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# C.V.O.CA'S

# NEWS & VIEWS

FOR MEMBERS / SUBSCRIBERS / VOL. 25 - NO. 5 DECEMBER 2021

## From President's Desk...

### Dear Professional Colleagues and Readers,

This time Diwali was celebrated with whole heart everywhere, bright lighting all around brought happiness and positive rays of hopes in every one's life. Soon this year 2021 will end with Christmas celebration and New Year will start with new resolutions and goals. As we all know the environment of uncertainty going on all over globe, let's hope the things will going to back to normal soon and this year leaves happiness, health and wealth in everyone's life.

*"The best way to predict the future is to create it." Abraham Lincoln*

**Elections of ICAI - Central Council and Western India Regional Council**

Election of ICAI will be held on 3rd and 4th December 2021, so I personally appeal to each and every member come forward and cast their vote to right candidate for betterment of society.

I also like to wish best of luck to member contesting for Election.

Further, In December CA exams will be conducted so I wish to all students best of luck for the examinations. Remember always, there are no shortcuts to success. Keep doing hard work and faith in you and achieve success with flying colours.

***Recent Indian Economy & its Prospects***

Robust Foreign investment inflows resulted in strong growth in the Indian capital market as investor's risk perception of India as an alternate investment destination improved. India was among the very few nations that witnessed strong foreign direct investment (FDI) in 2020 and the momentum has continued in 2021. Recent reforms and policies to further liberalize FDI in a few sectors such as insurance, agriculture, telecommunications services and defence have attracted global investors. Schemes such as the production – linked incentives (PLI) and labour reforms have increased foreign interest in several investable.

India is projected to be one of the world's fastest – growing economies. The most important criteria for risk assessment of an economy as an investment destination are its growth outlook and stability. Economies with high growth and low inflation are usually deemed as low –risk and high return investment destinations. Strong growth increases the probability of higher returns on investment, while low inflation prevents erosion of the value of their investment returns in the long run.

**Block your dates for Residential Refresher Course (RRC)**

**Learning is endless**. There is no age bar for learning. We are in to profession that will also require continuous leaning and acquiring knowledge and achieving excellence in our field. Dadar East CPE Study Circle is planning to organise RRC on 4th to 6th March, 2022, detailed schedule will be announced soon.

Reserve yourself for these dates for optimum gaining of knowledge sharing to multiply the excellence and networking with our professional friends.

**Public programme held on 28.11.2021 on Emotional & Mental Health by BK Shivani Didi**

Program was really enriching in achieving mental peace. Further, it was great to hear BK Shivani Didi on Association's YouTube Channel & also there was live online Meditation Session, which was energising.

We need to remember Formula given by BK Shivani Didi in our day to day professional as well as social life:

**Stress = Pressure / Resilience** and try to increase denominator and manage the stress level.

Ultimately, **Health is Wealth....**

**"Always bear in mind that your own resolution to succeed is more important than any one thing." - Abraham Lincoln**

*Thank you all..... Always in Gratitude*

CA Rahul Nagda

**December 1, 2021**

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# BUSINESS RESTRUCTURING





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# DEMOCRACY/ ELECTION/ INTROSPECTION

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## FROM THE DESK OF CHAIRMAN

I AM proud of India and proud of our institute. We have been inherited an healthy Democracy, The word democracy itself means rule by the people/members, A democracy is a system where people can change their Rulers/Management in a peaceful manner We by proper elections can ensure that the best has a chance to be reflected.

It is truly said that for a person in the society, his true asset is his Goodwill. When he loses Goodwill, he has lost everything. The goodwill is an unique asset. For a professional, this is the ultimate truth. We have the prerogatives of: (i) Conducting audit and reporting to all stake holders; and (ii) Representing our clients before tax authorities. Because the society believes (believed) that we will find out the truth and report /represent the whole truth. This is a matter of human belief. Not a matter of legal charter. The charter is only recognition of the Government`s belief. And Government is a part of the Society. The charter – Our Certificate of Practice is recognition of our Goodwill,not a "Shop & Establishment Registration Certificate". When the Goodwill is lost - Both the charters can be lost. And that will be the end of the profession.

Individual Goodwill vs. Institutional Goodwill. An individual member`s Goodwill is good for him. When he is gone, the goodwill is gone. An Institution`s Goodwill is of Course built by the individual members. However every generation of members continues to have expertise and character; that Goodwill continues and even grows.

Why is our Institute`s election becoming more like the political elections? When we started voting on the basis of caste; and on the basis of – what favor the candidate can give us; we started our degeneration.

As I recollect In the mid of 1980`s, Canvassing was not that fierce/aggressive. Members knew candidates and voted on the basis of merits. Not on the basis of canvassing. Today with large membership it is difficult for members to know the candidates. But at the same time, for the same reason, canvassing has become most difficult and costly. Hence our institutes has come out with broachers giving information of all candidates. If we the members vote on the basis of canvassing, we will create a situation where only those will contest elections that can spend huge amount of money.

It is said in Olden days in any conferences, the most humble men would be the president of institute and the office bearers. Today there is sycophancy. When a President comes to any conference, all others including the guest and the speaker are sidelined. All the council member are eager to come in the eyes of the President. This sycophancy makes the President of the members or leader of the members, but ruler of the member.

Today we are in great danger of losing our Goodwill and hence losing the very reason of our existence. If we the CAs prove to be greedy/corrupt; why should the society need us? Why should the society give us any charter?

Friends we have many members of great knowledge and high character as candidates, those who have volunteered to contest election do include people of highest integrity and expertise, and good administrative skills to perform the work , They have done their job by contesting., they have declared their determination to sacrifice their time for the betterment of the Institute . It is our job to elect them. And to ensure that these people do not have to spend huge time & money for contesting elections.

I will not measure that, who have come to me for canvassing and those who have not. But I assure, I will vote purely on merits and past track record and performance , irrespective of whether a candidates has contacted me or not. This is my call now, as in the past and as will be in future.

And I urge you, the voter to give this call. And I urge every candidates- “when you get elected, prevent sycophancy and work for the growth of our Goodwill”. If a President does something wrong and gets away with it whole a Council is responsible.

Friends Election can bring out: (i) the best in the society; or (ii) the worst in the society. Our Regional and Central Councils and even office bearers at branch level have to be the best that our institute membership has to offer. Our elected representative should be experts in their knowledge and integrity that government would like to come to the institute for guidance in all the matter of Accounting and Taxation Laws, etc. Our representative should not be the people who run after the Politician and the bureaucrats.

Some people contest election for the benefit that the office offers; for the joy of power and authority that an office gives. They go there to rule, not to serve the institute. These will be worst an election process can offer. If we elect our member purely on his/her merits, we will offer our best to the nation. If we elect candidates on any one or more of the following grounds, we will offer our worst:

(i) Caste or religion

(ii) Whether the candidate is affiliates with a particular firm or not.

(iii) How many parties he has thrown or will throw (Not possible in current situation).

(iv) Whether he comes to meet me or not.

(v) Who has recommended the candidates?

When we vote, we decide whom are we sending to represent us. We decide whether our Goodwill continues or not. We decide whether our institute has a reason to exist or not. Action always starts with individual. Let each of us decide that we will vote purely based on merits.

**!!!!! TREAT OTHERS THE WAY YOU WANT TO BE TREATED !!!!!!**

**!!!!! REMEMBER THE SOUL IS ON JOURNEY !!!!!**

*Thank you all..... Always in Gratitude*

*CA Dinesh Shah*

# "Amalgamation and Demerger including Outbound and Inbound Scenarios. Transfer of Business (Slump Sale, Slump Exchange and itemized sale)"

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## The World is restructuring and so the Corporate are........

Yes, you read it right, the world is restructuring. In almost last two years what we have undergone is nothing but the way nature is restructuring the earth.  Lot of discussions have happened all around the world on the implications of pandemic, the vaccines, the way of living etc. The pandemic has changed the way we live, the way we do business, the though process etc. The things that were taken for granted suddenly were high in demand.

Mergers / Demergers / Capital Reduction are nothing but type of restructuring which an organisation undergoes to conduct its business /growth / survival. Restructuring happens by way of expansion of business, forward integration, background integration, balance sheet right sizing etc. Each and every type of restructuring has its implications. The scope of this article is limited to tax implications arising on various modes of restructuring:

Before we discuss the implications let us first understand what the different types of restructuring and its objectives:

1. Merger / Amalgamation - Consolidation of business though amalgamation
2. Demerger - for value unlocking, raising funds for business transferred to resulting company or for subsequent sale
3. Slump Sale of business for exit / fund raising/ joint venture
4. Itemised sale – Monetisation of not required  assets for meeting cash requirements
5. Capital Reduction - leaning the balance sheet of company, return of capital, exit to selective shareholders

## Amalgamation

Amalgamation (Section 2(1B) of Income-tax Act, 1961): means merger of either one or more companies with another company or merger of two or more companies to form one company in such a manner that:

- All the property/liability of the amalgamating company/companies becomes the property/liability of amalgamated company.
- Shareholders holding minimum 75% of the value of shares in the amalgamating company (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company .

Any amalgamation to be tax neutral has to satisfy above conditions and conditions specified in Section 47. In case of merger of wholly owned subsidiary into its holding company there would not be any issue of shares. Still it would be tax neutral merger since company cannot issue shares to itself. Now take a scenario where a company is getting merged with its wholly owned subsidiary. In this case can one say that all assets and liabilities are getting transferred pursuant to merger as investments of company into wholly owned subsidiary will get cancelled.

## Discharge of consideration

Can the company issue preference shares instead of equity shares. The section talks about of issue of shares. It can be equity / preference or mix. In the scheme of amalgamation of **Minda Industries Limited** there was an option given to shareholders to either opt for equity or preference. We can say that this was an option given to some shareholders to take exit from the company.

There is no mention of cash as consideration in the section. So can the consideration be discharged in the form of cash? In scheme of amalgamation of **Shriram Piston and Rings Limited** consideration was discharged in the form of preference share and cash.

Now let us understand implications in hands of company as well as shareholders"

| In the hands of | Taxability/Treatment | Section | Conditions |
|---|---|---|---|
| Amalgamating Company | No capital gains on transfer of assets | 47(vi) | Amalgamated Company should be an Indian Company |
| Shareholders of Amalgamating Company | No Capital Gains on transfer of shares | 47(vii) | 1. Consideration to be in form of shares in amalgamated company (except where the amalgamated company itself is a shareholder)<br>2. Amalgamated company should be an Indian company |
| Cost of acquisition of shares received on amalgamation by the shareholders | = Cost of acquisition of shares held by the shareholders in the amalgamating company | 49(2) | Transfer as referred u/s. 47(vii) |
| Period of holding of shares received on amalgamation by the shareholders | Includes period of holding of shares held by the shareholders in the amalgamating company | Expln. (i)(c) to 2(42A) | Transfer as referred u/s. 47(vii) |
| Cost of Assets for Amalgamated Company: - Stock - Capital Assets - Depreciable Assets | = Cost of acquisition of the stock / capital assets to the amalgamating company = WDV of depreciable assets held by amalgamating company | - 43C - Expln. 7 to 43(1) - 49(1) - Expl. 2 to 43(6)(c) | Amalgamated company should be an Indian company |
| Period of holding of capital assets received by Amalgamated company pursuant to amalgamation | Includes period for which capital assets were held by the amalgamating company | Expln. (i)(b) to 2(42A) r.w.s. 49(1) and 47(vi) | |

Now one important question that arises is depreciation on goodwill. Finance Act 2021 has amended the provisions to prohibit depreciation on goodwill as goodwill is no longer an intangible asset. So what would be the implication on other intangibles acquired pursuant to merger and recorded as goodwill? Can the company record the difference between net assets acquired and consideration paid as intangibles in the form of IPR, Brands etc.

## Carry forward of business losses and unabsorbed depreciation

As per section 72A **a**ccumulated business loss and unabsorbed depreciation of the amalgamating company shall be deemed to be business losses or unabsorbed depreciation (as the case may be) of the amalgamated company for the previous year in which the amalgamation is affected. But this is available only to industrial undertaking, banking company and public sector company. Companies not falling under above can look for carry forward of unabsorbed depreciation u/s 32. The carry forward of losses shall get fresh life of 8 years. Carry forward is subject to certain conditions as given in section 72A. One has to also analyse implications u/s 79 in case of change in shareholding pursuant to merger.

## Demerger

Demerger (Section 2(19AA)): means the transfer of one or more undertakings to any resulting company pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956 in such a manner that:

- All the property/liability of the undertaking becomes the property/liability of the resulting company.
- All the property/liabilities are transferred at book value (excluding increase in value due to revaluation).
- The resulting company issues shares to the shareholders of demerged company on a proportionate basis, except where resulting company is a shareholder of the demerged company.
- Shareholders holding minimum 75% of the value of shares become shareholders of the resulting company (other than shares already held therein immediately before the demerger by, or by a nominee for, the resulting company or its subsidiary).
- The transfer of an undertaking is on a going concern basis.
- The demerger is in accordance with the conditions notified under Section 72A (5) of IT Act, 1961.

“Undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity [Explanation 1 to Section 2(19AA)].

“Demerged company” means the company whose undertaking is transferred to a resulting company pursuant to demerger [section 2(19AAA)].

“Resulting company” means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger [section 2(41A)].

| In the hands of | Taxability/Treatment | Section | Conditions |
|---|---|---|---|
| Demerged Company | No capital gains on transfer of assets | 47(vib) | Resulting company should be an Indian company |
| Shareholders of Demerged Company | No capital gains tax on receipt of shares from the resulting company | 47(vid) | |
| Cost of acquisition of shares received on demerger by the shareholders | = Cost of acquisition of shares in demerged company be split on the basis of net book value of the assets transferred bearing to the Net worth of the Demerged Company immediately before such demerger | 49(2C) | |
| Period of holding of shares received on demerger by the shareholders | Includes period of holding of shares held in the demerged company | Explanati on 1(i)(g) to Section 2(42A) | |
| Cost of Assets for Resulting Company: - Depreciable Assets - Capital Asset | = WDV of depreciable asset to be the same as WDV in the hands of the Demerged Company = No specific provision for cost of Capital Asset acquired | Expln 7A to 43(1) - Expln 2B to 43(6)(c) - 49(1) | Resulting company should be an Indian company |
| Period of holding of capital assets | Includes period of holding of capital assets held by the demerged company | Expln 1(i)(b) to 2(42A) r.w.s. 49(1) and 47(vib) | |

Definition of undertaking plays important role in demerger. What constitutes an undertaking has to be evaluated properly for the demerger to be tax neutral. It is not necessary that all assets and liabilities are to be transferred pursuant to demerger of undertaking. If the undertaking can function independently with certain assets on standalone basis, then also it is fine. Requirement is going concern and functioning as a business unit. So whatever assets and liabilities are required to function as an independent unit if only those assets and liabilities are transferred then also it will in compliance with demerger.

Recently disinvestment of public sector units is in limelight. Before disinvestment government is separating non-core assets from the company and then going for disinvestment. For example in case of BEML limited has undertaken a scheme of arrangement for demerger, transfer & vesting of the identified surplus /non-core assets from BEML Limited. Now one may question whether it would be in compliance with definition of demerger as no undertaking is getting transferred. Finance Act 2021 has made amendment in Section 2(19AA) where in even if the definition of undertaking in case of Public Sector Company is not satisfied it would be considered as demerger if it fulfils conditions notified by Central Government.

In case of demerger can a company other than resulting company issue shares as consideration to shareholders of demerged company. One can look at schemes of arrangement **Havells India Limited** where in pursuant to demerger instead of resulting company, holding company of resulting company issued to shares as consideration. Such type of restructuring is also used for externalisation i.e moving structure out of India. One can look at **schemes of arrangement of Globep Financial Services (India) Limited, Vyome Therapeutics limited, Reckitt Benkiser (India) Private Limited**. Also in case of demerger of **Ajmera Realty Limited**, the demerged company itself is issuing shares to shareholders pursuant to demerger.

### Carry forward of business losses and unabsorbed depreciation

Where accumulated business losses and unabsorbed depreciation are directly relatable to the undertaking demerged [Section 72A(4)(a)] - Entire amount of directly relatable business losses and unabsorbed depreciation is allowed to be carried forward and set off in the hands of the resulting company.

Where accumulated business losses and unabsorbed depreciation are not directly relatable to the undertaking demerged [Section 72A(4)(b)] - The accumulated business loss and unabsorbed depreciation should be apportioned between the resulting company and the demerged company in the ratio of the assets transferred to the resulting company and assets retained by the demerged company and be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be.

There is no fresh life of 8 years for carry forward of losses. Only balance period can be availed.

Below are certain scenarios which need to be evaluated before going for demerger:

- Can an investments in shares and securities be considered as undertaking? (Investment vs investment in SPVs – **case of demerger of India Bulls Real estate**)
- Can a company having only one undertaking, be demerged? (**Spectra Motor Case**)
- Can a project under construction be considered as an undertaking?
- If certain common assets /back-office operations are not transferred, will it jeopardize the nature of undertaking?

## Tax holidays

Before considering demerger one also has to evaluate implications for companies enjoying tax holidays.

## MAT Credit

- MAT payable on book profits in the absence of Nil / lower tax profits.
- Credit for MAT allowable to the assessee company who has paid such taxes.
- Amalgamating company ceases to exist after amalgamation.

No specific provision in the IT Act for carry forward of MAT credit in case of amalgamation or demerger. However, Mumbai ITAT and Ahmedabad ITAT have endorsed a favourable view in case of amalgamation and demerger (proportionate basis) respectively.

## Section 56:

No implications on receipt of properties in the hands of the Transferee Company pursuant to amalgamation or demerger - Clause (IX) to the proviso of Section 56(2)(x).

## Slump Sale

As per section 2(42C) – Slump sale is

- the transfer of one or more undertakings
- by any means for a lump sum consideration
- without values being assigned to individual assets and liabilities in such sales
- Explanation - Determination of value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities

## Capital gains

**Capital gains in the hands of seller Section 50B:**

- Capital Gains = Consideration less Net Worth (deemed COA) of Undertaking
- No indexation benefit will be available
- Net worth = Aggregate value of total assets of the undertaking - Book value of liabilities of such undertaking
- Value of total assets = Tax WDV of depreciable assets + Book value of other assets Capital Gains will be classified as long-term, if undertaking is held for more than 3 years

Slump Exchange is a scenario where instead of lump sum cash consideration, shares are issued to the transferor company. There were litigations on taxability of such transaction. But now even slump exchange is covered under the ambit of slump sale and taxable as per the provisions of section 50B.

Earlier companies used to transfer business under slump sale to its wholly owned subsidiary (WOS) at tax net worth and subsequently selling the WOS or raising stake in WOS at fair value. However post amendment in 2021 now Slump sale has to be done at fair market value even if it is slump sale to WOS.

Recently **Cipla Limited** has filed one scheme of arrangement wherein it is transferring two undertakings to two wholly owned subsidiaries without any consideration. Even **Lakshmi Machine Works Limited** is doing slump sale of its aerospace division for which consideration will be discharged in the form of debentures.

## Itemised Sale

- Not defined under IT Act
- Involves individual sale of assets
- Consideration is identifiable against each asset

Buyer discharges consideration to the seller for the asset acquired

**Tax Implications:**

| Nature of Assets | Nature of Income |
|---|---|
| Depreciable Assets | Provisions of Section 50 are applicable – Short term capital gains (if the consideration > WDV of the relevant block of asset) |
| Non-Depreciable Assets | Short term capital gains / Long term capital gains (Depending on the period of holding) |
| Current Assets | Business Profits |

## Capital reduction

Capital reduction is resorted to by a company in following scenarios:

- Writing of accumulated losses against Equity capital / securities premium
- Return of capital to shareholders
- Giving exit to selective shareholders
- Distribution of investments to shareholders

**Tax Implications:**

| | |
|---|---|
| Tax implications in the hands of Company | • Distribution to shareholders by a Company on the reduction of its capital is deemed as dividend to the extent to which the Company possesses accumulated profits, whether capitalized or not<br>• Deemed dividend u/s 2(22)(d) is subject to withholding tax u/s 194 |
| Tax implications in the hands of shareholders | • Reduction of share capital by a company and pro-rata distribution of cash / assets to the shareholders amount to transfer and therefore, taxable as capital gains<br>• For determining the amount liable to capital gain tax, full value of consideration is reduced by the amount, which has been reckoned as dividend |
| Other provisions | • Capital loss on account of capital reduction in the hands of the shareholders not involving payment of any consideration cannot be allowed under the provisions of IT Act. [Bennett Coleman & Co. Ltd. v. The Addl. CIT (ITA No 3013/MUM/2007)]<br>• As there is no receipt of shares by the company, Section 56(2)(x) – Not Applicable |

As discussed above the companies undertake restructuring taking into consideration its objective, growth prospects, changing business scenario etc. Before undertaking any restructuring one has to analyse the commercial as well as tax implications so that the ultimate objective achieved to be is cost effective and beneficial to the company. Restructuring if done properly it can be a boon or it can become self-destructing weapon.

**Stay tuned for regulatory implications in mergers and acquisition.**

# Conversion of Company into LLP, Sole Proprietorship/ Partnership Firm into Company

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This article discusses the nuances related to the conversion of the company into LLP. We shall first understand the rationale for converting a company into LLP, followed by the relevant provisions of the LLP law dealing with conversion of company into LLP and thereafter the implications under the income-tax law relating to the conversion in the hands of the company, LLP and shareholders.

## 1. Rationale for Conversion - Why select LLP over a Company?

1.1 In this article we are mainly going to discuss on the conversion of a company into a Limited Liability Partnership ('LLP'). Before we get into our discussion on the key aspects related to the conversion and the tax implications thereof, it is imperative to consider the rationale for conversion of a company into LLP particularly considering the case that the tax rates applicable to companies have been extensively slashed. As we are aware that with the introduction of the new corporate tax regimes under the framework of section 115BAA and section 115BAB of the Income-tax Act, 1961 ('IT Act') the base tax rates applicable to a company have been reduced to 22% and 15% respectively, though this comes with some conditions and restrictions which require a taxpayer company to forego various deductions. Considering that the tax rates have been reduced for a company, whether the LLP framework still proves to be effective and attractive enough? Let us examine this through a simple illustration:

| **Taxation in hands of Company** | | | | |
|---|---|---|---|---|
| **Particulars** | **Normal** | **Turnover less than 400 crs** | **115BAA** | **115BAB** |
| Total income | 100.00 | 100.00 | 100.00 | 100.00 |
| Base Tax rates | 30.00% | 25.00% | 22.00% | 15.00% |
| Tax rates | 34.94% | 29.12% | 25.17% | 17.16% |
| **Tax liability of Co. (A)** | **34.94** | **29.12** | **25.168** | **17.16** |
| Surplus | 65.06 | 70.88 | 74.83 | 82.84 |
| Surplus distributed by way of Dividend | 65.06 | 70.88 | 74.83 | 82.84 |
| Balance | - | - | - | - |

| Taxation in hands of Shareholders | | | | | |
|---|---|---|---|---|---|
| | | Dividend Model | | | |
| Taxable Income | | 65.06 | 70.88 | 74.83 | 82.84 |
| **Tax liability of shareholders (B)** | **35.88%** | **23.34** | **25.43** | **26.85** | **29.72** |
| **Total tax liability (A+B)** | | **58.29** | **54.55** | **52.02** | **46.88** |
| **Effective tax rate** | | **58.29%** | **54.55%** | **52.02%** | **46.88%** |
| | | Buy Back Model | | | |
| Distributable Surplus | | 65.06 | 70.88 | 74.83 | 82.84 |
| **Buy back tax rate (C)** | **23.30%** | **12.29** | **13.39** | **14.14** | **15.65** |
| Effective Buy back tax rate | | 18.89% | 18.89% | 18.89% | 18.89% |
| Buy back proceeds received (exempt in hands of shareholders) | | 52.76 | 57.49 | 60.69 | 67.19 |
| **Total tax liability (A+C)** | | **47.24** | **42.51** | **39.31** | **32.81** |
| **Effective tax rate** | | **47.24%** | **42.51%** | **39.31%** | **32.81%** |

| Taxation in hands of LLP | |
|---|---|
| Particulars | Amount |
| Total income | 100.00 |
| Base Tax rates | 30.00% |
| Tax rates | 34.94% |
| **Tax liability of LLP (D)** | **34.94** |
| Surplus | 65.06 |
| Surplus distributed as Share of | |
| Profit | 65.06 |
| Balance | - |

| Taxation in hands of Partners | |
|---|---|
| Particulars | Amount |
| Total income – exempt | 100.00 |
| **Tax liability of Partner (E)** | **0.00** |
| **Total tax liability (D+E)** | **34.94** |
| **Effective tax rate** | **34.94%** |

**Entities with low tax rate – Company v. LLP:**

| **Co. vs. LLP** | **Normal** | **Turnover less than 400 crs** | **115BAA** | **115BAB** |
|---|---|---|---|---|
| Dividend Model | LLP | LLP | LLP | LLP |
| Buy Back Model | LLP | LLP | LLP | Co. |

1.2 From above illustration it can be seen that in a case where the funds are not needed to be reinvested and deployed for purposes of business and are instead distributed to the stakeholders either by way of dividend or buy back model, then the aggregate tax liability in hands of the company and the shareholder works out higher than that the aggregate tax liability applicable to a LLP and its partners, except in a case where the company has opted for section 115BAB regime and funds are distributed by way of buy-back. However, it is to be noted that the buy-back model comes with the restriction on the amount that can be bought back annually. Hence, considering the above parameters, LLP framework may prove to be more tax effective as compared to a company and thus warranting us to explore the route for conversion of a company into LLP.

1.3 One may also keep in mind that in some cases especially a business owned by a single family, they may prefer not to distribute dividends over a longer period of time in which case a company may still be a preferred option. Further, company structure would be more effective and workable in cases where funding is sought to be raised from banks and financial institutions, raising funds from private equity investors, issuing debentures, listing on stock exchanges is to be undertaken, etc.

1.4 One of the key features that score well over the company is the ability of LLP to grant loans or accept loans/deposits from the partners and other parties. The LLP can easily accept loans and advances from any person, unlike a company that is required to comply with Companies (Acceptance of Deposit) Rules, 2014 which permits borrowings from only specific sources. Also, the provisions of deemed dividend contained in the IT Act do not apply to LLP, unlike a company.

1.5 Apart from the above tax and deposit rules consideration, incorporating LLP requires lesser legal compliances. Further, an LLP agreement offers more operational flexibility in structuring and managing LLP compared to a company bound by the memorandum of association and its articles of association. A company also has to undertake several statutory compliances such as holding general meetings, board meetings, maintaining registers, and much more which are not required in the case of LLPs. Unlike the shareholders in the case of a company, the partners of an LLP have the right to manage the business directly.

Having briefly discussed the advantages of the LLP, we shall now discuss the route of conversion of a company into an LLP and its tax implications in the hands of the company, LLP, and shareholders.

## 2. Conversion of Company into LLP – Provisions of the LLP Act:

2.1 The Limited Liability Partnership Act, 2008 ('LLP Act') permits the conversion of a private company and unlisted public company into LLP. The enabling provisions permitting the conversion into LLP are contained in section 55 of the LLP Act. Further, the framework for the conversion of a private company and unlisted public company into the LLP is contained in section 56 and 57 of the LLP Act read along with the Third and Fourth Schedules to the LLP Act, respectively. Section 58 of the LLP Act deals with the provisions relating to the registration of the LLP and the effect of conversion of an entity into LLP.

2.2 LLP Act permits conversion of a private company into LLP. Following are some of the key aspect of the LLP Act related to the conversion of company in to LLP:

- There is no security interest created in its assets and which is subsisting or in force at the time of application.
- The partners of the LLP to which it converts comprise all the shareholders of the company and **no one else.**
- Upon conversion, the shareholders of the private company, the LLP to which such company has converted, and the partners of LLP shall be bound by the provisions of the LLP Act read with rules.
- An application along with the specified documents is required to be filed with the Registrar of Companies ('ROC').
- The ROC on satisfying that a private company has complied with the provisions of the LLP Act read with relevant rules, shall register the documents submitted and issue a certificate of registration.
- From the date of registration specified in the certificate of registration:
    - o There shall be LLP by the name specified in the registration certificate;
    - o All tangible (movable or immovable) and intangible property vested in the company, all assets, rights, interests, privileges, liabilities, obligations relating to the company, and the whole of the undertaking of the company shall be transferred to and vest in LLP <u>without further assurance, act or deed</u>;
- The company shall be deemed to be dissolved and removed from the records of ROC.

- All deeds, contracts, bonds, agreements, applications, instruments, and arrangements subsisting immediately before the date of registration relating to the company **shall continue in force** as if they relate to the LLP and shall be enforceable by or against the LLP.

- Every contract of employment shall continue in force on or after the date of registration as if the LLP were a party instead of the company.

- Any approvals, licenses issued to the company under any other Act, which is in force immediately before the LLP is registered shall also continue in force as if they relate to the LLP. However, this is subject to the provisions of the respective Act under which such approval or license has been issued. It is sometimes observed that some government contracts or approvals are granted with the conditions that the tender applicant is a company and that there is specific debarring for the LLP. In such a case, extreme care should be taken at the time of deciding the conversion of the company into LLP.

- As the assets are vested in LLP on conversion, the transfer of the assets and liabilities is at book value.

## 3. Implications of stamp duty on the conversion of a company to LLP

The LLP Act does not expressly contain any provision relating to stamp duty. As per the provisions of the LLP Act on conversion the assets and liabilities of the company vest in and stand transferred to the LLP without any further assurance, act, or deed. Hence, given that there is no instrument, or a conveyance deed required for the transfer of assets from the company to the LLP and that the assets stand transferred pursuant to the framework of the LLP Act it may be a good case to argue that the stamp duty shall not apply on the conversion of company into LLP.

## 4. Conversion – Approach/ Alternative:

The conversion of a company into LLP can be undertaken through the following two approaches:

- Conversion under LLP Act carried out in accordance with section 47(xiiib) of the IT Act (tax compliant conversion)

- Conversion under LLP Act carried out without compliance of conditions prescribed in section 47(xiiib) of the IT Act (non-tax compliant conversion)

### 4.1 Approach 1: Conversion carried out in accordance with section 47(xiii b) of the IT Act (tax compliant conversion)

- The Finance Act, 2010 has inserted special provisions by way of section 47(xiiib) of the IT Act to incentivize the conversion of smaller companies into LLP. Subject to compliance with the conditions laid down, the provisions of section 47(xiiib) of the IT Act provide an exemption from taxation of capital gains both in the hands of the company and its share holders on account of the conversion of the company to LLP.

- The non-compliance of the conditions of section 47(xiiib) of the IT Act would trigger the taxability of the gain so treated as exempt at the time of conversion both in the hands of the successor LLP and the partners (shareholders) in the year in which such condition/s are not fulfilled.

- Compliance with each of the conditions of section 47(xiiib) of the IT Act is mandatory to avail exemption. There are overall six conditions, of which two conditions require compliance both at the time of conversion and for a further specified period.

- The conditions laid down under section 47(xiiib) of the IT Act are as under:

**Conditions of Section 47(xiiib) of the IT Act and their Analysis**

Condition 1: All the assets and liabilities of the company immediately before the conversion become the assets and liabilities of the LLP

Analysis:

The conversion of a company into LLP is in terms of the provisions of the LLP Act. In terms of the conversion framework specified in the LLP Act all assets and liabilities of the company automatically become the assets and liabilities of the LLP. Thus, compliance with this condition is relatively easy. However, if some asset/s are sought to be kept out of LLP, then before the conversion the same can be transferred out of the company. This condition requires to be fulfilled only at the time of conversion.

Notably, section 47(xiiib) of the IT Act provides for the conversion of a company into LLP, unlike section 47(xiii) and 47(xiv) of the IT Act which provides for succession by company in the business of the erstwhile partnership firm and sole proprietorship concern, respectively. Consequent to the requirement of conversion under section 47(xiiib) of the IT Act all the assets of the company are required to be transferred, whereas for cases covered by section 47(xiii) and 47(xiv) of the IT Act there is flexibility in this regard as the requirement is to only transfer the assets relating to the business of the firm immediately before the succession by the company.

While converting a company into LLP, care needs to be taken to ensure that soon after the conversion of the company into LLP, all the assets in the name of the company are effectively transferred in the name of LLP. Any follow-up required to achieve this ought to be undertaken. In a few cases where the assets are not transferred in the name of the LLP, one may be able to argue that by virtue of the process enshrined under the law, such transfer is deemed to have taken place. However, this may result into avoidable litigation and hence proactive compliance is preferable.

Condition 2: This condition lays down two requirements, namely:

1. all the shareholders of the company immediately before conversion become the partners of the LLP; and
2. capital contribution and Profit-Sharing Ratio ('PSR') in the LLP are in the same proportion as their shareholding in the company on the date of conversion

Analysis of sub-condition 1:

As per the conversion framework of the LLP Act, partners of the LLP shall be all the shareholders of the company and no one else. Hence, this condition of section 47(xiiib) of the IT Act shall be easy to comply with.

However, the important factor to keep in mind is that '*all the shareholders of the company shall become partners of LLP*' thereby requiring both equity and preference shareholders to become the partners in the LLP. This may not be of concern, where the equity and preference shareholders are the same parties. However, this could be of concern if the preference shareholders are parties different from equity shareholders. The company in such a case can evaluate redeeming the preference share capital before undertaking conversion.

Further, as per section 5 of the LLP Act, only individuals or body corporate may become a partner in LLP. Hence a HUF through its Karta cannot become a partner in the LLP. In a scenario where the shares of the company are held by the HUF, then before conversion, the shareholding of HUF in the company should be aligned to ensure compliance with the requirement of the LLP Act as well as section 47(xiiib) of the IT Act.

Analysis of sub-condition 2:

As per this condition, the capital contribution and PSR of the shareholders in the LLP (upon becoming the partner on conversion) shall be in the same proportion as their shareholding in the company. There may arise some difficulty in complying with this condition if the company has issued both equity as well as preference shares to different parties or where the equity and preference shares are issued in different proportions. There could be different approaches to look at the compliance of this condition, namely:

Approach 1: Since only equity shareholders have voting rights in the company, subject to exceptional cases, therefore on conversion into LLP the PSR shall also be in line with the equity capital of the company. The preference shareholders may be passed on returns by way of fixed coupon interest proportionate to their entitlement to the dividend as preference shareholders. However, this interpretation does not flow from the literal reading of the provisions of section 47(xiiib) of the IT Act. Since there is no ambiguity in the language of section 47(xiiib) of the IT Act this approach may not stand the compliance test.

Approach 2: The PSR, as well as capital contribution, could be decided by aggregating the equity and preference share capital of the company before the conversion. This could be a simple approach however this will put both the equity and the preference shareholders at par and hence may not be equitable. Nevertheless, it shall ensure compliance with the condition.

Approach 3: If possible, the preference shares may be redeemed before the conversion or be acquired by the equity shareholders.

Condition 3: Shareholders 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 of LLP

Analysis:

- The purpose of this condition is to ensure that the shareholders under the style of conversion do not end up monetizing their shareholding. Hence, it is imperative that no consideration is passed on to the shareholders/ partners other than by way of capital contribution or share in profit.
- There is no specific requirement for complying with this condition for a continuous period. Further, the condition puts a restriction on the shareholder to not receive any other form of consideration. The status of shareholders is only up to the stage of conversion and that thereafter there is no shareholder but a partner. Hence, it could be possible to contend that this condition is to be complied with only at the time of conversion and that on and for conversion the shareholder should not receive any other consideration. However, out of abundant caution, one may exercise restraint and ensure that there is no questionable consideration passed on to the shareholders/ partners in the near period after conversion.
- However, this shall not restrict LLP to pay a justifiable amount of remuneration to the working (designated) partners. It could be also noted that the remuneration is allowable as per section 40(b) of the IT Act and that as per section 40(b) of the IT Act the remuneration is paid out of the profit of the LLP. Thus, if the profit is allowed to be paid to the partners, then the remuneration paid out of the profits of the LLP shall also be permitted to be given without being treated as in violation of the provisions of section 47(xiiib) of the IT Act. A similar principle should apply also to interest paid on partners' capital. Further, if the condition is to apply only at the time of conversion, then in such case the remuneration and interest paid after conversion should not be subject to limitation.

Condition 4: Aggregate of PSR of the shareholders of the company in the LLP shall not be less than 50% at any time during the period of 5 years from the date of conversion

Analysis:

- The rationale of this condition appears to ensure that for a period of five years the majority control over the LLP through PSR remains with the persons who were controlling the company immediately before the conversion and that they should not make a complete exit before 5 years.
- One may admit new partners, however, the admission shall not have the effect of reducing the aggregate PSR of all the existing partners in the LLP below 50%. In case the partners wish to admit new partners with PSR of such partner being in excess of 50%, then in such case, their admission as nominal shareholder/s in the company immediately before the conversion could be explored.
- It should be possible to forcefully argue that changes amongst the existing (shareholders) partners shall not have an impact on the compliance of this condition so long as on an aggregate basis the 50% threshold is always met. In other words, partners can undertake realignment of their existing PSR and that would not be violative of this condition.

- The condition requires that the aggregate PSR of the partners being the shareholders of the company is at least 50%. As discussed above, if the rationale of the condition is to ensure that control over the converted entity (LLP) remains with the (shareholders) partners for five years such that 50% of the profit get passed on to the shareholder partners, then it shall be sufficient compliance if at-least 50% of PSR of LLP is with any one or more of the (shareholders) partners but not necessarily all the shareholders of the company. Further, in this regard, one can also refer to the provisions of the General Clauses Act, 1897, wherein section 13 provides that the words in the singular shall include the plural and vice versa i.e., the plural shall include singular. Basis this provision of the General Clauses Act 1897 it can be contended that if singular can be interpreted to include many, and similarly if many (plural) can be read to mean singular, then the usage of the term 'shareholders' in section 47(xiiib) of the IT Act should not be strictly read as multiple shareholders. Even a single shareholder continuing to be a partner in LLP with PSR of 50% should suffice with the compliance of this condition. Alternatively, a safer view could be to ensure that all the shareholders of the company at the time of conversion continue to remain partner for said period of 5 years.
- Though the Supreme Court in the case of CIT v. Vegetable Products Ltd held that where two interpretations are possible, then the one which is beneficial to the assessee ought to be adopted. However, again the Supreme Court in the case of Commissioner of Customs (Import), Mumbai v. Dilip Kumar & Company [2018] 95 taxmann.com 327 (SC) held that the eligibility condition of the exemption/ incentive provision should primarily be interpreted in a strict manner. Though this ruling is in the context of the indirect tax law, the principle shall apply to the provisions of alike nature under the IT Act as well. Therefore, considering that the exemption is at stake, any position should be undertaken with utmost care and consideration.
- It is possible to argue that non-compliance of this condition owing to involuntary events such as the death of a partner may not be regarded as a violation of this condition. Impossibility in performance of condition cannot be read as a violation of condition.
- This condition is required to be fulfilled for a continuous period of five years from the date of conversion. It is to be ensured that at no point in time i.e., not even for a single day or moment this condition is breached.
- Further, as the conditions are required to be fulfilled for a period of five years, therefore it should be ensured that the LLP continues to exist during this period.

<u>Condition 5:</u>Total sales, turnover, or gross receipts in the <u>business</u> of the company in <u>any of the 3 previous years preceding the previous year</u> in which the conversion takes place does not exceed Rs. 60 lakhs

<u>Analysis</u>:

- Total sales, turnover, or gross receipts "in the business" are to be considered. Hence if some receipts like dividends, capital gains, etc. do not form part of the business, then they could be excluded in computing the limit of Rs. 60 lakhs. Further as per the CBDT circular No. 1/2011 [F. No. 142/1/2011-SO(TPL)], dated 6-4-2011 total sales, turnover, or gross receipts in the business of the company which are taxable under the head “Profits and gains of the business or profession” should be seen for testing the condition of Rs. 60 lakhs.

- Further, the turnover of the preceding three previous years is to be seen. Thus, if the turnover of the company in the year of conversion is more than Rs. 60 lakhs, then that should not disqualify such a company from seeking conversion as per section 47(xiiib) of the IT Act.
- If a company is in existence for a period of only two years, then it may be possible to argue that this test should be seen from the period since the company is in existence. The fact that three previous years have not been completed may not disqualify the company to avail benefit under section 47(xiiib) of the IT Act. Impossibility of performance of condition should not be regarded as case of breach of condition. A condition should be seen purposefully and objectively.

<u>Condition 6</u>: Total value of 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

<u>Analysis</u>:

- This condition applies to all the assets including the current assets. Further, the amount of five crores rupees is to be seen qua gross value of assets i.e., without netting off the current liabilities.
- One should take care that the value of assets should not exceed five crores rupees at any point in time during this period of three years.
- Further, the value of assets of the preceding three previous years is to be seen. Thus, if the value of assets in the year of conversion is more than five crores, then that shall not disqualify such a company from seeking conversion as per section 47(xiiib) of the IT Act.
- While the section has used the term 'value' however since it is followed by the words 'as appearing in the books' have been used, it is the book value that ought to be considered. It is understood that the term 'as appearing in the books' is qua value of assets and not qua assets appearing in books.
- Where the assets are upward or downward revalued, should the revaluation impact be ignored? Section 47(xiiib) of the IT Act only uses the term 'book value', it nowhere provides for making an adjustment to exclude the revaluation impact. Unlike in section 50B of the IT Act where the assets where the proviso to Explanation 1 provides for ignoring the revaluation while working out the 'net worth'. Hence on a plane reading of the provisions, it may be possible to argue that in cases where the assets have been revalued, the value as appearing in the books should be considered. It goes without saying that where such revaluation may be the subject matter of questions, hence revaluation if any, should be adequately backed and justifiable.

<u>Condition 7</u>: No amount is paid, either directly or indirectly, to <u>any</u> partner out of the balance of accumulated profit standing in the accounts of the company on the date of conversion, for the period of 3 years from the date of conversion

<u>Analysis</u>:

- This condition requires that the accumulated profit standing in the accounts of the company should not be passed on to <u>any</u> partner/s directly or indirectly by the LLP. This puts restriction on all the partners i.e., even partners that would have been admitted after conversion. The rationale of this condition is that the accumulated profits of the company which were so far locked in the company and were subject to dividend taxation, should not be allowed to be withdrawn for a specified period.

- This condition needs to be complied with not just at the time of conversion but for a period of three years from the date of conversion.
- Out of abundant caution, the accumulated profits standing in the books of the company on the date of conversion can be parked and recorded in a separate account under separate nomenclature in the books of LLP for a period of three years during which this condition is required to be complied with. To this effect, suitable terms may also be recorded in the LLP agreement which would provide for restriction on withdrawal of said accumulated profits for the specified period. Further, the LLP agreement can also provide the manner of distribution of this amount amongst the partners upon the completion of the compliance period.
- Another notable point is that this provision puts restriction only on the withdrawal of accumulated profits. Hence a better view is that the amount of share capital, securities premium, etc. are not subjected to this restriction.
- Whether capitalization of the accumulated profits by the issue of bonus shares and subsequent withdrawal of such capitalized profits post-conversion is impacted by this condition? On a literal reading, where the accumulated profits are capitalized into share capital just <u>before the date of conversion</u>, such that there are no or nominal accumulated profits on the date of conversion then only such accumulated profits on the date of conversion only should be tested for this condition.
- However, this may be against the spirit of the provisions of section 47(xiiib) of the IT Act. Further, the term accumulated profit has not been defined under section 47(xiiib) of the IT Act, however in section 2(22) of the IT Act the term accumulated profits is at places suffixed with the terminology '*capitalized or not*', hence support may also be drawn from the same by tax authorities to treat this as a colorable transaction. Further, the conditions in section 47(xiiib) of the IT Act provides that the accumulated profits of the company should not be paid '*directly or indirectly*', in this context the tax authorities may argue that by capitalizing the profits before conversion the accumulated profits have been indirectly passed on and paid to the (shareholders) partners through a colorable route. Further, this approach may also be subject to huge litigation. Therefore, it seems advisable to avoid such an approach and comply with the language in its true spirit as the entire exemption under section 47(xiiib) of the IT Act is at stake.
- Whether the money can be advanced by the LLP to the partners by way of loan? The Income-tax Appellate Tribunal ('Tribunal') at Kolkata in the case of Aravali Polymers LLP v. JCIT [2014] 47 taxmann.com 335 (Kolkata) had the opportunity to deal with this issue. In said case, the Tribunal held that granting of a loan to the partners from the accumulated profits of the company amounted to a violation of this condition of section 47(xiiib) of the IT Act. Thus, considering this peculiar ruling it should be ensured that where any advances or loans are sought to be advanced to any partner then a suitable trail shall be maintained which demonstrates that the loans are given out of current profits of LLP or from borrowing made by LLP, and suitable evidence should be maintained to prove that accumulated profits of the company before conversion are not touched and used for granting such loans.

**4.2 Other provisions that stand attracted in case of conversion in terms of section 47(xiii b) of the IT Act:**

- **No step-up in cost of assets**: As per Explanation 2C to section 43(6) of the IT Act the actual cost of the block of assets transferred to LLP on conversion shall be the WDV of the block of assets in the hands of the company on the date of such conversion. Similarly, as per section 49 of the IT Act, the cost of non-depreciable assets in the hands of the LLP shall be deemed to be the cost for which the company had acquired such asset.

- **Depreciation in the year of conversion**: In the year of conversion, the depreciation allowance on the assets transferred on conversion to the LLP is allowed both to the company and the LLP based on the number of days for which such assets were used by the company and the LLP.

- **Carry forward of losses**: Where the conversion is undertaken in compliance with the conditions listed in section 47(xiiib) of the IT Act, the tax losses and unabsorbed depreciation allowance of the company stand transferred to and become losses of the LLP. Further from the construct of the language of section 72A(6A) of the IT Act it could be possible to say that the losses stand to review on conversion i.e., they get a fresh lease of life for carry forward and set off, from the year of conversion. However, if the conditions laid down in section 47(xiiib) of the IT Act are not complied with then in such case the loss shall not be allowed to be carried forward, and where any loss is set off then such loss shall be deemed to be the income of LLP in the year in which conditions of section 49(xiii b) of the Act.

- **Transfer of MAT Credit**: Section 115JAA(7) of the IT Act clearly provides that in case of conversion of company into LLP, the provisions of section 115JAA of the IT Act allowing carry forward and set-off of MAT credit shall not apply to successor LLP. In other words, the MAT Credit of the company shall stand lapsed and will not be available to the LLP for carry forward or set-off.

- **Allow ability of deduction linked to Undertaking**: The deduction or exemption say under section 80-IA, 10AA, etc., attaches to "the undertaking". The Board vide its letter F. No. 15/5/63 dated 12.5.1963 has clarified that the deduction under section 84 of the IT Act was available to the undertaking and not to the owner thereof. The said position of the Board has also been made applicable to other sections wherein the deduction is linked to the undertaking. Hence on the transfer of the undertaking as a going concern, the benefit of the deduction will be available to the transferee. Similarly, on conversion, the undertaking identity remains intact and the incentives, deduction, etc linked to the undertaking continue to attach. Therefore, upon conversion, the LLP shall be entitled to claim the deduction, incentives, etc., as are linked to eligible undertaking received upon conversion.

- **Dividend Implication**: Whether on the transfer of assets on conversion, will there be any deemed dividend implications under section 2(22)(a) of the IT Act? In case of conversion, the assets of the company are transferred to and vest in LLP, there is no distribution to the shareholders. Thus, the transfer and vesting of the assets to the LLP cannot be regarded as a distribution to the shareholders. Hence there should not be any deemed dividend implication under section 2(22)(a) of the IT Act.

**4.3 Implication on violation of the conditions of section 47(xiii b) of the IT Act:**

- Where any of the conditions specified in section 47(xiiib) of the IT Act is not complied with then gain arising to the company and its shareholders on conversion into LLP shall be taxable under section 45 of the IT Act. However, where initially the company has been converted into LLP in compliance with the condition of section 47(xiiib) of the IT Act and subsequently either of the condition is not complied with, then in terms of section 47A(4) of IT Act the gain on conversion that was treated as exempt in hands of company as well as shareholders under section 47(xiiib) of the IT Act shall be taxable as income of the successor LLP and the shareholders in the year in which such condition/s are violated.

- **<u>In the hands of Company</u>**: Since under the LLP Act, the transfer of the assets on conversion is to be done at the respective book values, therefore, it may be reasonable to contend that the sale consideration to be adopted in the case of the company shall be taken as the book value of assets at which they have been transferred on conversion. In the case of Aravali (*supra*) the AO treating the conversion as non-tax compliant conversion, computed the capital gains in the hands of the company by adopting the fair market value of the assets (being investments in that case) transferred as the sale consideration. The Tribunal however struck down such basis of imputing the sales consideration on the ground that there is no provision to deem fair market value of the assets (being investments) as the sales consideration arising on conversion. The Tribunal considering that the assets were transferred at book value held that capital gain was to be computed by adopting such book values. However, this principle may not hold good for all cases, and in cases where the immovable property gets transferred to LLP in a non-tax compliant conversion, the AO may consider imputing the stamp duty ready reckoner value of such immovable property in terms of section 50C of the IT Act.

- Thus, where a company seeks conversion in terms of section 47(xiiib) of the IT Act and claims exemption thereof in accordance with provisions of section 47(xiiib) of the IT Act, then upon violation of the conditions of section 47(xiii b) of the IT Act the provisions of section 47A of the IT Act shall stand attracted. Alternatively, it may be possible to argue that the conversion of company into LLP is a case of statutory vesting and shall not be construed as 'transfer' under section 2(47) read with section 45 of the IT Act (discussed in detail in Approach 2 below) and as a back-up comply with the provisions of section 47(xiiib) of the IT Act to secure exemption for shareholders.

- **<u>In the hands of the shareholders</u>**: This is discussed in detail in the latter part of this note along with Approach 2.

**4.4 Approach 2: Conversion carried out in terms of LLP Act and without compliance of conditions prescribed in section 47(xiiib) framework (non-tax compliant conversion)**

- In cases where the condition under section 47(xiiib) of the IT Act cannot be complied with or for any other reason, the parties may explore the conversion of a company into LLP without compliance with the provisions of section 47(xiiib) of the IT Act. In the case of a non-tax compliant conversion, there would be potential implications both in the hands of the company and the shareholders.

- In the case of non-tax compliant conversion, provisions of section 72A(6A) of the IT Act enabling carry forward of losses of the company to LLP shall not apply. Consequently, losses of the company will not stand transferred to the LLP.

**Tax implications in the hands of the company:**

- In case of conversion of a company into LLP, all the assets, liabilities, and the undertaking of the company would stand transferred to the LLP. Whether such transfer is taxable as capital gains in the hands of the company? If one were to consider the provisions of section 56 of the LLP Act pursuant to which such conversion is sought to be undertaken, then it could be argued that the transfer and vesting of assets are consequent to the conversion of the company into LLP. The relevant provisions of section 56 of LLP Act are as under:

> "*S. 56. Conversion from private company into limited liability partnership. – A private company may* ***convert*** *into a limited liability partnership in accordance with the provisions of this Chapter and the Third Schedule*."

[Emphasis supplied]

- Thus, the enabling provision of the LLP Act i.e., section 56, section 57, **provides for conversion** of a company into LLP. The process of conversion however has been spelled out in the Third Schedule. Also, the framework for conversion of company into LLP under the LLP Act ensures that all the assets, liabilities, and the undertaking of the company vests in the LLP without any assurance, act, or deed. Hence in substance, the statute provides for the conversion of one of form of entity into another form.

- The term 'conversion' as referred in section 56 and 57 of the LLP Act is a verb and is to be understood as an act of 'change'. Further, it is defined in various dictionaries as under:

  Cambridge Dictionary: "to (cause something or someone to) change in form or character"

- Thus, the term 'conversion' means transformation or change in the form, of a company into LLP. Whereas the term 'transfer' in its general sense means to pass or give. Hence in the case of conversion, the basic test of transfer i.e., to pass or to give, from one person to another is not satisfied. In case of conversion, the transferor and transferee are the same person, and one cannot transfer to himself (unless the provisions specifically deems so like section 45(2) of the IT Act).Thus, the test of 'transfer' is not fulfilled. Consequently, it may be argued that conversion of company into LLP pursuant to the statutory provisions of the LLP Act does not constitute a transfer for purposes of IT Act and consequently there shall be no capital gain in the hands of the company.

- Further, the High Court of Bombay in the case of CIT v. Texspin Engg. & Mfg. Works [2003] 129 Taxman 1 (Bombay) in context of conversion of a firm into a company as per Part IX provisions of the Companies Act, 1956, held that transfer of assets, etc. was pursuance to the statutory vesting under the Companies Act, 1956 and that same did not tantamount to transfer under the IT Act. Further, while coming to the said conclusion, the High Court stated that for a transfer to take place there shall be a transferor as well as a transferee, both existing at the same point in time i.e., together/ simultaneously. However, in the peculiar case of conversion, the transferor and the transferee do not exist together and at the same point in time. It is a case of conversion of the transferor into transferee. In other words, only when the transferor ceases to exist that the transferee comes into existence. Thus, the fundamental test of having the transferor and transferee for the purposes of transfer is not achieved under the conversion framework. Thus, it was held that the statutory vesting of assets on conversion was not to be regarded as transfer and consequently no capital gain arose on such conversion.

- The conversion of the company into LLP under the LLP Act is similar to the conversion framework prescribed under the Part IX provisions of the Companies Act, 1956. Hence the ruling in the case of Texspin Engg. & Mfg. Works (*supra*) shall equally apply in case of conversion of company into LLP. Thus, basis the above proposition it could be argued that even if the conversion of the company into LLP is not in compliance with section 47(xiiib) of the IT Act, there still should not be taxable capital gains.

- **No consideration received by the company:** Furthermore, on conversion, the company dissolves, and that it does not receive any consideration. Thus, even if one were to say that there is conversion, it can be argued that as consideration is absent, therefore the computation mechanism, laid down under section 45 read with section 48 of the IT Act, fails. This proposition has been affirmed by various courts including the High Court of Bombay in the case of Texspin Engg. & Mfg. Works (*supra*). Further, the Supreme Court in the case of Sunil Siddharth bhai v.CIT [1985] 156 ITR 509 (SC) held that even where a transaction may involve a transfer [i.e., within the meaning of section 2(47) of IT Act], however, if there is no consideration for such transfer, then no profits or gains can be said to arise for the purpose of the IT Act.

**Analysis of the recent ruling of the Tribunal in case of Celerity Power LLP:**

- At this stage, it is relevant to discuss the ruling of the Tribunal at Mumbai in the case of ACIT v. Celerity Power LLP [2018] 174 ITD 433 (Mumbai), wherein the Tribunal has disregarded the proposition of statutory vesting in the context of conversion of company into LLP and held that the non-tax compliant conversion was a transfer and gain there from was chargeable to tax.

- The Tribunal has disregarded the contention of no transfer owing to statutory vesting as well as distinguished the ratio of the High Court of Bombay in the case of Texspin Engg. & Mfg. Works (*supra*) on the ground that the term 'convert' means 'transfer'. The emphasis of the Tribunal has been predominantly on the definition of the term 'convert'. The term 'convert' is to be read contextually and in accordance with the scheme of things. While it is important to give weightage to the words used in the definition, but such words are to be read together with other words surrounding it and in the context of the purpose for which such provisions are enacted. The Third Schedule of the LLP Act provides that a company can convert into LLP. As part of this process the assets which were so far held in the entity operated in the form and style of a company will now be held in an entity which is to exist in the form and style of the LLP. Thus, consequently on account of the change in form and structure of the entity from company to LLP, the assets, liabilities, contracts, litigations, etc., shall also belong to and vest in the LLP and to give effect to the same law provides that such assets shall be reckoned to have been transferred to the LLP. It is a framework which gives force to the process of conversion and to give effect to this conversion under various laws it is imperative to state and provide that the assets of the company now belong to the LLP. It is important to note that the definition nowhere uses that the assets shall be transferred **by the company to the LLP**, instead it provides that convert means transfer **of assets of the company to the LLP**. From the definition, it could be clearly seen that it provides for 'transfer of assets' and not 'transfer by company of assets'. There is huge difference in both the phrases, the first phrase simply talks of assets getting transferred to LLP (on conversion of company into LLP), whereas the second phrase talks of transfer of assets by one person being a company to another person being an LLP. The second phrase pre-requires the existence of both the parties i.e., the transferor (company) and the transferee (LLP). However, as evident from the LLP Act on conversion and upon the issue of the registration certificate the company ceases to exist, and the LLP is registered. Thus, under the LLP Act, both the company and LLP do not simultaneously exist. If put simply, then LLP is an altered form of a company and for that reason, there can be no situation where both the company and LLP can co-exist.

- Further, without prejudice to the above discussion, if at one instance the view of the Tribunal in case of Celerity Power LLP (*supra*) was to be accepted, even then the definition of the term 'convert' is only restricted to the Third Schedule. The definition cannot stand extended to and apply to the term 'convert' used in the main provisions of section 56 of the LLP Act. The term 'convert' used in enabling provisions of section 56 of the LLP Act has to be given its natural meaning and cannot be read to mean a transfer from one person to another. While interpreting in the manner it is done, the Tribunal has failed to appreciate that the substantive provisions of section 56 of the LLP Act that provide that the company may get converted into LLP. The Third Schedule of the LLP Act only provides the mechanism for giving effect to the conversion. However, the Tribunal without giving enough weight to the substantive and enabling provision has proceeded to deny the benefit by resting the analysis purely on the words used in the procedural provisions of the Third Schedule of the LLP Act. Furthermore, the Tribunal has not considered or discussed upon the term '*transferred to and shall vest in limited liability partnership without further assurance, act or deed*'. These phrase as used in the Third Schedule of the LLP Act clearly demonstrate that the transfer and vesting are pursuant to the statutory provision of the LLP Act providing for the conversion of company into LLP.

- Further, the Tribunal has invoked the provisions of the Transfer of Property Act, 1892 ('TOPA') to contend that in terms of the provisions of the TOPA also vesting of assets on conversion to oneself also constitutes transfer. The relevant provisions of section 5 of TOPA as referred to by the Tribunal are as under:

  *In the following sections "transfer of property" means an act by which a living person conveys property, in present or in future,* ***to one or more other living persons, or to himself, 1[or to himself] and one or more other living persons****; and "to transfer property" is to perform such act.*

- The Tribunal has by reading the above provisions along with the definition of 'convert' in Third Schedule of the LLP Act, held that on the conversion of company into LLP there is transfer. The provision of the TOPA provides that there shall be a transfer of property where (i) one living person transfers to another; and (ii) one living person transfers to himself and one or more other living persons. Now in the case of conversion, neither of these two situations get covered. Firstly, there is no transfer of assets by a living person (say company) to any other living person. As the LLP does not exist at the time when the company exists, thus there is no living person to whom the assets are transferred by the company. Further, the second limb of section 5 of TOPA provides that a living person can transfer to 'himself and one or more other living persons. Again, as on conversion the company ceases to exist, there is no transfer to himself. However, if it was to be argued that the company exist in a new form (i.e., LLP), even then section 5 of the TOPA provides for the transfer of assets which was singularly held (or owned) to group of persons including the transferor. Thus, second limb of section 5 of the TOPA provides for a scenario of transfer of assets to common or joint holding (or ownership) of asset where transferor is one of the parties, *and not the sole party*. Thus, the case of vesting of assets on account of conversion of the form of an entity is not covered within the ambit of the provisions of section 5 of the TOPA.

- Further the provisions of section 5 of the TOPA envisage an 'act' of transfer on the part of the transferor. Now in the case of the conversion under the LLP Act, on conversion the assets stand vested into LLP **without** further assurance, ***act***, deed. Thus, even this condition of section 5 of TOPA is not satisfied. Thus, it shall be safe to say that the conversion does not tantamount to transfer even under the provisions of TOPA.

- Another notable point is that similar words were used in Part IX of the Companies Act, 1956 which were tested by the High Court of Bombay in the case of Texspin Engg. & Mfg. Works (*supra*). The Part IX provisions contained the phrase 'pass to and vest in' as against the phrase 'transferred to and shall vest in' as used in the Third Schedule of the LLP Act. The relevant provision of section 575 of the Companies Act, 1956 reads as under:

  *"575. ……..Vesting of property on registration: All property, movable and immovable (including actionable claims), belonging to or vested in a company at the date of its registration in pursuance of this Part, shall, on such registration* ***pass to and vest in*** *the company as incorporated under this Act for all the estate and interest of the company therein."*

  [Emphasis supplied]

- Thus, the only difference between is the use of words 'pass' in the Companies Act, 1956 and 'transferred' in the LLP Act. However, in general parlance, both these words i.e., pass and transfer should have a similar meaning and that therefore the law as laid down by the High Court of Bombay in the case of Texspin Engg. & Mfg. Works (supra) shall equally apply to conversion of company into LLP in terms of the LLP Act. Thus, with all due respect in my humble opinion the principle laid down by the Tribunal in the case of Celerity Power LLP (*supra*). Having said so, the litigation on this approach is likely and it is advisable to obtain an opinion of senior counsel on this matter so as to safeguard from the penal exposures if any.

- The Tribunal in Celerity Power LLP (*supra*) while dealing with the manner of computation of the gain arising to the company on the conversion held that on conversion the assets vest into LLP at their book value. Hence, the full value of the consideration of assets transferred was held to be taken as their book value. The Tribunal observed that while imputing the full value of consideration one cannot impute the market value of assets on the date of transfer and that as the assets stood transferred at book value, that was the amount which became due from the LLP on account of transfer of assets on conversion.

**Tax implications in the hands of the shareholders:**

- **Whether transfer test satisfied?** On conversion of the company into LLP, the shareholders of the company cease to be shareholders and become partners in the LLP entitled to bundle of rights including right to (i) share in the profit,(ii) manage of operation of LLP, (iii) capital contribution in their name, etc. The definition of transfer under section 2(47) of the IT Act is wide enough and includes the sale, exchange, or relinquishment of the asset. It also includes the extinguishment of any rights in an asset. On conversion of the company into LLP the shares held by the shareholders in the company cease to exist and so the rights therein are extinguished. Further, the receipt of the partnership interest in the LLP is consequent to the partner holding shares in the company. Thus, there is nexus between the extinguishment of rights in shares and receipt of the partnership interest in the LLP. Furthermore, the Supreme Court in the of case Grace Collis - 248 ITR 323 [SC] involving the amalgamation of a company where shareholder receives shares in the amalgamated company in place of his shareholding in the amalgamating company, held that the term "the extinguishment of any rights therein" can be either on account of transfer of rights or otherwise i.e., even on extinguishment of the asset. The Supreme Court thus held that on amalgamation there was a transfer so as to be liable to capital gains. Hence, on the conversion of company into LLP, there shall be an extinguishment of the rights of the shareholder in the shares held in the company and the same shall constitute a transfer.

- In this regard and in the context of conversion of company into LLP, the AAR in its recent ruling in the case Domino Printing Science Plc [AAR No. 1290 of 2012] also held that as the shareholding of the shareholders in the company stands extinguished on the conversion of company into LLP, such extinguishment of shares shall be regarded as transfer under the provisions of the IT Act.

- **What shall be the consideration?** Even, if there is a transfer, in order that such extinguishment is taxable as capital gains, there has to be a consideration for such transfer. What is the consideration that accrues in the hands of the shareholder? The Supreme Court in the case of Sunil Sidharthbhai - 156 ITR 509 (SC) held the amount credited to the capital account of a partner is not the full and final consideration that accrues to the partner, the amount will constantly undergo change on account of share of profit and loss getting credited to partners' capital account. Hence the consideration arising to the partner was not ascertainable at the stage of contribution, thereby causing the computation mechanism to fail. The principles laid down by the Supreme Court in the case of Sunil Sidharthbhai - 156 ITR 509 (SC) could have equally applied to the case of conversion of company into LLP. However, to overcome such scenarios, section 50D has been introduced in the IT Act.

- As per the provisions of section 50D of the IT Act in the case where consideration is not ascertainable or cannot be determined, then for the purpose of computing the capital gains, the fair market value of the asset transferred on the date of transfer shall be deemed to be the full value of consideration received or accruing as a result of such transfer.

- The term fair market value is not defined under section 50D of the IT Act however section 2(22B) of the IT Act defines the fair market value to mean the price that the capital asset will ordinarily fetch on sale in the open market on the relevant date. If such price is not ascertainable, then one may determine the price in accordance with the methods prescribed under the IT Act or IT Rules in the context of different provisions. In the case of the shares of private limited company which are not marketable or freely transferable, the popular methodology is to adopt the mechanism laid down in Rule 11UA of IT Rules. Alternatively, one may adopt the amount that is credited by LLP to the partners' capital account (including therein reserves and surplus of the company as on date of conversion). The AAR in the case of Dominos Printing Science Plc (*supra*) was also posed with the question regarding the quantification of the sale consideration accruing to the shareholders in the case where the conversion is a taxable conversion. In this regard, the AAR held that the full value of the consideration accrued to each shareholder on account of relinquishment of shares will be the value of the capital in the newly formed LLP. It further observed that if any of the shareholders receive any extra consideration or benefit, directly or indirectly, in any form or manner, then the full value of the consideration received shall be enhanced accordingly for the purpose of computation of capital gains under section 48 of the IT Act. The AAR gave a finding that even if the assets of the company were transferred to LLP at their book value, the value of partnership interest in LLP will be certainly more than the face value of the shares foregone by the applicant considering the reserves and surpluses transferred. Thus, the AAR held that on non-compliance of provisions of section 47(xiiib) of the IT Act the transaction involving extinguishment of shares was a transfer, and that gain on such transaction was chargeable to tax on the lines as discussed above. For computing the gain, the cost paid for acquisition of the shares shall be allowed as deduction from the sales consideration so determined.

**4.5 GAAR implication**

- The LLP Act was enacted to provide a separate legal form of entity to the businessmen, taxpayers, etc. to operate from. Though one of the reasons for having LLP was to have a regulated framework for the partnership firms which are not so well regulated till date and at the same time provide the benefit of the limited liability to the partners, etc. The scope of the LLP Act was not just to cover the partnership firms, but even the companies that wished to operate under the partnership framework. Accordingly, the LLP Act provided the framework for the conversion of the company into LLP. Further, to encourage the companies to convert themselves into LLP even the provisions of the IT Act were amended by the insertion of section 47(xiiib) of the IT Act vide Finance Act 2010 to provide that transfer of assets on the conversion of a company into an LLP in accordance with section 56 and section 57 of the LLP Act shall not be regarded as a transfer for the purposes of capital gains tax under section 45 of the IT Act, subject to certain conditions. Also, the Finance Minister in his Budget Speech relating to Finance Bill, 2010 which inserted the provisions of section 47(xiiib) of the IT Act, stated that the measure is intended to facilitate the tax-neutral conversion of small companies.

*"To facilitate the conversion of small companies into LLPs, I propose that this will not be subject to capital gains tax".*

- Thus, the conversion of the existing company into LLP has been acknowledged by the IT Act, and that there is a separate provision inserted to provide an exemption to such transfer. Thus, there has been a clear intent from the Government to allow the taxpayers to exercise such route and avail exemption if they are able to satisfy the conditions that are laid down under section 47(xiiib) of the IT Act. Thus, there exist Specific Anti-Abuse provisions (SAAR) which seek to confer exemption only to entities fulfilling the conditions. Further, section 47(xiiib) of the IT Act has continued to remain on statute even after the introduction of the GAAR provisions. Though CBDT has vide Circular no. 7 of 2017 dated 27 January 2017 provided that GAAR provisions are in addition to the SAAR provisions and shall apply even if the SAAR test was satisfied. However, the same being circular it shall not have any binding effect on the assesses and the courts. Further, such circular is to be read purposively and reasonably so that due merit is served to the current provisions of section 47(xiiib) of the IT Act.

- Additionally, selection between the form of entity (company, firm, LLP, etc.) ought not to be the subject matter of GAAR provisions. It is for the taxpayer to decide which entity it wants to operate through. The right and freedom to choose an entity should not be questioned and neither should the taxpayer be directed to select one form of entity over other. Hence, it may be a good case to argue that GAAR provision ought not to apply in such cases. However, it is advisable, to back the conversion with some sound commercial rationale as well, rather than solely justifying on the tax grounds. This will add more safeguards and build a strong case in favor of the taxpayer.

**4.6 Conclusion:**

- The LLP as an entity framework is attractive as it provides various benefits including the benefits of limited liability in a partnership structure and lesser compliances burden. The LLP operates through the terms agreed in the LLP Agreement and thus provides immense flexibility to parties in arranging their inter-se relationships i.e., between the partners, also between partners, and the LLP. However, the law on LLP is relatively new and recent and thus the jurisprudence thereon remains limited, but with the passage of time it should get settled. Basis the facts and requirements of each case one should evaluate the feasibility of operating through the LLP structure and plan out the approach in an effective and efficient manner.

# Tax Implications and Controversies around Buyback of Shares

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*Background*

The Finance Act, 2013 introduced the provision of section 115QA (i.e. Tax on distributed income to shareholders) in the Income-tax Act, 1961 ('the Act'). This section creates a charge on domestic unlisted companies to pay additional income tax on the buyback of shares from the shareholders.

As per the Memorandum to the Finance Act, 2013, the intention behind the introduction of such provision was to bring within the tax net unlisted companies that resort to buyback of shares instead of payment of dividend in order to avoid dividend distribution tax which was levied under section 115-O r.w.s.2(22) of the Act.

Further, the Memorandum to the Finance Bill, 2019, mentioned that instances of even listed companies indulging in the similar practice of restoring to buyback of shares instead of payment of dividend had been noticed. Accordingly, vide Finance Act (No.2) of 2019 section 115QA has been expanded to include even listed companies within its ambit.

In the hands of the shareholders, any income arising from the buyback of shares held by it shall be exempted from tax under section 10(34A) of the Act.

**Taxability in the hands of the company**

As per the provision of section 115QA of the Act, where the consideration paid by the company for the purchase of its own shares (i.e. buy back of shares) is in excess of the sum received by it at the time of issue of such shares, then, such excess amount i.e. “Distributed Income”, paid to the shareholders will be chargeable to tax in the hands of the company at the rate of 20% (plus applicable surcharge and cess)(hereinafter referred as Buyback Tax ('BBT').

“Distributed Income” is the consideration paid by the company on buyback of shares as reduced by the amount, which was received by the company for the issue of such shares.

Rule 40BB of the Income-tax Rules, 1962 ('the Rules') prescribes the methodology for determining the amount received by the company for the issue of shares under different circumstances such as shares issued pursuant to amalgamation, demerge, ESOP, consideration in kind, bonus shares etc.

*Overview of the provision of section 115QA of the Act*

- The section provides for a levy of additional tax on the company by terming it tax in respect of Distributed Income.
- The provision starts with a non-obstante clause and applies notwithstanding any provision to the contrary in the Act.
- BBT is payable by a domestic company in addition to income tax which is chargeable in respect of its total income.

- It specifically provides that the company shall be liable to pay BBT even if no income tax is payable by the company under other provisions of the Act.

## Taxability in the hands of the Shareholder

*Scope of section 10(34A) of the Act*

- It provides an exemption in respect of income which arises to the shareholder on account of buyback of shares by the company as referred under section 115QA of the Act.
- As per explanation to Section 115QA,"buyback" means purchase of share by the company in accordance with the provision of any law for the time being in force in relation to such companies.
- Thus, any income that arises to the shareholder on account of buyback of shares by a domestic company in accordance with the provision of any law for the time being in force should be exempt in the hands of the shareholder. Such exemption is available irrespective of whether shares bought back are held as stock in trade or capital assets or whether income is in the nature of capital gains or business income for the shareholders.

While the provision of section 115QA rw Rule 40BB provides clarity on various aspects, there are still many issues which need to be addressed while applying the said provisions practically. Specific practical issues/ambiguities arising from the interpretation and implementation of the provision of section 115QA rw Rule 40BBare discussed below:

***Whether the provision of section 115QA of the Act will get triggered in case of a capital reduction (effected via National Company Law Tribunal ('NCLT') scheme under section 66 of the Companies Act 2013)?***

- Here it is essential to evaluate whether, the provisions of section 115QA are wide enough to cover NCLT approved capital reduction within its scope. The amendment to section 115QA in 2016, which now covers consideration paid on buyback without referring to the specific provisions of the Companies Act under which buyback may be undertaken. The Explanation to section 115QA (prior to amendment in 2016) defined 'buyback' to mean purchase by a company of its own shares in accordance with the provision of section 77A of the Companies Act 1956. Thus, buy back undertaken under the other provision of the Companies Act (say section 391 read with section 100 to 104 of the Companies Act 1956) were not covered within the purview of section 115QA of the Act. The Hon'ble Bombay High Court also took this view in the case of Capgemini India (P.) Ltd[1]
- Relevant extracts of the Memorandum to Finance Act, 2016 amending the definition of buyback under section 115QA of the Act is reproduced as under:

  *For the purpose of section 115QA of the Act, it is the effect of buyback being in the nature of distribution of income which is relevant rather than particular provision of the law relating to companies under which it has been undertaken........*

  *In order to provide clarity and remove any ambiguity on the above issues, it is proposed to amend section 115QA of the Act to provide that the provision of this section shall apply to any buyback of unlisted shares undertaken by the company in accordance with the provisions of the law relating to the Companies and not necessarily restricted to section 77A of the Companies Act 1956......*

- In view of the amended definition of buyback in section 115QA of the Act, a question arises whether shares cancelled pursuant to capital reduction would also fall within the purview of section 115QA of the Act.

[1] *Company Scheme Petition No.434 of 2014*

- The following arguments may help to contend that capital reduction ought not to be covered by section 115QA of the Act.

  The provisions of the Act regarding taxability of capital reduction transaction and buyback transaction have been provided distinctly. As per section 2(22) of the Act, dividend includes *inter-alia* any distribution to its shareholder by the company on the reduction of its capital, to the extent to which the company possesses accumulated profits.

  The Hon'ble Supreme Court in the case of G Narasimhan[2] has held that distribution on reduction of capital by the company, to the extent of the accumulated profits, would be taxable as dividend and balance may be subject to capital gains in the hands of the shareholder.

  Therefore, there is a specific provision of the Act and Supreme Court ruling specifically dealing with capital reduction transaction. As per the rules of interpretation of the statute, a specific provision in law overrides a general provision. Accordingly, section 2(22) of the Act being the specific provision on capital reduction, shall override section 115QA of the Act.

  Further, while the meaning of the term 'buyback' for the purposes of section 115QA of the Act is amended to cover purchase by a company of its own shares in accordance with the provision of any law relating to companies (and not restricted only to section 68 of the Companies Act 2013), corresponding amendment is not made to sub-clause (iv) of section 2(22) of the Act to exclude capital reduction from the purview of section 2(22) of the Act.

  Therefore, a view is possible that the distribution of accumulated profits in the case of capital reduction still fall within the ambit of section 115-O rw 2(22)(d) of the Act. If the capital reduction is also to be taxed under section 115QA, then section 2(22)(d) of the Act will become redundant or lead to double taxation of the same income, which cannot be the intention of the law.

  The decision of the Mumbai Tribunal in the case of Goldman Sachs[3] also support the proposition that buyback is different from capital reduction.

  In the case of capital reduction, the shares stand directly cancelled, the same may not be tantamount to the purchase of shares by the company within the meaning of section 115QA of the Act.

  Section 66(6) of the Companies Act 2013 dealing with capital reduction provides that" *Nothing in this section shall apply to buyback of its own securities by a company under section 68*". Accordingly, this further supports the above contention that the company law also provides a distinction between buyback of shares and capital reduction.

- Having regard to the above contentions, the provisions of section 115QA of the Act should be restricted to buyback of issued share capital and should not apply in case of capital reduction. However, the revenue authorities may take a divergent view and allege that the transaction of capital reduction is akin to the purchase of own shares. Accordingly, section 115QA of the Act should apply. It is essential that the company maintains adequate documentation to demonstrate that capital reduction is the cancellation of shares and does not involve any purchase of shares by the company.

***For determining Distributed Income, whether all the shares which are being bought back by the company needs to be considered on a consolidated basis (qua an event) or should it be calculated vis-à-vis each shareholder/each share)?***

[2] *[1999] 236 ITR 327 (SC)*
[3] *ITA No.3726/Mum/2015*

- The above issue is explained by way of an illustration as under:

  XYZ Private Limited ('XYZ') is proposing to buyback equity shares as per the provision of the Companies Act, 2013. Pursuant to the announcement made by XYZ, multiple shareholders may furnish shares which may have been allotted by XYZ in different tranches. Consideration paid on the buy back of each share is same i.e. INR 300 per share. Shareholders X, Y and Z have placed the following 3 shares for the buyback.

| Shareholder | Buyback consideration (A) | Mode of shares issue | Amount received on issue (B) | Distributed income (A) – (B) |
|---|---|---|---|---|
| X | 300 | Tranche I – Shares issued at a premium | 650 | (350) |
| Y | 300 | Tranche II– Bonus | 0 | 300 |
| Z | 300 | Tranche III– Shares issued at face value | 100 | 200 |
| **Total** | **900** | | **750** | **150** |

- In the above situation, the issue arises whether BBT will be payable only on INR 150 or INR 500 (INR 300 + INR 200 for Tranche II and III, respectively)?

- The tax authorities on the following premises may likely to contend that, BBT is payable on INR 500 and the benefit to set-off INR 350 is not available.

  Negative value of distributed income ought to be considered as nil as there is no set-off provision in section 115QA of the Act.

  There is a sale by each shareholder.

  The amount is paid to each shareholder separately. It is therefore, possible to compute Distributed Income for each shareholder/share separately.

- The following arguments may support a view that BBT is payable on INR 150.

  While the amount is paid to each shareholder separately, it still qualifies as the consideration paid by the company on buyback. Further, even the amount received by the company for the issue of shares is more than the consideration paid on buyback, it still qualifies as the amount received by the company for the issue of shares which are bought back. Therefore, with presence of amount paid to the shareholder on buyback and amount received from the shareholder for the issue of shares, computation of Distributed Income is possible.

The entire section refers buyback of given shares (plural).

The following provisions of the Companies Act and Rules indicate that the buyback is an event.

- The offer is made to all the shareholders, fixed consideration for all the shareholders.
- The offer remains open for the same number of days for all the shareholders.
- In case of an excess number of valid applications qua the offer size, the acceptance needs to be on a proportionate basis.
- There is a single date of completion of buyback.
- Securities bought back needs to be extinguished and physically destroyed within 7 days of the last day of completion of the buyback.
- The company needs to file a return with MCA qua the event of buyback.

- There is no specific provision under section 115QA of the Act read with Rule 40BB of the Rules suggesting that gains on buyback have to be computed separately qua each shareholder/share. Accordingly, it may be possible to adopt a view that while computing the Distributed Income, consolidation could be done for all the shares bought back, and only the net income (INR 150) ought to be subject to BBT.
- In this regard, the following steps could be adopted :-

The computation of distributed income as under:-

a) Identification of shares purchased.

b) Determination of the amount received for each such share in the prescribed manner.

c) Aggregating such amount received from all shareholders

d) Computing total consideration paid by the company for buyback of all the shares.

e) Distributable income is equal to (d) – (c).

For the purpose of determining the amount of each such share as mentioned in clause (b) above, the amount received by the company for the issue of such shares has to be determined individually shareholder wise as per Rule 40BB of the Rules.

Thus, net distributed income is to be computed for all the shareholders together at a company level on the difference between the consideration paid by the company for buyback of shares and the total amount received by the company on such shares.

***Whether buyback of shares at a price below Fair Market Value ('FMV') (determined as per Rule 11UA of the Rule)of such shares would attract provisions of section 56(2)(x) of the Act, in the hands of the company undertaking buyback of equity shares?***

- Section 68 of the Companies Act 2013 (erstwhile section 77A of the Companies Act, 1956) empowers a company to buy back its own shares or other specified securities. A company is required to ensure compliance with the provision of the said section to conduct a buyback.
- As per section 68(7) of the Companies Act 2013, once the buyback process is completed, the company shall, within seven days of the last day of the completion of buyback, extinguish and physically destroy the shares bought back by the company.

- The provision of section 56(2)(x) of the Act are attracted when any person receives, *inter-alia*, any shares for a consideration which is less than the FMV of such shares. The difference between the FMV of such shares and the consideration received would be chargeable to tax as 'Income from other sources' in the hands of a recipient.
- The term 'receives' as mentioned in section 56(2)(x) is not defined in the Act. As per the Advanced Law Lexicon Dictionary, the term 'receive' has been defined as "To receive means to get by a transfer, to receive a gift, to receive a letter, or to receive money and involves an actual receipt.
- Whether the meaning of the term "receives" can be extended to the temporary custody of shares on account of buyback of shares by an Indian company which are subsequently extinguished in accordance with the provision of section 68 of the Companies Act, 2013.
- Such an interpretation may not be entirely apt, as section 67 of the Companies Act 2013 restricts a company from issuing shares to itself. Hence, no company can hold its own shares. The company cannot be called as a 'recipient' of its own shares on buyback, which are received merely for cancellation/extinguishment.
- The company making a buyback under section 68 has to maintain a register of the shares or securities bought back as per Companies (Share Capital and Debentures) Rules, in Form SH-10. The format of SH-10 has field (the name of the last holder of the security bought back), it does not mention the company's name as the holder of the securities bought back.
- In this context, reliance can be placed on the decision of the Mumbai Tribunal in the case of Vora Financial Services (P) Ltd[4]. Wherein in relation to the provision of section 56(2)(viia), it was held that deeming provision would not be applicable in case of buyback in the hands of the recipient of the shares. The relevant extract of the judgement are cited below –

  *"Therefore, it follows the shares should become "property" of recipient company and in that case, it should be shares of any other company and could not be its own shares. Because own shares cannot become property of the recipient company. Accordingly, we are of the view that the provisions of section 56(2)(viia) should be applicable only in cases where the recipient of shares become property in the hands of recipient and shares the shall become property of the recipient only if it is "shares of any other company". In this instant case, the assessee herein has purchases its own shares under buyback scheme and the same has been extinguished by reducing the capital and hence the tests of "becoming property" and also "shares of any other company" failed in this case. Accordingly, we are of the view that the tax authorities are not justified in invoking the provision of section 56(2)(viia) for buyback of own shares".*

- Additionally, it can also be argued that when shares are held in dematerialised form, there may not be a receipt even as custodian of shares as there is no receipt in the hands of the company.
- In light of the above discussions, provisions of section 56(2)(x) of the Act may not apply to the buyback of shares in the hands of the company. However, considering that section 56(2)(x) is relatively new, having limited jurisprudence, litigation with the tax authorities cannot be ruled out.

***Whether the expenses incurred in relation to buyback of share can be claimed under section 37(1) of the Act?***

- Often during the process of buyback, companies incur various expenses such as brokerage fees, SEBI Fees, expenses on advertisements, stock exchange fees, legal charges, certification fees etc. The buyback is a process where the share capital of the company is reduced. Since the capital is reduced, there is no creation of any assets or enduring benefit. Hence, these expenses should be treated as revenue in nature.

[4] *ITA 532/Mum/2018 (Mumbai Tribunal)*

- The Delhi High Court in the case of Selan Exploration Technology Limited[5] held that" *where no such flow of funds or increase in the capital employed, the expenditure incurred would be revenue expenditure, as in such a case the company would not acquire benefit or addition of enduring nature*".
- A similar view has been upheld in the case of Aditya Birla Nuvo Ltd[6], Bayer Vapi (P.) Ltd[7], Bramha Bazar Hotels Ltd[8], Merck Ltd[9].
- It is imperative to note that the nature of buyback expenses may impact the allow ability of the expense. The expenditure incurred should be in relation to carrying out the buyback scheme or for implementation of buyback of shares and may not include the price paid to the shareholder for buying back the shares.
- Further, as per provision of section 115QA(5) of the Act, no deduction is allowed to the company in respect of BBT paid. Here it would be interesting to explore whether the 'education cess' paid on BBT can be claimed as a deduction by adopting the principles emanating from the following decisions :-
  - Education cess paid on income tax held as allow able deduction

    Chambal Fertilisers and Chemicals Limited[10]

    Sesa Goa Limited[11]

    *(There are catena of Tribunal decisions allowing deduction of education cess)*
  - Education cess paid on dividend distribution tax held as allow able deduction in case of Aditya Birla Nuvo Ltd[12].

***Whether the capital loss incurred by the shareholder on the buyback can still be claimed by the shareholder?***

- Section 10(34A) of the Act provides for an exemption of "*any income arising to an assessee, being a shareholder, on account of buyback of shares by the company as referred in section 115QA*".
- Here the department may raise a contention that when a source of income is exempt from tax, then as a corollary, even loss from such source of income cannot be set-off against any other income that is chargeable to tax.
- In this regard, the reference to the decision of Hon'ble Supreme Court in the case of J.H.Gotla[13] would be relevant, wherein it was held that income includes loss.
- There is no direct judicial precedent dealing with the issue of set-off / carry forward of capital loss on the buyback of shares by the shareholder. Further, the judicial view in the context of allow ability of long-term capital loss arising out of the sale of shares [covered within the scope of section 10(38)] is also divided as discussed below.

  In the following decisions, the claim of long term capital loss on listed equity shares (on which Security Transaction Tax ('STT') is paid) was allowed on the premise that

  when a source of income (Capital Gain under section 45) is otherwise chargeable to tax, but only specific item of income derived from such source is granted exemption (income under section 10(38)), in such cases, the proposition that the term "income" includes loss will not be applicable.

*[5] ITA No.508 of 2009 (Delhi High Court)*
*[6] ITA No. 1571 of 2014 (Bombay High Court)*
*[7] ITA No.166 of 2019 (Gujarat High Court)*
*[8] ITA No.1721 of 2013 (Bombay High Court)*
*[9] ITA No.726 of 2017 (Bombay High Court)*
*[10] ITA No.52 of 2018 (Rajasthan High Court)*
*[11] ITA No.17 of 2013 (Bombay High Court)*
*[12] ITA No. 2525/Mum/2014 (Mumbai Tribunal)*
*[13] [1985] 156 ITR 323 (SC)*

Raptako Brett and Co. Ltd[14]

United Investments[15]

Somnath Vaijanath Sakre[16]

Nomura India Investment Fund Mother Fund[17]

Shiv Kumar Jatia[18]

In the following decisions it has been held that profits arising from the transfer of shares on which STT is paid are exempt under section 10(38) of the Act. Therefore loss arising from such source also cannot be set-off against any other income which is chargeable to tax.

Appolo Tyres Ltd[19]

Kishorebhai Bhikhabhai Virani[20]

Asia Pacific Performance SICAV[21]

G.K.Ramamurthy[22]

Nikhil Sawhney[23]

- The above favourable ruling in the context of section 10(38) of the Act can be distinguished on the premise that, charging provision of the buyback is covered in section 46A of the Act and not under section 45 of the Act. Since section 46A deals with only capital gains on buyback of shares, the tax authorities can argue that the entire source of income under section 46A is exempt under section 10(34A) of the Act.
- Additionally, the Central Board of Direct Tax vide the FAQ[24] (Question 23) has clarified as under:-

*"As the exemption from long-term capital gains under clause 10(38) of section 10 will be available for transfer made between 1st February 2018 and 31 March 2018 the long term capital loss arising during this period will not be allowed to be setoff or carried forward"*

In view of the above discussion and in the absence of direct judicial precedent, loss on account of buyback of shares may not be allowed to the shareholder.

## Closing remarks

The above discussion is on the selected issues emanating from the interpretation and practical implementation of section 115QA of the Act and Rule 40BB of the Rules. There could be many more issues on several aspects such as whether redemption of preference shares and shares bought back pursuant to compromise or arrangement under section 230 of Companies Act 2013 gets covered under section 115QA of the Act, whether under a treaty the BBT is creditable in the hands of the non-resident shareholder, determination of the amount received by the company in case of buyback of split or consolidated shares, the applicability of transfer pricing provisions in case buyback is from associate enterprise, etc. The detailed analysis of the income tax provision in light of peculiar facts of the buyback scheme is paramount. Also, it is essential to evaluate the entire buyback transaction under the lens of General Anti Avoidance Rules) ('GAAR') before practically implementing the same.

[14] *ITA No.3317/Mum/2009 & ITA No.1692/Mum/2010 (Mumbai Tribunal)*

[15] *ITA No.522/Kol/2017 (Kolkata Tribunal)*

[16] *ITA No.2986/Pun/2016 (Pune Tribunal)*

[17] *ITA No.8140/Mum/2010 (Mumbai Tribunal)*

[18] *ITA No.241/Del/2019*

[19] *ITA No.216 of 2013 (Kerala High Court)*

[20] *ITA No.440 of 2013 (Gujarat High Court)*

[21] *ITA No.7106/Mum/2010 (Mumbai Tribunal)*

[22] *ITA No.1367/Mum/2009 (Mumbai Tribunal)*

[23] *ITA No.1248/Del/2017 (Delhi Tribunal)*

[24] *(F No.370149/20/2018-TPL) dated 4 February 2018*

# Restructuring the shareholding pattern: Transfer of Shares, Capital Reduction, Conversion of Securities

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*"Restructuring encompasses formulating a new structure, to rebuild or to rearrange. It starts with the intention of redefining or researching on the purpose of doing business. Once the purpose is adequately explored and examined, scope for restructuring surfaces"*

- With rapid advances in information technology and acute resource constraints across the globe, the business world has become more complex and fluid in recent times. To survive and compete the present day, organizations have to put more emphasis on the business process as a whole to achieve certain predetermined objectives at corporate level. Such objectives include the following:

- orderly redirection of the firm's activities;
- deploying surplus cash from one business to finance profitable growth in another;
- exploiting inter-dependence among present or prospective businesses within the corporate portfolio;
- diversification and risk reduction; and
- development of core competencies

- Business restructuring is the process of significantly changing a company's business model, management team or financial structure to address challenges and increase shareholder value. It is an inorganic growth strategy to ensure long term viability.

  The restructuring process requires various aspects to be considered before, during and after the restructuring. They are:

  - Valuation & Funding
  - Legal and procedural issues/ regulatory approvals and disclosures
  - Taxation and Stamp duty aspects
  - Accounting aspects
  - Competition considerations etc.
  - Human and Cultural synergies

  Based on the analysis of aforesaid aspects, an appropriate strategy is determined and implemented.

- Various techniques of Business Restructuring include the following

| Expansion Techniques | Divestment Techniques | Other Techniques |
|---|---|---|
| Merger | Sell – off / Hive off | Going Public / IPOs |
| Takeover | Demergers | Share Repurchasing/ Buyback |
| Joint Ventures | Slump sale | Share Transfers |
| Strategic Alliance | Leveraged Buy outs | Capital reduction |
| Franchising | Liquidation/ winding off | Conversion of securities |
| Holding Companies | | Legal entity rationalization |

## 1. Transfer of Shares

### 1.1 General overview

### 1.2 Tax implications

**The authority responsible for tax on transfer of shares includes the following:** The Central Board of Direct Taxes, which is a part of the Department of Revenue in the Ministry of Finance. The Central Board of Direct Taxes supports policy framing and planning for direct taxes, which are administered federally through the income tax department
Stamp Duty Authorities

**A) Capital Gains Tax:**

i) **Where Securities Transaction Tax ('STT') is paid** (for an equity share in a company),the tax rates (excluding surcharge and cess) are as follows:

- (STT paid at the time of acquisition and transfer) for a long-term capital asset, the gains exceeding INR100,000 are subject to a tax of 10% for residents and non-residents
- (STT paid at the time of transfer) for a long-term capital asset, the gains are taxable at 20% (with indexation benefit) and 10% (without indexation benefit) for residents and non-residents
- (STT paid at the time of transfer) for a short-term capital asset, the gains are taxable at 15% for residents and non-residents

ii) **Where no STT is Payable**(for an equity share in a company),the tax rates (excluding surcharge and cess) are as follows:

- Domestic companies:

- short-term capital gains: 30%; and
- long-term capital gains: 20%
- FPIs:
- short-term capital gains: 30%; and
- long-term capital gains: 10%
- Non-residents(including body corporates) other than FPIs:
- short-term capital gains: 40%;
- long-term capital gains: 10% (without indexation and foreign exchange fluctuation benefit);

**iii)** Capital gains = Full Value Consideration (less) expenses incurred wholly and exclusively in connection with transfer (less) cost of acquisition/ indexed cost of acquisition (less) cost of improvement/ indexed cost of improvement.

One needs to determine each of the aforesaid parameters adequately and also the period of holding of shares as contained under the Indian income tax provisions, to further determine the capital gains (long term/ short term).

**iv)** The following transactions are exempt from tax (subject to certain conditions):

- The transfer of a capital asset by a holding company to its wholly-owned Indian subsidiary, or the transfer of a capital asset by a wholly-owned subsidiary to its Indian holding company.
- Transfers involving the conversion of bonds, debentures, debenture stocks and deposit certificates into shares and debentures of the same company.
- Transfer by way of conversion of preference shares into equity shares of a company.
- Any transfer of shares between shareholders in certain corporate restructurings such as company mergers and demergers.

**B) Other considerations**

- The transaction value is to be in accordance with Indian income tax provisions and supported by a Valuation Report or it may lead to gif tax implications for the transferee
- In the case of closely held companies, losses cannot be carried forward and set off if more than 49% of equity shares change hands. However, companies that undergo a change in shareholding under an insolvency resolution plan can apply to the jurisdictional tax authority for an exception from this rule.
- A non-resident seller can be exempt from tax on the sale of shares under a DTAA.
- A non-resident is not necessarily able to take credit for securities transaction tax paid on a disposal of shares. The non-resident can also be required to comply with an annual tax filing and comply with transfer pricing rules in the case of a sale to a related party.

- Tax clearances: In the case of a pending proceeding against the transferor, the tax authorities have the power to claim any tax on account of completion of the proceeding from the transferee. Income tax law provides the mechanism for obtaining a tax clearance certificate for transfer of assets/business.
- Indirect taxes: No indirect taxes are applicable on transfer of shares
- Stamp duty: Stamp duty is payable on specified instruments and documents (i.e. share transfer deeds, share subscription agreements, share purchase agreements etc). Generally, stamp duty is charged at a percentage of the value in the instrument liable to stamp duty. The rates of stamp duty on instruments differ from state to state in India. However, transfers of shares (on delivery basis) are subject to stamp duty at the rate of 0.015 percent of the market value of the shares transferred under the Indian Stamp Act. The buyer generally pays the stamp duty. However, parties to an agreement can agree otherwise
- Securities Transaction Tax: STT may be payable if the sale of shares is through a recognized stock exchange in India. STT is imposed on purchases and sales of equity shares listed on a recognized stock exchange in India at 0.1 percent based on the purchase or sale price. STT is payable both by the buyer and the seller on the turnover (which is a product of number of shares bought/sold and price per share).
- Tax indemnities and warranties: In a share acquisition, the purchaser takes over the target company together with all its related liabilities, including contingent liabilities. Hence, the purchaser normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

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**1.3 Legal and Regulatory considerations:**

The following laws needs to be adhered to from a legal and regulatory perspective

- Provisions contained under the Companies Act, 2013 and the rules, orders, notifications and circulars issued thereunder
    - prescribes the procedure for the transfer of shares by public and private companies including passing of Board resolutions and shareholders resolutions
    - a company will register the transfer of shares and other securities only upon successfully filing of share transfer form i.e. Form No.SH 4 - duly stamped with adequate value executed on the behalf of the transferor and transferee
    - Company shall register the transfer of securities of beneficial owners with the proper instrument of transfer is not more than sixty days from the date of execution.
- Provisions contained under the Foreign Exchange Management Act, 1999and the rules and regulations issued thereunder, read together with the circulars, directions and rules issued by the Reserve Bank of India (where transfer is between a resident and a non-resident)
    - Contains pricing guidelines for determination of price at which securities of an Indian company can be issued,
    - Contains sector related restrictions and sectorial caps i.e. permitting investments in certain sectors under automatic route and others under Government approval route
    - Specifies the various reporting requirements

- Securities and Exchange Board of India Laws (where transfer pertains to listed securities)

  Governs the transfer of listed shares, requirements of making open offer on crossing certain thresholds, pricing, exemptions etc

  Lays out the disclosure requirements pre-transfer and post transfer

- Provisions contained under the Competition Act, 2002 - Notifiable transactions are reviewed and regulated by the Competition Commission of India (CCI), a quasi-judicial body set up under the Competition Act, 2002

## 2. Capital Reduction

### 2.1 General Overview

- Share Capital Reduction is the trimming of issued, subscribed and paid-up capital of a company. Companies reduce their existing share capital for a variety of reasons some of which include making the capital structure more efficient or eliminating losses or providing returns to the shareholders.

- A company limited by shares or a company limited by guarantee and having a share capital may, if authorized by its articles, by special resolution, and subject to its confirmation by the Court on petition, reduce its share capital in any way and in particular: (a) by reducing or extinguishing the liability of members in respect of uncalled or unpaid capital e.g., where the shares are of Rs. 100 each with Rs. 75 paid-up, reduce them to Rs. 75 fully paid-up shares and thus relieve the shareholders from liability on the uncalled capital of Rs. 25 per share; (b) by paying off or returning paid-up capital not wanted for the purposes of the company, e.g., where the shares are fully paid-up, reduce them to Rs. 75 each and pay back, Rs. 25 per share; (c) by paying off the paid-up capital on the conditions that it may be called up again so that the liability is not extinguished; (d) by following a combination of any of the preceding methods; (e) by writing off or canceling the capital which has been lost or is under represented by the available assets

- In the recent past, a few companies like Syngenta India Limited, Atlas Copco, etc. have, after their delisting from the stock exchanges, followed the Sec 66 of Companies Act, 2013 route to selectively reduce their non-promoter capital and provide a means of exit to minority shareholders.*[1]* Sec 66 allows a company to distinguish between shareholders of the same class by compulsorily extinguishing their holding without affecting others within the same class. This is one form of Share Capital Reduction.

### 2.2 Tax implications

Since, the shareholder is receiving some form of income/return on the investment he/she has made, there is bound to be a liability to pay income tax.

Taxability on reduction of share capital can be dividend in the following two parts:

**A) Part I – Taxability as dividend income**

- Any distribution by a company on reduction of its capital is 'dividend' to the extent to which the company possesses accumulated profits, whether capitalized or not, shall be taxable as dividends

- As per the Supreme Court ruling in the case of *PK Badiani*,[1] accumulated profits can be interpreted as profits made by the company in a real and true sense and not merely assessable profits or profits liable to tax, as a company distributes dividend out of its business profits and not out of its assessable income. Further, in the case of *Shree Balaji Glass Manufacturing Pvt. Ltd.*, [2] the High Court of Calcutta held that securities premium should not be considered as accumulated profits for the purposes of capital reduction. This view has been upheld subsequently in other cases as well and is thus a settled view. However, CRR is created out of a company's profits under certain circumstances like buybacks, as per the provisions of the Companies Act, 2013 . Essentially, a transfer to CRR is merely a book entry to comply with the provisions of the law. The wording of section 2(22) of the Act reads as "*accumulated profits, whether capitalized or not*". From this, it appears that CRR forms a part of accumulated profits.

- Dividends is taxable in the hands of shareholders. The domestic company paying dividends (in this case reducing the share capital) shall be liable to deduct taxes.

**i. Taxability in the hands of resident shareholders:**

- <u>Head of income for taxability:</u>

  A person can deal in securities either as a trader or as an investor. The income earned by him from the trading activities is taxable under the head business income. Thus, if shares are held for trading purposes then the dividend income shall be taxable under the head business or profession. Whereas, if shares are held as an investment then income arising in nature of dividend shall be taxable under the head other sources.

- <u>Withholding tax liability</u>

  An Indian company shall deduct tax at the rate of 10% from dividend distributed to the resident shareholders if the aggregate amount of dividend distributed or paid during the financial year to a shareholder exceeds Rs. 5,000.

- <u>Taxability in the hands of shareholders</u>

  In the hands of shareholders, dividend income shall be chargeable to tax at normal tax slab rates as applicable in case of an assessee.

- <u>Deduction of expenses</u>

  Where dividend is assessable to tax as business income, the assessee can claim the deductions of all those expenditures which have been incurred to earn that dividend income such as collection charges, interest on loan etc.

  Whereas if dividend is taxable under the head other sources, the assessee can claim deduction of only interest expenditure which has been incurred to earn that dividend income to the extent of 20% of total dividend income. No deduction shall be allowed for any other expenses including commission or remuneration paid to a banker or any other person for the purpose of realizing such dividend.

**ii. Taxability in the hands of non-resident shareholders**

- Head of income for taxability

  A non-resident generally invests in India either directly as private equity investors or as Foreign Portfolio Investors (FPIs). A non-resident person can also be a promoter of an Indian Company. A non-resident person generally hold shares of an Indian company as an Investment and, therefore, any income derived by way of dividend is taxable under the head other sources except where such income is attributable to Permanent Establishment of such non-resident in India.

  As regards FPIs, securities held by them are always treated as a capital asset and not as stock-in-trade. Thus, in case of FPIs also, the dividend income shall always be taxable under the head other sources.

- Withholding tax liability

  Where the dividend is distributed to a non-resident shareholder, the tax shall be required to be deducted as per section 195 of the Income-tax Act. As per section 195, the withholding tax rate on dividend shall be as specified in the Finance Act of the relevant year or under Double Taxation Avoidance Agreement ('DTAA'), whichever is applicable in case of an assessee.

  The dividend income, in the hands of a non-resident person (including FPIs and nonresident Indian citizens (NRIs)), is taxable at the rate of 20% without providing for deduction under any provisions of the Income-tax Act, However, one needs to consider the eligibility to claim beneficial rate as contained in the relevant read with the Multilateral Instrument to determine the dividend taxation rate for non-residents as If the withholding tax rate as per DTAA is lower than the rate prescribed under the Finance Act then tax shall be deducted at the rate prescribed under DTAA

**B) Part II – Taxability as capital gains**

- Where the reduction is greater than the accumulated profits, then it is a case of genuine reduction of capital. Reduction of share capital by a company and paying off the balance to the shareholders would result in extinguishment of rights in the shares held by the shareholder and would amount to transfer. On reduction of share capital the rights of the shareholders in the dividend and net assets are extinguished. Therefore, capital gains would arise (Supreme Court decision in the case of Kartikeya V. Sarabhai v CIT (1997) and *G. Narasimhan*).

- Taxability of capital gains shall be the same as highlighted above for "transfer of shares"

- Applicability of deemed income tax provisions: Section 56(2)(x) of the Act provides for taxation in the hands of the recipient in case of receipt of property for inadequate consideration.

- However, in case of capital reduction, the shares are cancelled immediately on the scheme becoming effective. Therefore, in essence, the company does not receive any property and therefore, should not be subjected to tax. This view has been upheld in the context of buyback by the Mumbai Tribunal in the case of Vora Financial Services Pvt. Ltd.[5] as well. Further, the cost of the property which has been subject to taxation under section 56 has been specifically provided under section 49. This implies that for section 56 to apply, the property should remain in existence even after receipt, which necessitates providing for a cost for such properties in section 49. Based on the above arguments, one might possibly argue that section 56 should not apply to capital reduction.

**2.3 Procedure for capital reduction[1]:**

i. Convene a Board Meeting a) To approve the reduction of share capital; b) To fix the date of general meeting of the company to get approval of members.

ii. Hold the general meeting and pass Special Resolution approving reduction of share capital.

iii. File e-form MGT-14 with ROC within 30 days of passing the Special Resolution.

iv. Apply to NCLT by filing an application to confirm reduction of share capital of a company along with prescribed fees. The application shall be accompanied with the prescribed attachments.

v. The NCLT shall within 15 days of submission of the application give a notice to Central Government, ROC and SEBI and to every creditors of the company in prescribed form seeking their representations and objections, if any.

vi. The notice shall be sent, within 7 days of the direction or such other period as may be directed by the Tribunal, to each creditor whose name is entered in the list of creditors submitted by the company about the presentation of the application and of the said list, stating the amount of the proposed reduction of share capital and the amount or estimated value of the debt or the contingent debt or claim or both.

vii. The NCLT shall also give direction for the notice to be published within 7 days of such direction in a leading English and vernacular language newspaper, both having wide circulation in the State in which the registered office of the company is situated, or such newspapers as may be directed by the Tribunal and for uploading on the website of the company (if any) seeking objections from the creditors and intimating about the date of hearing.

viii. The Company shall file an affidavit confirming the dispatch and publication of the notice within 7 days from the date of issue of such notice.

ix. Representation by Central Government, ROC, SEBI and creditors shall be sent to the NCLT within 3 months of receipt of notice and copy of which shall also be sent to the company. If no such representation has been received by NCLT within the said period, it shall be presumed that they have no objection to the reduction.

x. Company shall send the representation or objections so received along with responses of the company thereto to the NCLT within 7 days of expiry of period up to which objections were sought.

xi. The Tribunal may, if it is satisfied that the debt or claim of every creditor of the company has been discharged or determined or has been secured or his consent is obtained, make an order confirming the reduction of share capital on such terms and conditions as it deems fit.

xii. The order of confirmation of the reduction of share capital by the Tribunal shall be published by the company in such manner as the Tribunal may direct.

xiii. The company shall deliver a certified copy of the order of the NCLT and of minute approved by the Tribunal to the ROC within 30 days of the receipt of order.

xiv. The ROC shall issue a certificate to that effect.

[1]*Brief procedure has been highlighted. The same is subject to confirmation from lawyers/ subject matter experts*

**Other compliances**

- Additional compliance by a Listed Company: In case a listed entity is in the process of implementation of any scheme with respect to reduction of capital they have to comply with various provisions under SEBI (LODR) Regulations, 2015.
- Transfer of shares by a non-resident to an Indian company under capital reduction scheme of the company require to comply with the provisions of Foreign Exchange Management Act, 1999, Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 read with Foreign Direct Investment (FDI) Policy 2020.
- Stamp duty consideration need to be considered.

***(Please note the Article is based per the laws and regulations contained as on the date of this Article. In case of any subsequent amendments to the laws and regulations, the Article needs to be revisited. I have expressed my views in the said Article. They are not linked to the views of my employer)***

# GST IMPLICATION ON BUSINESS RESTRUCTURING

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In today's business dynamics, we commonly come across businesses resorting to restructuring activities. The business restructuring could be in response to market / economic forces and trends, changes in ownership, changes in corporate strategy, to bring synergy, to increase cash flow and so on. While there are several modes of restructuring, they can be bucketed into the following categories for the purpose of understanding GST implications:

- Transfer of Business vide Business Transfer Agreement (slump sale) or Mergers & Acquisitions (merger, demerger, amalgamation)
- Itemized or Piecemeal sale of Assets
- Transfer of Business as sale or transfer of Securities

## I. GST Implications on Transfer of Business

1.1 In order to determine GST implications on transfer of business, let us first understand the GST provisions. The charging section 9(1) of the CGST Act, 2017 ('***GST Act***'), levies tax on "supply" of goods and services. As per section 7(1) of the GST Act, '*supply includes all forms of supply of goods or services or both such as sale, transfer, barter, exchange, license, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business….*'

1.2 Therefore, the important elements for an activity to fall within the folds of the 'supply' definition are:

(i) There should be supply of 'goods' or 'services'

(ii) There should be 'consideration'

(iii) The same should be done in the course of furtherance of 'business'

1.3 The term 'goods' has been defined in section 2(52) of the GST Act to mean '*every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply*'.

1.4 In terms of section 2(102) of the GST Act, 'services' means *anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged.*

1.5 Further, Clause 4(c) of Schedule II of the GST Act states that:

"*(c) where any person ceases to be a taxable person, any goods forming part of the assets of any business carried on by him shall be deemed to be supplied by him in the course or furtherance of his business immediately before he ceases to be a taxable person, unless —*

*(i) the business is transferred as a going concern to another person; or*

*(ii) the business is carried on by a personal representative who is deemed to be a taxable person.*"

1.6 Schedule II of the CGST Act prescribes the list of activities to be treated as a supply of goods or supply of service, whereas in Clause 4(c), transfer of business assets has been considered as supply of goods. The 'transfer of business as a going concern' does not constitute as supply of goods as per the clause 4(c). Hence, it would be important to delve into the aspect whether transfer of business constitutes supply of a 'service'.

1.7 As seen from the definition of 'service', it is defined very widely to mean 'anything other than goods'. Hence, on a strict reading, it appears that transfer of business would fall within the ambit of 'service'. And more so when an exemption has been provided in entry No. 2 of Notification No. 12/2017-Central Tax (Rate) dated 28th June 2017, '***Services*** by way of ***transfer of a going concern***, as a whole or an independent part thereof'. Accordingly, the GST law recognizes that (i) transfer of business is a service and (2) further exempts the same by way of an exemption notification.

1.8 However, the question that merits consideration is whether there is existence of a 'supply' at all. When the transfer of business includes transfer of assets (goods), liabilities, contractual obligations, employees, technology, cash equivalents etc. can it be said that the same amounts to supply of 'service'? A layman understanding of the phrase 'transfer of business', would definitely result into a negative answer. Section 2 which defines service, starts with "unless the context otherwise requires" and it has also been held by various judicial precedents that a literal adoption of the term which results in absurd interpretation should be avoided. Further, section 7 requires supply to be in the 'course or furtherance of business'. When the business per-se is being transferred, can it be said to be in the course or furtherance of business. Under erstwhile VAT laws, Courts have in many instances, held that the dealer cannot be said to be engaged in the 'business' of 'transfer of business'. The activity of transfer of business cannot be said to be incidental or ancillary to trade, commerce, adventure or concern. Reference in this regard is made to the decisions of ***Monsanto Chemicals of India (P.) Ltd. v. State of Tamil Nadu [1982 51 STC 278 Mad HC] and Deputy Commissioner (C.T.), Coimbatore v. Behanan Thomas [1977 39 STC 325 Mad HC], Coromandal Fertilisers Limited v. State of A.P. [1999 112 STC 1 AP HC]*** and ***Paradise Food Court v. state of Telangana [Writ Petition No. 2167 of 2017 on 18-04-2017].***

1.9 As regards the exemption notification which exempts the 'service' of transfer of business, it is a settled law that an exemption notification cannot levy tax on a transaction and subsequently exempt the same. Accordingly, if there is no supply per se, the question of making the same exempt does not arise.

1.10 Hence, the authors are of the view that there is no supply in case of transfer of business. Nevertheless, the same would be exempt from GST even if considered otherwise. Many GST Advance Rulings have held that transfer of business amounts to supply of service and the same is exempt from GST in lieu of the exemption entries. Reliance in this regard, is placed on ***Rajashri Foods Pvt Ltd [2019 (22) GSTL 293 (AAR GST)], Rajeev Bansal & Sudershan Mittal [2020 (35) GSTL 510 (AAR – GST – UK)], Innovative Textiles Ltd [2019 (24) GSTL 480 (AAR – GST)]*** and ***Shilpa Medicare Ltd [2020 (39) GSTL 34 (AAR – GST – AP)].***

**What is 'Going concern' and whether transfer of a Unit (part of business) can be considered as 'Transfer of a going concern'?**

1.11 As per NN 12/2017, in order to qualify for the exemption, the following conditions ought to be satisfied:

- Transfer of business shall be a transfer of going concern
- Business which is transferred shall be as a whole or an independent part

1.12 Reference is drawn to the AAR-Karnataka in the case of ***Rajashri Foods (P.) Ltd. [***2018 (13) G.S.T.L. 221 ***(A.A.R. - GST)]*** whereby the applicant intended to sell one of their animal feed manufacturing units and undertake a transaction envisaging transfer of all assets and liabilities to the buyer. The AAR held that the unit sought to be sold is a fully functional unit and the transaction contemplates the transfer of the entire business to a new person, who would not only enjoy a right over the assets but shall also take over the liabilities. Hence, treating the transaction as transfer of Business and not solely transfer of Business Assets. The court held that: *"**9**.A going concern is a concept of accounting and applies to the business of the company as a whole. Transfer of a going concern means transfer of a running business which is capable of being carried on by the purchaser as an independent business. Such transfer of business as a whole will comprise comprehensive transfer of immovable property, goods and transfer of unexecuted orders, employees, goodwill, etc".*

1.13 Further, in the Ruling of **Rajeev Bansal & Sudershan Mittal (supra)**and **Innovative Textiles (supra)**, it was held that:

*"In terms of financial transaction 'going concern' has the meaning that at the point, in time to which the description applies, the business is live or operating and has all parts and features necessary to keep it in operation. We further find that internationally accepted guidelines (applicable to the case in hand) issued by His Majesty's Revenue & Customs (HRMC) to treat transfer of business as a going concern are as under :*

*(a) The assets must be sold as part of a 'business' as a 'going concern'*

*(b) The purchaser intends to use the assets to carry on the same kind of business as the seller*

*(c) Where only part of a business is sold it must be capable of separate operation.*

*(d) There must not be a series of immediately consecutive transfers*

1.14 Hence, it can be seen that if a running business is sold to the seller who intends to run the said business, the same would qualify as a going concern. Even if a unit or a vertical from the entire business is transferred to a buyer, the same will qualify as transfer of a going concern, provided all the assets and liabilities pertaining to the said unit are transferred.

**Transfer of Input Tax Credit**

1.15 Section 18(3)of the GST Act allows transfer the input tax credit which remains unutilized in his electronic credit ledger to the sold, merged, demerged, amalgamated, leased or transferred business. Rule 41 of CGST Rules, 2017 ('***GST Rules***') provides that the registered person shall request for transfer of unutilized ITC in Form ITC-02 electronically on the common portal.

1.16 In case of demerger, ITC shall be apportioned in the ratio of the value of assets, irrespective of whether ITC on the same is availed or not, of the new units as specified in the scheme of demerger. CBIC vide ***Circular No.133 03/2020-GST dated 23rd March, 2020*** has clarified on some issues pertaining to the transfer of ITC. It has been clarified that transfer of unutilized ITC is optional and not mandatory.

**<u>Whether Reversal of ITC is required?</u>**

1.17 If transfer of business as a going concern is considered as an 'exempt' service,then it appears ITC reversal under Section 17(2) read with Rule 42 is required to be made. However, if it is contended that transfer of business is not a supply per se (as mentioned in para 1.8 to 1.10), then there is no question of ITC reversal.

1.18 Further, section 18(3) of GST Act read with Rule 41 of GST Rules specifically provide for transfer of unutilized ITC. Hence, there is a contention that when a specific provision has been prescribed (to transfer the unutilized ITC), then the same could prevail over the general provision (to reverse ITC due to exempt turnover). In few Advance Rulings, even though transfer of business has been held as exempt service, transfer of unutilized ITC has been permitted. Reference is placed on ***Shilpa Medicate Ltd [2020 (39) GSTL 34 (AAR – GST – AP)]*** and ***B.M. Industries [2019 (22) G.S.T.L. 293 (A.A.R. - GST)].***

**<u>Can ITC be claimed by the merged entity (transferee company) in case where old invoice has been raised in the name of the transferor company</u>**

1.19 There may be a scenario wherein the invoice pertaining to the transferor company is received post-transfer by the transferee company. In the context of Excise law, Hon'ble Hyderabad Tribunal in the case of ***Farmax India Ltd. vs Commr. OF Cus., C. EX. & S.T., Hyderabad-IV [2020 (43) G.S.T.L. 526 (Tri. - Hyd.)]*** has held that in case of merger, all the assets and liabilities of the transferor companies are transferred to the transferee and therefore there is no reason or requirement for the transferee to take permission from the Tax Authorities for availment of credit on the invoices raised on the transferor companies by the transferee company. Similar decision was also held in the case of ***Lanco Industries Ltd vs. CCE [2008 (223) E.L.T. 550 (Tri. - Bang.)]***.

1.20 The said rationale may also be applied in the GST regime to allow ITC. However, there would be practical difficulties as the amounts would not appear in GSTR-2A/2B of the transferee company and the taxpayers may have to litigate to avail such ITC.

**<u>Liability and Registration in case of transfer of business</u>**

1.21 The taxable person and the person to whom the business is so transferred are <u>jointly and severally</u> liable either wholly or to the extent of such transfer to pay the tax, interest or any penalty due from the taxable person upto the time of such transfer irrespective of whether such tax, interest or penalty has been determined before such transfer and has remained unpaid or is determined there after.Where the transferee of a business carries on such business, he shall be liable to pay tax on the supply of goods or services effected by him with effect <u>from the date of such transfer</u>.

1.22 Accordingly, it is from such date of transfer that the transferor company can apply for cancellation of registration and the transferee company would be required to obtain new registration /amend its existing registration.

**Liability and Registration in case of Amalgamation or Merger of companies**

1.23 When two or more companies are amalgamated or merged pursuant to a court or Tribunal order and the order is to take effect from a date earlier to the date of the order and any two or more of such companies have supplied or received any goods or services to or from each other during the intervening period (commencing on the date from which the order takes effect till the date of the order), then such transactions of supply and receipt shall be included in the turnover of supply or receipt of the respective companies and they shall be liable to pay tax accordingly.The said two or more companies shall be treated as distinct companies for the period up to the date of the said order.

1.24 As per section 87(2) of GST Act, the registration certificates of the said companies shall be cancelled with effect from the date of the said order.

1.25 Further, in terms of section 22(4), the transferee shall be liable to be registered with effect from the date on which the Registrar of Companies issues a certificate of incorporation giving effect to such order of the High Court or Tribunal.

1.26 It can be seen that there is a dichotomy between the above provisions – the date of cancellation of Transferor Company is date of court order and date of new registration of transferor company is date on which ROC issues incorporation certificate. There could be an intervening period between the court order and date of ROC certificate.

1.27 However, there could be practical issues in surrendering the GST registration when Form GSTR-9 (Annual Return) and Form-9C (reconciliation statement) have not been filed, as the portal would get inactive after cancellation of registration. Accordingly, taxpayers may choose to file GSTR-9/9C first and then opt of cancellation of registration and lastly filing of Final return.

**Liability of Directors/Partners**

1.28 Where any tax, interest or penalty due from a private company in respect of any supply of goods or services for any period cannot be recovered, then every person who was a director of the private company during such period shall be liable, jointly and severally unless he proves that the non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the company. The above provision will not be applicable in case of conversion of private limited company to public limited company.

1.29 Where any firm is liable to pay any tax, interest or penalty, the firm and each of the partners of the firm shall, jointly and severally, be liable for such payment. Where any partner retires from the firm, he or the firm, shall intimate the date of retirement of the said partner to the Commissioner by a notice in that behalf in writing and such partner shall be liable to pay tax, interest or penalty due up to the date of his retirement whether determined or not, on that date. If no such intimation is given within one month from the date of retirement, the liability of such partner shall continue until the date on which such intimation is received by the Commissioner. This underlines the importance of timely communication to the Department regarding changes in constitution of the entities.

## II. GST IMPLICATIONS ON ITEMIZED/PIECEMEAL SALE

2.1 Where assets and liabilities of a business are transferred by way of assigning the value to each item, it is known as an itemized sale. This means the sale by the way of transfer of specific assets of a business after assigning a value to these assets. Transaction of itemized assets is considered as supply under the ambit of GST and tax will be applicable in case of Itemized/piecemeal sale at the rate applicable to respective individual items.

2.2 However, if piecemeal assets are sold for a lumpsum consideration, then the same may qualify as 'mixed supply' as defined under section 2(74) of the GST Act. Accordingly, the highest rate of GST applicable to any individual items would be applicable to the entire lumpsum consideration.

## III. GST IMPLICATIONS ON THE SALE/TRANSFER OF SECURITIES

3.1 Another method of acquisition of a business is share acquisition. The definition of both goods as well as services specifically excludes 'securities'. Hence, shares of a company are neither treated as goods nor services under the GST law, and accordingly, there is no GST liability on sale or transfer of securities.

Based on the above, the following points should be considered from a GST perspective while business restructuring or drafting a business transfer agreement:

- Transfer of business as a going concern or not
- Transfer of all the assets and liabilities of the said unit / business vis-à-vis itemized transfer
- Manner of determining consideration – lumpsum vis-à-vis individual amounts
- Treatment of Input tax credit – Reversal as well as Transfer of unutilized ITC
- In case of amalgamation or merger or demerger - Transactions between the two entities,disclosure of turnover / ITC and authorized signatory for compliance / litigation during the intervening period
- Liability of the transferor and transferee company
- Amendment, cancellation and new registrations pursuant to the restructuring activity

# DUE DILIGENCE IN BUSINESS RESTRUCTURING

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"..Byju's acquires Aakash Educational Services in nearly $1-billion deal
Groww acquires Indiabulls Housing Fin's MF
Joint-partnership between BharatPe and Centrum Finance to infuse funds in PMC Bank
Pharmeasy bought controlling stake in Thyrocare.."

In an ever-growing deal making landscape, smaller and mid-sized companies are now seeking the smartest route forward in their growth strategies. The big highlight for this year has been the rally in ambitions of Indian start-ups who are taking bold bets by acquiring established businesses that could be arguably described as old economy.

Majority of the companies have resorted to route through private equity/venture capitalists funding orinorganic growth for improved business synergies and access to greater customer base. Mergers & Acquisitions are at the core of business growth and restructuring life cycle. However, there also exist other restructuring options like (i) joint ventures, (ii) strategic alliance, (iii) reverse merger, (iv) divestiture, (v) IPOs, (vi) buybacks, and so on.

It is of prime importance that the buyers in any transaction should carefully examine their business strategy and then align themselves with any of the above-mentioned restructuring options for successful acquisition or partnerships.

- **Background**

In this article we will learn that to thrive amidst competitive conditions, timely and accurate intelligence isn't just an option, it's a necessity – and that means a professionally executed due diligence process.

Due Diligence process equips buyers as well as investment partners and lenders with a clear understanding of the story behind the numbers, different than conventional reporting or audits can reveal. Due diligence ordinarily incorporates investigative measures directed against all relevant matters pertaining to restructuring, a series of operations including data analysis and field surveys amongst others.

There are different due diligence processes such as financial due diligence, legal due diligence, human resources due diligence, operational due diligence and the list goes on. Today we will focus on financial due diligence.

Let's understand, why financial due diligence is to be performed? Prime reason for conducting diligence is to showcase the corrective purchase price, also highlight any red flags in terms of 'go or no-go' situation for buyer (considering it is a buy side diligence). Below is the pictorial presentation of impact on purchase price of key due diligence processes collectively known as statement of adjustments.

| Enterprise value: Multiple of EBITDA or DCF<br>*Due diligence coverage: Quality of earnings adjustments on EBITDA of business* | - | Net Debt: Identify liabilities that could be considered as debt, and reduced from purchase price<br>*Due diligence coverage: Debt and debt like analysis* | +/- | Change in Working Capital: Level ofworking capital to be delivered at Closing(Target working capital).<br>*Due diligence coverage: working capital analysis* | = | **TOTAL PURCHASE PRICE**<br>**(Subject to other share purchase agreement considerations)** |
|---|---|---|---|---|---|---|

- **Quality of earnings (QofE) analysis**

The goal of a QofE is to adjust the reported EBITDA to calculate a proforma restated EBITDA that best reflects the current state of the company on an ongoing basis. The analysis also presents a historical adjusted EBITDA that is comparable throughout the last two or three years, thus reflecting the normalized EBITDA over the period of analysis.

The purpose of normalizing EBITDA is to assist clients with valuation, also safeguarding value erosion and leakage up to the date of closing. QofE adjustments are differences between the value of the business as stated at the reporting date and value arrived at the closing date. These adjustments are subjective as there are no strict rules for the same. Following are few illustrative adjustments that are provided to restate the EBITDA-

| Type | Example |
|---|---|
| **Accounting/ gap adjustments** | • Inappropriate iGAAP policies (revenue recognition, lease accounting, etc)<br>• Cut-off adjustments/ period adjustments<br>• Recognition adjustments<br>• Non provision of doubtful debts/ warranty/ guarantee/ employee |
| **Non-recuring transactions** | • "One-time" transactions such as legal settlements, unusual transactions, etc.<br>• Restructuring initiatives<br>• Sundry balances written-off/ written-back |
| **Proforma adjustments** | • Run-rate or ramp-up margin adjustments<br>• Increase in salary going forward<br>• Bonus/ incentives held back for previous years<br>• Hiring for vacant positions<br>• Impact of foreign exchange |
| **Management adjustments** | • Out of deal perimeter margins<br>• Personal expenditure (if any)<br>• Non-core activity margins<br>• Off book sales/ cash sales |

Above mentioned EBITDA adjustments are to arrive at the proforma adjusted EBITDA from the reported EBITDA. Likewise, the reported revenue of the seller can be adjusted to arrive at proforma adjusted revenue in a similar fashion by giving adjustments like one-off revenue, discontinued sales, revenue recognition changes, cut-off adjustments, etc.

➢ **Debt and debt-like analysis**

Most mergers and acquisition deals are negotiated on a cash-free and debt-free basis (CFDF). In simple terms, this means that the seller keeps all the cash and pays off the debt at the time of the sale of business. The idea seems straightforward, however, to arrive at the actual CFDF terms can be contentious point of the negotiation and thus affect the pricing of the deal.

The term cash-free means that the cash and cash equivalents like cash on hand, balance with banks, term deposits with banks, petty cash, etc will be subtracted from the reported debt, however, restricted cash, restricted fixed deposits are not subtracted, as they might be placed as security/lien for availing letter of credits, term Loans, forward contracts, and cash credit facilities. It becomes paramount to understand another term 'cash-like items', these are non-operational surplus assets, which are reduced from the reported net debt amount. Few examples of such assets are non-operating investments, government and marketable securities, obsolete assets, capex advances given, loans to directors, loans to related parties, etc.

The term net debt includes term loans, working capital loans, unsecured borrowings, vehicle loans, loans from related parties etc. Following are few illustrative adjustments that are provided to restate the net debt-

| Type | Example |
|---|---|
| **Financial items within net working capital (NWC) reclassified to debt** | • Current maturities of long-term debts<br>• Overdue trade payables<br>• Capex creditors net off advances given<br>• Accrued financial liabilities (such |
| **Obligations to pay cash with no additional benefit to the company** | • Proposed dividend and tax thereon<br>• Advance tax net of provision for |
| **Obligations that may/ may not result in cash outflows during the buyer's investment horizon** | • Unfunded pensions, gratuity, leave encashments<br>• Deferred tax liabilities<br>• Exposure to direct/ indirect tax liabilities |
| **Commitments and contingencies** | • Minimum purchase agreements<br>• Letter of credit<br>• Outstanding bank guarantees<br>• Capital commitments |
| **Other matters for consideration** | • Upgrades required for accounting, HR, or IT systems |

➢ **Working capital analysis**

In a transaction, working capital is calculated as current assets minus current liabilities, subject to all cash or debt balances which are excluded (including any cash-like or debt-like items). Furthermore, working capital is broken down in trade working capital and other working capital.

Trade working capital includes accounts for the business operations, mostly being inventories, trade receivables and trade payables. Other working capital includes the remainder of the working capital accounts, such as personnel liabilities, taxes payables and other current payables and receivables.

As the working capital is used to finance the day-to-day operations of the business, for a buyer it is important they receive a business after acquisition with sufficient working capital. The level of sufficient working capital is defined as the normal level of net working capital, also known as normalized working capital. The normalized working capital is to be then compared with the benchmark working capital levels also known as target working capital. Any excess/ shortfall between normalized and target working capital should be adjusted to the enterprise value.

Another way to understand the net debt and working capital would be to bifurcate/ tag each of the balance sheet items into either a debt-like item or working capital item, excluding the shareholders' funds and fixed assets which are neither of both. This exercise will make sure that none of the balance sheet items are inadvertently overlooked in the calculations.

In net working capital, seasonality is important to understand, because that indicates the maximum and minimum financing requirements in a yearly pattern. Buyer would then understand the peak seasons requiring greater funding as well as the slack seasons. The required level of working capital is generally calculated as the average of the last twelve months (LTM). By taking twelve months any seasonality impact is included.

For a transaction, it does not matter if the working capital is positive or negative. As long as it reflects the normal level needed to operate the business and there is no need for an additional capital contribution. For example, a normal negative level of working capital could be applicable in case of direct cash sales (i.e., shops or supermarkets) or business with a high level of prepayments.

➢ **Few general pointers for other key areas in due diligence processes**

- Before analysing any area in financial due diligence, any consultant should answer three questions, basis which they would have a perspective of key figures in analysis carried out,
    - What are the key performance indicators,as per the seller company's Management?
    - What are the key performance indicators,as per the buyer company's Management?
    - How are the industry dynamics currently viewed in this business?
- Analysing the year-on-year growth or fall, will help in better understanding of the delta in the business and eventually understand whether the same forms part of one-off expense/ income or any other QofE adjustment.
- Customer concentration or even excessive dependence on location, product/ service stream, could be a possible red flag.
- Transactions or contracts entered with related parties should be scrutinized for any possible abnormalities.
- Specific clauses in contracts or agreements entered with the customers or suppliers should be checked such as minimum commitment of revenue/ purchase, penalty clauses, guarantees, etc.
- General understanding of the industry with regards to market demand, supply chain, competitors, benefits offered or curtailed by the government, etc.

➢ **Due diligence processes in pandemic era**

While conducting due diligence under pandemic period with imposed travel restrictions, face-to-face meetings, on-site visits, physical verifications are no longer an option. Consulting firms are doing away with the traditional means of due diligences and now resorting to digital technology, thus using virtual data rooms with data protection and control access facilities.

With due diligence under pandemic era, the buyers/investors are trying to understand the short-term direct impact as well as seller management's long-term planning and operations. Below are few areas of financial due diligence that should be considered-

- **Revenue:** Analyse the top line impact with the sales trend before and after pandemic. Consider the supply chain and value chain to find potential laggard pandemic impacts. Consultants should also focus on demand for the products/ services in the post pandemic era. Also, the forecasts laid down by the Management should be given due importance while analysing revenue.

- **EBITDA margins:**Months directly affected by COVID cannot be indicative of the historical performance nor of the future outlook, therefore consultants should try to normalize the EBITDA and compare EBITDA with trends for the period before COVID-19 (on a seasonally adjusted basis) to impacted months. Comparison with peers in the industry and management's near-term forecasts could also be resorted.

- **Employee cost:** Understanding whether the company has resorted to employee lay-offs, suspension of pay, salary pay-cuts, deferred bonuses/ increments. In such cases, a run-rate and proforma adjustment wherein salaries/ bonuses have not been paid will need to be considered. Also, it becomes salient to analyse whether the current employee workforce is normative and there are no vacancies or shortages to sustain the revenue or EBITDA levels.

- **Other SG&A costs:** Adjustments for one-time expenses due to COVID-19 must be factored, force majeure clause in rental agreements must be referred in case of shutting down of premises, other expenses such as transportation costs, electricity, advertisement, and other SG&A costs will be analysed considering past year expenses and current absorption rates.

- **Working capital:** Due to pandemic, assessing the payment cycle of trade receivables and payables for bad debts and overdue payables became crucial. Monthly/ quarterly working capital and cash requirements analysis could be performed and then marry it with the financial position of the company.

- **Debt-like items:** Assessing whether the target has acquired additional loans to resolve the financial crises. Comprehending whether financial covenants and onerous clauses are met. Ability to repay debt post moratorium period will need to closely be looked upon along with the tag of 'going concern'.

➢ **Conclusion**

To conclude, while it is impossible to forecast the long-term effects of the outbreak, there is still a way out for well-informed parties to continue with their deals: by altering due diligence to serve as means of accelerating the transaction, rather than treating it as an obstacle, on account of the inability to conduct it in the traditional way.

Undoubtedly, in times to come "cash is the king", buyers with funding would be able to dominate and leverage their position to obtain favourable deals. Seller on the other hand, would want to adopt "wait and watch" approach rather than diluting their stake at lower side of the valuations. However, all said and done, buyers and sellers, both are flexing their muscles and there are no holdbacks from their sideswith M&A activities in India beingon rise and continuing higher.

*Note: Views expressed in this article can be subjective and that of the readers on the same topic may differ.*

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# "DREAMZZ UNLIMITED": STORIES THAT INSPIRE

CA Dinesh Ghalla
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I thank CVOCA for giving me a reason to jog down memory lane and relive some of the important events of my life and provide me with a platform to share some of my learnings with you.

I congratulate the team for this excellent idea that has provided me with an insight into the life of my fellow CA colleagues who shared their life learnings on this platform.

Some of my key life learnings over the four decades of my professional life are mentioned below before I provide the context of my journey:

1. Gratitude for what you have, your family and your background - you may not have everything but you do have something that can help you take the next step forward.
2. Take some calculated risks but don't be too aggressive and over optimistic. And it's okay to fail - don't let it dishearten you and learn from it and take the next step with calibrated risk.
3. Partner with people smarter than you, or who bring different skill sets and don't be afraid to divide your pie first and then wait for it to grow. Your understandings must be clearly articulated and documented as an MOU. Empower people, set them free with authority and responsibility and aim at building an Institution.
4. Ethics is not just some buzz word but something you have to fully believe in and live. Your ethical behaviour will eventually be noticed and appreciated.
5. Give back to society and positively contribute to others life and this is so fulfilling that it is its own reward.
6. The biggest investment is investment in people and relations and the biggest reward is trust and love that you gain in reciprocation.
7. Commit what you can deliver and then deliver what you committed.
8. Your physical, mental and spiritual wellbeing is paramount - stay objective with client and work demands without getting emotionally involved. Always value the contribution of the people who played an important role in making you what you are and care for the wellbeing of everyone in your team.
9. Understand the changing nature of competition and market demands - you will need to upskill, specialize and expand your team as more work gets automated or mundane - keep the focus on what the clients' requirements are and not what your current skill sets are - the skillsets for the individual and the firm need to evolve to be relevant and add value to the client relationship

Being born to Premkumari and CA Devchand Ravji Ghalla, who was the first CA of our CVO community in 1953 and the founder of CVOCA Association in 1973, I have eaten, lived and breathed about becoming a CA right from my birth in 1957. I was blessed to be born in a family that was always forward looking and adapting to times and encouraged risk taking, as my father also took up the uncommon profession of becoming a Chartered Accountant at a time when there were very few idols to look up to.

I have been an average student and took two attempts to become a CA! While I joined Sydenham College after going through two schools, St Ignatius High School and St Xaviers Boys Academy in my early years, I started CA foundation in 1977 and left Sydenham college to join Lala Lajpatrai College as it offered morning college which allowed me time during the day for my Articleship.

While my father had started 'Ghalla & Bhansali, Chartered Accountants (G&B)' with his friend CA Niranjan Bhansali in 1955, my father insisted that I do my articleship with another firm. I was fortunate to get an articleship at M/s P. C. Hansotia and Company, under CA H. H. Tapia with mentoring from my father's friend CA J. J. Gandevia, where I met extremely bright and talented fellow articles who have been my friends, family and even clients till date!

G&B was already 26 years old when I joined the 360 square feet office at Churchgate in February 1981. This was soon after I got married to Priti, in between my exams and results in December 1980. This really required me to be optimistic about my future and take some risks! I am grateful to Priti for having taken this risk in her life too, to move to Bombay after being born and brought up in Bhuj and being a pillar of strength for me and the family, through all my professional challenges, social commitments, financial struggles and successes.

The initial years were challenging for me personally as I was helping my father in servicing his clients and I couldn't objectively evaluate my potential and contribution. Working with family, it was also difficult to clearly understand my personal path to financial independence. The years from 1983 to 1986 were further difficult as my father had 4 heart attacks and had to be taken to the USA for treatment. During those years, he was unable to attend office regularly and this gave me a chance to handle work independently to the satisfaction of the clients while sharing his cabin but sitting in a chair next to his without occupying his seat. This was the time when I would find out if clients would continue with our firm in my father's absence after his untimely death at the age of 56 in 1986. Barring one group, all other clients continued with us and this was a big achievement at that time for us.

In 1986, just 5 years after being in G&B and in the year my father passed away, CA Haresh Chheda joined G&B as a partner. In 1988 we expanded to Masjid Bunder with another office and CA Mukesh Dedhia and Vijay Nandu joined as partners. These were risks for me as a young professional to take - our senior partner CA Niranjan Bhansali was not convinced about these actions and I took a calibrated risk by reducing my share in the firm in favour of the incoming partners.

In 1989, Vipul Vira joined us to deepen our client relationships by helping them address their financial requirements. Later, CA Mukesh Dedhia noticed an upcoming opportunity where clients required a professional approach towards investments. In 1990, he retired from the CA practice and led our joint activity as a sub-broker, furthering our foray into the field of finance. This was the coming together of a family that was built by G&B ex-articles, partnering together to grow and diversify the areas of activity. In November 1994, we took a bold step by taking membership of the NSE when it was launched and I surrendered my certificate of practice (COP) for 2.5 years as I needed to look into that business.

In 1995, we found a like minded firm, M/s. S. K. Rambhia and Co., and decided to merge practices. This was an emotional decision for both firms as CA Shantilal K. Rambhia was the second article of G&B in the early 1960s. After 3 years of the merger, we jointly evaluated our merger synergies and decided to amicably demerge and separate out again. Some decisions may not work out as planned and we have been fortunate to have found partners who all dealt with this gracefully and we continue to have great mutual respect and a cordial relationship till date.

Clarity between partners is a must and having a clear MOU with retirement plans should be made as soon as possible and I would have loved to have this initiated and made when we were younger but in an an urge to grow the firm to the next level, urgent and pressing client matters took precedence over the important and internal partnership related matters in those years.

Good human relations, financial acumen and out of the box approach has been effective in motivating the team and maintaining close relationships with clients. Our clients have been a great source of our strength and some of them have evolved to be our friend, philosopher and guide. A deep understanding of the client's business and family situations have enabled us to be involved as an arbitrator in a number of family matters of the clients - this is the true test of one's objectivity. It has been rewarding to see some amicable resolutions that have protected the personal and financial wellbeing of the clients and their businesses.

I have followed my father's footsteps and tried to contribute towards society in a small way. Seeing him be the founding president of CVOCA Association in 1973, Lions Club in 1974, Jain Social Group of Bombay South in 1976 and be the past president of KVO Seva Samaj in 1960, and through the institutions he built, his impact on society is felt today, even 35 years after his death. Being a founder (1995) and President (2014-16) of Kutch Corporate Forum (KCF), past president of CVOCA Association in 1992-93, election officer for multiple elections for the CVO Deravasi Jain Mahajan and other trusts, have been very satisfying experiences. I encourage everyone to do their bit to serve society selflessly in any manner that appeals to them.

Looking back, I can see that I have sacrificed family and health in the earlier years due to work pressure. Not being able to effectively balance the load, lead to early onset of hypertension - one key learning is that balance is a must and one must strive to stay objective with client demands and not get emotionally involved in client matters. Having done Vipassana meditation from 1991 has helped keep these stressors controlled to some extent.

Today, 66 years later, G&B has evolved its identity to GBCA & Associates LLP, Chartered Accountants as a full-service firm, after having had offices in Churchgate, Masjid Bunder, Dadar and now at Lower Parel. The articles have been our greatest treasure as we continue to be personally and professionally engaged with a number of them. As the firm has grown from two partners to a dozen partners, seven of the partners are ex-articles of the firm. There is immense satisfaction in having been able to help create 283 CAs, with a number of rank-holders, out of the 455 articles that have been associated with us. We are thankful to everyone who has been, and is currently a part of GBCA for always keeping the firm ahead of the individual. I am also very grateful to the wonderful partners I have had - professionally, in social organizations and in my life - and having love and respect from these people in my life, is one of life's greatest rewards.

# EVENTS IN RETROSPECT

| Day & Date | Committee | Program Name | Speaker | Attendance / Views |
|---|---|---|---|---|
| 29th October 2021 (From 6:00 PM to 8:00 PM) Physical Meeting | Capital Market Committee | Preparing Market Myths | Chairman - Speaker Nimesh Chandan | 40+ |