

Conversion of Proprietorship/ Firm/ LLP into Private Limited Company & vice versa – Tax & Procedural implications

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Overview of Taxation Laws (Amendment) Ordinance, 2019

Taxation Laws (Amendment) Ordinance, 2019

- The Taxation Laws (Amendment) Ordinance 2019 was promulgated by President amending Income tax Act, 1961 on 20 September 2019;
- The above Ordinance 2019 has introduced two new sections, viz. Section 115BAA and Section 115BAB in the Income tax Act, 1961 ('the Act');
- These sections provide for availing preferential tax rates for companies fulfilling certain conditions and not claiming any exemptions or benefits under the Act;
- Broadly speaking, section 115BAA provides for preferential rate of 22%* as against existing corporate tax rate of 25%* (for companies whose turnover is less than 400 crores in FY 2017-18) or 30%* (for all other companies)
- Similarly, section 115BAAB provides for preferential rate of 15%* for new manufacturing companies set up on or after 1 October 2019 as against existing corporate tax rate of 25%* / 30%*

*excluding surcharge and cess

Comparison of Tax Rates

Particulars	Ordinance		Existing		
	S.115BAB (15% CTR)	S.115BAA (22% CTR)	S.115BA	Normal Tax rate	LLP
Base tax rate	15%	22%	25%	30%	30%
Effective tax rate after including surcharge & cess	17.16%	25.17%	29.12%	34.94%	34.94%
Income	100	100	100	100	100
Less: Corporate tax (B)	17.16	25.17	29.12	34.94	34.94
Profit after tax	82.84	74.83	70.88	65.06	65.06
Less: Dividend distribution Tax at 20.56% (D)	14.13	12.76	12.09	11.10	NA
Net amount available to owners (E)	68.71	62.07	58.79	53.96	65.06
Total tax outflow (B+D)	31.29	37.93	41.21	46.04	34.94

Note 1: Tax outflow above is without considering super rich levy on dividend u/s 115BBDA

Company structure is better if it is eligible for 15% tax rate else LLP structure is better

Preferential Corporate tax rates (CTR) – Conditions Applicable

Parameters	22% CTR	15% CTR
Effective tax rate (ETR)	25.17%	17.16%
Year of applicability	FY 2019-20 and onwards	FY 2019-20 and onwards
Existing or new domestic companies	Applicable to all, existing as well as new domestic companies	New domestic manufacturing companies set up and registered on or after 1 October 2019 and commencing manufacture by 31 March 2023
Nature of Industry	No restriction (Covers everyone including service/ trading industry/ finance entities)	Companies engaged solely in manufacture/ production of any article or thing and related research or distribution
Exercise of option	<ul style="list-style-type: none"> On or before due date of filing of return for any year Option once exercised cannot be withdrawn 	<ul style="list-style-type: none"> On or before the due date for filling the 1st year return Option once exercised cannot be withdrawn
Any formative conditions applicable	None	<ul style="list-style-type: none"> Yes; not formed up by split-up/ reconstruction of existing business Not to use second hand plant and machinery (subject to 80:20 condition)
Specified domestic transfer pricing provisions	Not applicable	Applicable

Preferential Corporate tax rates (CTR) – Conditions Applicable

Parameters	Details
Denial of exemptions / Incentives	Reduced rate can be claimed subject to computation of total income: <ul style="list-style-type: none">• Without taking the benefit of additional depreciation or specified exemptions and incentives• Certain incentives/ deductions like Sec. 32, 35(1)(vi), 80JJAA to continue• Without setting off carried forward losses attributable to specified deductions• Claiming normal depreciation in a manner to be prescribed
MAT	Not applicable
Sunset Date	No Sunset date

Conversion Process of Sole Proprietorship / Partnership Firm / LLP into Company

LLP – Salient Features

- Liability of Partner is limited to his agreed contribution
- Every Partner is the agent of LLP & not of other Partner
- Perpetual Succession and Continuity & No limit on Number of Partners
- No Partner is liable on account of the independent or un-authorized acts of other partners
- Initiate Legal proceeding and own property on its own name
- The rights of a partner to share profits or losses of LLP is transferrable either in whole or in part
- Simplified compliances

Conversion of LLP into Company – Regulatory Process

- No specific provision under Companies Act, 2013 for conversion of LLP into Company
- MCA issued Notification dated 31 May 2016 allowing for conversion of LLP into Company
- Various requirements to be followed for conversion of LLP into Company viz:
 - Minimum 7 partners are required;
 - Approval from all partners;
 - Advertisement in local and national newspaper;
 - Necessary incorporation forms and all documents needs to be filed;
 - NOC from ROC that all processes have been completed;
 - After all processes are completed, ROC issues certificate of incorporation;
 - LLP to intimate Registrar, LLP for its dissolution as LLP

Conversion of Firm into Company – Regulatory Process

- Conversion of Partnership Firm into Company under Chapter XXI (Part I) of Companies Act, 2013 (akin to Part IX of Companies Act, 1956)
- Conversion process to be governed under The Companies (Authorized to Registered) Rules, 2014
- Various requirements to be followed for conversion of LLP into Company viz:
 - Minimum 2 partners are required;
 - Approval from all partners;
 - Advertisement in local and national newspaper;
 - Necessary incorporation forms and all documents needs to be filed;
 - NOC from ROC that all processes have been completed;
 - After all processes are completed, ROC issues certificate of incorporation;
 - Firm to intimate Registrar of Firms for its dissolution as Firm

Conversion of Sole Proprietorship into Company – Regulatory Process

- No specific provision under Companies Act, 2013 for conversion of sole proprietorship into Company
- Generally speaking, sole proprietorship can be succeeded by Company

Income tax perspective – LLP / Partnership Firm into Company

Reference to Section 47 (xiii) of the Act

- **No income tax implications if Partnership firm / LLP is converted into Company on compliance of following conditions:**
 - All assets and liabilities of Firm / LLP to vest with the Company;
 - All Partners of Firm / LLP become shareholders in the Company in same proportion as their capital account stood before conversion;
 - Partners do not receive any benefit / consideration, directly or indirectly from Company other than allotment of shares
 - Shareholding of partners is not less than 50% of total voting power of Company for five years from the date of conversion

Income tax perspective – LLP / Partnership Firm into Company

Non compliance of provisions of Section 47 (xiii) of the Act

- Even if conditions prescribed in section 47(xiii) of the Act are not fulfilled, Courts have held that conversion of Partnership Firm into Company is not transfer as it is statutory vesting by operation of law and hence, no capital gains tax applicable;
- Refer illustratively following judgments:
 - CIT vs. Texspin Eng. & Mfg. Works (263 ITR 345) (Bombay HC) - Conversion of partnership firm to company will not attract provisions of Section 45(4) as there is no distribution of capital asset on dissolution and provisions of Section 45(1) also does not apply as the vesting of the properties of the firm in the company was not consequent or incidental to a transfer as contemplated u/s 45(1).
 - CIT v. Ravishankar R Singh [2018] TS 447 (SC) (SLP Dismissed);
 - Umicore Finance Luxemborg (76 taxmann.com 32) (Bombay HC);
 - Well Pack Packaging (Tax Appeal No. 368 of 2001) (Guj HC);
 - Lincoln Pharmaceuticals vs DCIT (5 SOT 599) (Ahmedabad ITAT);
- Hence, it judicially settled that conversion of LLP / Partnership Firm into Company without complying section 47(xiii) of the Act would not have any adverse tax implications

Income tax perspective – Sole Proprietorship into Company

Reference to Section 47 (xiv) of the Act

- **No income tax implications if Sole Proprietorship is succeeded into Company on compliance of following conditions:**
 - All assets and liabilities of Sole Proprietorship to vest with the Company;
 - Sole Proprietor does not receive any benefit / consideration, directly or indirectly from Company other than allotment of shares
 - Shareholding of Sole Proprietor is not less than 50% of total voting power of Company for five years from the date of succession

Income tax perspective – Sole Proprietorship into Company

Non compliance of provisions of Section 47 (xiv) of the Act

- If conditions prescribed in section 47(xiii) of the Act are not fulfilled, capital gains would apply on transfer of assets from sole proprietorship to company on account of following reasons:
 - There is no statutory process of conversion of sole proprietorship into company unlike the same in LLP / Partnership Firm
 - Accordingly, transfer of capital assets from Sole Proprietorship to Company would be considered as succession and hence, taxable if conditions are not fulfilled;
 - Not possible to rely on judicial precedents given in the preceding slide for conversion of firm / LLP into company

Implications of Taxation Laws (Amendment) Ordinance, 2019 on Conversion

Conversion of LLP / Firm / Sole Proprietorship into Company – Implications under Taxation Laws (Amendment) Ordinance, 2019

- **Section 115BAA – 22% Base tax rate**

- No formative conditions are prescribed;
- No conditions relating to use of second hand / old plant & machinery
- Hence, possible for Sole proprietorship / LLP / Partnership Firm converted into Company to claim benefit of 22% tax rate
- However, before taking benefit of preferential rate, need to undertake cost - benefit analysis of incentive provisions if any claimed and impact of additional depreciation on effective tax rate

- **Section 115BAAB – 15% Base tax rate**

- Formative conditions prescribed, i.e. it is applicable only to New Manufacturing Companies set up on or after 1 October 2019 and which has commenced manufacturing before 31 March 2023;
- 80:20 conditions prescribed for use of old / second hand plant & machinery;
- Accordingly, for conversion of existing sole proprietorship / LLP / Partnership Firm into Company may not be eligible for beneficial rate of 15%

Conversion Process of Company into LLP

Conversion of Company into LLP – Regulatory Process

- **Relevant Provisions of LLP Act, 2008**
- Who can opt for such conversion ? - Existing private / public limited company (except Listed company)
- Outstanding secured loan in the books of company ? – Such company cannot opt for conversion
- All the existing shareholders to be partners in LLP.
- To ensure that the charge on loans is removed before conversion
- Relevant provisions:
 - Chapter X – Section 56 and 57 of LLP Act, 2008
 - Third and Fourth Schedule of the LLP Act, 2008
 - Rule 39 and 40 of LLP Rules, 2009

Income tax perspective –Company into LLP

Reference to Section 47 (xiiib) of the Act

- **No income tax implications if Company is converted into LLP on compliance of following conditions:**
 - Assets and liabilities to vest with LLP;
 - Shareholders to remain same;
 - No consideration other than share in profit and after conversion no payment out of accumulated profits of company to partners for 3 years;
 - Turnover in 3 preceding previous years is less than 60 lakhs;

Income tax perspective –Company into LLP

Reference to Section 47 (xiiib) of the Act

- **No income tax implications if Company is converted into LLP on compliance of following conditions:**
 - Book value of assets in 3 preceding previous years is less than 5 crores;
 - Same capital contribution and profit sharing ratio;
 - Share of profit of shareholders is not less than 50% for five years from the date of conversion

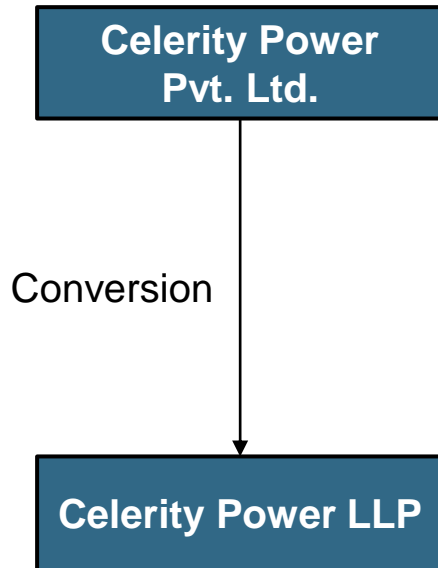
All above conditions needs to be cumulatively satisfied for capital gains exemption

Income tax perspective – Company into LLP

Non compliance of provisions of Section 47 (xiiib) of the Act

- Even if conditions prescribed in section 47(xiiib) of the Act are not fulfilled, based on judicial precedents given earlier, possible to take a view that capital gains do not apply as conversion of Company into LLP is statutory process;
- However, due to specific wordings of LLP Act, Courts have taken different view on tax implications arising on non-compliant conversion of Company into LLP:
 - **Aravali Polymers LLP (Kolkata ITAT)**
 - Facts - Loan given to partners post conversion of Company into LLP
 - Ruling – Capital Gains would be applicable on transfer of assets from Company to LLP
 - Value at which assets were taken over by LLP would be sales consideration and cost of those assets in books of Company would be cost of acquisition
 - Set aside to AO for computation of capital gains
 - **Domino Printing Services PLC (AAR)**
 - Shareholders receiving partner's interest on conversion of firm into company would be subject to capital gains tax

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



Ruling:

(A) Taxability on conversion of company to LLP:

Held that conversion of company to LLP is a taxable transfer on account of the following:

- Transactions covered under section 47 are 'transfers' - not chargeable to tax under section 45 subject to fulfillment of conditions
- Relied on AAR ruling in the case of Umicore Finance Luxembourg and distinguished Bombay High Court ruling in the case of Texspin Engg. & Mfg. Works.
- Use of the expression 'transfer and vest' in the relevant provision of LLP Act 2008 as compared to the expression 'pass and vest' in Part IX provisions in Companies Act as well as the fact that the ruling in case of Texspin was a case of Part IX conversion

(B) Full value of consideration

- Full value of consideration on conversion of company to LLP would be the value at which assets and liabilities were vested in the LLP i.e. book value
- Relied on the Supreme Court rulings in the case of Gillanders Arbuthnot and George Henderson for the ratio that 'full value of consideration' does not mean 'market value'

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

Ruling:

(C) Capital gains computation

- Capital gains machinery provision rendered unworkable as the difference between transfer value and cost price would be Nil.

(D) Section 47A(4)

- Section 47A(4) comes into play for withdrawing an exemption earlier availed by the assessee under section 47(xiiib)

(E) Section 170

- Capital gains, if any, arising on conversion to LLP would be taxable in the hands of the successor LLP under section 170 of the Income tax Act, 1961

(F) Allowability of claim of deduction under section 80-IA

- Commissioner (Appeals) order upheld on the basis that section 80-IA applies to an undertaking and the bar under section 80-IA(12) applies only in case of amalgamation or demerger

Income tax perspective – Company into LLP

- **Carry forward of loss - Section 72A(6A) of Income tax Act, 1961**

- **Section 72A(6A) :**
- Conversion satisfies the conditions stipulated in section 47 (xiiib) of the Income tax Act, 1961.
- LLP can carry forward business losses or unabsorbed depreciation of the company
- **Alternative View:**
 - Conversion of company into LLP without satisfying the conditions of section 47 (xiiib) but as the transaction is not transfer as per the decision of Hon'ble Bombay high court in the case of **CIT vs Texspin Engg. & Mfg. Works** and the LLP is allowed to carry forward losses ?

Income tax perspective – Company into LLP

- Other relevant provision of Income tax Act, 1961

Section	Description
Section 32(1) 5th Proviso	Depreciation in the year of conversion will be pro-rata allocated between the company and LLP
Section 35 DDA (4A)	Amortization of expenditure incurred on Voluntary Retirement Scheme – LLP eligible to claim deduction for balance period
Section 43(1) Explanation 13(b)(iii)	Actual cost – where deduction is allowed u/s 35AD – cost will be Nil
Section 43(6) Explanation 2C	Written down value in the hands of company will be written down value in the hands of LLP
Section 49(1)(iii)(e)	Cost to previous owner – cost in the hands of LLP will be cost in the hands of company
Section 49 (2AAA)	Rights of partner in LLP – Cost of acquisition
Section 72A (6A)	Carry forward of business loss and unabsorbed depreciation
Section 115JAAA(7)	Carry forward of MAT credit of Company not available to LLP

- Note:** If the exemption is not available u/s 47(xiiib) or assessee opts not to avail exemption u/s 47(xiiib), whether the benefit of above provisions will be applicable ?

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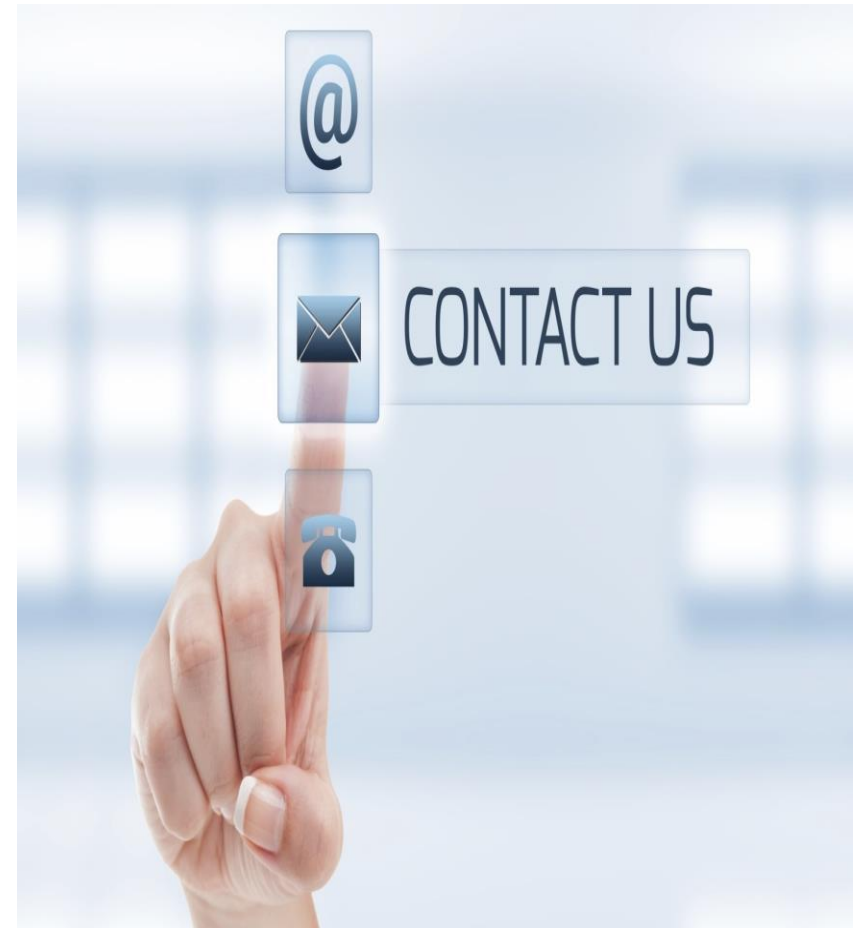
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Thank You

The background features abstract geometric shapes, primarily triangles, in various shades of blue and green. These shapes overlap and intersect, creating a dynamic, layered effect. The colors range from light, airy blues to deeper, more saturated greens and blues. The overall composition is clean and modern, with the text centered in a classic serif font.