

AAR holds that no income arises at the time of conversion of partnership firm into a Company under Part IX conversion

The Authority for Advance Rulings (“AAR”) has delivered a ruling in the case of Umicore Finance Luxembourg on the tax implications at the time of conversion of a partnership firm into a private limited company under Part IX of the Companies Act, 1956 (“Cos Act”).

Facts of the case

- Umicore Finance Luxembourg (“the Applicant”) is a company incorporated under the laws of Luxembourg. It is the holding company of Anandeya Zinc Oxides Pvt Ltd (“Anandeya” or the “WOS”). It purchased 99.96% of the shares of Anandeya and the balance stake was purchased by its nominee, Umicore Finance, Belgium.
- Anandeya was incorporated as a private limited company under Part-IX, and more particularly section 565, of the Indian Companies Act, 1956 and all the assets and liabilities of the partnership firm - Anandeya Oxides were vested in Anandeya.
- At the time of registration of Anandeya under Part-IX of the Cos Act, its shareholders were the partners of the erstwhile partnership firm.
- The Applicant also stated that the aggregate of the shareholding in Anandeya by the erstwhile partners of the Firm was never less than 50 percent, given that one of the partners always had more than 50 percent of the voting power in the Company.
- About 7 years prior to the Part IX conversion, the assets of the partnership were revalued and the revaluation credit was given to the respective partners in their capital accounts.

Main issue before the AAR

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On the maintainability of the Application

- Whether the application before the AAR is maintainable since prima facie, the determination sought by the Applicant was in relation to the tax liability of Anandeya and therefore, a doubt had arisen whether the Applicant being a non-resident can seek an advance ruling?

On merits

- Whether the conversion of partnership firm as a private limited company under Part-IX of the Cos Act will be regarded as 'transfer'?
- The Act provides that one of the conditions for the exemption from capital gains in cases of succession of a firm by a Company is that at least 50 percent shareholding in the Company succeeding the firm should be retained by the partners of the Firm for a period of 5 years from the date of succession.
- Since the Applicant was buying the entire share capital of Anandeya, would this condition be violated and if so, will it give rise to capital gains liable to income-tax consequent upon the transaction entered into by the applicant of buying the shares of Anandeya?

Applicant's contentions

On maintainability

- The Applicant contended that the transaction which has been undertaken has given rise to this application which, in turn, directly affects the Applicant by reason of the stipulations in the agreement which state that unless the capital gains tax payable by Anandeya is determined, the purchase consideration payable cannot be finally determined. Moreover, the Applicant's obligation to provide audited financial statement reflecting the net debt as on the completion date is also linked up to the capital gain tax liability in the hands of Anandeya.

On merits

- The registration of the firm as a Company under Part IX and the consequent vesting of assets did not amount to 'transfer' nor any capital gains had arisen and therefore, irrespective of the violation of the condition related to succession, a liability to pay capital gains cannot be fastened onto Anandeya.
- The Applicant further submitted that on conversion, there was no revaluation of the assets and the assets and liabilities of the firm as also the partners' capital and current

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accounts were taken at their book value and the net worth of Anandeya as on the date of conversion was the same as in the hands of the firm and there was no increase in the subject value.

- The Applicant drew reference to section 575 of the Cos Act and contended that there is a statutory vesting of property on registration and that a firm is also treated as a company for the purpose of registration under Part IX.

Ruling of the AAR

On maintainability

- As regards the maintainability of the application, the AAR vide its order **AAR No 797 of 2009** dated July 6, 2009 held that the application is maintainable and that there is no specific requirement that determination should relate only to the tax liability of a non-resident. Further, going by the averments of the Applicant, it is clear that the capital gains tax issue arising in the case of the acquired Indian company (viz, Anandeya) has a direct and substantial impact on the Applicant's business in view of the stipulations in share purchase agreement.

On merits

- Section 47(xiii) of the Act specifically excludes certain categories of transfer from the ambit of capital gains, subject to fulfillment of certain conditions. In the given case, while all other conditions are satisfied, the condition requiring that the shareholding of the Partners should continue for a period of 5 years from the date of succession has not been fulfilled by virtue of the transfer of shares of Anandeya to the Applicant before the expiry of 5 years.
- Accordingly, based on the premature transfer, prima facie it may appear that Anandeya which succeeded the firm, has forfeited the exemption granted under section 47(xiii). However, it should be noted that section 47A(3) which governs the withdrawal of exemption uses the words “the amount of profits or gains arising from the transfer of such capital assets or intangible assets”. Hence, there is a presupposition that there was a transfer of capital asset and that certain profit or gain resulted therefrom which has not been charged to tax earlier.
- Therefore, in this case, the questions to be answered were:
 - a) Was there a “transfer”?
 - b) If there is a “transfer”, did profits or gains accrue from it?
- The AAR brought out the fact that section 47(xiii) read with section 47A(3) was enacted by the Finance Act, 1998, for the purpose of extending tax benefits in a case of

business reorganisation where a firm is succeeded by a company. Reliance was also placed on the decision of the Bombay High Court in the case of **CIT vs Texspin Engg & Mfg Works (263 ITR 345)**, where it had inter alia been held that section 47(xiii) was introduced to encourage more firms to become limited companies and given that a firm is treated as a Company under Part IX, it is similar to a transmission, which is fortified by the fact that 47(xiii) provides that succession of a firm by a company would not be regarded as taxable.

- The consequence of section 47A(3) is that the amount of profits or gains arising from transfer of such capital asset not charged under section 45 shall be deemed to be the profits and gains chargeable to tax of the successor company in the previous year of non compliance of the conditions prescribed in the proviso to section 47(xiii).
- The AAR observed that the deeming fiction in section 47A(3) is not absolute as only the profits and gains arising from transfer of such capital asset not charged earlier are deemed to be profits of the successor company. Therefore, if no profits arose earlier at the time of conversion or if there was no transfer of a capital asset, the deeming provision under section 47A(3) cannot be invoked.
- The AAR held that assuming that a process of transfer of capital or intangible assets takes place, the question which arises is whether there is any profit or gain which arises and secondly, have the partners gained anything, by virtue of the statutory vesting of assets.
- In respect of the above questions, the AAR ruled that shares allotted to the partners of the erstwhile firm consequential to the registration of the firm did not give rise to any profit or gain. It also mentioned that by merely receiving shares, the value of which is not more than the sum total of the value of their interest in the firm or the worth of their shareholding, no profit/ gain arose.
- The worth of the shares allotted to the former partners was not different from their interest in the firm in monetary terms.
- The AAR drew upon the Texspin case and held that the very asset which was transferred or parted with, cannot be the consideration for transfer and hence the market value of the asset cannot be considered for computing the capital gains.
- The AAR referred to the Texspin case where it was held that the consideration for the transfer of a capital asset is what the transferor receives in lieu of the assets parted by him, and therefore, the expression 'full value of the consideration' can only mean the full value of things received by the transferor in exchange for the capital asset transferred. Given that the company had allotted shares to the partners of the erstwhile firm, the same has no correlation to the statutory vesting of assets and as nothing

accrues to the firm, the above transaction is outside the ambit of capital gains taxation.

- The charging provision under section 45 has to be read in conjunction with the computation under section 48 as held by the Supreme Court in the case of **BC Srinivasa Setty's case (128 ITR 294)** and that the term 'full value of consideration' cannot be construed to mean the market value of the assets transferred.
- In the context of whether there was a "transfer", the AAR refrained from answering this question.

Conclusion of the AAR

- The AAR held that section 47(xiii) read with section 47A(3) cannot be construed to introduce a fiction to the effect that the income which is not chargeable to tax under the other provisions of the Chapter on capital gains can be deemed to be capital gains, if the violation of conditions take place.
- Section 47A(3) only emphasizes the chargeability to tax of profits and gains resulting from the transfer of capital asset. The same can be decided based on a combined reading of Section 45(1) and Section 48 and hence, section 47A(3) cannot be read as a 'stand alone' provision.
- The AAR ruled that no profits or gains arose at the time of conversion of the partnership firm into a private limited company under Part IX of the Cos Act and notwithstanding violation of the conditions prescribed in the proviso to section 47(xiii), there is no liability to capital gains tax.

BMR comments and analysis

This Ruling reiterates the fine distinction between transmission (for eg on statutory vesting) and 'transfer'. Although, the AAR has refrained from giving a ruling on whether there was a 'transfer' in a process recognized by a statute, it has, in no uncertain words, held that no profits or gains arose.

The observations of the AAR on the maintainability of the application seeking the advance ruling are also welcome and relevant to non residents seeking to invest in Indian business where there is a potential tax liability. Importantly, the AAR ruling is also relevant for transactions involving conversion to Limited Liability Partnerships.

To view a copy of the Ruling, click [here](#).

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