loans to AE when losses sustained by latter, not to be nil rated

ITAT Mumbai has reiterated that as long as the transaction is an international transaction within the framework of law, the computation of income there-from has to be on the basis of arm's length principle. The assessee had advanced loans to its AE in furtherance of business interest i.e. for the purpose of further lending to step down subsidiary as well as to acquire the stake in another entity. Interest though charged in few years, was not charged in particular AY in question primarily in view of the fact that the aforesaid loans became doubtful due to losses sustained by the AE. The Tribunal however held that argument of principles of commercial expediency or notional income or revenue neutrality fails. Assessees argument that loans being stressed asset / non-performing assets and therefore, are to be benchmarked at Nil rate of interest, was rejected. [*Laqshya Media Limi ted* v. *Assistant Commissioner of Income Tax* - I.T [TP]. A. No.1984/Mum/2017, decided on 14-11-2018, ITAT Mumbai]

NEW DELHI
5 Link Road, Jangpura Extension,
Opp. Jangpura Metro Station,
New Delhi 110014
Phone : +91-11-4129 9811

B-6/10, Safdarjung Enclave
New Delhi -110 029
Phone : +91-11-4129 9900
E-mail : lsdel@lakshmisri.com

MUMBAI
2nd floor, B&C Wing,
Cnergy IT Park, Appa Saheb Marathe Marg,
(Near Century Bazar)Prabhadevi,
Mumbai - 400025
Phone : +91-22-24392500
E-mail : lsbom@lakshmisri.com

CHENNAI
2, Wallace Garden, 2nd Street
Chennai - 600 006
Phone : +91-44-2833 4700
E-mail : lsmds@lakshmisri.com

BENGALURU
4th floor, World Trade Center
Brigade Gateway Campus
26/1, Dr. Rajkumar Road,
Malleswaram West, Bangalore-560 055.
Ph: +91(80) 49331800
Fax:+91(80) 49331899
E-mail : lsblr@lakshmisri.com

HYDERABAD
'Hastigiri', 5-9-163, Chapel Road
Opp. Methodist Church,
Nampally
Hyderabad - 500 001
Phone : +91-40-2323 4924
E-mail :lshyd@lakshmisri.com

AHMEDABAD
B-334, SAKAR-VII,
Nehru Bridge Corner, Ashram Road,
Ahmedabad - 380 009
Phone : +91-79-4001 4500
E-mail : lsahd@lakshmisri.com

PUNE
607-609, Nucleus, 1 Church Road,
Camp, Pune-411 001.
Phone : +91-20-6680 1900
E-mail :lspune@lakshmisri.com

KOLKATA
2nd Floor, Kanak Building
41, Chowringhee Road,
Kolkatta-700071
Phone : +91-33-4005 5570
E-mail : lskolkata@lakshmisri.com

CHANDIGARH
1st Floor, SCO No. 59,
Sector 26,
Chandigarh -160026
Phone : +91-172-4921700
E-mail :lschd@lakshmisri.com

GURGAON
OS2 & OS3, 5th floor,
Corporate Office Tower,
Ambience Island,
Sector 25-A,
Gurgaon-122001
phone: +91-0124 - 477 1300
Email: lsgurgaon@lakshmisri.com

ALLAHABAD
3/1A/3, (opposite Auto Sales),
Colvin Road, (Lohia Marg),
Allahabad -211001 (U.R)
phone . +91-0532 - 2421037, 2420359
Email:lsallahabad@lakshmisri.com