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Amalgamation – Action in concert for tax benefit?

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The High Court of Gujarat observed in *Wood Polymer*[1] *"…and the court would not lend its assistance to defeat public interest, namely, tax provision."* A recent order of National Company Law Tribunal (NCLT) refusing to accord sanction to amalgamation scheme has raised certain interesting yet important questions.

The phrase 'likely to be affected' means a person may or may not suffer injury or damage though there is a fair chance that he may come to some detriment. This would be the common understanding of the phrase. Of course, since this phrase is part of Section 230(5) of the Companies Act, 2013 applying *mutatis mutandis* to Section 232 which deals with merger and amalgamation of companies, it assumes significance since income tax authorities are specifically mentioned as one of the parties to whom notice of amalgamation is to be given providing them an opportunity to make representation. Under the Companies Act, of 1956, notice was to be issued to the Central Government and the interests or concerns of the tax department were highlighted either by the government or at time by shareholders objecting to the scheme and so on. With the Act of 2013 in place, the income tax department no longer needs to implead itself, to prove *locus standi* as a creditor or interested party to object to the possible revenue leakage in the proposed transaction[2].

Amalgamations – Concessions under IT Act

Some of the benefits which are envisaged for transactions of amalgamation and merger are that the transfer of shares by an amalgamating company by a shareholder would not be considered a transfer for purpose of capital gains, subject to certain conditions. The Income Tax Act (the Act) also provides for carry forward of losses and depreciation by the amalgamated company (subject to conditions). These provisions were enacted to incentivize reconstruction or revival of sick or loss-making companies so that the public and stakeholders like workmen are not adversely affected by closure of industrial units. The Act defines amalgamation and also states that the property of the amalgamating company should become the property of the amalgamated company otherwise than as a result of purchase.

NCLT Order

In a recent case before NCLT[3] (*Ajanta Pharma*), the income tax department objected to the scheme of amalgamation proposed by the petitioner/applicant companies which had common shareholders stating that the main purpose of the amalgamation was avoidance of tax and that it amounted to abuse of the provisions of the Act. The NCLT declined to sanction the scheme stating that tax concerns must be addressed prior to approaching the NLCT for sanction. The fact that the amalgamating company undertook to pay

[1] [1977] 109 ITR 177 (GUJ.)
[2] Vodafone Essar, [2013] 35 taxmann.com 397 (Gujarat)
[3] CSP No. 995 & 996/ 2017, CSA No. 791& 792 /2017, Order of NCLT, Mumbai Bench dated 30.8.2018

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applicable taxes was not accepted to be a sufficient redressal of the concerns of the tax authorities. The NCLT also held that the scheme was not in public interest since it would benefit only the four common shareholders who were members of the promoter family who would receive shares valued at about Rs. 1477 crores whereas the investment was only about Rs. 48 crores. It was of the view that the scheme did not confer any benefit to the thousands of other shareholders who had consented to the scheme.

Precedents distinguished

The transaction in question may be described as quite commonplace, in which an investment company wherein members of the promoter group are shareholders, was sought to be amalgamated with the other so as to reduce the number of layers of share-holding. The objection of tax department was that ideally the company should have sold its investment or property - which is shares in the other company and paid tax on the business income, applicable taxes on distribution of dividend – all of which were avoided by the scheme of amalgamation. Such objections have been raised in the past, but decisions have tended to favour applicants for amalgamation reasoning that an otherwise legitimate or commercially sound transaction should not be questioned only because it confers some tax benefits. The principles laid down in various judgments including *Azadi Bachao Andolan*[4] have invariably been followed to hold in favour of the assessee/business rather than the revenue department. However, in the decision under discussion the NCLT distinguished the decisions in favour of the applicant / taxpayer including that of *AVM Capital Markets*[5].

[4] [2003] 263 ITR 706

[5] CSP No. 670/2011, decision of High Court of Bombay dated 12-7-2012.

Applicability of GAAR

It is interesting to note that in its Circular 27-1-2017, the CBDT had clarified that GAAR would not apply in case the scheme of amalgamation is sanctioned by the Court after explicitly and adequately considering the tax implications. However, in *Ajanta Pharma* the GAAR provisions have been cited at the stage of sanction and perhaps, all that the revenue authorities had to show was the likelihood or possibility of detriment. This is a much lesser threshold than the application of GAAR which requires the Assessing Officer to convince the Principal Commissioner and the Approving Panel that GAAR is applicable to the transaction.

GAAR provisions were made applicable in respect of any assessment year beginning from or after 1-4-2018, i.e. transactions upto 31-3-2017 would not attract GAAR. The provisions were made applicable from 1-4-2017 after being deferred a couple of times since 2012 when the provisions were introduced into the Act. Thus, it would appear that the idea was to give the industry comfort in terms of the applicability of the provisions aimed at tax avoidance. In *Ajanta Pharma*, the appointed date was fixed as 1-4-2016 though the sanction of the NCLT would have be at a later date, that is after 1-4-2017. The applicability of GAAR to this transaction is not free from doubt.

Determination of an impermissible arrangement under GAAR is a highly subjective exercise. However, in the transaction under discussion, it would seem that establishing that the main purpose (rather than 'one of the main purposes' in the original definition) was tax avoidance would be a difficult task.

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Way forward

The decision in *Ajanta Pharma* and the NCLT's acceptance of the objections raised by the income tax department as being 'valid objections' can for sure become hurdle to business plans unless one is able to demonstrate the commercial substance in transactions. This would involve adequate analysis of tax implications of transactions and ensuring that the scheme framed is not seen as being against public interest. The current jurisprudence is largely in the context of the Companies Act of 1956 and GAAR were or could not have been not cited. Hence, the open questions are likely to be addressed only when they are examined by the higher judicial fora.

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Notification

CBDT notifies transactions to which condition of Securities Transaction Tax (STT) having been paid would not apply

As per section 112A, long term capital gains accruing on transfer of equity shares are chargeable to tax at 10% if STT has been paid on acquisition and transfer. CBDT, vide Notification No. 60/2018 dated 1-10-2018 has notified the transactions to which the condition of payment of STT as mentioned in Section 112A(1)(iii)(a) will not apply. The transaction covered are acquisition of equity shares entered into before 1-10-2004 or, on or after 1-10-2004 to which STT does not apply. However, acquisition of listed shares which are not frequently traded and made through preferential issue, where transaction is not entered into through a recognised stock exchange would not be covered. Certain other acquisitions to which the condition of STT will not apply are acquisition by scheduled banks, reconstruction and securitization companies in the ordinary course of business, acquisition in accordance with SEBI Takeover Code, transfer on dissolution of a firm and a slump sale.

Ratio Decidendi

Interpretation of Articles 12 and 14 of Indo-German and Indo-Swiss DTAAs – More beneficial Article to apply

The assessee, an Indian company, was making payments to a German individual resident which according to the Revenue fell under the category of 'Fees for technical services' as per Section 9(1)(vii) of the Income Tax Act and Article 12 of the Indo-German DTAA and thus, the assessee was under obligation to deduct tax at source as

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per Section 195. The assessee's contention was that the payment was in the nature of 'independent scientific activity' as per Article 14 of the DTAA and thus, there was no liability to deduct at source. The Tribunal was of the view that the payment made fell within both the categories provided by Articles 12 and 14 of the DTAA. Therefore, the issue which arose was which provision was to be applied. The Tribunal relied on the rules of interpretation of treaties to accept the assessee's contentions and held that where both the Articles were applicable, Article 14 would take precedence over Article 12, because the former is a special provision while the latter is a general provision. The same is because Article 14 applies specifically to 'professional services' provided by 'individual residents', while Article 12 applies to all residents of a foreign country and is thus broader in scope and general in nature. It also held that since the assessee's case fell under the more beneficial provision i.e. Article 14, wherein no tax liability to deduct tax at source arose, the same was to be applied.

A similar issue also arose before the Tribunal involving the interpretation of Articles 12 and 14 of the Indo-Swiss DTAA, wherein payments of the nature mentioned above had been made to a Swiss resident. Therein, the Tribunal held that since Article 12(5) of the DTAA made a specific exclusion for payments made for services covered under Article 14, there was no obligation on the assessee to deduct tax at source. [*Poddar Pigments* v. *ACIT* - ITA No. 5083/Del/2014]

Test of privity and locus with source of income to determine whether there is diversion by overriding title

The assessee was the exclusive licensee engaged in manufacture and sale of alcoholic beverages. It had entered into an agreement with the subsidiary of a foreign company in terms of which it received the right to use the trademarks and also the concentrate used for bottling. It received funds to meet operating expenses and at the end of the year it transferred the surplus funds to the Indian subsidiary and claimed the same as expenses. The assessee received remuneration at an agreed rate from the Indian subsidiary for whom it acted as bottler and offered the same to tax. The arrangement between the parties was that the contractor could directly swipe the account leaving the amount due to the assessee.

The Assessing Officer however held that the surplus is not an allowable expenditure, but it is income of the assessee. The assessee argued that it had offered the bottling charges to tax and the surplus transferred was not its income. It also stated that the Indian subsidiary (contractor) had overriding title over the sums in question. Alternatively, the assessee argued that the sum should be treated as trading loss of the assessee. Ruling against the order of the CIT(A) as well as the Tribunal, the High Court held that though the contract between the assessee and the Indian subsidiary seemed to indicate that the assessee was only a job worker, it was in reality the person earning the income. As exclusive licensee, the assessee was the proprietor of the business and any transfer of the surplus was only an application of income. The surplus was taxable in the hands of the assessee and it was immaterial whether the same had been offered to tax by the other party. The High Court also observed that to satisfy the principle of overriding title there must be either a statutory basis or decretal binding and though private contractual arrangement may also bring about such overriding title it has to be examined carefully to ensure that it is not a device to divert applicability of income tax laws. [*Pr.CIT* v. *Chamundy Winery and Distillery* - [2018] 97 taxmann.com 568 (Karnataka)]

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Interest on mobilisation advance given to contractor for construction of plant is capital receipt

The High Court of Kerala has held that interest received on mobilisation advances made to the contractor would be capital receipt and not revenue receipt. The assessee had made certain advances to the contractor to ensure that the project- construction of steel plant is commenced and completed smoothly. On completion of the project the amounts were adjusted in the final bills of the contractor. The Tribunal had held that the interest received by the assessee was revenue in nature. However, relying on *CIT v. Bokaro Steel Ltd*. [1999] 102 Taxman 94 the High Court held that since the mobilisation advances were intrinsically connected with the construction of the steel plant and not from any independent source, interest thereon would be capital receipt. [*Roads and Bridges Development Corporation of Kerala Ltd* v. *ACIT* - [2018] 257 Taxman 392]

Liquidated damages received for failure to construct building could form part of consideration for relinquishment of capital asset

The assessee company entered into a memorandum of understanding with a builder, pursuant to which a sum of Rs 40 Crores was paid by the former to the latter, for acquiring right, title and interest in a well- constructed property. This was followed by an allotment letter from the builder, pursuant to which the builder was obliged to give the possession of the allotted area within an agreed period of time. However, the builder failed to give the possession of the property within time and also the damages for the same. In the arbitration proceedings the parties entered into a cancellation of MOU whereby the assessee company relinquished its right in the constructed area and was also refunded the sum of Rs 40 crores. Further, a settlement deed was entered, accordingly, the assessee company was awarded liquidated damages to the tune of Rs 10 crores. Later, the assessee company claimed the receipt of Rs 40 crores as long term capital loss and liquidated damages received were claimed to be exempt on account of it being compensation for loss of source of income. The assessing officer rejected the claim of long term capital loss on the contention that since the property was not in existence when the MOU was entered, no right in the nature of capital asset came into existence.

With regard the liquidated damages, the assessing officer treated same as short term capital gain and also calculated MAT on the same. The Tribunal rejected the assessing officer's contention of there being no capital asset vis-a vis MOU. The Tribunal relying on the judgement of the High Court of Bombay in the case of *M/s Bina Indrakumar* held that since the allotment letter was enforceable under Maharashtra Ownership of Flat Act 1963, the rights were capable of being enforced. Thus, the allotment letter created a transferable/assignable right in the immovable property yet to be constructed and by relying upon the judgement of Supreme Court In the case of *Sanjeev Lal vs. CIT*, this right was held to be a capital asset u/s 2(14) of the Income-tax Act, 1961. When the assessee relinquished this right, there was a transfer of capital asset and hence receipt of Rs. 40 crores were liable to be taxed u/s 45 of the Act. However, with respect to the liquidated damages, the Tribunal held that this forms part and parcel of the consideration received for the relinquishment of the right in immovable property and hence capital gains shall be computed by taking Rs. 50 crores as sales consideration. [*Bhansali Infotech (P.) Ltd*. v. *DCIT* - Mumbai 2018 96 taxmann.com 376]

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Compounding fee which is compensatory in nature is an allowable expense

The Assessing Officer disallowed expenditure towards compounding fee paid by the assessee as per the direction of the Legal Metrology department stating that it was covered within the ambit of Explanation to Section 37(1). As per the Explanation an expense which is for any purpose which is an offence or prohibited by law would not be allowable as an expenditure incurred for the purpose of business. The Tribunal held that on perusal of the letter from the Inspector of Legal Metrology and facts and circumstances of the case, the payment did not appear to be a penalty and it was compensatory in nature. Further, the assessee had incurred the expenditure to avoid protracted litigation and hence was motivated by commercial purpose and not any illegal purpose. Hence, it was held that the expenditure towards compounding fee was deductible business expense. [*Ocean Agro (India) Ltd* v *DCIT* - [2018] 172 ITD 157]

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