III. THE CONVERSION CONUNDRUM: TAXATION AND BEYOND

- Neha Sharma and Samyak Lohade*

ABSTRACT

Every business owner endeavours to conduct its business in the most efficient and profitable manner. At the same time, a business has to grow in sync with the changing requirements of the industry to stay relevant. It is on the basis of several considerations like the objectives of the entity, statutory and regulatory compliances and tax implications, that such decisions are made by businessmen. If the objective is to reduce the overall burden of compliance requirements, then one may consider converting the existing business type into another form. During the year 2008, the Limited Liability Partnership Act introduced a hybrid entity in the form of a Limited Liability Partnership, having lesser compliances and limited liability, amongst others, making it a sought-after business structure, especially for the small businessmen and entrepreneurs. Having said so, the benefits in the case of an LLP cannot be seen in isolation and one has to undertake a holistic analysis, more so from an income-tax viewpoint. While the Income-tax Act allows the conversion of an LLP into a company and vice-versa to be tax-exempt in case of fulfilment of the mentioned conditions, there remains a controversy regarding the taxation of conversion in case of non-fulfilment of the said conditions. Although the Courts have held the conversion into a company to be not a transfer and thus non-taxable, the same view has not been adopted in case of conversion into an LLP exposing the stakeholders to uncertainty as regards the tax implications.

* The authors are Senior Associate and Associate at Lakshmikumaran & Sridharan Attorneys, respectively. Views stated in this paper are personal.

I. INTRODUCTION

Business organisations are dynamic. They are constantly evolving in innumerable ways, primarily through internal organic growth. However, in the past few decades, businesses have discovered the potential which can be harnessed through inorganic modes of growth, such as amalgamations and demergers, purchase of other business undertakings, etc. While the primary intent of each such event is to achieve faster growth, sometimes, the main reason for such business reorganisation activities is to consolidate control over the entities or reduce the overall compliance burden involved in certain types of entities. In the latter situation, business reorganisation moves away from the conventional amalgamation-demerger model to the conversion of entities to either a private limited company or a partnership. In this article, the authors seek to explore the benefits that an entity would derive by converting into a Limited Liability Partnership ("LLP") with a primary focus on the income-tax advantages that could accrue to an LLP.

II. COMPANY *VERSUS* LLP: TO CONVERT OR NOT TO CONVERT?

With the advent of the Limited Liability Partnership Act, 2008 ("LLP Act"), a new form of corporate entity was introduced to the Indian business landscape. This new form of an entity was a hybrid between a company and a partnership and offered the best of both worlds. The Lok Sabha Standing

Committee on Finance[1] envisaged the LLP as a corporate form distinct from a joint-stock company, with the basic difference being focussed around the internal governance of both. While the internal governance of a company is regulated by statute; an LLP is governed by the contractual arrangement amongst the partners. This allows for a host of benefits for a company looking to convert into an LLP, such as:

A. Organizational Flexibility

An LLP is an entity created and governed by internal agreements between the parties, who are free to incorporate any clause for the sake of management of affairs. The management of a company, on the other hand, is highly regulated by statute, i.e., the Companies Act, 2013 ("Companies Act") and the allied rules. Additionally, the format of LLP retains all the major benefits of a company, such as limited liability, perpetual succession leading to the growth of professional expertise and entrepreneurial initiative in a flexible, innovative, and efficient manner.

B. Lower Compliance Burden

An existing company is saddled with a large amount of compliance under the Companies Act, which ranges from filing various forms with the Registrar of Companies (**"**RoC**"**) to getting its books of accounts statutorily audited every year. It is also compulsorily required to hold board meetings and annual general meetings every year.

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[1] STANDING COMMITTEE ON FINANCE, 14TH LOK SABHA, FIFTY-EIGHT REPORT ON THE LIMITED LIABILITY PARTNERSHIP BILL, 2006.

An LLP has much fewer compliances to observe vis-à-vis a company. It is also not required to conduct any board meetings or annual general meetings. This is suitable for entrepreneurs and small-scale businesses, which prefer not to be bogged down by compliances while looking to keep a corporate structure.

C. Restriction on number of owners

A private limited company can have a maximum of 50 owners (shareholders). There is no restriction, however, on the number of partners in an LLP.

D. Borrowing & Lending Funds

There are stringent rules prescribed for a company in order to take a loan, which effectively prohibits it from taking loans from certain persons. Further, a company can neither lend money nor give guarantees for loans taken by the directors and other specified persons.

Such rules relating to borrowing and lending do not apply to an LLP, which can freely take and/ or give loans to its partners and/ or other related persons.

Overall, the LLP structure is targeted to benefit small businesses and entrepreneurs, by creating a suitable vehicle for management of the business, while providing comfort at the same time to investors looking for a corporate structure. However, there are also certain disadvantages in converting into an LLP, which are discussed as under:

A. Transferability of Ownership

Transferring ownership in a company is relatively easy since ownership in a company is through the holding of shares. Ownership can thus easily be transferred by selling these shares to another person. This transfer can, however, be restricted by the Articles of Association of the company. In an LLP, on the other hand, the induction and retirement of partners is a cumbersome process requiring amendments in the agreement governing the LLP, amongst others.

However, from an income-tax point of view, it may be possible to transfer the interest in an LLP in a more tax-efficient manner than the transfer of shares in a company. Accordingly, the ease in the transfer of shares vis-à-vis the transfer of partnership interest would have to be analysed along with the potential tax implications.

B. Taxation

Under the Income Tax Act, 1961 ("IT Act"), a company has an option of choosing a lower tax rate of 22% or 15% (plus surcharge and cess),[2] while an LLP is still taxed at 30% (plus surcharge and cess). While from a corporate-taxation perspective, it appears that a company has a tax advantage over the LLP; a holistic view, taking into account the taxation of the company as well as its shareholders, indicates that an LLP structure may be better off in this aspect as well.

[2] The Income-Tax Act, 1961, No. 43, Acts of Parliament, 1961, § 115BAA, 115BAB [hereinafter IT Act].

With the abolition of the Dividend Distribution Tax ("DDT"), repatriation of profits to the shareholders has been made tax-free in the hands of the company. This has been discussed in detail later.

III. STATUTORY PROVISIONS RELATING TO CONVERSION UNDER THE LAW RELATING TO COMPANIES AND LLP: A BRIEF OVERVIEW

Before delving into the income-tax implications arising from the conversion of a partnership into a company and vice-versa, it would be worthwhile to take note of the provisions as provided for under the Companies Act and LLP Act regarding the same.

A. Provisions under the Companies Act

Part I of Chapter XXI of the Companies Act lays down the provisions regarding the entities, including an LLP, which is authorised to register as a company under the said Act. Section 366 of the Act *inter alia* provides for the registration of an LLP as a company limited by shares.

Upon compliance with the requirements of registration under the Act, the Registrar shall certify the entity as having been registered under the Companies Act. Section 368 of the Companies Act states that all the property of the existing entity shall, on its registration, pass to and vest in the company incorporated under the Act.

B. Provisions under the LLP Act

Chapter X of the LLP Act deals with the conversion of entities, including a company, into an LLP. A private limited company can convert itself into an LLP under Section 56 of the LLP Act, in accordance with the provisions of Chapter X and the Third Schedule. Upon compliance with the requirements mentioned in the applicable Schedule to the LLP Act, the Registrar shall issue a certificate of registration to the incorporated LLP. By virtue of such registration, all the tangible and intangible property, assets, interests, rights, privileges, liabilities, obligations and the undertaking of the company shall be transferred to and shall vest in the LLP without further act, amongst others.

Clause 1(b) of the Third Schedule which deals with the conversion of a private company into an LLP, defines the term "convert" to mean a transfer of the property, assets, interests, rights, privileges, liabilities, obligations, and the undertaking of the private company to the LLP.

IV. TREATMENT OF CONVERSION UNDER THE INCOME TAX LAW

Section 4 of the IT Act provides for levy of income-tax on income at any rate, in accordance with the provisions of the Act. Section 2(24) of the IT Act which defines 'income' in an inclusive manner, covers not only those things which the clause declares that it shall include, but also such things as the word signifies according to its natural import.[3] Sub-clause (vi) of clause (24) defines income to include "any capital gains chargeable under Section 45."

Section 45 of the IT Act levies tax on the profits or gains arising from the transfer of a capital asset. Capital asset *inter alia* means "property of any

[3] Lachit Films v. CIT, (1992) 106 CTR (Gau) 98.

kind held by an assessee, whether or not connected with his business or profession."

The word 'transfer' in relation to a capital asset, has been defined to include the sale, exchange, or relinquishment of the asset; the extinguishment of any rights therein or the compulsory acquisition thereof under any law, amongst others.[4]

Section 47, on the other hand, deems certain transactions to not be a transfer for the purposes of capital gains tax. The conversion of an LLP into a company and of a company into an LLP is a tax-neutral transaction under clause (xiii) and (xiiib) respectively if the conditions laid out therein are satisfied. The breach of any of the conditions mentioned in the provisos to Section 47(xiii) and Section 47(xiiib) would lead to withdrawal of the exemption granted. Accordingly, tax implications in the hands of the company and LLP and/or shareholders of the company would arise, in the year in which the condition(s) is/are breached.[5]

V. TAX TREATMENT OF CONVERSION *DEHORS* THE SPECIFIC EXEMPTION UNDER THE INCOME TAX LAW: JUDICIAL JURISPRUDENCE

As mentioned above, the conversion has been exempted from taxation under Section 47 of the IT Act pursuant to satisfaction of the conditions mentioned thereunder. However, the tax implications in case of non-satisfaction of the condition(s), whether in the year of conversion or subsequent years as provided for under Section 47A of the IT Act, has been a

[4] *IT Act*, § 2(47).
[5] *IT Act*, § 47A(3), 47A(4).

point of debate. It has been time and again contended by the assessee that even if the conversion does not fall within the four corners of Section 47, it cannot be taxed since (a) the conversion itself is not a 'transfer' so as to invoke Section 45 of the IT Act and levy capital gains tax; and alternatively, (b) the computation machinery fails and renders taxation invalid.

A. Conversion of a partnership into a company

The taxation of conversion of a firm into a company was examined by the Hon'ble Bombay High Court in the case of *Texspin Engg. & Mfg. Works*.[6] Therein, the Department *inter alia* argued that the conversion has resulted in the vesting of the properties of the firm into the company by virtue of Section 368 of the Companies Act. Such vesting has resulted in the extinguishment of all the rights of the firm in the capital assets and therefore, the same was a 'transfer' taxable under Section 45(1) of the IT Act. Accordingly, the capital gains would be computed under Section 45(1) read with Section 48[7]. For the purpose of Section 48, it was contended that the 'full value of consideration' would be the value of the assets transferred by the firm to the company.

The High Court, rejecting the arguments of the Department, held that the essential ingredients of a transfer of a capital asset, i.e., the existence of two parties and consideration, are not fulfilled in the case of a conversion. Further, the vesting of properties in the company is by operation of law (Section 368 of the Companies Act) and not by way of a transfer contemplated under the IT Act. Accordingly, the Court concluded that no transfer of a

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[6] CIT v. Texspin Engg. & Mfg. Works, [2003] 263 ITR 345 (Bombay).
[7] IT Act, § 48, prescribes mode of computation: Income chargeable under "Capitals Gains" = Full value of consideration - (expenditure incurred on the transfer + cost of acquisition of the asset).

capital asset as envisaged under Section 45(1) takes place as a result of conversion. As regards the computation mechanism in case the transfer is assumed to take place, the Court noted that Sections 45(1) and 48 are to be read together and Section 48 does not stipulate the 'full value of consideration' as the market value of the asset on the date of transfer. The expression refers to the consideration received by the transferor in lieu of the assets it parts with and not the value of the very assets parted with. It, therefore, held that since in the instant case, no consideration has flown to the firm, the computation machinery fails and renders taxation unworkable.

The ruling in the aforementioned case has been followed by the Hon'ble Punjab and Haryana High Court in *Rita Mechanical Works*[8] and by the Hon'ble Madras High Court in *CADD Centre.*[9]

B. Conversion of a company into an LLP

The taxation of conversion of a company into an LLP first came up for consideration before the Income Tax Appellate Tribunal ('ITAT'/ 'Tribunal') Kolkata in the case of *Aravali Polymers LLP*.[10] However, the question of the conversion itself not being a transfer under the IT Act was not raised by the LLP. Accordingly, the Tribunal went on to observe that having lost the protection from taxation under Section 47(xiiib), the capital gains arising on account of conversion is liable to be taxed. At the same time, the Tribunal held that the value at which the shares/assets of the company were taken over by the LLP would be the sale price and the cost of acquisition thereof would be as per the books of the erstwhile company. That is, the capital gain is to be

[8] CIT v. Rita Mechanical Works, [2013] 33 taxmann.com 525 (Punjab & Haryana).
[9] CADD Centre v. ACIT, [2016] 383 ITR 258 (Madras).
[10] Aravali Polymers LLP v. Jt. CIT, [2014] 47 taxmann.com 335 (ITAT Kol.).

computed on the basis of the book value of the transferred assets and not as per the market value.

Subsequently, the ITAT Mumbai had an occasion to adjudicate upon the issue in the case of *Celerity Power LLP*[11]. The Tribunal held the conversion to be a transfer, reasoning that since Section 47 exempts the 'transfers' from the scope of capital gains chargeability under Section 45 of the IT Act, the non-availability of the exemption would automatically lead to taxation. Such conclusion was also supported by the *Memorandum explaining the Finance Act, 2010* [amended the IT Act to *inter alia* insert clause (xiiib) to Section 47], that stated the conversion to have definite tax implications under the then-existing provisions of the IT Act. The Tribunal also considered the definition of the term "convert" as laid down in Clause 1(b) of the Third Schedule, which indicates the conversion to involve the transfer of property. In concluding so, the Tribunal distinguished the conversion of a firm to a company as was dealt with by the Hon'ble Bombay High Court in *Texspin Engg. & Mfg. Works*. It noted that while the Companies Act provides only for vesting of the properties, the LLP Act provides for both transfer and vesting.

Having held the conversion to be a transfer, the next question dealt with by the Tribunal was regarding the computation of capital gains arising from the said transfer. The Tribunal relied *inter alia* on *Texspin Engg. & Mfg. Works* to hold that the "full value of consideration" cannot be construed as the market value of the assets but shall mean the price bargained for by the parties to the transaction, being the book value in the facts under consideration. It finally concluded that even though the conversion is a 'transfer', the

[11] Asst. CIT v. Celerity Power LLP, [2019] 174 ITD 433 (Mumbai).

difference between the transfer value and the cost of acquisition would be Nil (both being at book value), rendering the machinery provision for computation of capital gains as unworkable.

It is worthwhile to note that clause (xiiib) not only gives exemption to the company but also exempts the shareholders on the transfer of its share(s) held in the company on account of conversion. The question as to taxation of receipt of LLP interest by the shareholders in lieu of its shares held in the company upon conversion came up before the Authority for Advance Rulings ('AAR') in the case of *Domino Printing Science Plc*.[12]

The AAR held that on vesting of all the property in the LLP, the shareholder's interest in the shares of the company got extinguished. The AAR also relied on the principle laid down in the case of *Grace Collins*,[13] to conclude that the transaction is covered within the definition of 'transfer' under Section 2(47) of the IT Act and is liable for capital gains tax. As regard to the computation, the AAR held that the "full value of the consideration" received or accrued to each shareholder shall be the value of its partnership interest in the newly formed LLP. It was also highlighted by the AAR that even if the assets of the company are transferred to LLP at book value, the value of partnership interest in the LLP may be higher than the face value of the shares that got extinguished, on account of the reserves and surpluses of the company which now stands transferred to the LLP.

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[12] *In Re* Domino Printing Science Plc, [2021] 124 taxmann.com 187 (AAR – New Del.).

[13] CIT v. Grace Collis, (2001) 3 SCC 430 (The expression 'extinguishment of any rights therein' as occurring in section 2(47) of the IT Act extends to mean extinguishment of rights independent of or otherwise than on account of transfer).

VI. TAX TREATMENT OF CONVERSION *DEHORS* THE SPECIFIC EXEMPTION UNDER THE INCOME TAX LAW: AUTHORS' VIEW

While at multiple instances, the Courts have decided in the favour of the assessee, holding the conversion of a firm into a company to be not a 'transfer' and thus, to be outside the scope of capital gains taxation, the conversion of a company into an LLP has become a highly litigative issue. Primarily so, because under both the situations, the conversion and the vesting of property thereof happens by the operation of law, i.e. under the Companies Act and the LLP Act respectively.

In order to determine the capital gains taxability of a particular transaction under Section 45 of the IT Act, the first question that needs to be answered is whether that transaction constitutes a 'transfer'. For the purposes of Section 45, 'transfer' is defined under Section 2(47) of the IT Act. In the case of *Celerity Power LLP*, however, the Tribunal adopted a reverse analogy so as to conclude that if the exemption cannot be availed of due to non-satisfaction with the conditions, the conversion would be 'transfer' taxable under the IT Act. It is respectfully submitted that the same was not the correct approach to ascertain taxability.

With respect to the conversion of a company into an LLP, it may be contended that no transfer takes place upon conversion as:

1. The transfer of property takes place on account of conversion by virtue of Section 58 of the LLP Act and not on account of transfer. Further, the word 'transfer' as used in the LLP Act should not be equated with the

'transfer' as used under Section 45 of the IT Act, which has its meaning defined under Section 2(47) of the IT Act.

2. The basic characteristics of the transactions included in the definition of 'transfer' like the sale, exchange, or relinquishment of the asset, requires the existence of two parties (the transferor and the transferee), and the incoming consideration *qua* the transferor, as has also been held by the Hon'ble Bombay High Court in *Texspin Engg. & Mfg. Works*. In the case of conversion, however, it is only the status and character of a company that gets converted into an LLP. That is to say, at the time of conversion, there is no transferor and transferee. It is only when the transferor loses its identity as a company, that transferee comes into existence as an LLP, as per provisions of the LLP Act.

Alternatively, even if the conversion is considered a 'transfer', it may be argued that the machinery for computation of capital gains fails as no consideration has been received by the transferor on account of the transfer of its assets to the LLP. Section 48 of the IT Act provides for the method of computation of capital gains by deducting the cost of acquisition of the assets from the full value of consideration. Therefore, the conversion is a case of computational failure, in the absence of consideration itself. In the case of *B.C. Srinivasa Shetty,*[14] the Apex Court had observed that the charging section of each head of income and the computation provisions thereunder constitute an integrated code meant to be read together, and when the computation provisions cannot be applied, the charge to tax itself fails. Accordingly, the

[14] CIT v. B.C. Srinivasa Shetty, (1981) 128 ITR 294 (SC); *See also* Sunil Siddharthbhai v. CIT, (1985) 156 ITR 509 (SC).

conversion may not be taxable under Section 45 read with Section 48 of the IT Act.

Similarly, in the case of shareholders of the company, it may be argued that the shareholders' interest in the shares is extinguished on account of the conversion being operative by law and not on account of 'transfer' and that no benefit arises to the shareholders as they receive interest in the LLP in the same proportion and value of the shares as were held by them in the company.

In light of the foregoing, while a position may be taken as to non-taxability of the conversion, it nonetheless remains a highly debatable issue given the judicial backdrop on the concerned subject-matter. Accordingly, it would be helpful to the stakeholders if a specific provision treating the conversion as a non-taxable transfer is provided for under the IT Act. This would lead to certainty as regards the tax implications and would further assist in making an informed decision as regards the conversion of an entity.

VII. LATEST TAX REFORMS FOR COMPANIES: MAKING THE CHOICE OF CONVERSION HARDER?

With the introduction of Section 115BAA in the IT Act with effect from April 1, 2020, many companies will now be able to avail a reduced tax rate of 22% (plus surcharge and cess) on their income. This, however, comes with the rider that many of the weighted deductions such as deductions on research and development, deductions on capital expenditure in specified business, or even accelerated depreciation would not be available. Even with these riders, many companies have found it beneficial to opt for this reduced rate of tax. For a newly set up manufacturing company, the benefit is even higher as Section 115BAB of the IT Act prescribes a tax rate of only 15% (plus surcharge and cess) with similar riders.

This benefit is however not extended to LLP, which continues to be taxed at 30% (plus surcharge and cess). Thus, many existing companies which were earlier contemplating converting into an LLP for reduced compliance purposes are now having second thoughts about the conversion. One major factor which used to affect these decisions was the applicability of DDT under Section 115-O of the IT Act on the dividends distributed by the company to its shareholders. Whereas, the share of profits derived by a partner from the LLP is not taxable,[15] having suffered an incidence of tax in the hands of the firm.

However, *vide* Finance Act, 2020, the Government has abolished DDT. Thus, the dividends, which were earlier exempt upon payment of DDT, would now be taxable in the hands of the recipient shareholders, at the tax rates applicable to them. Thus, there is a double incidence of taxation. The profits earned by the company are first taxed in the hands of the company, and upon distribution are further taxed in the hands of the shareholders. Even if the profits are not distributed, the capital gains arising from the sale of shares are taxable in the hands of the shareholders.

Comparatively, the profits earned by the LLP are taxed in its hands, but the profits withdrawn by the partners are not taxed again in their hands. Even upon retirement from the firm, the sums received by the partner may not be taxed on the ground that the sum so received is capital receipts in the hands

[15] IT Act, § 10(2A), exempts the income earned by a partner from the LLP.

of the partner. This results in the LLP being a more tax-efficient structure than that of a private limited company.

From the standpoint of investors resident abroad, a company appears to be a cleaner and more efficient vehicle to invest and repatriate profits from. Earlier, with the levy of DDT, investors in companies used to suffer a higher incidence of tax, since the rate of DDT was higher than the rates prescribed under the Double Tax Avoidance Agreement ("DTAA"). This has now become a legacy issue with the abolition of DDT *vide* Finance Act, 2020. However, a noteworthy decision has been delivered by the Delhi Tribunal in the case of *Giesecke & Devrient (India) Pvt. Ltd*.,[16] wherein it has held that the DDT levied by the company should not exceed the rate specified in the DTAA. While the decision may not be of much relevance in the case of dividends distributed by companies post the abolition of DDT, it certainly affects the pending cases filed by companies and shareholders in various courts across India.

The repatriation of profits from an LLP is a more complex issue, when considered from an international tax point of view, as the treatment of partnership is as a tax-transparent entity in certain jurisdictions whereas tax-opaque in others. While this situation has been provided for in the OECD Model Tax Convention on Income and on Capital, 2017,[17] the DTAAs entered into by India have not yet been revised on the basis of the same. Hence, the issues surrounding the differential tax treatment of LLPs in different tax jurisdictions remain.

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[16] Giesecke & Devrient (India) Pvt Ltd v. Addl. CIT, ITA, 2020 SCC OnLine ITAT 419.
[17] *Articles of the Model Convention with Respect to Taxes on Income and on Capital*, OECD, Art. 1, ¶ 2, https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf.

VIII. CONCLUSION

The Statement of Objects and Reasons to the LLP Act states that the Act is targeted to benefit entrepreneurs and small businesses and professionals, many of whom had already incorporated companies to run their business. It was under such intention that the LLP Act sought to provide various benefits and relaxation vis-à-vis the Companies Act. Such commercial considerations thus became a driving force behind conversions of companies into LLPs.

In furtherance of its intention of providing benefits to the LLPs and to the small companies intending to get converted into an LLP, the Legislature made such conversions tax neutral, by inserting clause (xiiib) under Section 47 of the IT Act. The IT Act, therefore, now deems such a conversion to be not a transfer if the conditions mentioned therein are and/or remain satisfied. The controversy however remains as regards the taxation of conversion in case of non-fulfilment or breach of the conditions.

Along with the benefit of tax neutrality, a simplified and favourable tax regime for partnerships was an added incentive for companies looking to convert. However, over the past year, the taxation scheme for companies has undergone a sea change. For companies now looking to convert to LLPs, the impact analysis of this new scheme assumes importance.