

Tax Alert: Shareholders liable to capital gains on conversion of company into LLP: AAR

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Summary

The Income-tax Act, 1961 (the Act) provides capital gains tax exemption on conversion of a company into a Limited Liability Partnership (LLP) subject to the fulfilment of specified conditions. However, the manner of levy of tax in cases where the specified conditions are not fulfilled has been a subject matter of litigation.

In a recent decision¹, the Authority for Advance Ruling (AAR) has held that shareholders of a company which does not meet the specified conditions upon its conversion to an LLP would be liable to capital gains tax on the difference between the full value of consideration and the cost of acquiring the shares.

Background

- The Applicant, a UK resident, proposed to convert its Indian subsidiary into an LLP in accordance with the LLP Act, 2008.
- The Indian subsidiary did not meet one of the conditions of capital gains tax exemption², ie sales/turnover being less than INR 60 lakh in the preceding three years.
- In this regard, the Applicant approached the AAR to seek a ruling on tax implications in the hands of the Applicant, ie the shareholder upon conversion of equity shares into partnership interest in the LLP.

Applicant's contention

- **Definition of 'transfer' not satisfied:** The Applicant contended that conversion of equity shares into partnership interest will not tantamount to 'transfer'³ as it does not satisfy the following limbs in the definition

of 'transfer' under section 2(47) of the Act which are relevant in the instant case:

Sale	It is not a sale.
Exchange	It is not an exchange as 'exchange' postulates existence of two parties. In the present case, since the company and LLP do not co-exist, the conversion would not result in an exchange.
Relinquishment	The prerequisite for relinquishment is the existence of two parties along with the requirement that the asset being transferred continues to exist after the relinquishment. In the present case, as the

¹ Domino Printing Science Plc (AAR No.1290 of 2012)

² Specified under clause (e) of section 47(xiii b) of the Act

³ Section 2(47) of the Act defines 'transfer' as "sale, exchange or relinquishment of the asset; or the extinguishment of any rights therein ..."

	shares do not continue to exist after conversion, the transaction does not result in the relinquishment of an asset.
Extinguishment of rights	In such cases, the right in one entity should be merged or consolidated with another. In the present case, there is no merger/consolidation but mere conversion and the LLP came into existence after the conversion when the company ceased to exist.

- **Computation mechanism fails in the absence of a ‘consideration’:** The Applicant argued that in the absence of any consideration upon conversion of a company into LLP, the computation mechanism prescribed under the Act fails. Hence, provisions related to charging capital gains cannot be applied.
- **No profit or loss arose:** The Applicant further argued that since the value of shareholders’ fund in the company is equal to the partnership interest in the LLP, no profit or gain arose pursuant to the subject conversion.

Revenue’s contention

- **Definition of ‘transfer’ is inclusive:** The Tax Department contended that the definition of ‘transfer’ under the Act is an inclusive definition and even covers transactions which are not specifically mentioned.
- **Both ‘extinguishment’ and ‘exchange’ condition satisfied:** The Tax Department pointed out that as per the LLP Act, upon conversion, the company gets dissolved and removed from the records of the Registrar of Companies and consequently, the shares in the company are extinguished upon dissolution. Thus, the Tax Department argued that the transaction results in ‘transfer’. As regards the Applicant’s submission that extinguishment takes place only when there is a merger, the Tax Department relied on various Supreme Court rulings⁴ to refute the Applicant’s contention. Further, the Revenue also contended that conversion of company into LLP would also qualify as ‘exchange’ as the parties involved are the applicant and the LLP and the asset being exchanged is equity shareholding with partnership interest.
- **Computation mechanism workable:** The Revenue contended that the computation mechanism does not fail as the consideration is received by the shareholders as partnership interest in the LLP⁵. The Revenue also placed reliance on provisions of the Act⁶ which deem fair

⁴ CIT v Grace Collis [2001] 248 ITR 323 (SC); Kartikeya V. Sarabhai v CIT [1997] 228 ITR 163 (SC); Anarkali Sarabhai v CIT [1997] 224 ITR 422 (SC)

⁵ Per section 58(4)(c) of the LLP Act

⁶ Section 50D of the Act

market value as the consideration received or accruing upon transfer.

AAR's observations and ruling

Conversion of company to LLP not meeting conditions specified in section 47 (xiiib) amounts to 'transfer' under the Act

- The AAR held that the conversion of a company into an LLP results in a 'transfer' on account of the following:
 - All tangible and intangible properties of the company stand 'transferred' to and vested in the LLP.
 - Upon such vesting, not only the share capital of the company but also the shareholders' interest in the shares of the company get 'extinguished'.
- The AAR rejected the reliance placed by the Applicant on a Bombay High Court ruling⁷ by stating that the facts of that case were distinguishable⁸.
- Thus, the AAR ruled that since the cumulative conditions under the Act for claiming capital gain tax exemption are not fulfilled, the transaction shall be taxable.

Computation provision under section 48 of the Act

- As per the AAR, the mode of computation is provided in section 48 of the Act, which provides as under -

"The income chargeable under the head "Capital gains" shall be computed, by deducting from the **full value of the consideration received or accruing as a**

result of the transfer of the capital asset the following amounts, namely:

- (i) expenditure incurred wholly and exclusively in connection with such transfer;
- (ii) the **cost of acquisition** of the asset and the cost of any improvement thereto."

- **Full value of consideration:** The AAR referred to the Mumbai ITAT decision⁹ wherein it was held that as the assets and liabilities of the erstwhile company got vested in the LLP at their book value, such book value could be regarded as the full value of consideration for the purpose of computation of capital gains. Reliance was also placed on Kolkata ITAT's decision¹⁰ where the book value of the company's shares transferred to the LLP was treated as the consideration received for transfer by way of conversion.
- The AAR held that the Applicant acquires partnership interest in consideration of relinquishment of shares in the company. Therefore, in the instant case, the full value of consideration for purposes of section 48 of the Act will be the value of partnership interest in LLP.
- Further, such full value of consideration has to be adjusted for any extra benefit received, whether directly or indirectly. In case the value of consideration is not ascertainable, section 50D of the Act

⁷ CIT v Texspin Engg & Mfg. Works [2003] 263 ITR 345 (Bombay)

⁸ In this case, a partnership firm was registered as a company under Chapter IX of the Companies Act, 1956 and the question before the HC was whether vesting of the erstwhile firm in the limited company was covered by the expression 'transfer by way of distribution' in Section 45(4) of the Act.

⁹ ACIT v Celerity Power LLP [2018] 100 taxmann.com 129 (Mumbai-Trib.)

¹⁰ Aravali Polymers LLP v JCIT [2014] 47 taxmann.com 335 (Kolkata Trib.)

provides the fair market value to be deemed as the full value of consideration.

- **Cost of acquisition:** On the other hand, the cost of acquisition for the shareholder is the amount paid to purchase the shares.
- In view of the above, the AAR ruled that the computation mechanism in case of conversion of a company to LLP does not fail.

Value of the partnership interest equated to the shareholders' interest in the company

- The AAR observed that the value of shareholders' fund as appearing in the books of the company being equal to the value of partnership interest in the LLP is not a relevant factor for working out the capital gains in the hands of the shareholder.
- The precise asset of the shareholder that was extinguished upon conversion was the specific shareholding in the company, which was different and distinct from the shareholder's fund as appearing in the books of the company. The reserves and surplus appearing in the books of the company remain the property of the company till such time that they are distributed to the shareholders as dividend.

- The cost of acquisition of shares cannot be deemed to be equal to the cost of acquisition of partnership interest in the LLP; rather, it would be the purchase price paid by the shareholders to acquire the shares whose rights are being extinguished.
- Even in case where the cost of acquisition of the shares is taken equal to the value of partnership interest in the LLP, it will lead to a tax-neutral transaction and cannot be equated with failure of the computation mechanism.

Our comments

The AAR in this case has intricately discussed the issues at hand and has undertaken a detailed analysis of key rulings delivered by various courts in this context. Though the AAR's decision is not binding on other taxpayers, it does have a persuasive value. It is desirable that while evaluating the tax implications in similar transactions, the AAR's observations are carefully considered.

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