Advantages of converting the Partnership Firm into Private limited company:

Stamp Duty

All movable and immovable properties of the firm automatically vest in the Company. No instrument of transfer is required to be executed and hence no stamp duty is required to be paid.

Capital Gain Tax

No Capital Gains tax shall be charged on transfer of property from Partnership firm to Company.

Other Advantages

1. Separate legal entity.
2. Perpetual succession
3. Easy transferability of shares
4. Distribution of profits by way of dividends
5. Remuneration to directors.
6. Limited liability of members
7. Raising of capital through Issue of equity/ preference shares and debentures
8. Favourable attitude of financial Institutions while granting various facilities.

Precautions

1. Interest on capital cannot be paid.
2. Deposits can be accepted only from Members, Directors and their relatives
3. All legal proceedings by and against the company remain continued even after the conversion.

Effect of Registration under part IX of the Companies Act 1956[the Act] [Section 565 to 581 of the Act]

VESTING OF PROPERTY:

All property, movable as well as immovable, including actionable claims belonging to or vested in the firm at the time of registration shall, on such registration, pass to and vest in the company as incorporated under Part IX. [Section 575]

The registration of a company under Part IX shall not in any manner affect its rights or liabilities in respect of any debt or obligation incurred or any contract entered into, by, to, with or on behalf of the firm before registration. [Section 576]

All suits and other legal proceedings taken by or against the company or any public officer or member thereof which were pending at the time of registration may be continued in the same manner as if registration had not taken place. However, no execution can be done against the property or person of any individual member of the company on any decree or order obtained in such suit or proceeding. If the property of the company is inadequate to satisfy the decree or order, an order for winding up the company may be obtained. [Section 577]

All provisions of any Indian law or other instrument constituting or regulating the company shall apply to the registered company in the same manner as if the company had been formed under the Companies Act, 1956 and those conditions were required to be contained and were contained in its Memorandum and Articles of Association. [Section 578]

INCOME TAX ACT 1961:

As per section 45(1), profits and gains arising from the transfer of a capital asset **effected** in the previous year is chargeable to tax. The term "effected" as used in section 45(1) has a special meaning. Existence of the party (transferor) and the Counter party (transferee) is necessary for the applicability of section 45(1).

A decision of the Bombay High Court in *CIT v Texspin Engineering and Manufacturing Co. (2003) 263 ITR 345 (Bom)* has held that such conversion of firm into company by following the route under Part-IX of the Companies Act, 1956, does not occasion capital gains, since there is no transfer involved in such a case. The High Court after considering the provisions of Companies Act, provisions of income tax relating to capital gains and relying on the ratio of *Malbar Fisheries Company v CIT (1979) 120 ITR 49 (SC), CIT Vs. George Henderson & Co Ltd*

(1967) 66 ITR 622 (SC), CIT Vs. Gillanders Arbuthnot & Co (1973) 87 ITR 407 (SC), held that, when a firm is registered as a company, as per the procedure prescribed under Part IX of the Companies Act, no capital gains arise to the firm. When a partnership firm is treated as limited company, under Part IX of the Companies Act, the properties of the erstwhile firm vests in the limited company as they exist. There is no dissolution of the firm. Hence section 45 (1) of the Income Tax Act is not applicable. When shares of the Company are allotted to partners in consideration of capital standing in their accounts in the firm, there is no transfer of capital assets as contemplated under section 2(47)(iii) of the Income Tax Act (i.e. compulsory acquisition, thereof under any law), as partners are getting their own right to share Capital.

In *Well Pack Packaging Vs. Dy. CIT (2003) 78 TTJ (Ahd.) 448,* also the same view was taken that, corporatisation of the firm under the part IX route did not attract liability to Capital Gains in the hands of the firm. **In *Vali Pattabhiram Roa v Shri Ramanuja Ginnning & Rice Factory (P) Ltd. (1986) 60 Comp case 568 (AP),*** the Court has held that there is no transfer under general law if the constitution of the firm is changed to that of a company by registering it under Part IX of the Companies Act, as there shall be statutory vesting of title of all the properties of the firm in the newly incorporated company without any need for a separate conveyance.

<u>EXEMPTION UNDER SECTION 47(xiii) of the Income Tax Act:</u>

The Finance (No 2) Act, 1998, inserted section 47(xiii) with effect from assessment year 1999-2000. Clause (xiii) of section 47 provides that section 45 of the Income Tax Act would not apply to transfer of any building, machinery, plant, furniture or intangible asset (ie capital assets) to the company where a firm is succeeded by the company in the business carried on by it subject to certain conditions. These conditions are:

(i) that the transfer should be of business as a going concern with all assets and liabilities,
(ii) that the consideration for the transfer should be solely by issue of shares to the extent of partners' capital in the firm,
(iii) the partners of the firm do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company and
(iv) the interest of the partners in the paid-up capital of the company should continue and be retained at least to a minimum extent of 50 percent for the next five years.

Section 47(xiii) confers an exemption to encourage business reorganization and, therefore, should be interpreted in a manner that promotes the objective to be achieved and not frustrated. *(Bajaj Tempo Ltd. v CIT, 196 ITR 188)*

The decision of the Bombay High Court, regarding conversion of a firm to a company through the Part IX route, rendered in favour of the assessee was prior to the insertion of the exemption under section 47(xiii). **This means that even after the introduction of clause (xiii), there would be no liability as regards capital gains even if the conditions specified in the above mentioned clause are not adhered to.** It is, therefore, advisable that Part IX route is followed, wherever feasible, while taking care to adhere to the conditions under section 47(xiii) of the Income-tax Act, as a matter of abundant caution and additional shelter. Section 47(xiii) provides for exemption for capital gains tax on transfer of capital assets from the firm to the company subject to the conditions listed in the proviso. But the threshold condition is that, the transfer should have arisen as a result of succession of the firm by a company.

STEPS FOR INCORPORATION OF COMPANY UNDER PART IX:

Step 1: Hold a meeting of the partners to transact the following:

Assent of majority of its members as are present in person or where proxies are allowed, by proxy, at a general meeting summoned for the purpose of registering the firm under Part IX of the Companies Act, 1956. The majority required to assent as aforesaid shall consist of not less than ¾ of the members as are present in person or where proxies are allowed, by proxy.

To execute a supplementary Partnership Deed to align it with the requirements as under:

- There must be atleast 7 partners in the partnership firm;
- The firm may be registered with the Registrar of Firms[in some cases ROC insists that the First should be registered with the Registrar of Firms];
- There must be a fixed capital divided into units;
- There must be provision of converting a firm into company;
- There must be an agreement by the partners to convert the partnership to a company.
- This can be done by a contract in writing to this effect to which the partner's resolution for conversion can be attached as annexure.

Execute a settlement deed.

Step 2: Application for Director's Identification Number for all the proposed directors and Digital Signatures Certificate for atleast one director who will sign the documents/forms digitally.

Step 3: Name approval:

Under the Part IX route, one of the major advantages is that the business can be run under the same name as that of the firm except that in addition to the name of \ the firm the words 'limited' or 'private limited' has to be added. However, if there is a company already in existence, the name would not be available.

The following steps need to be taken.
An application in e-*Form No. 1A* needs to be filed with the Registrar of Companies (ROC) with necessary documents related to partnership firm.

Step 4: Registration of Company:

After obtaining the approval of name, following **e-Forms** are required to be filed with the Registrar of Companies **within 60 days** from the date of name approval:

Form No. 1 – Along with Memorandum and Articles of Association of the proposed company and Power of Attorney signed by all the subscribers of the Memorandum of Association authorizing one of the subscribers or any other person to act on their behalf for the purpose of incorporation and accepting the certificate of incorporation.

Form No. 18 - This is a form to be filed by one of the directors of the company informing the ROC the registered office of the proposed company.

Form No. 32 - This is a form stating the fact of appointment of the proposed directors on the board of directors from the date of incorporation of the proposed company and is signed by one of the proposed directors. **Consent letters from the proposed directors are required to be attached if the proposed company is a Public Limited Company**.

Form No. 37 – Along with a copy of the instrument constituting or regulating the company.

Form No. 39 – Along with a copy of resolution passed at the general meeting assenting to registration with limited liability and a List of equity or preference shareholders.

Steps after incorporation of company under Chapter IX of the Act :

Once the new company is formed, the takeover agreement would be entered between the Partnership Firm and the newly incorporated company and to be adopted in the Board Meeting.

In such a situation, the entire business of the firm along with all its assets and liabilities is transferred to the company.

The company may issue shares or other securities to the Partner of the firm.