Tribunal holds conversion of preference shares into equity shares is not transfer

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In brief

Recently,[1] the Mumbai bench of Income-tax Appellate Tribunal (Tribunal) held that the conversion of compulsory convertible preference shares (CCPSs) into equity shares will not be a "transfer" under section 2(47) of the Income-tax Act, 1961 (the Act), and thus deleted the capital gains addition made by the Tax Officer (TO).

In detail

Facts

- The taxpayer, a private limited company, was engaged in the business of investment activities. The taxpayer made investments in 51,634 CCPSs of company A (the company).
- As per the terms of the scheme for issue of CCPSs, one CCPS will, compulsorily and automatically get converted into one fully paid up equity share. The taxpayer was allotted 51,634 equity shares in the company on conversion of the CCPSs.
- The TO considered the conversion of the CCPSs as a transfer within the meaning of section 2(47) of the Act and computed the long-term capital gains as taxable.
- The Commissioner of Income-tax (Appeals) rejected the taxpayer's appeal and upheld the TO's order.

Issues before the Tribunal

Whether the conversion of the CCPSs into equity shares is a transfer of a capital asset under section 2(47) of the Act?

Taxpayer's contentions

- The conversion of CCPSs into equity shares was without any consideration and without any further action.
- The Central Board of Direct Taxes (CBDT) circular[2] which the Tribunal had followed in its earlier decision in the case of Vijay M Merchant[3] read as follows:

  "Where one type of shares 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."*
- Since the circular[2] above is beneficial to the taxpayer, it has to be adopted by the TO without any option. Therefore, gains, if any, on such conversions were not liable to capital gains tax under section 45(1) of the Act.
- Section 55(2) of the Act states that, when such newly converted shares are transferred later, the cost of acquisition of this share, for the purpose of computing the capital gains, shall be calculated with reference to the cost of the acquisition of

[1] ITA No. 1944/MUM/ 2018
[2] Circular dated 12 May, 1984 *vide* F. No. 12/1/64-IT(A)
[3] ITO *v.* Vijay M. Merchant [1986] 19 ITD 510 (Mumbai)

the original share of stock from which it's derived.

- If any capital gain tax arises on conversion, then the cost of acquisition would be the consideration adopted while computing this capital gain. However, by specifically stating so in section 55(2)(b)(v)(e) of the Act, the legislative intent is made clear to consider this conversion as a tax neutral.
- In case the taxpayer sells the equity shares received pursuant to the CCPSs, then the taxpayer will be allowed the original cost of the CCPSs as the cost of acquisition. If the conversion was taxable, the TO would tax the difference between the original cost of the CCPSs and the fair market value on the date of conversion. Thus, on actual sale of shares, it would tantamount to double taxation, considering the provisions of the Act.

Revenue's contention

Conversion of the CCPSs into equity is a transfer by way of exchange under section 2(47) of the Act, and the resulting gain is liable to tax as capital gain.

Tribunal's ruling

- The Tribunal relied on the decision in Vijay M. Merchant[3], which held that

  "...according to the circular, when the shares which are converted and are sold, capital gains are to be calculated on the basis of cost of original shares. Thus, the factum of conversion does not make any material difference in calculating the capital gains... the circular of the Government to which we have made reference above, clearly lays down that there *is no transfer when one type of share is converted into another type of share..."*

- According to the CBDT circular[2] where one type of share is converted into another type of share, there is no transfer of capital asset under section 2(47) of the Act. The present case before the Tribunal was not a case where one form of share was exchanged, bartered or swapped for other form of share. In the current case, one type of share was converted into another type, and the latter share had ceased to exist. Therefore, there was no exchange of any share, since the pre-conversion security had ceased to exist. Thus, it was evident that mere conversion of one type of share to another type would not be a transfer of a capital asset under section 2(47) of the Act.
- The decision in case of Vijay M. Merchant[3] was relied upon—wherein it was clearly laid down that, when shares, which were converted, was sold, capital gain was to be calculated based on the cost of the original shares. The factum of conversion did not make any material difference in calculating the capital gain. Therefore, it was held that there was no transfer when one type of share was converted into any type of share.
- There was no leakage of revenue if the above interpretation was adopted. It was of the view that this was in line with the legislative intent and in synchronisation with and without any conflict with other provisions.
- A contrary view is that, if the capital gain tax liability arose upon conversion, it would be against the legislative intent, making the composition of capital gain unworkable, and bringing it in conflict with other provisions of the Act. In fact, the contrary interpretation would lead to double taxation by, first, axing the capital gain upon such conversion. Second, at the time of computing capital gain upon the sale of such converted shares, double taxation would occur by allowing the cost of CCPSs as a cost of acquisition, instead of allowing for the consideration used in computing capital gain at the time of conversion.

The takeaways

The Finance Act, 2017 amended section 47 by inserting clause (xb), providing exemption to conversion of preference shares into equity shares of a company. However, this Tribunal ruling is a welcome move, since it provides clarity on the position adopted by taxpayers prior to introduction of the aforesaid amendment.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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