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Carry forward and set-off of losses allowed on conversion of US sub-trust into series / sub-fund of Limited Liability Company

The Bombay High Court rendered its decision that conversion of US sub-trust into series / sub-fund of a limited liability company did not constitute a new entity and thus, allowed carry forward and set-off of losses

Facts of the case:

- Aberdeen Asia Pacific Including Japan Equity Fund, Aberdeen Emerging Markets Equity Fund and Aberdeen Asia Pacific Excluding Japan Equity Fund [taxpayer(s)][1] are sub-funds of Aberdeen Institutional Commingled Funds, LLC (AICFL).
- AICFL is a Delaware (USA) based limited liability company (LLC). AICFL invests and deals in all securities and instruments across the world and has set-up various investment schemes in the form of 'sub-funds' or 'series' with different sets of investors for investing in specific strategies.

  AICFL was originally set-up as a Trust under the laws of the State of Delaware, USA, known as Aberdeen Delaware Business Trust (Trust), with three sub-trusts i.e. the taxpayers.
- In 2010, AICFL was reorganised / converted from Trust into an LLC, as per the Trust Act and the LLC Act in the State of Delaware, USA. Consequently, the three sub-trusts (i.e. the taxpayers) were converted to sub-fund / series of AICFL without dissolution.

  Both the US Securities and Exchange Commission and the Securities and Exchange Board of India (SEBI) accepted the conversion as nothing more than a change of name of the entity. Further, the taxpayers continued to use their existing sub-account registration with the SEBI for investing in India.
- The Indian tax authorities treated the taxpayers as separate independent entities from the LLC (i.e. AICFL), both before and after conversion. Prior to the conversion, the taxpayers as sub-trusts had incurred losses under the head capital gains and had disclosed the same in the Indian income-tax return. The taxpayers carried forward the said losses after conversion into sub-fund / series of the LLC under the provisions of the Indian Income-tax Act, 1961 (ITA).

Proceedings of AICFL (having bearing on the taxpayers' case)

- On 16 April 2012, AICFL filed an application before the AAR to determine whether AICFL (post conversion to LLC) was entitled to carry forward the accumulated losses as incurred by the taxpayers, for Indian income-tax purpose. However, the AAR (vide its order dated 21 February 2018) denied the carry forward of losses in the hands of AICFL.

[1] Aberdeen Asia Pacific Including Japan Equity Fund v. DCIT [2020] 117 taxmann.com 185 (Bom HC)

- On appeal, the Bombay High Court (HC) vide its order[2] dated 8 March 2019 upheld the AAR order and denied the carry forward of losses in the hands of AICFL, on the following grounds:
  – Based on principles of private international law, the status of an entity incorporated abroad was to be determined (even in India) according to the laws of the country of incorporation.
  – Under the laws of Delaware, AICFL (both as Trust and as an LLC) continued to be the same person and this position was accepted in India. Therefore, any gains or losses incurred by AICFL in its earlier *avatar* could not be denied only because of change in the status from Trust to LLC.
  – The HC noted that the AAR had denied carry forward of losses not due to change in legal status but due to the fact that AICFL was not the taxpayer, which had claimed the loss in the earlier assessment year.
  – AICFL was not possessed of any carried forward losses from earlier years, which could be set-off. It had not filed any income-tax return in India and did not have any Permanent Account Number.

  However, the HC clarified that the AAR ruling did not have impact on the three 'series' (i.e. the taxpayers) to claim the benefit of carry forward of losses (if entitled) as per the provisions of the ITA.

Audit proceedings in taxpayers' case

- In light of the AAR order in AICFL's case, the Assessing Officer disallowed the set-off and carry forward of losses and reassessed / assessed the income of the taxpayers for Financial Years (FY) 2010-11 and 2011-12, corresponding to Assessment Years (AY) 2011-12 and 2012-13, respectively.

  The same was on the basis that the old trust fund and the new LLC fund (i.e. the taxpayers) were separate legal entities for the purposes of the ITA. Therefore, the loss of the old trust fund could not be carried forward and / or set-off by the new LLC fund i.e. the taxpayers.
- The AO issued draft orders (considering that the taxpayers were non-residents) in this regard, as per the provisions of the ITA.
- Aggrieved by the AO's draft orders, the taxpayers filed writ petition before the Bombay HC.

Decision of the Bombay HC:

- The Bombay HC relied on the Supreme Court case[3], wherein it was held that questions as to the status of a corporation are to be decided according to the laws of its domicile or incorporation subject to certain exceptions including the exception of domestic public policy.
- The Bombay HC noted that the Revenue's stand during the proceedings before the Bombay HC (in relation to the AICFL's case) was that:

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[2] Aberdeen Institutional Commingled Funds LLC, v. AAR [2019] 104 taxmann.com 63 (Bom HC)

[3] Technip S.A. v. SMS Holding (P.) Ltd. [2005] 5 SCC 465 (SC)

- The Revenue had not disputed that the status of AICFL was to be decided by the law of the country of incorporation i.e. the State of Delaware, USA in the case under consideration.
- AICFL was not a taxpayer under the ITA and consequently had not filed an Indian income-tax return. Therefore, AICFL was not entitled to carry forward the losses.
- It was the three ‘series’ (funds) i.e. the taxpayers, each of which was a recognised taxpayer under the ITA which was entitled to carry forward the losses, if otherwise permitted.

- The Bombay HC also took note of the decision of the Bombay HC in AICFL’s case, wherein it was held that gain and loss earned by AICFL in its earlier *avatar* would not be denied only because of the change in status from Trust to LLC.
- In view of the above, the Bombay HC held that:
  - The gain and loss earned by the taxpayers in their earlier *avatar* could not be denied because of change in status from sub-trust of the Trust to ‘series’ (funds) of the LLC.
  - The finding of the AO that old trust fund and the new LLC fund are separate legal entities for the purposes of the ITA and therefore, loss of the old trust fund could not be carried forward was a misreading of the judgement of the Bombay High Court in AICFL’s case.
- In view of the above, the Bombay HC set aside and quashed the draft assessment orders passed by the AO and allowed the claim of carry forward of losses to the taxpayers.

Comments:

- Eligibility to claim carry forward and set-off of losses on reorganisation of taxpayer entity has been a litigative issue. This ruling re-affirms the principle that questions relating to the status of a person have to be decided according to the laws of its domicile or incorporation, subject to certain exceptions. Further, this ruling lays down principles applicable for carry-forward of losses in cases of conversion from US trust to LLC.