Conversion of a company into a Limited Liability Partnership (LLP) - capital gains tax implications for shareholder

The Authority for Advance Ruling (AAR) in the case of Domino Printing Science Plc[1] has dealt with taxability in the hands of the shareholder on the conversion of a company into LLP and ruled that such conversion amounts to a 'transfer' liable to capital gains tax in the hands of the shareholder. The findings of the AAR are briefly discussed below:

Background

Domino Printing Science Plc (Applicant) is a company incorporated in the United Kingdom (UK) and is a tax resident of UK. The Applicant had a wholly owned subsidiary in India, Domino Printech India Private Limited (Domino India/Company). Subject to certain conditions, Domino India was converted into an LLP pursuant to approval of the Foreign Investment Promotion Board.

On such conversion into LLP, the equity shares held by the Applicant in Domino India was converted into partnership interest in the LLP. Section 47(xiiib) of the Income-tax Act, 1961 (Act) provides for a tax neutral conversion subject to fulfilment of certain conditions. Domino India did not fulfil one of the conditions (i.e. the turnover threshold) on conversion into LLP.

The Applicant sought a ruling in respect of the capital gains tax implications in its hands (i.e. the shareholder) on the aforesaid conversion. The key questions raised before the AAR were:

- Whether conversion of equity shares into partnership interest in an LLP, amounts to a transfer under the Act?
- Whether on such conversion, capital gains tax computation mechanism under the Act fails?
- Whether there is a taxable capital gains as the value of partners' interest in LLP cannot be more than the value of shareholders' interest in the company?

[1] A.A.R. No. 1290 of 2012

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Applicant’s contentions

The key arguments advanced by the Applicant are outlined below:

- The partnership interest received on conversion of company into LLP should not be considered as a ‘transfer’ under section 2(47) of the Act as the same does not amount to a sale, exchange, relinquishment of an asset or extinguishment of rights in an asset.
- An extinguishment signifies existence of two entities and the right in one entity is merged/ consolidated with another entity. In the case of conversion of company into LLP, there is no merger/consolidation of a rights, but merely a substitution of shareholding in the company with partnership interest. Since the shareholder’s rights would remain in such LLP, there is no extinguishment of shareholder’s rights.
- The Applicant’s shareholding in the Company only stood converted into LLP capital of the same amount and the erstwhile shareholders became LLP partners. Therefore, there was no transfer in the hands of the shareholders on such conversion.
- The shareholder of the Company got partnership interest in the LLP which had no co-relation to the transfer of properties by the Company to the LLP. Therefore, the capital gains computation mechanism fails.
- The Applicant relied on the Bombay High Court decision in case of Texspin[2] wherein the High Court had held that vesting of properties in the company (under the erstwhile Part IX conversion) was a statutory vesting which did not constitute a transfer. On such vesting, the cloak given to the firm was replaced by a different cloak and the same firm was now treated as a company.

Revenue’s contentions

The key arguments advanced by the Revenue are outlined below:

- The definition of transfer under the Act is an inclusive definition. The conversion of a company into LLP is a transfer, as the company and LLP are distinct legal entities and the shareholding of the Applicant in the Company is converted into another asset namely, LLP interest.
- The shareholder’s rights in the company are extinguished and hence there is an extinguishment of rights as envisaged in the definition of transfer. As per the LLP Act, on such conversion, a company is deemed to be dissolved and removed from the records of the Registrar of Companies. As the Company is dissolved, the equity shares held by the Applicant are extinguished thereby resulting in a transfer under the Act.
- Such conversion amounts to an ‘exchange’, since the shareholder surrenders its interest in equity holding of the Company for interest in the newly formed LLP.
- Consideration in the form of partnership interest in LLP was flowing to the Applicant and accordingly, the capital gains tax computation mechanism does not fail.
- Even considering the book value, there is a consideration flowing to the shareholders comprising of equity share capital plus reserves and surplus. This would only increase

[2] CIT vs. Texspin Engineering & Manufacturing Works 263 ITR 345 (Bom)

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if market value of assets in accordance with the provisions of section 50D[3] of the Act is considered.

Ruling of the AAR

Conversion of company into LLP is a transfer

On conversion of company into LLP, all tangible and intangible properties vested with the Company were 'transferred' to and vested with the LLP. On such vesting, not only the share capital of the Company but also the shareholder's interest in shares of such Company are extinguished. The inclusive definition of transfer covers in its ambit such extinguishment of shareholder's interest on conversion.

The Bombay High Court decision in case of Texspin (supra) was distinguishable, inter alia, on the following basis:

- The issue decided therein was capital gains in the hands of the firm and not its partners, whereas in the Applicant's case, the capital gain taxability is to be considered in the hands of the shareholder.
- The provisions of the LLP Act specifically provide for transfer of all assets and vesting thereof in the LLP.
- On such conversion of company, as there is no vesting of properties in the hands of the shareholders there is no change of cloak for the shareholders (unlike the case of a company).

The existence of party and counter party is not mandatory for capital gains purposes and the transferor and transferee can be the same person.

The Supreme Court in the case of Grace Collis[4] has observed that the rights of the shareholder in shares of the amalgamating company are extinguished upon amalgamation with the amalgamated company. Applying the aforesaid ratio, the rights of the Applicant in the shares of Domino India were extinguished on conversion.

The Act[5] provides that where the conditions for tax neutrality are not complied with, there will be deemed capital gains tax implications in the hands of the successor LLP or the shareholder of the predecessor company as the case maybe, in the year in which the specified conditions are not complied with. In the facts of the case, the Applicant itself admitted that the Company does not comply with the tax neutrality conditions, thus the AAR held such conversion to be a taxable transfer.

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[3] Section 50D of the Act provides that where the consideration received on transfer of a capital asset is not ascertainable/cannot be determined, then for computing capital gains, the fair market value of the asset as on the date of transfer of such asset will be deemed to be the full value of consideration received.
[4]CIT vs. Grace Collis 115 Taxmann 326 (SC)
[5] Section 47A(4) of the Act

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Computation mechanism

The computation mechanism does not fail, and the capital gains in the hands of the shareholder can be computed as under:

- Full value of consideration received/accrued to the shareholder as a result of 'relinquishment' of shares will be the value of the capital in the newly formed LLP. The full value of consideration can be worked based on the accounts of the LLP and the erstwhile Company and the partnership interest in LLP should be evaluated on commercial and accounting principles.
- The cost of acquisition of the shares in the Company would be the amount paid by the shareholder at the time of purchase of its shares.
- In case the value of partnership interest cannot be determined, then the fair market value of the shares of the Company would be deemed as consideration as per section 50D of the Act.

Value of partner's interest in the LLP vis-à-vis value of shareholders interest in the Company

The value of shareholder's interest as appearing in the books of the Company might be equal to the value of LLP interest, but the same is not relevant for computing capital gains in the hands of the shareholder. The asset of the shareholder which is extinguished is shareholding in the Company, which is different from shareholder's funds (this includes reserves and surplus of the Company) appearing in the books of the Company. No shareholder can claim a right on the undistributed reserves and surplus of the Company. Thus, even if value of interest in the LLP is equivalent to the value of shareholders interest in the Company, it could still give rise to taxable capital gains in the hands of the shareholder.

Dhruva comments

While there have been several judicial precedents which discuss the taxability in the hands of the company on conversion of a company into LLP, there have been no decisions discussing the taxability in the hands of the shareholder. This AAR having dealt with the taxability, has also provided a mechanism for computing capital gains in the hands of the shareholders. Such computation could be based on books of accounts of the company.

Though an AAR is binding on the Applicant and the tax authorities qua the transaction, the AAR will have wide ramifications in case of similar conversions especially, where there is no capital gains tax exemption provided under an applicable tax treaty.

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