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EY Tax Alert

Shareholder liable to capital gains tax on receipt of partnership interest against shares on conversion of a company into an LLP under the LLP Act

Executive summary

This Tax Alert summarizes a recent ruling[1] of the Authority for Advance Rulings, New Delhi (AAR), dated 23 August 2019, in the case of Domino Printing Science Plc. (Taxpayer). The AAR, in this case, held that conversion of a company into a limited liability partnership (LLP) in accordance with the provisions of The Limited Liability Partnership Act, 2008 (LLP Act) results in transfer of shares by the shareholders of the converting company. The AAR further held that the value of interest in the LLP is to be considered as the “full value of consideration” received on the transfer of shares for the purpose of computation of capital gains under the Indian Tax Laws (ITL).

[1] AAR No 1290 of 2012
Background

- Under the ITL, capital gain arising from transfer of a capital asset is subject to tax in India. Transfer of a capital asset has been defined to include sale, exchange, relinquishment or extinguishment of any right in the capital asset. Capital gain for this purpose is computed by deducting the “cost of acquisition (COA)” of the capital asset from the “Full Value Consideration (FVC)” accruing on transfer of the capital asset.

- The LLP Act contains enabling provision for conversion of a company into an LLP. Conversion is defined under the LLP Act to mean transfer of the property, assets, interests, rights, privileges and obligations and the undertaking of the company to the LLP. Furthermore, as per the LLP Act, on conversion, all the assets, interests, rights, privileges, liabilities and obligations of the company are automatically transferred to and get vested in the LLP and the converted company stands dissolved.

- However, under the specific provisions of the ITL, a conversion of a company into an LLP in accordance with the LLP Act, which satisfies certain specified conditions, is not subjected to capital gains tax under the ITL for the company as also the shareholders of the company (exemption provision).

- If any of the conditions, subject to which the exemption is granted, is breached, then the capital gains which was exempted under the ITL in the year of conversion is subjected to tax in India in the hands of the successor LLP or, as the case may be, in the hands of shareholders of predecessor company in the year of breach (claw back provision).

Facts

- The Taxpayer, a tax resident of UK was a 100% shareholder of an Indian company (ICo). During the relevant year, ICo was converted into an LLP in accordance with the LLP Act. In the process of conversion, the shareholding of the Taxpayer in ICo was transformed into a partnership interest in the LLP.

- As one of the conditions specified in the exemption provision was not satisfied such conversion was not covered by the exemption provisions.

- The Taxpayer filed an application before the AAR and raised following issues for consideration:
  - Whether conversion of equity shares held by the Taxpayer in ICo into partnership interest in the LLP, consequent to the conversion of the ICo into an LLP, would be regarded as a “transfer” within the meaning of the ITL?
  - Whether the computation provisions of the ITL are capable of being applied to such transfer?
  - Whether the transaction can give rise to any taxable capital gains in the hands of the Taxpayer, when the value for the partnership interest in the LLP is the same as the value of the Taxpayer’s interest in ICo?
**Taxpayer’s contentions**

► In the absence of two parties to a transaction, conversion cannot be categorized as an exchange, relinquishment or extinguishment of an asset.

► Further, “relinquishment of an asset” necessitates existence of the asset relinquished. On conversion, the shares of the company cease to exist and, hence, conversion cannot be categorized as a “relinquishment”.

► Moreover, there is no extinguishment of rights of the shareholders in shares of the company as conversion merely results in substitution of the shareholding with partnership interest and the shareholders continue to hold partnership interest in the same proportion as their shareholding in the company.

► Existence of an exemption provision does not mean that conversion is subject to capital gains tax under the ITL. Where conversion does not result in transfer and/or no profits or gains arise on conversion, such transaction cannot be subject to capital gains tax.

► The Supreme Court (SC) decision in the case of Grace Collis [2] which held that amalgamation results in extinguishment of rights in shares of the amalgamating company resulting in a transfer for the shareholders of the amalgamating company cannot be applied to the case of conversion.

► The Bombay High Court (HC) ruling in the case of Texspin Engg. & Mfg. Works [3] and the LLP Act support the proposition that conversion merely results in a change in legal status/cloak of the converting entity without any change in the persons beneficially owning the asset.

► In the present case, the shareholder’s fund, comprising share capital, reserves and surplus and money received against share warrants, got converted into partnership right and the interest in the LLP of an equal value. Hence, there would be no profit or gain accruing to the Taxpayer pursuant to conversion into LLP.

► Further, on conversion there is neither a consideration flowing to the company nor there exists a co-relation between the transfer of properties by the company to the LLP and receipt of partnership interest in the LLP. Hence the computation mechanism fails.

**Tax Authority’ contentions**

► The definition of “transfer” under the ITL is inclusive in nature and covers within its ambit even transactions which are not specifically listed in the definition.

► Company and LLP are two distinct legal entities and by virtue of conversion, shareholding of the Taxpayer is transferred in consideration of receipt of partnership interest. Thus, conversion of one asset into another asset results in transfer.

► The LLP Act clarifies that on conversion, the company is deemed to be dissolved and removed from the records of the Registrar of Companies. On dissolution, the shares of the shareholders get extinguished resulting in a transfer under the ITL.

► Taxpayer’s contention that extinguishment of right takes place only in case of merger and amalgamation is not correct. Courts have held that reduction of capital [4] as well as redemption of preference shares [5] also results in “extinguishment”.

► Even otherwise, in the instant case, two persons were involved viz. Taxpayer and the LLP and there is an exchange of shares in the company with the LLP interest.

► The contention that the computation mechanism fails is incorrect. The Taxpayer receives partnership interest as a consideration for extinguishment of shares. In any case the ITL has a deeming provision which deems the fair market value (FMV) on the date of transfer as the FVC [6].

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[6] Section 50D of the ITL
AAR Ruling

On whether conversion would be regarded as a “transfer” of a capital asset

► The definition of transfer in the ITL is inclusive and, therefore, extends to events and transactions which may not otherwise be “transfers” according to ordinary, popular and natural sense of the term. The ITL also clarifies that transfer includes parting of any asset or any interest therein.

► There is no dispute on the fact that the shares held by the Taxpayer in ICo were no longer in existence on conversion and the same were replaced with the partnership interest in LLP.

► As per the LLP Act, conversion results in dissolution and vesting of all the assets of the company into LLP. On such vesting, the share capital of the company along with the interest of shareholders in the shares of the company gets extinguished. Thus, the contention of the Taxpayer that conversion does not result in transfer is incorrect. Alternatively, exchange of shares in the company with partnership interest results in an extinguishment of rights in the shares or parting of interest in the shares and, hence, qualifies as transfer under the ITL.

► The proposition laid down by the Bombay HC in the case of Texspin Engg. & Mfg. Works (supra) for determining capital gains taxation in the hands of the shareholder on conversion is not applicable in the impugned case for the following reasons:

► The Bombay HC in the case of Texspin Engg. & Mfg. Works (supra) was concerned with the issue of whether succession of a partnership firm by a company results in “transfer by way of distribution on dissolution of the firm”. The HC held that succession of firm by company does not result in transfer by way of “distribution”. Thus, this decision cannot apply to conversion. In any case the Bombay HC noted that there is extinguishment of rights in capital asset on reconstitution of the firm and introduction of new partners. This supports the latter proposition that conversion results in transfer for shareholders.

► Conversion of company into LLP is different from succession of partnership firm by company. The LLP Act specifically acknowledges that conversion of company into LLP results in transfer of all assets to the LLP.

► The argument that there is a change of cloak as propounded by the ruling of Texspin Engg. & Mfg. Works may apply to the company but not the shareholder. Hence, it will have no relevance in evaluating the implications in the hands of the shareholders.

► The other decisions relied by the Taxpayer have also, in turn, relied on the ratio of Texspin Engg. & Mfg. Works (supra) and, hence, cannot be applied in the present case.

► The Bombay HC ruling was delivered in relation to a year before the exemption provisions in respect of conversion of firm to company and provisions in respect of conversion of company to LLP were introduced into the ITL and, hence, cannot be applied to the facts of the present case.

► The contention that charge of capital gains trigger only when there is a transfer between two existing parties at a time is also not acceptable. The ITL nowhere requires existence of a counter-party for taxation of capital gains. This is evident by the fact that even conversion of capital asset into stock-in-trade is considered as transfer under the ITL.

► Reliance on judicial precedents

► The SC in the case of Grace Collis (supra) concluded that the extinguishment of a right includes extinguishment of a right in a capital asset independent of and otherwise than on account of transfer. As conversion results in extinguishment of the rights of the Taxpayer in shares of ICo, it results in a transfer under the ITL.

► The Mumbai Tribunal Special Bench (SB) decision in the case of Bennett Coleman & Co. Ltd. [7] was concerned with a case in which no consideration was received on capital reduction and it is for such reason that it was held that computation mechanism fails and capital loss arising from such reduction is not allowable under the ITL. The issue of whether extinguishment of a right in an asset in itself results in transfer was not disputed before the SB.

[7][2011] 14 taxmann.com 1 (Mumbai)
The AAR in the case of Umicore Finance Luxemborg[8] was concerned with the applicability of the claw back provisions to a company in the context of conversion of a firm into a company. The AAR held that where the worth of shares allotted in the successor company is equal to the value of interest in the firm, no gains accrue or arise on conversion and, hence, there should not be capital gains tax liability under ITL. The ratio of the AAR ruling is applicable only to the converting company and cannot be extended to the shareholders of the company.

The SC in the case of Kartikeya V. Sarabhai (supra) held that reduction of face value of shares by paying a part of the capital results in extinguishment of proportionate rights in the shares of the company and, hence, consideration received for such reduction is taxable as capital gains under the ITL.

In the case of Anarkali Sarabhai (supra) and Trustees of H.E.H. The Nizam's Second Supplementary Family Trust[9] it was held by the Supreme Court and Andhra Pradesh HC respectively that redemption and conversion of preference shares into equity shares result in transfer under the ITL.

The exemption provision under ITL clearly indicates that any transfer of share in the company as a result of conversion of company into an LLP as per the LLP Act amounts to transfer and the same is specifically exempted from tax under the ITL. This is also supported by the memorandum[10] explaining the intent behind providing a specific exemption for transfer resulting pursuant to conversion.

As the provisions of tax neutral conversion have not been satisfied, such conversion will be subject to capital gains tax under the ITL.

**On computation mechanism of capital gains arising on transfer as a result of conversion**

Under the ITL, capital gain is computed by deducting the “COA of the asset” from the “full value of consideration (FVC)”. On conversion, shareholders relinquish their shareholding in the company to acquire capital in the LLP in the same proportion in which shares were held in the company. Thus, FVC received/ accrued to each shareholder, as a result of relinquishment of shares, will be the value of the partnership interest in LLP for the purpose of computation of capital gains.

Further, such FVC has to be adjusted for any extra consideration or benefit received (in any form or manner), by the shareholder directly or indirectly. FVC will also need to be adjusted in cases where the profit-sharing ratio of the shareholder in the LLP is not in the proportion of shares held in the converting company.

FVC can be computed basis the accounts of the LLP taking into account the reserves and surplus transferred. If such FVC is not unascertainable, the deeming provision[11] under the ITL can be adopted to deem the FMV as the FVC. Accordingly, the computation mechanism does not fail.

Reliance in support of the above was placed on the Mumbai Tribunal ruling in the case of Celerity Power LLP[12] and the Kolkata Tribunal ruling in the case of Aravali Polymers LLP[13] which also agree that conversion of a private limited company into an LLP is transfer for which computation of capital gains is possible by considering the book value as the FVC[14].

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[9] [1976] 102 ITR 248 (AP)
[11] Section 50D of the ITL
[14] The decisions in the case of Celerity Power LLP and Aravali Polymers LLP were delivered in relation to capital gains implications in the hands of the converting company and not the shareholders.
On whether the value of interest in the LLP constitutes cost of extinguished shares

► With regard to the Taxpayer’s contention that the value of partnership interest is same as COA of shares in the company, the AAR held that this proposition is incorrect for the following reasons:

► This is against the provisions of the ITL which defines the term of “cost of acquisition”. Such definition does not deem that COA of shares be deemed as COA of partnership interest in the LLP.

► The cost of shares is the price at which shares are acquired.

► The COA may vary from one shareholder to another shareholder.

Nevertheless, even where the COA of shares is taken as the FVC of the interest acquired in the LLP, the computation mechanism of capital gains tax does not fail merely because of the equality of FVC and COA.

► Further, the contention of the Taxpayer that there is no capital gain on transfer of shares, as value of interest in the LLP is equal to the total shareholders’ funds in the company, is not correct for the following reasons:

► The argument that value of shareholder’s funds in the books of the company is equal to the value of interest in the LLP, is applicable only to the company and not the shareholders.

► The precise asset of the Taxpayer that got extinguished on conversion was the Taxpayer’s specific shareholding in the company which was distinct and separate from the shareholder’s funds appearing in the books of the company.

► Shareholders fund includes share capital as well as reserves and surplus and such reserves and surplus remains the property of the company so long as it is not distributed to shareholders as dividend.

► Therefore, the COA shall always be the amount paid by the Taxpayer at the time of acquisition by the Taxpayer while the value of shareholders’ fund can be different.

Comments

The AAR ruling deals with the taxability of the shareholders of a company which is converted into LLP, an issue on which there is no judicial precedent so far. To that extent, the AAR decision is of significance. It may be noted that the AAR ruling has dealt with tax implications under domestic law as the applicant before it did not have any benefit under the tax treaty in respect of capital gains income. A shareholder from other treaty countries can avail protection as may be applicable under the relevant treaty. Taxpayers who have undertaken conversion of company into LLP or are proposing to undertake conversion will have to consider the impact of the ruling to its case and, evaluate the applicable legal position.
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