

CORPORATISATION OF NON-CORPORATE ENTITIES



Presentation by:

CA. UMESH K. GALA

COVERAGE

- Factors for Selection of Entity
- Advantages & Disadvantages of Corporate Entity
- Process of Corporatization
- Conversion Options
- Part XXI Conversion under Companies Act, 2013 (Similar to Part IX)
 - ✓ Features
 - ✓ Key sections under Part XXI of Companies Act, 2013
 - ✓ Effect of Registration
 - ✓ Procedure for registration
 - ✓ Direct tax implications under Income-tax Act, 1961
 - ✓ Pros and Cons
- Conversion u/s. 47(xiii) / 47(xiv) of Income-tax Act, 1961
 - ✓ Features
 - ✓ Conditions for exemption
 - ✓ Effect of violation of conditions
 - ✓ Critical Issues
 - ✓ Pros and Cons
- Other modes
- Comparison between Part XXI and S. 47(xiii) / 47(xiv)

ENTITY SELECTION – FACTORS

➤ Factors:

- ✓ Size of business
- ✓ Scalability
- ✓ Fund raising requirements
- ✓ Liability – Limited vs. Unlimited
- ✓ Flexibility
- ✓ Valuation perception
- ✓ Lifecycle of business
- ✓ Number of persons involved
- ✓ Separation of Ownership and Management
- ✓ Growth opportunities
- ✓ Exit Opportunities

➤ Migration of entity like partnership firm / proprietary concern to corporate entity becomes necessary based on one or more of the above factors

ADVANTAGES OF CORPORATE ENTITIES

- Better Recognition
- Perpetual existence
- Limited Liability
- Fund Raising - Participation of large number of investors
- Ability to unlock value – Listing of shares / Fund Raising
- Enhanced Borrowing Capacity
- Scale and Size
- ESOP's – Attracting Talent
- Mergers and Acquisitions – Inorganic Growth
- Corporate Governance – Board Members
- Separating Ownership from Management
- Ability in transferring stake – fully or partly
- Move towards Professionalism

DISADVANTAGE OF CORPORATE ENTITIES

- Greater compliance requirements under Companies Act, 2013 and related costs
- Limits for accepting loans and deposits
- Limits on advancing loans
- Double taxation on dividends
- Higher tax liability arising from Minimum Alternative Tax (MAT) on book profits
- Greater public scrutiny and transparency
- Not easy to wind up

PROCESS OF CORPORATISATION

- Understanding the objects and reasons of corporatization
- Review and analysis of available methods of conversion
- Evaluation of business implications
- Evaluation of Direct, Indirect tax implications
- Stamp duty on conversion
- Other licenses / registration – continuance
- Valuation / Revaluation of Assets
 - ✓ Tangible Assets
 - ✓ Intangible Assets
- Time and cost implications
- Final Implementation

CONVERSION OPTIONS

- Part XXI of Companies Act, 2013 (Similar to Part IX)
- Conversion u/s. 47(xiii) / s. 47(xiv) of Income-tax Act, 1961
- Other methods

PART XXI CONVERSION

- Part XXI - s. 366 to s. 374 of Companies Act, 2013

- Features:
 - ✓ Special window created for registering a non corporate entity into a company
 - ✓ Permitted under Companies Act, 2013
 - ✓ A statutory vesting of assets and liabilities
 - ✓ Part XXI provides detailed framework – implications of registration
 - ✓ Existing Precedents may apply - No registered instrument of transfer required – Hence no stamp duty
 - ❖ Rama Sundari Ray V. Syamendra Lal Ray - ILR (1947) 2 Cal 1
 - ❖ Vali Pattabhirama Rao V. Sri Ramanuja Gining and Factory P. Ltd.
– 60 Company Cases 568 (AP-DB)

PART XXI CONVERSION – KEY SECTIONS

- S. 366 (erstwhile s. 565) – Companies capable of being registered
 - ✓ Word 'company' defined (not defined in erstwhile section)
 - ❖ Includes firm, LLP, co-operative society or other entity formed under any law
 - ✓ Could be Registered as a
 - ❖ Company limited by shares or
 - ❖ Company limited by guarantee or
 - ❖ Unlimited company
 - ✓ Entity should be registered under any act of Parliament / any law
 - ✓ Entity should have at least 7 members
 - ✓ To register as Company limited by shares - Entity should have permanent share capital divided into fixed amount
 - ✓ Consent required of majority members of Entity present at General Meeting
- S. 367 (erstwhile s. 574) – Certificate of registration of existing companies
 - ✓ The company shall be incorporated after Registrar certifies the registration, and in case of limited company certifies that it is limited

PART XXI CONVERSION – KEY SECTIONS

➤ Effect of registration:

- ✓ S. 368 (erstwhile s. 575) – Vesting of property on registration
 - ❖ The movable / immovable property of the predecessor entity - **Pass to** and **vest** in the incorporated company
- ✓ S. 369 (erstwhile s. 576) – Saving of existing liabilities
 - ❖ Rights / liabilities of any debt / obligation / contract entered by the predecessor entity – Not affected due to registration as company
- ✓ S. 370 (erstwhile s. 577) – Continuation of pending legal proceedings
 - ❖ Suits / legal proceedings taken by / against the predecessor entity before registration – Shall continue
- ✓ S. 371 (erstwhile s. 578) – Effect of Registration under this part
 - ❖ Table A may not apply (unless otherwise selected)
 - ❖ Every contributory (member) of company – liable for debts contracted by predecessor entity

PART XXI CONVERSION – KEY SECTIONS

- Effect of registration (Contd..)
 - ✓ S. 374 (**new section**) – Obligations of Companies registering under this part
 - ❖ To register as company - Consent of secured creditors required
 - ❖ Notice of predecessor entity – To be published in newspaper - seeking objections, if any
 - ❖ Members / partners of predecessor entity to file affidavit –
 - Stating that necessary documents for dissolution of predecessor entity shall be submitted to the authority with which it was registered

PART XXI CONVERSION - RULES

- Procedure –The Companies (Authorised to Registered) Rules, 2014
 - ✓ Covers – Limited by Shares / Guarantee / Unlimited
 - ✓ Limited by Shares - Rule 3(2)(a) – Form No. URC 1 – Submit the following details
 - ❖ List showing names, address and occupation of members and no. of shares held
 - ❖ List showing names, address, DIN, interest in other firms or body corporate of first directors of company along with consent to act as directors
 - ❖ Affidavit from first director that he is not disqualified to be a director
 - ❖ List containing names and address of partners of LLP
 - ❖ Copy of deed of partnership, bye-laws or other instrument regulating predecessor entity
 - ❖ Statement specifying following:
 - Nominal share capital and its division
 - No. of shares taken up by each member and amount paid up in share
 - Name of Company – addition of word ‘Limited’ / ‘Private Limited’
 - Written consent / NOC from all secured creditor
 - Written consent from majority members present at GM – agreeing for registration

PART XXI CONVERSION – DIRECT TAX

➤ In the hands of transferor entity:

- ✓ No transfer u/s. 2(47)
 - ❖ statutory vesting
 - ❖ duality of transferor and transferee missing
- ✓ No implication u/s. 45(4) – Distribution of capital assets on dissolution / otherwise
 - ❖ Statutory vesting is different from distribution
 - ❖ Statutory vesting not consequential or incidental to transfer
 - Texspin Engg. And Mfg. Works – 263 ITR 345 (Bom)
 - United Fish Nets – (2015) 228 TAXMAN 0302 (AP)
 - Krishna Electrical Industries – 4 SOT 143 (Del)
- ✓ 5th proviso to s. 32(1) - Depreciation to firm and company, both in year of conversion – based on number of days of assets used by each

➤ In the hands of partners / members of firm:

- ✓ Cost of shares allotted in the company in the hands of partners –
 - ❖ on the basis of capital balances in firm prior to conversion (ignoring revaluation of assets)

PART XXI CONVERSION – DIRECT TAX

➤ In the hands of Transferee entity:

- ✓ 5th proviso to s. 32(1) - In year of conversion –on number of days of assets used
- ✓ Company entitled to benefits and incentives available to firm
 - ❖ CBDT Circular: F. No. 15/5/63 – IT (AI) dated 13.12.1963
 - ❖ S.80-IA, s. 80-IB, s. 10AA etc. – Incentive qua undertaking and not qua assessee
 - Chetak Enterprises (P) Ltd 325 ITR 405 (Rajasthan HC)
 - Tech Book Electronic Services (P) Ltd – 100 ITD 125 (Del)
 - Kumaran Systems (P) Ltd. – 106 TTJ 484 (Chen)
- ✓ No carry forward of business losses and unabsorbed depreciation
 - ❖ S. 78(2) – *‘Where any person carrying on any business or profession has been succeeded in such capacity by another person otherwise than by inheritance, nothing in this Chapter shall entitle any person other than the person incurring the loss to have it carried forward and set off against his income.’*
 - ❖ Part XXI Conversion not Inheritance u/s. 78(2)
 - Amin Machinery (P) Ltd – 14 ITD 413 (Ahd.)
 - ❖ Solution - structure Part IX conversion as s. 47(xiii) / 47(xiv)
 - Inbuilt mechanism - S. 72A(6) – discussed later

PART XXI CONVERSION – DIRECT TAX

➤ In the hands of Transferee entity:

- ✓ S. 43B – benefit of deduction if predecessor entity's liability paid by Company
- ✓ Similar disallowances u/s. 40(a)(ia), 40(a)(i) – Company should get benefit
- ✓ Deduction of bad debts in respect of sales made by predecessor entity - Possible
 - ❖ Veerbhadra Rao - 155 ITR 152 (SC)
- ✓ AMT paid by predecessor entity u/s. 115JC – whether credit available to company
 - ❖ Difference in language of S. 115JD vs. S. 115JAA (7)
- ✓ Valuation of stock in trade – whether ALA Firm applies [1991] 189 ITR 285 (SC)
 - ❖ Refer also – Sakthi Trading Co - [2001] 250 ITR 871 (SC)

➤ Procedural Requirements:

- ✓ New PAN / New TAN
- ✓ Separate returns - till date of conversion after date of conversion

➤ Indirect Tax Implications

- ✓ Should be tax neutral
- ✓ Will require new registrations
- ✓ To be evaluated from expert

PART XXI CONVERSION

➤ Pros:

- ✓ A statutory vesting of assets and liabilities – hence no stamp duty – old decisions
- ✓ No capital gains, since no transfer of asset
- ✓ Continuity of business assured
- ✓ Track record of predecessor partnership firm eligible for IPO & other business purpose
 - ❖ Regulation 26 of SEBI ICDR

➤ Cons:

- ✓ No direct taxation shelter - unlike s. 47(xiii) or s. 47(xiv) of I T Act
- ✓ On subsequent sale of shares – capital gains based on original cost of acquisition
- ✓ If revaluation carried out, surplus to be written off / amortized in books – no step up for tax purposes
- ✓ Capitalization by revaluation of assets – may require disclosure in Fixed assets schedule as per ICAI guidance note
- ✓ All old liabilities shall be carried forward in new company

CONVERSION U/S. 47(xiii) or 47(xiv)

➤ Features

- ✓ Permitted by Income-tax Act, 1961
- ✓ Special incentive for the succession (conversion) of partnership firm or proprietary concern into corporate entities
 - Partnership Firm will include an LLP
- ✓ Transfer of a capital asset or intangible assets to the company would be treated as tax exempt subject to conditions
- ✓ Object and intention behind introduction of s. 47(xiii) / 47(xiv)
 - ❖ CBDT Circular No. 772 dated 23.12.1998
 - Business reorganizations have specific tax implications including levy of capital gains
 - Similarly, carry forward of accumulated losses and unabsorbed depreciation not available to successor business entity
 - In case of amalgamation, capital gains is not levied accumulated business losses and unabsorbed depreciation is available subject to certain conditions
 - The expert group has recognized the need to encourage business re-organization when they are in consonance with economic development and not merely devices to secure tax advantage

CONDITIONS FOR S. 47(xiii) /s. 47(xiv)

➤ Conditions for exemption u/s. 47(xiii):

✓ **All** the **Assets** and **Liabilities of the business** are transferred to the Company

❖ Individual assets and liabilities cannot be excluded

❖ Only those assets and liabilities which relate to business – no need of transfer of other / personal / non business assets

❖ Formal and legal transfer may not be necessary – Dominion and control over assets and liability required

▪ Podar Cement (P) Ltd– 226 ITR 625 (SC)

▪ Mysore Minerals Ltd – 239 ITR 775 (SC)

✓ Consideration solely in form of shares of Company

❖ Refers to consideration arising from transfer of business of the company

❖ Payment for remuneration, rent, etc. – not regarded as benefit flowing due to succession

❖ Receipt of higher value of shares because of re-valuation of assets at time of succession – Not violation of condition

▪ Joe Marcelinho Mathias - [2013] 34 taxmann.com 129 (Panaji - Trib.)

▪ Nayan L. Mepani - [2012] 18 taxmann.com 59 (Mumbai Trib)

CONDITIONS FOR S. 47(xiii) /s. 47(xiv)

- ✓ All partners of the firm become shareholders in the Company in proportion to their capital balances
 - ❖ Condition applicable to partners immediately prior to succession
 - ❖ Minor can be allotted shares in company – although minor not partner under Partnership Act, under Income-tax Act minor can be a partner
 - Shares can be allotted in name of minor – Circular No. 8/18(41)/63-PR dated 31.03.1964
 - ❖ Equity and preference shares, both can be allotted
 - ❖ Both fixed and current capital of partners to be considered –Loan given by partners??
 - ❖ Difficulty in case of negative capital balances of partners
 - ❖ Safe to ensure proportion of capital balances do not result in fractional ownership of shares in company
 - ❖ Whether partners can be shareholders in the company prior to succession
 - ‘Become shareholders’ does not mean shareholders for first time
 - ❖ If all partners become shareholders in reasonable time from date of succession – condition fulfilled
 - Sanjay Singh - [2012] 19 taxmann.com 88 (Delhi)

CONDITIONS FOR S. 47(xiii) /s. 47(xiv)

- ✓ The aggregate shareholding of partners is not less than 50% of the total voting power for 5 years from the date of succession
 - ❖ Condition to be fulfilled when shares are allotted in lieu of conversion
 - ❖ Requirement to be fulfilled on aggregate basis
 - ❖ Reference to voting power and not shares of company
 - ❖ Partners who require to fulfill condition – Partners immediately before succession
 - ❖ Condition of 50% not restricted to shares issued on account of succession –
 - Intention that s. 47(xiii) & s. 47(xiv) not used to transfer ownership
 - ❖ 50% of condition to be fulfilled for 5 consecutive years
 - Even if breach for 1 day – condition violated
 - ❖ 5 year period to be considered from the date shares allotted to partners
 - ❖ Transfer of shares amongst partners such that 50% condition fulfilled –allowed
 - Intention that post conversion no change of economic control
 - ❖ Merger of company with another company – violation - withdrawal of exemption u/s. 47A
 - Merger of another company with present company ok – 50% condition

CONVERSION U/S. 47(xiii) or 47(xiv)

- Conditions for exemption u/s. 47(xiv) - Similar to s. 47(xiii)
 - ✓ All assets and liabilities of sole proprietorship firm to be transferred to company
 - ✓ Sole proprietor should only receive consideration in form of shares
 - ✓ Shareholding of sole proprietors in company is not less than 50% of total voting power for 5 years from the date of succession

- Effect of Violation of conditions – S. 47A(3)
 - ✓ Transfer of business not charged to tax u/s. 45 shall be taxed as PGBP in the hands of successor company – In year in which conditions not fulfilled
 - ❖ S. 47A(3) applicable only when exemption available u/s. 47(xiii) / 47(xiv)
 - If conditions u/s. 47(xiii) / 47(xiv) not fulfilled – S. 47A(3) shall not trigger – capital gains taxable in the hands of firm
 - Divergent view – Prakash Electric Company – 118 TTJ 539 (Bang ITAT)

CONVERSION U/S. 47(xiii) or 47(xiv)

➤ Critical Issues:

- ✓ Succession is qua business – Business and profession are distinct
 - ❖ Conversion of profession – Difficulty in claiming benefit of s. 47(xiii) & 47(xiv)
- ✓ Succession is of business and not of firm –
 - ❖ Where firm has two distinct and independent business – possible to claim conversion u/s. 47(xiii) / s. 47(xiv) in respect of 1 business
 - Exemption can be claimed when no unity of control / management and no unity of funds
- ✓ Succession u/s. 47(xiii) / s. 47(xiv) is succession for s. 49(1)(iii)(a)
 - ❖ Succession denotes not only succession on death but covers other modes of transfer of business
 - S. Krishnamurthy - 152 ITR 669 (Mad)
 - ❖ Sale of business as going concern – where continuity and identity is maintained – would answer to definition of succession
 - K. H. Chambers - 55 ITR 674 (SC)
- ✓ The succeeding company need not be a new company

CONVERSION U/S. 47(xiii) or 47(xiv)

- ✓ Transfer by way of itemized sale – Exemption still available for capital assets or intangible assets
 - ❖ Transfer of stock in trade not covered
 - ❖ Other implications
- ✓ When exemption u/s. 47(xiii) / s. 47(xiv) eligible
 - ❖ S. 45(4) will not trigger
 - ❖ S.50 will not apply – s. 50 is only to modify computation of s. 48 and s. 49
 - ❖ S. 50B and s. 50C also not to apply
- ✓ Cost of shares in hands of partners allotted in pursuance of s. 47(xiii) and s. 47(xiv) –
 - ❖ At agreed price / amount at which shares issued
 - ❖ If shares allotted without specifying price – discuss
- ✓ Period of holding of shares - from date on which shares issued

CONVERSION U/S. 47(xiii) or 47(xiv)

- ✓ Depreciation to Successor Company
 - ❖ Depreciation available on costs paid
 - Kalooram Govindram - 57 ITR 335 (SC)
 - Govindoss Purushothamdoss - 124 ITR 319 (Mad)
 - Raj Narain Agarwala - 75 ITR 1 (Del)
 - ❖ S. 43(1) – No limitation on actual cost imposed on succession u/s. 47(xiii) / 47(xiv) – unlike amalgamation, demerger, transfer between holding company and subsidiary company etc.
 - ❖ Explanation 3 to S. 43(1)
 - Modular Infotech P. Limited - (2010) 40 DTR 172 (Pune Trib)
 - Chitra Publicity Co (P) Ltd - (2010) 4 ITR 0738 (Ahem Trib)
 - ❖ 5th proviso to s. 32(1) – depreciation in case of succession u/s. 47(xiii) / 47(xiv) on pro rata basis as if succession not taken place
 - Restricted only to 1st year of succession
- ✓ Cost of other non depreciable assets – cost to previous owner – Firm – s. 49(1)(iii)(e)
- ✓ AMT paid by Firm u/s. 115JC, whether credit would be available to Company
 - ❖ Difference in language of S. 115JD vs. S. 115JAA (7) ???

CONVERSION U/S. 47(xiii) or 47(xiv)

➤ Pros:

- ✓ No transfer u/s. 2(47) – No capital gains if the conditions mentioned fulfilled
 - ❖ If entire business transferred as slump sale u/s. 2(42C) – business will be capital asset
 - Max India Limited - 319 ITR 68 (P&H)
 - Mahalasa Gases & Chemical (P) Ltd - 84 TTJ 992 (Bang ITAT)
 - Premiere Automobiles - 182 CTR 202 (Bom)
- ✓ Possibility to claim Income Tax Depreciation on higher (fair) value at which assets transferred – Huge Cash Flow Savings
 - ❖ Tangible assets as per fair value
 - ❖ Intangible assets if identifiable as per AS-26 and S. 32(1)(ii)
- ✓ Transfer of accumulated losses, unabsorbed depreciation and unabsorbed scientific expenditure u/s. 35(1)(iv) of firm
 - ❖ Lapsed losses of firm cannot be carry forward
 - ❖ **Possible to argue fresh lease of life**
- ✓ Higher capitalization of assets – Better net worth – good for Balance Sheet
 - ❖ Needs to be backed by valuation report, projected valuations, etc.

CONVERSION U/S. 47(xiii) or 47(xiv)

➤ Cons:

- ✓ Stamp duty applicable on conversion
 - ❖ Immovable properties - at applicable rate – 5%
 - ❖ Movable Properties (including intangible) @ 3%
 - ❖ Some savings possible
- ✓ Need to amortize Intangible assets in books – Impact on Profit
- ✓ Restrictions on aggregate shareholding of the partners can limit dilutive capacity

OTHER METHODS

- New Company - New business
 - ✓ Start business in Company
 - ✓ Over period of time discontinue business in the Firm
 - ✓ Itemized transfer of some important assets / liabilities
 - ❖ No statutory protection
 - ❖ Implications under respective acts to be evaluated
 - ❖ Simple and easy to implement
 - ❖ Significant limitations
 - ❖ Dependent on specific facts

- Taxable Transfer of business
 - ✓ Incorporate new company
 - ✓ Transfer business to Company – taxable
 - ❖ Slump Sale vs. Itemised Sale
 - S. 50C implications

COMPARISON – PART XXI VS. U/S. 47(xiii) / (xiv)

A	In the hands of transferor		
Sr	Implications	Part XXI Conversion	S. 47(xiii) / 47(xiv)
1	Capital Gains in hands of transferor - Transfer u/s. 2(47)	No	Exemption
2	Tax implications u/s. 45(4)	No	No
3	Depreciation allowance- 5th proviso to s. 32(1) - on number of days of assets used	Yes	Yes
4	Exemption of capital gains on succession of profession	Yes	No
B	In the hands of partners / members		
Sr	Implications	Part XXI Conversion	S. 47(xiii) / 47(xiv)
1	Stepped up Cost of shares	No	Yes

COMPARISON – PART XXI VS. U/S. 47(xiii) / (xiv)

C	In the hands of transferee		
Sr	Implications	Part XXI Conversion	S. 47(xiii) / 47(xiv)
1	Depreciation - 5th proviso to s. 32(1) - on number of days of assets used	Available	Available
2	Step up in cost u/s. 43(1) / 43(6)	No	Yes
3	Explanation 3 to S. 43(1)	NA	Can apply
4	Benefit u/s.80-IA, S.80-IB, s.10AA available	Yes	Yes
5	Carry forward of business loss and unabsorbed	No- S. 78(2)	Yes - S.72A(6)
6	Tax u/s. 47A on violation of conditions	NA	Yes
7	Succeeding company to be new company	Yes	No

QUESTIONS

?



Thank You