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Legal & Compliance Services

# Conversion of a company into LLP amounts to ‘transfer’ under the Income-tax Act and shareholders are liable to capital gains tax on receipt of partnership interest upon such conversion

Recently, the Authority for Advance Rulings (AAR) in the case of Domino Printing Services Plc.[1] (the applicant) held that the conversion of the company into Limited Liability Partnership (LLP) amounts to transfer within the meaning of Section 2(47) of the Income tax Act, 1961 (the Act). On conversion of the company into an LLP, the computation provision under Section 48 of the Act are workable and capable of being implemented for working out capital gain arising in the hands of the shareholder. 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. Further even if the partner’s interest in the LLP is equal to the value of shareholder’s interest in the company, it does give rise to taxable capital gain in the hands of the applicant shareholder.

## Facts of the case

The applicant is a U.K. based company having its subsidiary in India. Out of total 40,80,000 equity shares issued by Domino India, 40,79,998 equity shares were held by the applicant and the balance were held by another foreign company. The Indian company proposed to be converted into an LLP as per the provisions of the LLP Act, 2008 and accordingly an application was filed with the Foreign Investment Promotion Board (FIPB) to obtain the requisite approval for conversion of Indian entity to an LLP. Upon conversion, the equity shares held by the applicant in Indian entity would be converted into 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.

## Issues before the AAR

- Whether conversion of the equity shares held by shareholders in an Indian entity into partnership interest in an LLP consequent upon the conversion would be regarded as a transfer under Section 2(47) of the Act?
- Whether computation provision under Section 48 of the Act are workable?
- As the value for the partners’ right or interest in the proposed LLP cannot be said to be more than the value of the shareholders interest in the private limited company, would the transaction give rise to any taxable capital gain?

## AAR’s ruling

### *Conversion of company into LLP*

The definition of transfer in Section 2(47) of the Act is ‘inclusive’ and therefore it extends to events and transactions which may not otherwise be ‘transfer’ according to its ordinary, popular and natural sense. The deeming provision of Explanation 2 to Section 2(47) of the Act stipulates that ‘transfer’ includes disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever.

- There is no dispute about the fact that the applicant was holding shares in Indian entity and they were no longer in existence on conversion. The applicant had got partners interest in LLP which was not independent of its shareholding in Indian entity. In fact applicant’s shareholding in Indian entity was replaced by the partnership interest in LLP. On conversion of a company into LLP, the company is dissolved and removed from the records of the Register of Company (ROC).

On conversion of Indian entity into LLP all tangible and intangible property vested in the company were transferred to and vested in the LLP. On such vesting, not only share capital of Indian entity but also shareholder's interest in the shares of Indian entity got extinguished. Thus, this transaction is clearly covered within the definition of 'transfer' as per Section as per Section 2(47) of the Act. The inclusive definition of transfer in Section 2(47) of the Act certainly covers the extinguishment of shareholder's interest on conversion of the company into LLP in its ambit.

The decision of the Bombay High Court in the case of Texspin[2] relied on by the taxpayer is distinguishable on facts of the present case on account of following reasons:

- The High Court decision 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 High Court held that the succession of firm by company does not result in transfer by way of 'distribution'. It was observed that there is extinguishment of rights in capital asset on reconstitution of the firm and introduction of new partners.
- The issue decided in the case of Texspin was with respect to the capital gains in the hands of the firm and not its partner. However, the capital gain to be considered in the present case is in the hands of shareholder of the company and not in the hands of the company or the firm.
- The conversion of a company into a LLP is differently placed in comparison to succession of a partnership firm by a company. The provisions of LLP Act specifically provides for transfer of all assets and vesting thereof in the LLP.
- The Bombay High Court decision 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 Act 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 Act did not 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 Act. The AAR relied on the decision of the Supreme Court in the case of Grace Collis[3] wherein it was observed that the expression 'extinguishment of any rights therein' as occurring in Section 2(47)(ii) of the Act extends to mean extinguishment of rights independent of or otherwise than on account of transfer.

The AAR also relied on the decision of the Mumbai Tribunal Special Bench in the case of Bennett Coleman & Co. Ltd.[4] wherein 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 Act. The issue of whether extinguishment of a right in an asset in itself results in transfer was not disputed before the Special Bench. The AAR referred the decision of the Supreme Court in the case of Kartikeya V. Sarabhai[5] where it was 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 Act.

In the case of Anarkali Sarabhai[6] and Trustees of H.E.H. The Nizam's Second Supplementary Family Trust[7] it was held by the Supreme Court and Andhra Pradesh High Court respectively that redemption and conversion of preference shares into equity shares result in transfer under the Act.

The exemption provision under Section 47(xiiib) of the Act 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 Act. This is also supported by the memorandum explaining the intent behind providing a specific exemption for transfer resulting pursuant to conversion.

The AAR held that in the instant case the cumulative fulfilment of the prescribed conditions has not been satisfied. Therefore, the transactions is a 'transfer' liable for capital gain tax under the provisions of Section 45 of the Act.

### *Computation mechanism under Section 48 of the Act*

The mode of computation of capital gains tax is prescribed in Section 48 of the Act. Thus, the capital gain shall be computed by deducting from the 'full value of consideration', the cost of acquisition of the asset, if there is no other expenditure involved.

On the conversion of a company into LLP, the shares in the hand of the shareholders of the company are converted into capital in the LLP. Thus, the shareholders relinquish their shareholding in the company and acquire capital in the LLP in the same proportion as was the shareholding in the private limited company. The full value of the consideration received/accured to each shareholder, as a result of relinquishment of shares, will be the value of the capital in the newly formed LLP for the purpose of computation of Capital Gains under Section 48 of the Act.

If any of the shareholders of the private company receives any extra consideration or benefit, directly or indirectly, in any form or manner, the full value of the consideration has to be enhanced accordingly for the purpose of computation of capital gains. Further, necessary adjustments has to be made to the full value of consideration, if the capital contribution and profit sharing ratio in the LLP are not in the same proportion, as their shareholding in the company, as on the date of conversion.

In the instant case the applicant's interest in the share capital of Indian entity has been extinguished and in return it has got partnership interest in LLP. So the full value of consideration of the shares foregone will be equivalent to the value of partnership interest in LLP. 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. If the value of partnership interest cannot be ascertained or determined for any reasons, then the fair market value of the same has to be taken as stipulated under Section 50D of the Act.

The AAR relied on the decision of Mumbai Tribunal in the case of Celerity Power LLP[8] and the Kolkata Tribunal decision in the case of Aravali Polymers LLP[9] where it was held 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 full value of consideration.

Simply because in a case there is no gain or loss due to full value of consideration being equal to the cost of acquisition, it cannot be said that the computation mechanism fails. The computation mechanism encompasses a situation which may be tax neutral.

The AAR in the case of Umicore Finance Luxemborg[10] 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 Act. The ratio of the AAR ruling is applicable only to the converting company and cannot be extended to the shareholders of the company.

Accordingly, AAR held that the computation mechanism under Section 45 read with Section 48 of the Act is workable and capable of being implemented in the present case.

### *Cost of acquisition of extinguished shares*

The applicant contended that the value of partnership interest is same as cost of acquisition of shares in the company. The AAR held that this statement is not correct as this is against the provisions of the Act which defines the term of 'cost of acquisition'. Such definition does not deem that cost of acquisition 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 cost of acquisition may vary from one shareholder to another shareholder.

In the present case, the AAR concerned that the capital gains arising in the hand of the shareholder and not in the hand of the erstwhile company. The value of total shareholder's fund as appearing in the books of the company might be equal to the value of total partnership right and interest in the LLP. However, this factor is not relevant for working out the capital gains in the hand of the shareholder.

The precise asset of the shareholder that got extinguished on the conversion of a company into LLP was his specific shareholding in the company, which was different and distinct from the shareholders fund as appearing in the books of the company. The reserves and surpluses remains the property of the company as long as it is not distributed to the shareholders as dividend. No shareholder can claim a right on the undistributed reserves and surplus of the company. Therefore, one cannot equate the reserves and surplus as appearing in the books of the company as part of shareholder interest work out of the capital gains in the hands of the shareholders.

Further, even if the value of total shareholders fund in the company equal to the value of total partnership interest in the LLP, it does not have an impact on the capital gain arising in the hands of the shareholder. Therefore, even if the value of partner's interest in the LLP is equal to the value of shareholder's interest in the company, it does give rise to taxable capital gain in the hands of the shareholder.

## Our comments

The present AAR ruling deals with the taxation aspects of the conversion of a company into an LLP. In the instant case, the AAR distinguished the Bombay High Court decision in the case of Texspin Engg. & Mfg. Works where it was held that the conversion of a partnership firm into a company does not amount to 'transfer'. However, in the instant case, the AAR treated the conversion of a company into an LLP as a 'transfer'. It appears that the AAR has proceeded on the basis that the event of conversion necessarily triggers capital gains taxation upon conversion of company into LLP. The non-chargeability of capital gains was not tested on general principles in the present case but on the basis of compliance of conditions of specific provision for exemption.

Further, the AAR relied on the decision of the Mumbai Tribunal in the case of Celerity Power LLP and Aravali Polymers where it was observed that conversion of a company into an LLP which does not satisfy the conditions of exemption was to be treated as ‘transfer’ of capital assets. The Tribunal held that since the taxpayer failed to satisfy the conditions of exemption provisions, the transaction was treated as ‘transfer’ of capital assets.

The AAR also held that on conversion of the company into LLP, the computation provision under Section 48 of the Act are workable and capable of being implemented for working out capital gain arising in the hands of the shareholder. 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. Further even if the partner’s interest in the LLP is equal to the value of shareholder’s interest in the company, it does give rise to taxable capital gain in the hands of applicant shareholder.

It is pertinent to note that the ruling of the AAR is binding only on the applicant, in respect of transaction in relation to which the ruling is sought and on the tax department, in respect of the applicant and the said transaction. However, it does have persuasive value on the Courts in India.