

India's Authority for Advance Rulings holds conversion of Indian private limited company to limited liability partnership is taxable to shareholders

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Executive summary

India's Authority for Advance Rulings (AAR) ruled on 23 August 2019 that the shareholders of an Indian private limited company (PLC) are subject to capital gains tax on the conversion of the PLC to an Indian limited liability partnership (LLP) for the difference between the value of LLP interest received by the shareholders on conversion and the cost of shares in the PLC.

This Alert summarizes the ruling.

Detailed discussion

Background

- ▶ The Indian domestic tax law (DTL) contains a specific capital gains tax exemption for both the PLC and the shareholder of the PLC on conversion of a PLC to an LLP, subject to specific conditions. Failure to satisfy the conditions results in a taxable capital gain.
- ▶ The DTL taxes gains arising from the transfer of a capital asset situated in India. The term "transfer" is defined very broadly to include an exchange, relinquishment or extinguishment of a right in a capital asset.

- ▶ Under the statutory conversion process, the assets and liabilities of the PLC are transferred to the LLP, and the PLC ceases to exist.
- ▶ The key issue considered by the AAR was whether the PLC's conversion to an LLP could still be tax exempt for the PLC shareholder, based on technical interpretations of the DTL and the statutory conversion process, even if the DTL's nonrecognition conditions are not satisfied.
- ▶ In the past, taxpayers have adopted a position that a conversion of one entity form to another, such as a conversion of partnership firms to Indian companies, was nontaxable to the converted entity's shareholders as the Indian Courts have held that such conversion may be tax free in the hands of the converting entity.

Ruling by the AAR

- ▶ The AAR ruled that the PLC's conversion to an LLP would be taxable to the shareholders, based on the following factors:
 - The term "transfer" is defined broadly under the DTL to include any form of disposition of any asset or any interest in such asset.
 - Upon conversion, the interests in the shares are exchanged for LLP interests.
 - Accordingly, the conversion transaction results in a "transfer" under the DTL.
- The taxpayer should not rely on earlier rulings by Indian Courts that dealt with the taxability of other entity forms under different legislation.
- An exemption in the DTL will be made available only when a taxpayer satisfies all conditions.
- ▶ The AAR held that the value of interest in the LLP received by the PLC shareholders in the conversion would be deemed to be the consideration received on the transfer of the shares; consequently, any excess over the cost of PLC shares would be subject to India's capital gains tax.

Implications

- ▶ The ruling is significant, as it deals with an issue on which there has been no Indian judicial precedent.
- ▶ An AAR ruling is only binding on the taxpayer and tax authority for the specific case that is ruled upon and is not binding on any other cases (although such rulings generally have persuasive value).
- ▶ The ruling deals with tax implications solely under the DTL. Treaty protection may be available, depending on the taxpayer's country of residence.
- ▶ Taxpayers who have undertaken or are planning the PLC conversion to an LLP should consider the impact of this ruling to their fact pattern.

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