Conversion of Partnership Firms and Private Limited Companies to LLP's

Sole proprietorship, partnership, company, co-operative societies are the vehicles for carrying on business, profession, vocation, occupation. Each vehicle has merit of speed, mileage and flip side of cost, security. Business vehicles are no exception to this general rule. Business is being carried on through any of such vehicles that suits most for the occasion.

Now arrived is a brand new business vehicle that will zap this millennium. *LLP*. Yes, they call it LLP. The law governing LLPs is contained in the Limited Liability Partnership Act, 2008. A Limited Liability Partnership (LLP) is a form of business entity which permits individual partners to be shielded from joint liability created by another partner's business decision or misconduct. In an increasingly litigious market environment, the prospect of being a member of a partnership firm with unlimited personal liability is, to say the least, risky and unattractive.

Considering the fact that Government desires businessmen to focus on business, LLPs are being encouraged.

As compared with company, restrictive provisions after implementation of Companies Act 2013 relating to Loan from Share Holders , managerial remuneration, acceptance of deposits (S. 58A), etc. of the Companies Act, 1956 are inapplicable to LLP, smooth functioning is possible. Moreover, LLP does not attract MAT and DDT, making it tax efficient. Therefore, the Finance Act, 2010 has made certain changes in tax provisions concerning conversion of certain companies into LLP. Theset of amendments are with a view to lighten tax burden associated with the process of conversion of company into LLP.

Conversion of Company into LLP:

In order to access several benefits as opposed to company form of organization, the businessmen may desire to convert the existing private limited companies or unlisted companies into LLP. Even a listed company can be so converted, the first step being of delisting of the company.

In this backdrop, let us examine the concessions offered for such conversion of company into LLP.

1. On the horizon of business matrix, a new star is now sited. While ease in operations of partnership and armor of limited liability is provided under a new format of business entity i.e. Limited Liability Partnership: (LLP).
2. For the purpose of taxation, the Income-tax Act, 1961 (the Act) equates LLP with the partnership firm [section 2(23)]. Therefore, no separate tax rate or legal provisions are prescribed for LLPs. Tax rate prescribed for firms of 30% is automatically applicable and similar is in case of the rest of the provisions.
3. On account of the obvious advantages of LLP medium for conducting business owned by multiple entities, it will be fancied by many. The new ventures will embrace to this

   ownership platform, however, what about the existing ones, who desire to convert to this new model?

Provisions of Relief:

4. The FinanceAct, 2010 has afforded some relief for the process of conversion.
5. Section 56 and section 57 of the Limited Liability Partnership Act, 2008 allow conversion of a private company or an unlisted public company (hereafter referred as company) into an LLP. Under normal provisions of Income-tax Act, conversion of a company into an LLP has definite tax implications. Transfer of assets on conversion attracts levy of capital gains tax. Similarly, carry forward of losses, unabsorbed depreciation and certain other allowances is not available to the successor LLP.
6. It is, now, provided that the transfer of assets on conversion of a company into an LLP in accordance with section 56 and section 57 of the Limited Liability Partnership Act, 2008 <u>shall not be regarded as a transfer</u> for the

purposes of capital gains tax under section 45. Clause (xiiib) has been inserted in section 47 of the Act. However, in order to access and retain this benefit, it is necessary to fulfill and continue to observe certain conditions. Similarly, transfer of shares by any shareholders of company in the process of such a conversion will not be treated as ‘transfer’ under the Income Tax Act, 1961 (the Act). However, conditions apply.

7. Certain other benefits available to the company are continued to be made available to LLP e.g. depreciation, amortization of VRS expenses, etc.

8. These conditions, referred to herein above in para 6, 7 and8 above, are as follows:

   (a) all assets and liabilities of the company immediately before the conversion become the assets and liabilities of the LLP;

   (b) all the shareholders of the company immediately before the conversion become partners of the LLP in the same proportion as their shareholding in the company;

   (c) for conversion, shareholders of the company do not receive any consideration, directly or indirectly, other than share in profit and capital contribution in the LLPS;

   (d) the shareholders of the company continue to be entitled to receive at least 50 per cent, in aggregate, of the profits of the LLP for a period of 5 years from the date of conversion;

   (e) the total sales, turnover or gross receipts in business of the company do not exceed sixty lakh rupees in any of the three preceding previous years;

   (f) for a period of three years from conversion, no amount is paid, directly or indirectly, to any partner out of balance of accumulated profit standing in the accounts of the company on the date of conversion.

9. Where the conditionsstipulated under section 47(xiiib) are not met, the benefit availed by the company shall be deemed to be the profits and gains of the successor LLP chargeable to tax for the year in which the aforesaid conditions have not been compliedwith [Section 47A(4)].

10. Fifth proviso to section 32 provides for computation of depreciation allowance on conversion of private or unlisted public company into LLP. Like in the case of amalgamation and demerger of companies, in case of succession of a company into LLP, the total depreciation allowable to the predecessor company and successor LLP will not exceed the total depreciation that would have been allowed if no succession had taken place. It further provides that in case of such succession, the amount of depreciation shall be apportioned the predecessor and the successor in the ration of number of days for which assets were used by them.

12. Section 43(6) of the Act defines 'written down value' of assets for claim of depreciation. The cost of acquisition of capital assets for the successor LLP will be deemed to be the written down value for thepredecessorcompanyon the date of conversion.

13. Section 35DDA allows amortization of expenditure incurred for payment of compensation of voluntary retirement scheme (VRS) in five equal annual installments from the year of compensation payment. On private company or unlisted public company is succeeded by a LLP fulfilling the conditions laid down in the proviso to clause (*xiiib*) of section 47, amount of deduction under section 35DDA unamortized in the hands of the predecessor company shall be allowed to the successor LLP as would have been allowed to the company, had the conversion not taken place. No deduction will be available to the company during the year in which the company is being succeeded by an LLP and the same will be fully allowed to the LLP.

14. Sub-section (6A) inserted in section 72A of the Act, enables carry forward and set-off of business loss andunabsorbed depreciation by the successor LLP which fulfills the above mentioned conditions of section 47(xiiib) of the Act,Amendments are alsomade in sub-section (7) of section 72A to clause (a) - 'accumulated loss' and to clause (b) - 'unabsorbed depreciation' to enlarge meaning of these terms so as to include loss and depreciation of a private

company or an unlisted public company, which has been converted into LLP. Breach of provisions of section 47(xiiib) result into confiscation of the carry forward of these allowances and its treatment as LLP's income to the extent set-off is claimed in the year when the conditions are not complied.

15. Credit in respect of tax paid by a company under section 115JB is allowed only to such company under section 115JAA. It is provided by sub-section (7) of section 115A that the tax credit under section 115JAA shall be allowed to the successor LLP. Interestingly, it appears that this benefit is available to any private company or an unlisted public company converted into LLP, whether conditions laid down under section 47(xiiib) have been complied with or not.

16. These amendments are applicable from 1st April, 2011 and will, accordingly, apply in relation to the assessment year 2011-12 and subsequent years.

Analysis and Issues

17. The condition in section 47(xiiib) stipulates that all assets and liabilities of the company should become assets and liabilities of the LLP. The condition in section 47(xiii) affording concession for conversion of firm/AOP into a company, stipulates that all assets and liabilities 'relating to business' of the firm / AOP should become assets and liabilities of the company. Is there any difference between the two sets or wordings?

18. In order to avail the benefits stated herein above, turnover of the company for past three years should be within the limit of rupees sixty lac. This condition will disentitle a number of companies from exemption capital gains tax. Similar condition has not been stipulated for giving concession from capital gains tax on conversion of proprietorship of partnership into a company. Therefore, this condition needs to be omitted.

19. In case of succession of a company by a LLP, there is no exemption from tax on sale / transfer of any property that is not a capital asset like stock in trade, raw materials, consumable stores and spares, etc. In this context, it needs to be noted that Supreme Court in case of ALA Firm v. CIT (189 ITR 285) has held that in

taking accounts for the purpose of dissolution, since the firm and the partners, being commercial men, would value assets on real basis and not at cost or their other value appearing in the books. Therefore, at the time of dissolution value of closing stock should be taken at market value and not at cost and the difference is income. Similarprinciples would apply at the time of conversion of a company into a LLP.

20. Is it possible to by pass section 47(xiiib) and yet claim exemption from capital gains tax? Attention is invited to the judgment in case of CIT v. Texspin Engg. & Mfg. Works [2003] 263 ITR 345/129 Taxman 1 (Bom). The assessee-firm which had been converted into limited company under Part IX of Companies Act, was subjected to capital gains tax under section 45(4) on the ground that there was transfer of assets by way of distribution and such transfer was on dissolution of firm. The Bombay High Court held that there was no transfer of capital asset as contemplated by section 45(1) in absence of existence of party and counter-party and incoming consideration qua transferor and even assuming that there was transfer of capital asset in instant case because of definition of word 'transfer' in section 2(47)(iii), a liability to pay capital gains tax would not arise because section 45(1) is required to be read with section 48 which provides for mode of computation and no consideration accrues or arises to the firm within the meaning of section 48.
21. If a shareholder is appointed as a working director or manager, will it amount to conferring any benefit on shareholder and resulting into forfeiture of exemption available under section 47(xiiib)? It has been held that 'Benefit' is a word of wide import, it means no more than 'advantage.' Gronia v. Grierson (1968) 1 All ER 593, 599 (HL).
22. Can shareholders transfer the shares inter-se? is it possibly to dispose of shares by some shareholders, as long as, in aggregate, shareholders hold not less than 50 per cent
shares in the LLP?

Conversion of Firm into LLP

23. A partnership firm which converts into LLP is, expressly, afforded the benefit of allowance of carry forward and set-off of business loss and unabsorbed depreciation to the successor LLP.
24. However, the other benefits are not made available to the firm. It is, perhaps, because, under the Act, there is no difference between a 'firm' and a 'LLP' and there is no necessity of express provision of concession, as in case of such a conversion status of the entity continues to be 'firm', there is no 'transfer'. As there is no transfer, the capital gain does not arise.
25. Taxation on conversion of firm into LLP also needs to be expressly clarified, in order to avoid litigation.

Other Issues

26. If you produce a vehicle running at 200 kmph, will it take you 100 kilo meters in a half an hour? – No. Why? The driver needs to be trained; roads should be smooth, no much traffic, etc. etc. is also necessary.
27. Similarly, merely by merely sparing LLPs capital gains tax, one cannot expect wholesale conversion of companies into LLPs. Because, besides capital gains tax, there are other issues involved. To list major ones: Stamp Duty, State Taxes, Central Excise and Service Tax, IEC code, Bank Borrowings, etc. While stamp duty causes substantial outflow, in other matters necessary paper work needs to be made. Under indirect taxes, carry forward on Cenvat or set-off not consumed may not be available. Fresh VAT & Service Tax Registrations need to be carried out due to change in constitution and PAN .

Sum Up

28. The amendments giving concession on conversion of company into LLP, are welcome. This new vechile of driving the entity is more or less more compaitable for the small scale business units in order to save themselves from this hardship of law as amended / introduced as companies act 2013.
29. However, utility of LLP as a business vehicle is so enormous that I believe within the next decade, private and unlisted public companies as well as partnership firms will perish, making way to LLPs.
30. The profession, therefore, needs to gear up for counseling LLPs in all aspects – tax, law, procedures and of course accounts and auditing.