Tax Wire

Mumbai tax tribunal holds that ‘Conversion of CCPS into equity shares is Not taxable’

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adwith
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Conversion of CCPS into equity shares – Not a transfer

Background

The provisions of section 45(1) of the Income Tax Act, 1961 (the Act) brings into tax the profits or gains arising from the **transfer** of **capital asset** under the head 'Capital Gains'. Both the terms transfer and capital asset has been defined under the Act.

One issue that came before the Mumbai Bench of the tax tribunal is, 'whether conversion of Cumulative and Compulsory Convertible Preference Shares (CCPS) into Equity shares would be considered as transfer within the meaning of section 2(47) of the Act for charging capital gain tax?'

The summary of the proceedings and the ruling of the tax tribunal in the case of **Periar Trading Company Pvt Ltd**(PTCPL or the Company) **vs. ITO, Mumbai** [1] is captured in the ensuing paragraphs.

Facts of the Case

PTCPL was engaged in the business of investment activities and was also a partner in a registered firm. It held certain CCPS of Trent Limited (TL). As per the terms of the scheme for issue of CCPS, such CCPS wouldcompulsorily and automatically get converted into one fully paid up equity share at a certain date. Accordingly, interms of the above scheme, PTCPL was allotted one equity share of TL for every preference shareheld in TL. Such conversion was compulsory and automatic.

According to the Assessing Officer (AO), such conversion was "transfer" within the meaning of definition provided u/s 2(47)(i) of the Act and he brought into tax the difference between fair market value (FMV) of equity shares and the cost of acquisition of CCPS as long-term capital gain. This was also upheld by Commissioner of Income Tax (Appeals) (CIT(A)) on appeal by the tax payer.

<u>Submissions of PTCPL before the tax tribunal</u>

PTCPL placed the following arguments before the tax tribunal:

- PTCPL relied on the circular[2] issued by Central Board of Direct Taxes (CBDT) which stated that where one type of share is converted into another type of share, there is no 'transfer' of capital asset within the meaning of section 2(47).

- The above-mentioned circular was considered by the Mumbai tax tribunal in itsother decision in the case of ITO v. Vijay M. Merchant[3].

- It was also contended that, in case if such converted equity shares are sold, cost of acquisition to be considered while computing capital gain would be the original cost of CCPS as per section 55(2)(b)(v)(e) of the Act and not the consideration adopted while computing capital gain on conversion. Hence, on conversion of such CCPS if taxes are levied and again if the capital gain is taxed on actual sale of equity shares, it would tantamount to double taxation.

<u>Department's Submissions before the tax tribunal</u>

- Department placed reliance on the decision of Hon'ble Bombay High Court in the case of CIT vs. Santosh L. Chowgule [4] which categoricallyheld that preference shares and equity shares are different.

- They also relied on the decision in Addl. CIT vs. Trustees of H.E.H. The

[1] [2018] 100 taxmann.com 263 (Mumbai - Trib.)

[2] CBDT Circular F. No. 12/1/84-IT(AI) dated 12-5-1964

[3] [1986] 19 ITD 510 (Mum.)

[4] [1999] 105 Taxman 372/ [1998] 234 ITR 787

Nizam's Second Supplementary Family Trust [5] wherein the Hon'ble Andhra Pradesh High Court had held that conversion of preference shares into equity shares is nothing but barter, which constitute transfer by way of exchange within the meaning of section 45 of the Act.

- Further, they also relied on the Hon'ble Supreme Court ruling in the case of CIT vs. Motors and General Stores (P.) Ltd[6] where it was held that exchange of cinema hall for certain number of tax-free cumulative preference shares is transfer.

Ruling by the Tax Tribunal

The tax tribunal ruled in favour of the arguments placed by the tax payer and against the tax department for the following reasons:

- The tax tribunaltook cognizance of its own decision in Vijay M. Merchant (supra) where it wasclearly laid down that when shares, which are converted and sold; capital gain is to be calculated on the basis of cost of original shares. The Factum of conversion does not make any material difference in calculating the capital gain.

- The Hon'ble Tribunal held that the present case is not a case where one form of share has been exchanged, bartered, swapped for other form of share. It considered it as conversion, where one type of share is converted into other type and earlier type of share is ceased to exist and held that there is no exchange of any share as the pre-conversion security has ceased to exist.

- Tribunal relied on the circular of CBDT and stated that the present case is a case where one type of share is converted into another type of share, thereby it is not a transfer of capital asset within the meaning of section 2(47) of the act.

- The tax Tribunal also stated that, if it is held that conversion of CCPS into equity would not give rise to any taxable event, then it would be within the ambit of legislative purview and would also not result in any revenue loss, hence it is also logical. Further, the tribunal also stated that if it is held that conversion would result into taxable capital gains, then, it would result into double taxation - once on conversion of shares and then because of section 55(2), the cost on further sale would also be the cost which was incurred to purchase the CCPS and not the FMV offered to tax on conversion, resulting in double taxation.

Advith Comments

- The tax tribunal has upheld the most logical interpretation of taxability of conversion of shares of one form to another. Issuing convertible instruments and then letting them convert into equity shares is a regular mode of structuring transactions. Such a mode is adopted with varied intentions which are of commercial relevance. Taxing such an event which does not result in any form of gain, would be against the legislative intent. Therefore, it is a very welcome decision and should all those facing similar litigations.

- It is important to note that this ruling pertains to period prior to the amendment by Finance Act, 2017 which introduced specific provision (section 47(xb)) into the Act, with effect from 1st April 2018 exempting conversion of preference shares into equity shares from Capital Gain Taxation. With this ruling, it puts to rest that such conversion was never intended to be taxable.

[5] [1976] 102 ITR 248
[6] [1967] 66 ITR 692

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