



## ERGO

*Analysing developments impacting business*

### AAR RULES ON CAPITAL GAINS TAXABILITY IN THE HANDS OF SHAREHOLDERS UPON THE CONVERSION OF A COMPANY TO AN LLP

13 September 2019

#### Introduction

In the recent case of Domino Printing Science Plc., In Re (AAR 1290 of 2012 decided on 23 August 2019), the Authority for Advance Rulings (AAR), ruled that shareholders of a company are liable to capital gains tax upon the conversion of a company to a Limited Liability Partnership (LLP) as the conditions of a tax neutral transfer are not fulfilled. Under the Income Tax Act, 1961 (IT Act) any transfer of a capital asset by a company to an LLP or shares held by the shareholder in the company, as a result of conversion of a company into an LLP, would be tax neutral, subject to conditions. This ruling assumes importance as it is the first decision which deals with taxability in the hands of the shareholders on the breach of conditions of a tax neutral transfer.

#### Facts

Domino Printing Science Plc., United Kingdom (Taxpayer) is a company registered in the UK and had a wholly owned subsidiary company, Domino Pintech India Private Limited (Domino India). Domino India had proposed to be converted into an LLP (Domino LLP) in accordance with the provisions of the Limited Liability Partnership Act, 2008. Therefore, upon conversion, the equity shares held by the Taxpayer in Domino India would be converted into partnership interest in Domino LLP.

The Taxpayer filed an application before the AAR in respect of the applicability of capital gains tax in the proposed transaction. The AAR dealt with the following three principal issues.

- *Transfer under the IT Act:* Whether the conversion of equity shares by shareholders in Domino India into partnership interest in Domino LLP would be regarded as 'transfer' for the purpose of computation of capital gains tax under the IT Act?
- *Capital Gains Tax Computation:* Whether the computation provisions in relation to capital gains are workable?
- *Relevance of Value of Shareholder's Interest in the Company:* Whether the transaction would give rise to capital gains if the partnership interest was equal to the shareholder's interest in the company?

## Ruling

The AAR ruled that the conversion of equity shares held by the Taxpayer in Domino India into partnership interest in Domino LLP was a 'transfer' and the capital gains computation provision under the IT Act was workable. Further, it ruled that even if the value of the partnership interest in Domino LLP was equal to the value of the shareholder's interest in Domino India, it gave rise to taxable capital gains in the Taxpayer's hands.

The AAR's rationale for the above ruling has been summarised below:

### ➤ *Transfer under the IT Act*

The AAR held that upon conversion of Domino India into Domino LLP, shareholder's interest in the shares of Domino India would get extinguished and hence, the transaction is covered within the definition of 'transfer' under the IT Act. The AAR referred to the decision in CIT v Grace Collis 248 ITR 323 (SC) to re-iterate that extinguishment of rights in a capital asset includes extinguishment of rights independent of and otherwise than on account of transfer.

The AAR rejected the contention of the Taxpayer that there is no transfer as the elements of 'transfer' (such as sale, exchange, relinquishment of an asset or the extinguishment of any right in an asset) under the IT Act were not fulfilled.

The Taxpayer relied on the Bombay High Court decision in *Texspin*, which had held that succession of a partnership firm (which is akin to an LLP for income-tax purposes) by a company was not a taxable transfer as it was a case of statutory 'vesting' of property upon the converted company. The AAR distinguished the decision in *Texspin* on the ground that in *Texspin*, taxability was in the hands of the firm and not its partners. Further, it noted that *Texspin* was in the context of provisions prior to the insertion of tax neutral transfer conditions in relation to capital gains under the IT Act. Further, the AAR emphasized that the intent behind the enactment of beneficial tax provisions was to allow tax neutral conversions subject to the fulfillment of conditions.

### ➤ *Capital Gains Tax Computation*

The AAR held that the computation provision in relation to capital gains tax is workable. It held that the full value of consideration would be the value of the partnership interest in Domino LLP as can be worked out from the books of accounts of Domino LLP. Further, the AAR held that if the partnership interest in the LLP cannot be ascertained or determined then the fair market value (FMV) as provided under the IT Act must be considered. The cost of acquisition of shares, was held to be the amount paid at the time of purchase of shares.

### ➤ *Relevance of the Value of Shareholder's Interest in the Company*

Even if the value of the partner's interest in the LLP is equal to the value of the shareholder's interest in the company, it gives rise to taxable capital gain in the hands of the Taxpayer as the full value of consideration (value of partnership interest as determinable from the books of accounts) has to be reduced by the cost of acquisition (price at the time of purchase).

## Comments

In the past, there have been decisions (eg ACIT v Celerity Power LLP, 2018 100 taxmann.com 129) in the context of taxability upon conversion of a company to an LLP. These decisions have held that such conversions amount to a 'transfer' as per the IT Act if the conditions of a tax neutral transfer are not fulfilled. However, the present ruling, as noted earlier, is the first decision which deals with taxability of such a

# ERGO | AAR RULES ON CAPITAL GAINS TAXABILITY IN THE HANDS OF SHAREHOLDERS UPON THE CONVERSION OF A COMPANY TO AN LLP

transaction at the level of shareholders. Although, it can be argued that this decision will only be of persuasive value as AAR decisions are binding only on the applicant and the concerned officer, and in respect of the matter referred for advance ruling; this decision will definitely be of significant relevance while undertaking transactions involving the conversion of a company into an LLP. Lastly, tax implications for shareholders will also be subject to relevant tax treaty provisions.

- *Vinita Krishnan (Director), Aditi Sharma (Principal Associate) and Kruthika Prakash (Associate)*

For any queries please contact: [editors@khaitanco.com](mailto:editors@khaitanco.com)

*We have updated our [Privacy Policy](#), which provides details of how we process your personal data and apply security measures. We will continue to communicate with you based on the information available with us. You may choose to unsubscribe from our communications at any time by clicking [here](#).*

**For private circulation only**

The contents of this email are for informational purposes only and for the reader's personal non-commercial use. The views expressed are not the professional views of Khaitan & Co and do not constitute legal advice. The contents are intended, but not guaranteed, to be correct, complete, or up to date. Khaitan & Co disclaims all liability to any person for any loss or damage caused by errors or omissions, whether arising from negligence, accident or any other cause.

© 2019 Khaitan & Co. All rights reserved.

**Mumbai**

One Indiabulls Centre, 13<sup>th</sup> Floor  
Tower 1 841, Senapati Bapat Marg  
Mumbai 400 013, India

T: +91 22 6636 5000  
E: [mumbai@khaitanco.com](mailto:mumbai@khaitanco.com)

**New Delhi**

Ashoka Estate, 12th Floor  
24 Barakhamba Road  
New Delhi 110 001, India

T: +91 11 4151 5454  
E: [delhi@khaitanco.com](mailto:delhi@khaitanco.com)

**Bengaluru**

Simal, 2nd Floor  
7/1, Ulsoor Road  
Bengaluru 560 042, India

T: +91 80 4339 7000  
E: [bengaluru@khaitanco.com](mailto:bengaluru@khaitanco.com)

**Kolkata**

Emerald House  
1 B Old Post Office Street  
Kolkata 700 001, India

T: +91 33 2248 7000  
E: [kolkata@khaitanco.com](mailto:kolkata@khaitanco.com)