

Tax Hotline

November 21, 2018

TRIBUNAL: CONVERSION OF COMPULSORILY CONVERTIBLE PREFERENCE SHARES NOT A TAXABLE TRANSFER

- Conversion of CCPS into equity shares is not a taxable transfer
- Conversion does not involve an 'exchange' as the preference shares cease to exist.
- Sale of the resulting equity shares on conversion will be a taxable transfer
- Gains on sale to be calculated on the basis of cost of the original preference shares

Recently, on November 9, 2018, the Mumbai Bench of the Income Tax Appellate Tribunal ("**Tribunal**") held¹ that conversion of compulsorily convertible preference shares is not a taxable transfer.

BACKGROUND

Periar Trading Company Private Limited (the "**Taxpayer**") participated in a rights issue of Trent Limited (the "**Company**") and subscribed to 1,634 compulsorily convertible preference shares ("**CCPS**") of the Company at INR 550 per share for a total consideration of INR 2,83,98,700 (approx. USD 400,000). The CCPS were automatically convertible into equity shares of the Company in ratio of 1:1.

The Assessing Officer ("**AO**") treated the conversion as a taxable transfer and taxed INR 2,85,01,968 (approx. USD 400,000), being the difference between the fair market value of resulting equity shares of the Company and cost of acquisition of the CCPS, as long-term capital gains.

The first appellate authority (the "**CIT(A)**"), relying on rulings of the Bombay High Court in *CIT v. Santosh L Chowgule*² and the Andhra Pradesh High Court in *ACIT vs. Trustees of H.E.H. The Nizam's Second Supplementary Family Trust*³, rejected the Taxpayer's appeal and held that the conversion of the CCPS was nothing but a transfer by way of 'exchange' under section 2(47)⁴ of the Income Tax Act, 1961 ("**ITA**") taxable under section 45⁵ of the ITA.

Aggrieved, the Taxpayer appealed to Tribunal against the order of the CIT(A).

ISSUE

Whether the conversion of the CCPS constituted a taxable transfer under the ITA.

RULING

The Tribunal followed its earlier decision in the case of *ITO v. Vijay M Merchant*⁶ where, on the basis of a circular⁷ (the "**Circular**") issued by the Central Board of Direct Taxes ("**CBDT**") explaining the rationale behind the introduction of section 55(2)(b)(v)⁸, the Tribunal had ruled that conversion of preference shares into equity shares would not be a taxable transfer. The Circular provides that:

"... Section 14 of the Finance Act, 1964, introduces a new clause (v) in sub-section (2) of section 55 of the Income-tax Act, 1961, laying down the method for determining the cost of acquisition of a new share which becomes the property of the assessee on conversion of one type of share into another type of share. A question has been raised whether the transaction of conversion of one type of share into another attracts the capital gains tax under Section 45(1) The position in this regard is as follows:

(1) Where one type of share is converted into another type of share (including conversion of debentures into equity shares), there is, in fact, no "transfer" of a capital asset within the meaning of section 2(47) of the Income-tax Act, 1961. Hence, any profits derived from such conversion are not liable to capital gains tax under section 45(1) of the Income-tax Act. However, when such newly converted share is actually transferred at a later date, the cost of acquisition of such share for the purposes of computing the capital gains shall be calculated with reference to the cost of acquisition of the original share of stock from which it is derived."

The Tribunal acknowledged that treating the conversion as a taxable transfer by way of an exchange would give rise to undesirable double taxation – because section 55(2)(b)(v) would have the effect of denying the taxpayer a step-up in basis, and that the conversion did not constitute an exchange since, on conversion, the CCPS ceased to exist.

The Tribunal distinguished the cases relied on by the tax authorities in support of their argument on the ground that neither case had considered neither section 55(2)(b)(v) of the ITA nor the Circular.

The Tribunal also relied on a Supreme Court ruling in *Gillanders Arbuthnot & Co.*⁹ and a Bombay High Court ruling in *Texspin Engg. & Mfg. Works*¹⁰ to hold that section 48¹¹ of the ITA did not allow for the market value of the resulting

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equity shares to be treated as the 'full value of consideration' for the purpose of determining capital gains, and therefore the conversion was not a taxable transfer. In *Texspin*, the Bombay High Court, following the landmark Supreme Court ruling in *BC Srinivasa Setty*¹², held that in the absence of a prescribed method to determine the 'full value of consideration' for the purpose of computing capital gains, a transaction (in *Texspin*, it was a conversion of a partnership firm into a private limited company) could not be regarded as having been intended to fall within the scope of the charging provision i.e., section 45.

ANALYSIS

Until very recently, because of the wide definition of the word 'transfer' under the ITA, taking the position that conversion of preference shares into equity shares was not a taxable transfer was a position fraught with risk. In order to avoid costly and time-consuming litigation, taxpayers often ended up treating the conversion as a taxable transfer (despite the existence of the Circular and the potential double taxation risk).

However, Finance Act, 2017 amended section 47 of the ITA (Transaction not regarded as Transfer) with effect from April 1, 2018 to insert clause (xb) which provides that the conversion of a preference shares into an equity shares will not be regarded as a taxable transfer. Further amendments¹³ were introduced to provide that the holding period of the resulting equity shares would commence from the date of acquisition of the original preference shares, and that the cost basis of the resulting equity shares would be that of the original preference shares.

The amendments were welcomed by the private equity and venture capital investor community (who frequently structure investments through the use of CCPS), and are a strong step in the direction of introducing certainty to India's tax laws. The Tribunal's ruling will likewise be welcomed, especially by investors who undertook conversions prior to April 1, 2018 and took the position that the conversion was not a taxable transfer.

– Joachim Saldanha & Ashish Sodhani
You can direct your queries or comments to the authors

¹ *Periar Trading Company Private Limited v. ITO*, ITA No.1944/Mum/2018
² [1998] 234 ITR 787 (This case dealt with the question of whether the conversion of optionally convertible redeemable preference shares ("OCRPS") into equity shares constituted taxable transfer by way of an exchange. Holding in the affirmative, the High Court held that capital gains accruing on such conversion are liable to be taxed.)
³ (1976) (102 ITR 248) (This case dealt with the question of whether the holding period of preference shares issued to a shareholder in lieu his equity shareholding in a company, pursuant to a re-organization of that company's share capital, would commence from the date on which the post-reorganization preference shares were issued, or the date on which the original equity shares were issued. The High Court held that the re-organization did not entail merely a change in nomenclature of the shares but was an exchange of one kind of shares by another kind of shares, having different rights and liabilities, and accordingly, the holding period of the preference shares would commence from the date of issue of the preference shares.)
⁴ Section 2(47) of the ITA. Section 2(14) defines 'transfer', in relation to a capital asset, to include a sale, exchange or relinquishment of a capital asset, or the extinguishment of any rights therein.
⁵ Section 45 of the ITA. Section 45 provides for the charge of a capital gains tax on gains arising from a transfer of a capital asset.
⁶ [1986] 19 ITD 510
⁷ Circular dated May 12, 1984 vide F.No. 12/1/64-IT(A)
⁸ Section 55(2)(b)(v). Section 55 supplies the meaning of 'cost of acquisition' in certain special cases. Section 55(2)(b)(v) provides that where a taxpayer receives shares of a company on the conversion of one kind of shares into another kind, the cost of acquisition is to be calculated with reference to the cost of acquisition of the original shares.
⁹ 66 ITR 622
¹⁰ 263 ITR 345
¹¹ Section 48 of the ITA. Section 48 provides machinery to compute gains arising from a transfer of a capital asset. In short, gains are computed by deducting, from the 'full value of consideration' received or accruing as a result of the transfer of the capital asset, (a) its cost of acquisition and (b) any expenditure incurred wholly and exclusively in connection with the transfer.
¹² (1981) 128 ITR 294 (SC)
¹³ Section 2(42A)(hf) & section 49(2AE) of the ITA

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