India’s Authority for Advance Rulings (AAR) ruled on 23 August 2019 (AAR No. 1290 of 2012) that the conversion of a private limited company into a limited liability partnership (LLP) gives rise to taxable capital gains for the company’s shareholders.

Background and facts

The taxpayer is a company registered in and a tax resident of the UK. The taxpayer had a wholly-owned Indian subsidiary that it wished to convert into an LLP in accordance with the provisions of the Indian LLP Act, 2008. An application for approval for the conversion was made to the Foreign Investment Promotion Board (FIPB) and the FIPB granted approval in May 2012, subject to certain conditions.

On conversion of the company into an LLP, equity shares held by the taxpayer in the Indian subsidiary would be converted into capital/a partnership interest in the LLP of INR 40,799,980, equivalent to the amount of paid-up share capital held in the subsidiary prior to the conversion.

Sub section xiiib of section 47 of the Income-tax Act, 1961 (ITA) provides that any transfer of a share or shares held in a company by a shareholder as a result of the conversion of the company into an LLP in accordance with specific provisions of the LLP Act, 2008 should not be considered as a taxable transfer subject to satisfying the prescribed conditions. The Indian subsidiary, however, did not satisfy one of those conditions because its total sales/turnover in at least one of the three years prior to the year preceding that in which the conversion took place exceeded INR 6 million.

Ruling of the AAR

The AAR was asked to rule on:

- Whether the conversion of equity shares held by the taxpayer in the Indian subsidiary into a partnership interest in an Indian LLP resulting from the conversion of the subsidiary into an LLP would be regarded as a transfer of those shares under section 2(47) of the ITA;
- Whether the provision of the ITA for calculating capital gains for nonresidents is workable and capable of being applied in the context of a conversion; and
- Since the value of the partner’s (taxpayer’s) right or interest in the proposed LLP would not exceed the value of the shareholder’s (taxpayer’s) interest in the private limited company, would the conversion give rise to taxable capital gains?

On the first question, the AAR ruled that on a conversion of the subsidiary into an LLP, all tangible (movable or immovable) and intangible property vested in the company would transfer to and be vested in the LLP. This would extinguish both the share capital of the company and the shareholder’s interest in the shares of that company. The transaction, therefore, falls within the definition of a transfer in section 2(47) of the ITA. The AAR observed that for the purpose of assessing capital gains under the ITA, the existence of a party and a counterparty is not mandatory; the legislation provides for the situation where the transferor and transferee are a single person. The AAR also commented that since clause xiiib of section 47 provides for the conversion of company into an LLP not to be a taxable transfer where certain conditions are met, this creates the presumption that such conversions otherwise are taxable.

Addressing the second and third questions, the AAR ruled that the computational mechanism under the ITA is workable and capable of being applied to the case at hand. The full value of the consideration for the purpose of computing the shareholder’s (taxpayer’s) capital gain would be the value of the taxpayer's partnership interest in the LLP, and the cost of acquisition of the shares would be the amount paid by the taxpayer to purchase the shares. The AAR ruled that the taxpayer's partnership interest in the LLP is capable of being evaluated by reference to commercial and accounting principles and if it cannot be done, the fair market value would be determined in accordance with section 50D of the ITA that deems the fair market value to be the full value of the consideration in certain cases.

The AAR accordingly ruled against the taxpayer on all three questions, finding that the failure to meet the conditions for a transfer not to be regarded as a taxable transfer would result in the conversion of the company into an LLP being a taxable transfer giving rise to taxable capital gains for the taxpayer.

Comments

While the ruling has clarified the position in the particular case, it also gives rise to a number of related issues, including the following:

- The legal vesting of assets (on the death of an individual or the cessation of a company) generally should not be a transfer under section 2(47) of the ITA. However, by providing a conditional exemption, the tax authorities have deemed legal vesting to constitute a transfer. It is questionable whether the specific exemptions provided in section 47 read in conjunction with section 47A of the ITA dilute the legal stance, if the validity of such exemptions is not challenged.
- Section 47A(4) of the ITA provides for withdrawal of the exemption where any of the conditions laid down in the proviso to clause xiiib of section 47 and initially met by the taxpayer subsequently are not satisfied. In such cases the successor LLP or the shareholder of the predecessor company will be subject to tax in the year of noncompliance.
- The system of taxation of a partnership and its partners is different to the tax treatment applied to a company and its shareholders. A distribution to a partner on retirement or dissolution should not be taxable.
- The AAR remarked that the issue of whether capital gains arising to the company on conversion are taxable if the conditions in clause xiiib of section 47 of the ITA are not met, was not raised before the AAR.
- In a November 2018 order the Mumbai Income Tax Appellate Tribunal held that the conversion to an LLP is a taxable transfer if the conditions stipulated in clause xiiib of section 47 of the ITA are not satisfied but that if the conversion takes place at book value, no capital gain would arise to the company.
- The AAR referred to section 50D of the ITA. Section 50CA addressing the determination of consideration on a transfer of shares other than quoted shares that takes place at less than the fair market value of the shares also should be considered in light of the ruling.