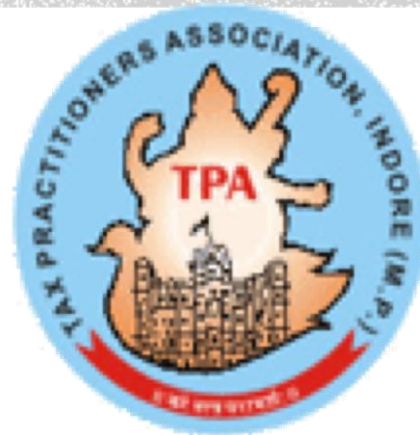


- **Partnership Firm Vs LLP Vs Pvt. Ltd. Company**
- **Taxation Analysis**

CA. Pranay Goyal

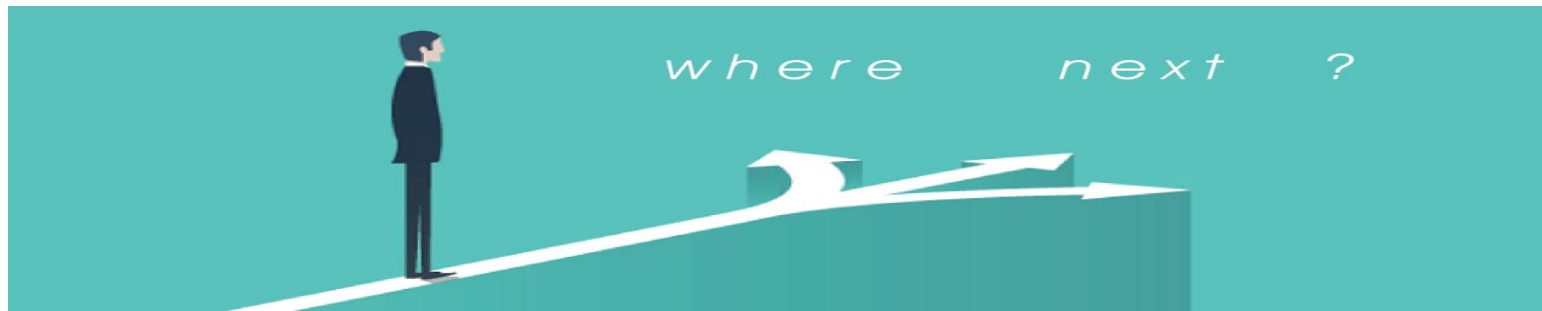
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Facts to be considered for choosing the right form of business

- Nature and Size of Business - Small/Medium/Large
- Fund Raising Requirements - Equity/Debt
- Tax Rates - Different Flat rates & Surcharge applicable to LLP/Firms and that to companies under different Sections i.e. Normal, 115BA, 115BAA & 115BAB.
- Personal Liability Protection - Limited/ Un-Limited
- Tax on Distribution of profits - DDT/10(2A)



Effective Tax Rate (Inclusive Surcharge & Cess)

Total Income	Effective Tax Rate (Inclusive of Surcharge and Cess)			
	Co. Doesn't opts for Special Rates	Co. opts for Section 115BAA	Co. opts for Section 115BAB	LLP/Firm
Up to 1 Crore	26%	25.17%	17.16%	31.20%
More than 1 Crore but up to 10 Crore	27.82%	25.17%	17.16%	34.94%
More than 10 Crore	29.12%	25.17%	17.16%	34.94%

- In case of LLP/Firm Flat rate of 30% and surcharge of 12% if Net income exceeds Rs. 1 Crore
- In case of company not opting for special rates and if turnover in AY 2020-21/22 less than 4 Crore, then Flat rate 25%, surcharge 7% if TI exceeds 1 Cr. And 12% if TI exceeds 10 Cr.
- In case of company opting for Section 115BAA, flat rate 22% and surcharge of 10% irrespective of TI
- In case of company opting for Section 115BAB, flat rate 15% and surcharge of 10% irrespective of TI
- H & EC is 4% in all the above cases

OTHER IMPORTANT PROVISIONS AFFECTING THE CHOICE OF BUSINESS FORMS

- Most important factor to choose whether to go for LLP or Company is Tax on distribution of profit to the partners/Shareholders.
- The Finance Act 2020 brought a major amendment by abolishing DDT and resultantly, dividend declared by the Indian Companies have been made taxable in the hands of shareholders w.e.f 01.04.2020.
- Deemed Dividend U/s 2(22)(e).
- Profit distributed by LLP/Firm is exempt U/s 10(2A).
- Calculations and benefit may vary as remuneration to partners and directors are allowed as deduction, however in LLP/Firm, maximum limit of salary restricted by Sec. 40(b).
- Interest on capital allowed in case of firm/LLP but not in case of company.

OTHER IMPORTANT PROVISIONS AFFECTING THE CHOICE OF BUSINESS FORMS

- Immovable Property can be contributed into the firm at book value U/s 45(3) which overrides Sec. 50C and concessional stamp duty @ 2% applicable. No such benefit in case of company.
- Taxation if the owners want exit from the business entity is also important as in case of Firm/LLP applicability of provisions of Sec. 45(4) i.e. capital gain when partner received capital asset or money in case of reconstitution and provisions of Sec. 9(b) in case partner received Stock in trade or capital asset in case of dissolution or reconstitution.
- In case of company the shareholder can sell the shares to another person LTCG or STCG is applicable as per the Facts. Provisions of Sec. 50CA applicable which substitutes the actual net sale consideration with FMV to be calculated as per Rule 11UA (book value to exclude jewellery, artistic work, shares, securities and immovable property) - concept of sale in open market/ stamp duty value etc.

OTHER IMPORTANT PROVISIONS AFFECTING THE CHOICE OF BUSINESS FORMS

- Shares issued for a consideration more than the FMV, Sec. 56(2)(viib). When consideration received on issue of shares exceeds the Face Value.
- Source of income of applicant of shares not explained [Proviso 1 to Sec. 68]. However in case of capital contribution by partner the ratio Hon'ble SC in case of PCIT Vs. Vaishnodevi Refoils & Solvex [2018] 96 taxmann.com 469 (SC) and of Hon'ble MP High Court in case of CIT Vs. Metachem Industries [2001] 116 Taxman 572 (M.P.) comes to the rescue of the Firm.
- Joint & Several liability in case of unrecovered tax of the directors of the company if attributed to gross neglect, breach of duty etc. Sec. 179.
- Additional income tax on buy back of shares at the rate of 23.296% on distributed income i.e. consideration paid for buy back of shares less amount received on issue of shares (Rule 40BB). No tax implication on withdrawal of capital by partner.

Applicability & Implications of Section 115BAA of the Act

S. No.	Question	Answer
1.	Who shall exercise the option	All the domestic companies subject to certain conditions can exercise options for AY 2020-21 & thereafter.
2.	Process of exercising option	By electronic furnishing of Form 10-IC as prescribed by Rule 21AE on or before the due date of furnishing ROI U/s 139(1)
3.	What are the conditions for exercising options	<p>Following Set of deductions will not be allowed;</p> <ul style="list-style-type: none"> - Sec. 10AA – Provisions for newly established units in SEZ - Sec. 32(1)(ia) – Additional Depreciation - Sec. 32AD – Investment Linked Deduction - Sec. 33AB – Tea/Coffee/Rubber development account - Sec. 33ABA – Site Restoration Fund - Sec. 35 – Exp. on scientific research - Sec. 35AD – Deduction in respect of exp. on specified business - Sec. 35CCC – Exp. On agricultural extension project - Sec. 35CCD – Exp. On Skill development project - W.e.f A.Y. 2021-22 no deduction under chapter VIA will be allowed except U/s 80JJAA (employment of new employee) and Sec. 80M (in respect of inter corporate dividend

Effective rate
Of tax
25.17%

Applicability & Implications of Section 115BAA of the Act

S. No.	Question	Answer
4.	Brought Forward Losses and unabsorbed depreciation from Previous A.Y.'s	Shall be set off against the income on the condition that they must not be attributable to the deduction mentioned in point 3 above.
5.	Whether MAT Provisions Applicable	MAT provisions U/s 115JB not applicable and MAT credit shall not be available after exercising of the option
6.	Impact on Capital Gain Tax	There will be no impact on rates of tax of LTCG/STCG and brought forward losses under the head capital gain.
7.	What if conditions mentioned in point 3 not satisfied	The option shall become invalid in such previous year and subsequent years
8.	Can option be withdrawn	once the option has been exercised for any previous year, it cannot be subsequently withdrawn for the same or any other previous year.
9.	When 115BAB section option becomes invalid can option be exercised in Sec.115BAA	Yes, if above conditions are satisfied.

Effective Tax Rate 17.16% - Additional Provisions

- the company has been set-up and registered on or after the 01/10/2019, and has commenced manufacturing/ production of an article on or before the 31/03/2024.
- It should not be formed by Splitting up, or the reconstruction, of existing business.
- Plant & Machinery Should be New (20% of total P&M should be second Hand.
- Imported P&M shall be treated as new (however, should not be previously installed in India and No depreciation has been allowed in respect of such P&M.
- It Should not use any building previously used as a hotel or a convention center, in respect of which deduction u/s 80-ID has been claimed and allowed.

Sec. 115BAB - Tax on Income of certain new domestic manufacturing Companies

- The company is not engaged in any business other than the business of manufacture or production of any article or thing and research in relation to, or distribution of, such article or thing manufactured or produced by it.
- Manufacturing will not include development of computer software, Mining, Conversion of marble blocks into slab, bottling of gas into cylinder, printing of books & production of films.
- Assessing officer has wide power if due to close connection with a person more than ordinary profits are generated.
- If income other than manufacturing tax rate 22%
- STCG on transfer of capital asset on which no depreciation is allowable tax at 22%
- Rule 21AF and Form 10ID for exercising option.

Important Consideration before opting for Special Rate of Tax

- Availability of MAT Credit
- Claim of specified deductions, incentives, exemptions etc.
- Additional Depreciation
- Brought forward losses on account of above.
- In such cases option can be exercised after set off of losses so accumulated and after utilizing MAT Credit.
- Mathematical calculations should be done as per facts and circumstances of each case to assess the beneficial tax structure.

Tax liability in case of succession of the firm by the company

As per the provisions of Sec. 47(xiii) any transfer of a capital asset or intangible asset by a firm to a company as a result of succession of the firm by a company in the business carried on by the firm will not be regarded as transfer if following conditions are satisfied;

- all the assets and liabilities of the firm relating to the business immediately before the succession become the assets and liabilities of the company.
- all the partners of the firm immediately before the succession become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the succession.
- the partners of the firm do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company; and
- the aggregate of the shareholding in the company of the partners of the firm is not less than fifty per cent of the total voting power in the company and their shareholding continues to be as such for a period of five years from the date of the succession.

Tax liability in case of conversion of company into LLP

As per the provisions of Sec. 47(xiiiib) any transfer of a capital asset or intangible asset by a private company or unlisted public company to a limited liability partnership or any transfer of a share or shares held in the company by a shareholder as a result of conversion of the company into a limited liability partnership in accordance with the provisions of section 56 or section 57 of the Limited Liability Partnership Act, 2008 (6 of 2009) shall not be regarded as transfer if following conditions are satisfied;

- all the assets and liabilities of the company immediately before the conversion become the assets and liabilities of the limited liability partnership;
- all the shareholders of the company immediately before the conversion become the partners of the limited liability partnership and their capital contribution and profit sharing ratio in the limited liability partnership are in the same proportion as their shareholding in the company on the date of conversion
- the shareholders of the company do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of share in profit and capital contribution in the limited liability partnership

Tax liability in case of conversion of company into LLP

- the aggregate of the profit sharing ratio of the shareholders of the company in the limited liability partnership shall not be less than fifty per cent at any time during the period of five years from the date of conversion
- the total sales, turnover or gross receipts in the business of the company in any of the three previous years preceding the previous year in which the conversion takes place does not exceed sixty lakh rupees.
- the total value of the assets as appearing in the books of account of the company in any of the three previous years preceding the previous year in which the conversion takes place does not exceed five crore rupees; and
- no amount is paid, either directly or indirectly, to any partner out of balance of accumulated profit standing in the accounts of the company on the date of conversion for a period of three years from the date of conversion.

Non-Compliant Conversion of a company into LLP

When the above requirements are not met, the question of taxability continues with contentions possible on both the sides

Argument that conversion still not taxable	Arguments that conversion is taxable
Absence of two parties at the time of conversion	Company and LLP involved two separate and distinct entity
No consideration is paid to the company	Non-compliance of prescribed conditions would result in non-entitlement to exemption
Allotment of LLP interest to shareholders of the converted company is not tantamount to consideration in lieu of extinguishment of rights in case of legal vesting	Partnership interest in LLP is received by the shareholders of the company in exchange of shares held by them

Non-Compliant Conversion of a company into LLP

- As per Sec. 45(1) any profit or gain arising from the 'transfer' of a 'capital asset' is chargeable to income tax under the head capital gain and shall be regarded as income of the previous year in which the transfer takes place.
- Sec. 2(47) of the act defines the term 'transfer' to include sale, exchange, relinquishment of an asset or extinguishment of any rights therein.
- Therefore, in case of conversion it can be argued that extinguishment of rights of company in its asset or extinguishment of the rights in shares of the share holder in case of conversion to llp may be covered under the definition of transfer as per Sec. 2(47) and thus, the transaction may be chargeable under sec. 45(1).
- Sec. 48 the computation mechanism for capital gain specifies that Full value of 'consideration' shall be reduced by expenditure incurred in connection with transfer, indexed cost of acquisition and indexed cost of improvement.

Non-Compliant Conversion of a company into LLP

- One of the mandatory requirements for computing the capital gain is the existence of 'consideration'. However in the case of conversion, no consideration would be receivable by the company since the company itself would be converted into the LLP and therefore cease to exist. Therefore the computation mechanism in case of conversion will fail.
- Implications of Sec. 50D, which says that where the consideration received or accruing as a result of the transfer of capital asset by an assessee is not ascertainable or cannot be determined, Then FMV of the consideration on the date of transfer shall be deemed to be full value of consideration.
- However, still provisions of above section may not be applicable as it says that person should receive the consideration and the value of such consideration is not ascertainable. But Sec. 50D should not be triggered in case of nil consideration.
- On conversion, the assets and liability of 'the company' will be transferred to the LLP at their book values, thus even if capital gain is applicable the same would be nil as is also held in the case of Aum Chemicals Vs. ACIT [2009] 119 ITD 21 (Mumbai)

Non-Compliant Conversion of a company into LLP

- Sec. 45(3) shall also not be applicable as company is not becoming partners but the companies shareholders are becoming. Even if applicable transfer at book value will not lead to arising of tax liability in the hands of company.
- In the case of CIT Vs. TexspinEngg. & Mfg. works [2003] 129 Taxman 1 it was held that two important ingredients in the case of transfer of capital asset are existence of a party and counter party and secondly incoming consideration qua the transferor, in the fact of conversion both the conditions are not fulfilled and it is a case of statutory vesting of property.
- Para 7 of the Fourth schedule of the LLP Act requires the property of the company to vest in the LLP.
- Conversion cannot be classified as liquidation therefore possibility of treating credit of the companies accumulated profit to the partners capital account as deemed dividend U/s 2(22)(c) does not arise. [As per Sec. 2(22)(c) any distribution to share holders on liquidation to the extent attributable to accumulated profit is considered to be dividend]

Non-Compliant Conversion of a company into LLP

Decision of CIT Vs. Celebrity Power LLP [2018] 100 taxmann.com 129 (Mum. Tribunal)

In this case conversion due to non fulfilment of the condition of turnover less than 60 lakhs, AO determined the capital gain of 1.76 Cr. On estimate basis by invoking the provisions of Sec. 47A(4)

CP LLP put forth below arguments to support the view that there is no transfer	Hon'ble Tribunal Held that though the conversion is a transfer, though no taxable capital gain results from it
Conversion results into statutory vesting of assets & liability of the company into LLP and relied upon the Hon'ble HC decision in case of CIT Vs. Texpin Engg & Mfg. works	The judgment of Texpin is distinguishable as it pertained to a partnership firm being treated as a company under the statutory provisions of companies Act rather than conversion
No consideration was received by CP Company	On perusal of the term 'Convert' (as per clause 1(b) of the Third Schedule to the LLP Act, 2008) it can be gathered that conversion involves transfer of assets etc.
Non-satisfaction of the prescribed conditions would not automatically lead to taxing the transaction	Succession of partnership firm by a company, where there is only statutory vesting of property is distinguishable.
Alternatively, it was submitted that the entire undertaking had been transferred, COA of which could not be determined, hence computation mechanism fails.	Book Value of the assets was to be considered as full value of consideration and cost to the company was cost of acquisition, therefore difference is Nil

Authority of Advance Ruling's (AAR ruling in case of Domino)

Domino Printing Science Plc., In re A.A.R. No. 1290 of 2012, dated 23-8-2019 (Domino UK) had a wholly owned subsidiary company in India ('Domino India'). Domino India proposed to be converted into LLP. Admittedly, Domino India did not comply with the aforesaid conditions for a tax neutral conversion. Independent of the explicit exemption, Domino UK claimed before the AAR that the charging provision under the Act would not apply since there is no 'transfer' of shares of Domino India on its conversion into LLP, which is prerequisite for any capital gains to arise. Mentioned below in a nutshell were its substantive arguments with regard to various limbs of the definition of 'transfer' under the Act:

- There was no 'sale' or 'exchange' of shares of Domino India since a single person i.e. Domino UK cannot sell or exchange the shares with itself.

Non-Compliant Conversion of a company into LLP

Authority of Advance Ruling's (AAR ruling in case of Domino)

- There was no 'extinguishment' of right in shares since such right had not merged with another right and the percentage of shareholding of Domino UK remained same as it continued to hold interest in LLP in the same proportion as its shareholding in Domino India.
- Domino UK relied on decisions of the Bombay High Court CIT v. Texspin Eng. & Mfg. Works [2003] 129 Taxman 1/44 SCL 239 (Bom); CIT v. Umicore Finance Luxemborg [2016] 76 taxmann.com 32/[2017] 244 Taxman 43 (Bom.) i.e. contention of statutory vesting of rights in property transferred.
- Computation mechanism fails since no profit arises on conversion in hands of Domino UK as the balance in the capital account in books of the LLP would be exactly same as the amount of share capital and reserves of the company.
- No gains arises in the hands of Domino UK since the value of partnership interest in LLP was not higher than shareholder" interest in Domino India.

Non-Compliant Conversion of a company into LLP

Tax Authorities Argument

- The transaction was of 'exchange' as two persons i.e. Domino UK and the LLP were involved and shares of Domino India were exchanged by Domino UK for interest in LLP.
- There was 'extinguishment' of rights in shares of Domino India since as per provisions of the LLP Act, Domino India would be deemed to be dissolved on conversion into LLP. The ratio of the decision of the Supreme Court in case of *CIT v. Grace Collis* [2001] 115 Taxman 326 (SC) was incorrectly applied by Domino UK to state that extinguishment takes place only where there is merger. Merger was only one example of extinguishment.
- The decisions of Bombay High Court are not applicable as it held that there was no profit or gain since no consideration was received by the transferor. However, Domino UK had received partnership interest in LLP in exchange of shares held by it in Domino India

Non-Compliant Conversion of a company into LLP

AAR concurred with the Tax Authorities

Held that on conversion, Domino UK's interest in shares of Domino India was extinguished. Accordingly, the transaction was 'transfer'. The argument regarding statutory vesting of property in the company (based on decisions of Bombay High Court) is not tenable for the following reasons:

- These decisions dealt with capital gains in hands of partnership firm and not its partners.
- The LLP Act specifically provides for transfer of all assets and vesting thereof in the LLP unlike the Companies Act.
- The AAR also held that the computation mechanism did not fail. While consideration would be the value of partnership interest in LLP, the cost would be the cost incurred by Domino UK at the time of purchase of shares of Domino India. The difference between the consideration and cost would be capital gains. Further, even if the value of Domino UK's partnership interest in LLP is not capable of being ascertained, fair market value of shares of Domino India could be considered as consideration pursuant to Section 50D of the Act.

Non-Compliant Conversion of a company into LLP

Key Take aways

- The decision of CIT Vs. Celerity Power LLP discussed supra is important but Mumbai ITAT had not dealt with the taxability of shareholders of the company.
- The AAR ruling is not binding but it does have a persuasive value, AO may apply it widely in similar situations but such AAR or decision is challengeable at higher forum.
- On conversion fixed capital should be kept as issued paid up capital and the balance in reserves & surplus and share application money should be credited in partners current account. Withdrawal from such accounts can not be regarded as revenue receipts. Sec. 10(2A) also specifically exempts the share of profit.

Conversion - Other important provisions/consideration

- Carry Forward and set off losses and unabsorbed depreciation of the company is deemed to be loss/depreciation of the successor LLP, the previous year in which conversion was effected, thus such loss can be carried forward for further 8 years in the hands of successor LLP.
- As per Sec 49(1)(iii)(a) when capital asset becomes the property of the assessee due to Devolution (which should cover the case of conversion) the cost of acquisition of any capital asset shall be deemed to be the cost at which the company has acquired such asset. Further, the period of holding shall also include the period wherein the assets were held by the company.
- **Stamp duty on conversion of a Private company into LLP;**
 - As per Sec. 58(4) of the LLP Act, 2008 All tangible, movable or immovable property shall be transferred and shall vest in LLP without further assurance, act or deed. Clause 6 of the Third schedule also provides for the similar provisions on and from the date of registration.
 - Clause 7 of the Third schedule provides that if any property is registered with any authority, then the LLP shall as soon as practicable notify such authority of the conversion in the prescribed manner as may be specified by the authority.

Conversion - Other important provisions/consideration

- It has also been held in certain cases of succession by the company of the firm that as per Sec. 575 of the companies act 1956 under Part- IX corresponding Sec. 368 of the companies Act 2013 in case of conversion there is legal vesting of the property in the company. The vesting being statutory, no registered instrument of transfer is necessary as was held in the case of Rama Sundari Ray Vs. Syamendra Lal Ray, ILR (1947) 2 Cal which was followed by the A.P. High Court in the case of Vali Pattannhrama Rao and Another Vs. Sri Ramanuja Ginning and Rice Factory Pvt. Ltd. And others [1986] 60 Comp. Cas. 568 (DB) (AP)
- However, in clause 6 of the third schedule since the word 'transferred' is used specifically, it may give rise to litigation.

Thank you

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