Tax Snippets

Shardul Amarchand Mangaldas

Conversion of Company into Limited Liability Partnership ("LLP")

Introduction

An LLP form of business entity offers operational flexibility and tax efficiency because of which conversion from a company structure to LLP has drawn the fascination of many investors. The Limited Liability Partnership Act, 2008 ("**LLP Act**") permits and regulates the conversion of a Company into LLP.

The provisions dealing with tax neutrality of such conversions are contained in section 47(xiiib) of the Income-tax Act, 1961 (the "**IT Act**") which confers a tax exempt status on such conversions both in the hands of the converting company and its shareholders - subject to meeting certain prescribed conditions, such as amongst others, a ceiling on turnover/gross receipts (INR 60 lakh) and total value of assets (INR 5 crore) of the converting company.

The conversions that do not satisfy the prescribed conditions raise questions with regard to tax implications of such non tax neutral ("**NTN**") conversions, namely –

a) Taxability in the hands of the Company;
b) Taxability in the hands of the shareholders of the company.

Taxability in the hands of company on NTN conversions

Historically, basis certain judicial precedents (in the context of conversion of partnership firm into company), it was possible to argue that a conversion of a company into an LLP or partnership firm is not a 'transfer' so as to trigger capital gains tax implications, notwithstanding whether the conditions for a tax neutral conversion under section 47 of the IT Act are satisfied or not[1].

The ruling of Income Tax Appellate tribunal in the case of ***ACIT v. Celerity Power LLP***[2] lends clarity on this aspect by concluding that a conversion of a company into an LLP, which does not meet the prescribed conditions for tax exemption, would be subject to capital gains tax in the hands of the transferor/converting company. The said judgment distinguishes the earlier rulings which dealt with a reverse conversion of partnership firm into company. The conclusion in the ruling is briefly summarized as below.

- Conversion of a company into LLP would be a taxable transfer where such conversion fails to meet the prescribed conditions. Accordingly, there would be a capital gains tax in the hands of the transferor entity, being the converting company.
- The tax so levied would be recovered from LLP, as 'successor' of the company under section 170 of the IT Act.
- Regarding computation of the capital gains, the ruling re-affirms the principle that the full value of consideration refers to the price bargained for by the parties and not the market value of assets transferred. In this case, since the assets and liabilities of the erstwhile company got vested in the LLP at their book values, it was held that such book value would be treated as 'full value of consideration' and therefore, no capital gains would arise in the hands of the company as the consideration was equal to the undertaking's cost basis.

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The Income Tax department has filed an appeal against this ruling before the Bombay High Court.

Taxability in the hands of the shareholder on NTN conversions

NTN conversions also raise a question as to whether they entails any tax implications in the hands of the shareholders of the converting company for the reason that their shareholding in such company gets extinguished upon conversion, and in consideration whereof, they get partnership interest in the LLP.

A recent ruling by the Authority of Advance Rulings (AAR) deals with this very issue concerning tax implications of such NTN conversions in the hands of the shareholder[3], which concludes as under.

- A NTN conversion would result in the transfer of shares from the shareholder in exchange of LLP interest, which constitutes 'transfer' of a capital asset so as to trigger capital gains tax, in the hands of the transferor, being the shareholder(s).
- The capital gains will be computed as the difference between value of capital/ partnership interest in LLP less cost basis of the shares of the converted company. Further, if the value of such partnership interest cannot be ascertained or determined for any reason, its fair market value on the date of transfer would be treated as consideration for the purpose of computation of capital gains.

Conclusion

The above rulings help answer questions around tax implications of NTN conversions by holding that such conversions would be taxable both in the hands of the converting company and the erstwhile shareholders. However, the computational framework and consequent tax exposure still remains a grey area requiring further clarity. While Celerity Power holds that the consideration in the hands of the converting company would be the book value of assets recorded, the AAR ruling holds that consideration in the hands of shareholders would be the 'value' of capital/ partnership interest.

Section 194N – TDS on cash withdrawals

Introduction

Aiming to promote a less-cash economy, the Finance Act 2019, introduced Section 194N to the IT Act (with effect from September 1, 2019) which provides for levy of 2% TDS on cash payments in excess of INR 1 crore, in aggregate made in any year, by a banking/ co-operative banking company or a post office to any person from all accounts maintained by the recipient.

This provision will not apply where the recipients of such payments made to certain specified persons including the government, white label ATM operators, banking company or co-operative banks etc.

Ambiguities on the newly introduced 194N

The new section 194N necessitates clarity on certain issues, such as its operation (whether prospective or retrospective) and implementation of this provision. Confusion also existed on whether TDS will be deducted from the gross or net withdrawal, and whether the INR 1 crore has to be calculated per bank/ post office or in aggregate. More so, if the latter is correct then how will the information flow among banks/ post offices.

Clarifications from CBDT

The CBDT has partly addressed these ambiguities *vide* its press release dated 30 August 2019, clarifying that while the INR 1 crore threshold will be counted from 1 April 2019, there will be no TDS on cash withdrawals made prior to 1 September 2019. Therefore, if a person has already withdrawn INR 1 crore or more in cash up to 31st August, 2019 from one or more accounts maintained with a banking company or a cooperative bank or a post office, the 2% TDS shall apply on all subsequent cash withdrawals.

Unresolved issues

This section still requires clarity on the following issues:

- The manner of claiming the credit of taxes deducted under Section 194N of the Act - especially in the context of amendment to Section 198 of the IT Act stating that such TDS will not be deemed to be income of the assessee, whether the taxes deducted under Section 194N of the Act will be reflected in Form-26AS or not, gains importance.
- How will the threshold be applied in cases where one bank account is jointly held by two taxpayers?

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- Typically, TDS provisions require deduction of tax on income 'chargeable to tax'. In that context, the validity of TDS on cash withdrawals, sans income character, beckons pondering on the constitutional validity of such a provision.

Unilateral Global Measures To Tax The Digital Economy

There has been a growing consensus across the world that the existing international tax rules are incapable to fully address the base erosion and profit shifting ("**BEPS**") opportunities that digital economy presents. The existing rules lack clarity on nexus as well as profit allocation – two key ingredients for taxation of digital economy. The challenges in taxation of digital economy are also echoed by Organization of Economic Cooperation and Development ("**OECD**"), which has recently adopted a 'Programme of Work' ("**PoW**") on May 31, 2019, outlining the process for reaching global consensus on resolving tax challenges related to digitalization of economies and it aims to unlock a consensus based long term solution by end of 2020.

While, OECD gathers consensus amongst its 34 member countries, several nations have already taken unilateral measures, pending global consensus, to address the tax challenges arising due to digital economy. Some of these unilateral measures in key jurisdictions are discussed in the table below:

Country	Measures
France & Spain	• Beginning in 2019, France has introduced the 'GAFA Tax' – named after Google, Apple, Facebook, Amazon – which is a 3% tax on digital advertising and other revenues of tech firms with worldwide revenues of more than 750 million euros ($842 million). It has also levied a 2% tax on advertising revenue by resident or non-resident platforms broadcasting free/paid videos online (such as YouTube, Netflix etc.) • Spain imposed a similar digital services tax ("**DST**") of 3% on online advertising, online marketplaces, and data transfer service (i.e., revenue from sales of user activities) within Spain.
Italy	• Introduced a 3% web tax on internet services provided by both residents and non-residents to local businesses, subject to certain threshold conditions. It has also introduced a Significant Economic Presence ("**SEP**") test amending the definition of permanent establishment ("**PE**") which makes physical presence not mandatory to create a PE and amended transfer pricing rules that stipulate use of valuation techniques other than cost based indicators for determining ALP of digital transactions.
United Kingdom	• UK's diverted profits tax ("**DPT**") aims at establishing a nexus between the entity producing the income and the place where the income originates. The DPT is an upfront tax at 25% (as opposed to UK Income tax of 19%) of punitive character. The conditions for levy are purposeful avoidance of PE, structures lacking economic substance and mismatch arrangements to shift profits. • In April 2018, UK proposed a targeted royalty withholding tax applicable to IP royalties paid by a non-UK resident entity to a related party in a low-tax jurisdiction. This proposed tax requires no UK presence for the taxpayer beyond a UK customer base. • UK is also proposing to implement a 3% DST similar to France and Spain in 2020.

Legacy Dispute Resolution Scheme

The Sabka Vishwas (Legacy Dispute Resolution) Scheme, 2019 ("**Scheme**") first introduced *vide* the Finance (No. 2) Act, 2019 has been notified by the Central Government with effect from 1 September 2019. Detailed rules have also been notified for efficient implementation of the Scheme. The last date of filing applications under the Scheme is 31 December, 2019.

Application process

The Scheme provides for complete waiver of interest and penalty as well as immunity from prosecution. In addition, the Scheme also provides for a partial waiver of the tax liability

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based on quantum of arrears. However, the relief under the Scheme is available only to a select class of taxpayers.

Under the Scheme, an online application is to be filed on the CBIC portal (https://cbic-gst.gov.in) in Form SVLDRS 1. Separate applications are to be filed for each matter in respect of which the benefit of the Scheme is to be availed. Such applications (except in case of voluntary disclosures) would be verified by a designated committee within 60 days of making the application.

In case there is a dispute in relation to the quantum of tax liability declared by the taxpayer, the designated committee will issue a notice to the taxpayer within 30 days granting him a personal hearing.

Efficacy of the Scheme to cover all legacy disputes

Interestingly, while the Scheme encourages settlement of legacy disputes under erstwhile central indirect tax laws, the Scheme segregates the taxpayers on the basis of the stage of the proceedings. Accordingly, the Scheme fails to provide a solution for all classes of taxpayers, such as:

- The basic premise of the Scheme is to reduce legacy litigation. However, while the benefit of the Scheme is available to taxpayers who are litigating before higher judicial fora where the matter is not finally heard, the same is not available to taxpayers in cases where the final hearing in a show cause notice have taken place as on 30 June 2019. Accordingly, the benefit of the Scheme is not available to matters which are in the nascent stage and where the litigation can be nipped at the preliminary stage itself
- The benefit of the Scheme is not available, in cases where pursuant to an audit, enquiry or investigation, the demand has not been quantified in writing as on 30 June 2019. It is notable that in many cases, the intelligence wing of the department conducts investigations on the business affairs of taxpayers to unearth revenue leakages. However, such intelligence wings typically do not quantify the demand prior to issuance of the show cause notice. In such cases, where no written communication is made either by the department quantifying the tax liability or by the taxpayer admitting such tax liability, no relief can be claimed under the Scheme.
- Where a taxpayer has received an unfavorable order and chose to never contest the same, such taxpayers can avail the benefit under the Scheme. However, a taxpayer who contested a demand but where the final hearing took place prior to 30 June 2019, is excluded from the Scheme. While the Scheme is a blessing for the former category of taxpayer, the latter category is excluded from the Scheme without any intelligible differentia.

Therefore, while the Scheme promises to provide a one shot solution to all legacy disputes, the efficacy of the Scheme is reduced to a large extent due to unwarranted exclusions of various categories of taxpayers.

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1 CIT v. Texspin Engg. & Mfg. Works [2003] 263 ITR 345 (Bom)
2 [2018] 100 taxmann.com 129 (Mum-Trib.)
3 Domino Printing Science Plc (AAR No. 1290 of 2012)

Please feel free to address any further questions or request for advice to:

Amit Singhania
Partner
amit.singhania@AMSShardul.com

Abhay Sharma
Partner
abhay.sharma@AMSShardul.com

Rajat Bose
Partner
rajat.bose@AMSShardul.com

Gouri Puri
Partner
gouri.puri@AMSShardul.com