



## Tax Implications On Mergers And Acquisitions Process

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### Abstract

*In today's fast changing economic & market conditions, the organizations has to come across with many opportunities & challenges, to cope with these organizations adopt many strategies, mergers and acquisitions is also one of them. Mergers & acquisitions provides many advantages to the organization concerned like technological, financial, competitiveness, tax benefit and many other benefits. The current paper deals with tax implications on corporate reconstruction in terms of mergers & acquisitions. The tax implications are studied in terms of buyers & sellers, acquiring and acquired firms and shareholders perspectives. The paper gives a broad outline of tax advantages in legal perspective to the organization going for corporate restructuring in any form like mergers & acquisitions, buyout, takeover, cross border merger etc.*

**Keywords:** mergers & acquisitions, corporate restructuring, share buyout, slump sale.

### Introduction

The terms 'mergers', and 'acquisitions' are often used interchangeably. However, there are differences. While merger means unification of two entities into one, acquisition involves one entity buying out another and absorbing the same.

There are several advantages in M&A — cost cutting, efficient use of resources, acquisition of competence or capability, tax advantage and avoidance of competition are a few. The first part deals with the buyers and sellers perspective with regard to neutrality of Tax

The Indian Income-Tax Act refers to amalgamations to mean merger of one or more companies with another company or the merger of two or more companies to form another company. There are different strategies for acquiring the business which I have tried to address in this paper.

The Indian law starts on the premise that transfer of capital assets in a scheme of amalgamation by the amalgamating company to the amalgamated company will attract capital gains tax. However, if the amalgamated company is an Indian company, it is exempted from capital gains tax.

The transfer of capital assets by the amalgamating company will not be considered as transfer so as to exempt the transaction from capital gains tax. The shareholder is also conferred exemption as long as the two entities are Indian companies. However, exemption is not available when cross-border M&A takes place, unless the resultant company is an Indian outfit. One of the major considerations will be the carry forward of tax losses of the acquired company so as to reduce the tax burden in the hands of the profit-making acquirer company. After all, Section 47 clearly indicates that amalgamation is not regarded as transfer.

Companies often undertake M&A to get the benefit of carry forward and set off of operating losses or tax credit. The condition insisted upon is that the acquirer should

continue to operate the pre-acquisition business of the company. This will hold good even in respect of cross-border amalgamation.

When the asset is acquired on amalgamation, the cost taken will have to be as that of the amalgamating company, as provided under Section 49(i) (iii) of the I-T Tax Act.

Whether the tax incentives that encourage merger activity are desirable or not, it is important to know what their impact is. The tax impact of properly structuring the disposition and acquisition of a company can have a very material impact on the economics of the transaction to both parties. , there are numerous tax planning opportunities that allow each party to obtain its specific tax and economic objectives without harming the other party. This part deals with the implications of tax on shareholders of amalgamating company, implications on amalgamating and amalgamated companies.

Finance Act 1999 made amendments to avoid adverse tax implications in the case of demerger of companies. Transfer of capital assets by a demerged company to a resulting Indian company is exempted under Section 47 (vi) (b)). Transfer of shares of an Indian company by a demerged foreign company to the resulting foreign company is exempt provided shareholders holding at least three-fourths in value of the shares of the demerged company continue to be shareholders of the resulting company and the transfer is not liable to capital gains tax in the country where the demerged company is incorporated. This part summarizes the work and there has been surprisingly little research on this question



The proviso to this clause clarifies that the provisions of Sections 391 to 394 of the Companies Act shall not apply in the case of such demergers. Transfer or issue of shares by the resulting company to the shareholders of the demerged company in consideration of the demerger of the undertaking is exempt. The Indian Income Tax act at the individual and corporate level imposes an extremely complicated set of provisions for mergers and acquisitions; the tax system is certainly not neutral in this area. **But do taxes really play a significant role in the merger decision.**

Merger & Amalgamation would raise some very pertinent issues and tax aspects, which I have tried to address in this paper i.e. whether the acquirer company would enjoy same tax benefits, which were previously enjoyed by the acquired company in respect of its business incomes/expenses. How the gains from sale/ transfer of the assets/undertaking of the acquired company would be treated? And what about the allotment of shares in the acquirer company to shareholders of the acquired company? (The above issues will have principally impact on the two heads i.e. **Income from Profits & Gains of Business impacting** (Expense claims and Exempt incomes) and **Income under the head Capital Gains arising from** ( Transfer of capital assets of the acquired company and Exchange of shares in the acquired company for shares in the acquirer company.))

### Methodology

Two ways of research have been followed in completing this paper

- a) Analytical research
- b) Applied research

As far analytical is concerned materials and essential readings were made through different books and articles and application of mind was done to understand it in a better manner. In applied section I have tried to answer the question that arose in my mind in this regard.

In this era of cyber age the potentiality of the internet resources cannot be undermined. Consequently, researcher has referred to the internet resources in the major portions of this paper. Researcher basically relied on internet option to complete her paper

Reference has also made to news papers and other multimedia. The researcher has tried to find out strategic implications of the decision of the board of directors for reconstruction of the companies. Further the researcher has tried to provide the basic concepts and introduction of these concepts, their use and significance in the decision of the board as far as tax implications are concerned.

### Objective Of The Paper

The objective of the paper is to understand the principle and tax implications of the reconstruction of the companies.

### M&A - Income Tax perspective

Throughout the waves of mergers, there has been no shortage of explanations for the increase in the activity in the market for corporate control. Some explanations emphasize the positive role that mergers and takeovers play in the allocation of resources in society. For example, corporate acquisitions may lead to the replacement of a poor management team; they may facilitate the contraction of an industry in which no firm would voluntarily adopt a reduction in size; they may generate synergies through the combination of complementary resources.

Yet clearly there are also explanations that have negative implications for social welfare. The most obvious, of course, is a reduction in the level of competition in a market. The tax motive has also been mentioned frequently. To the extent that corporation and their shareholders reap windfall gains via tax reductions, the treasury may be unintentionally subsidizing takeover activity that must be paid for by others in the fiscal system. It is noteworthy, however, that combining firms may also facilitate more efficient behavior on their own part by reducing their taxes. For example wiping out tax losses may increase firm's incentive to invest, particularly when new investment brings large, immediate depreciation deductions and investment tax credits that can only be used by the taxpaying firm.

The Income Tax Act, 1961(here in after, "The Act"), primarily governs levy and collection of Income Tax in India, wherein it is provided that tax is levied on a "person"<sup>1</sup> in respect of his taxable 'income'. The Act prescribes five principle head of income.<sup>2</sup> It is further provided that every receipt must qualify under any of the five heads for it to be taxable; else the same cannot be taxed.

<sup>1</sup> Person' is defined as an individual, a company, a firm, an association of persons or a body of individuals whether incorporated or not. Company includes Indian companies and foreign companies. The category of 'person' influences the tax treatment and the tax rates. The residential status of the person influences the scope of income liable to tax in India

<sup>2</sup> Heads of income are, Salary, Income from House Property, Profits and Gains of Business or Profession, Capital Gains, and Income from Other Sources (viz., interest, dividends and specified receipts).



## Seller and Buyer perspective- Merger could be tax Neutral

### Seller's perspective

1. No tax for the amalgamating company or its shareholders.
2. Cost of acquisition for new shares received would be the same as the cost of acquisition for shares held in amalgamating company. The period of holding of shares also to be reckoned from the time shares were held in amalgamating company.

### Buyer's perspective

1. Amalgamated entity can avail the tax benefit in relation to the accumulated losses and the unabsorbed depreciation of the amalgamating company, in the previous year in which the amalgamation was effected, subject to prescribed conditions.
2. Tax Benefits in the nature of tax incentive for export oriented units, expenditure for scientific research, acquisition of patent rights/copyrights, expenditure on prospecting for minerals and amortization of preliminary expenses pertaining to transferor company will be available to transferee company.
3. Depreciation on assets – both intangible and tangible will be proportionately available to the transferor and transferee.

### Tax Concessions:

Broadly speaking the following tax concessions are available if an amalgamation satisfies the conditions of Section 2(1B) and the amalgamated company is an Indian company:

1. Non-chargeability of capital gain on the transfer of a capital asset including shares held by a shareholder at the time of amalgamation<sup>3</sup>
2. Eligibility of amalgamated company for the deduction in respect of any asset representing expenditure of a capital nature on scientific research,<sup>4</sup>
3. Eligibility of the amalgamated company for the deduction in respect of acquisitions of patent rights or copy rights<sup>5</sup>
4. Similar deduction in respect of expenditure on know-how as provided in<sup>6</sup>.
5. Amortization of expenditure for obtaining telecom licence fees<sup>7</sup>
6. Amortization of certain preliminary expenses<sup>8</sup>.
7. Amortization of expenditure on amalgamation.<sup>9</sup>

<sup>3</sup> Section 47(vi) and (vii) .

<sup>4</sup> Section 35(5).

<sup>5</sup> Section 35A(6).

<sup>6</sup> Section 35AB(3)

<sup>7</sup> Section 35ABB(6).

<sup>8</sup> Section 35D(5) read with rule 6AB

<sup>9</sup> Section 35DD

8. Amortization of expenditure on prospecting etc. for certain minerals.<sup>10</sup>
9. Writing off bad debts.<sup>11</sup>
10. Deduction in respect of any expenditure for the purposes of promoting family planning as<sup>12</sup>
11. Computation of written down value of the transferred fixed assets in the case of amalgamated company.<sup>13</sup>
12. Continuance of deduction available.<sup>14</sup>
13. Benefit of carry forward and set-off of accumulated losses and unabsorbed depreciation<sup>15</sup>

## Types of Acquisitions in India

Depending upon the business strategy, an entity may acquire

- (a) The entire business, done by way of: Merger/Amalgamation or Share buy-out
- (b) A part of the business, being a unit or an undertaking, by way of Acquisition through a De-merger or Slump sale

The Act seeks to extend tax neutral treatment to transactions of mergers and de-mergers. The tax neutrality is subject to fulfillment of prescribed conditions under the Act.

### Merger that will not be called as amalgamation as per Income tax Act

- The merger should be pursuant to a scheme of amalgamation.
- All the assets and liabilities of the amalgamating company should be included in the scheme of amalgamation.

## Merger or Amalgamation

For a merger to qualify as 'amalgamation' under the provisions of the ITA, the definition<sup>16</sup> highlights that the following conditions need to be satisfied:

<sup>10</sup> Section 35E(7) read with Rule 6AB

<sup>11</sup> Section 36(1)(vii)

<sup>12</sup> Section 36(1)(ix).

<sup>13</sup> Explanation 2(b) to Section 43(6)

<sup>14</sup> Section 80-IA and 80-IB

<sup>15</sup> Section 72A.

<sup>16</sup> Section 2(1B) of the ITA defines amalgamation as, "Amalgamation in relation to one or more companies means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that:

(i) All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of amalgamation.



- a) No prescribed time limit exists within which the property of the amalgamating company should be transferred to the amalgamated company.
- b) The requirement that the shareholders holding seventy five per cent (75%) in value of the shares in the amalgamating company to be shareholders in the amalgamated company applies to both preference and equity shareholders. However, it does not prescribe any minimum holding in the amalgamated company, nor does it stipulate for how long they should continue being shareholders in the amalgamated company.
- c) The consideration to the shareholders of the amalgamating company can be a combination of cash and the shares in the amalgamated company.

In *Central India Industries Limited v. CIT*<sup>17</sup>, it was laid down that amalgamation is an arrangement whereby the assets of two companies become vested in or, under the control of one company (which may or may not be any one of the original two companies), which has as its shareholders all, or substantially, all the shareholders of the two companies.

### Implications under the Income Tax Act, 1961

Tax implications can be understood from the following three perspectives:

- a) Tax concessions to the Amalgamated (Buyer) Company
- b) Tax concessions to the Amalgamating (Seller) Company
- c) Tax concessions to the shareholders of an Amalgamating Company.

#### a) Tax concessions to the Amalgamated Company

If the amalgamating company has incurred any expenditure eligible for deduction under sections 35(5), 35A(6), 35AB(3), 35ABB, 35D, 35DD, 35DDA, 35E and/or 36(1)(ix), prior to its amalgamation with the amalgamated company as per section 2(1B) of the Act and if the amalgamated company is an Indian company,

(ii) All the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of amalgamation.

(iii) Shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies (other than shares held therein immediately before the amalgamation or by a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of distribution of such property to the other company after the winding up of the first-mentioned company.”

<sup>17</sup> (1975) 99 ITR 211

then the benefit of the aforesaid sections shall be available to the amalgamated company, in the manner it would be available to the amalgamating company had there been no amalgamation. Also under section 72A of the Act, the amalgamated company is entitled to carry forward the unabsorbed depreciation and unabsorbed accumulated business losses of the amalgamating company provided certain conditions are fulfilled.

#### b) Tax concessions to the Amalgamating Company

Any transfer of capital assets, in the scheme of amalgamation, by an amalgamating company to an Indian amalgamated company is not treated as transfer under section 47(vi) of the Act and so no capital gain tax is attracted in the hands of the amalgamating company.

#### c) Tax concessions to the Shareholders of an Amalgamating Company

When the shareholder of an amalgamating company transfers shares held by him in the amalgamating company in consideration of allotment of shares in amalgamated company in the scheme of amalgamation, then such transfer of shares is not considered as transfer under section 47(vii) of the Act and consequently no capital gain is attracted in the hands of the shareholder of amalgamating company. The above are only few out of the various tax concessions available to the aforementioned categories of the assesses due to M&A transactions.

In the following discussions, wherever applicable, appropriate inputs are given in case of specific requirements relating to acquisitions by foreign entities.

Where an Indian target entity is sought to be acquired by a foreign entity, it may be noted that the corporate laws permit only domestic companies to be amalgamated. So the foreign acquirer have to create a local special purpose vehicle (SPV) in India to give effect the amalgamation with the Indian company and more over the SPV avails the tax benefits on amalgamation under the Act since the same are subject to the amalgamated company being an Indian company.

### Specific conditions for foreign companies to avail tax concessions on Merger/De-Merger

In the case of foreign companies holding shares of Indian companies, on amalgamation or de-merger of the foreign company with another foreign company, the transfer of shares would enjoy exemption from capital gains tax, subject to the following conditions:

- a. At least 25% shareholders of the amalgamating foreign company<sup>18</sup> 75% of shareholders of the de-

<sup>18</sup> S.47(via) of the Act



merged company<sup>19</sup> continue to remain share holders of the amalgamated foreign company/resulting foreign company and

- b. Such transfer does not attract tax on capital gains in the country of incorporation of the amalgamated/resulting company. Amalgamation when effective: – Date of amalgamation.

Every scheme of amalgamation provides for a transfer date from which the amalgamation is effective i.e., the ‘Appointed Date’.

The ‘effective date’ is the date when the amalgamation actually takes place after obtaining the jurisdictional Court Approval and furnishing of the relevant documents with the Registrar of Companies.

The effective date thus differs from the appointed date. To illustrate, the management of two companies have agreed that the merger shall be effective January 1, 2007 (the appointed date). However, the merger may be completed say, on October 31, 2007 (the effective date). For purposes of income-tax, the appointed date mentioned in the Scheme, and not the date of receiving the last approval for the amalgamation, should be considered<sup>20</sup>.

For the period between the appointed date and the effective date, the amalgamating company would carry on business as trustee of amalgamated company. During such period, provisional tax filing with adequate disclosure is required to be made.

## Tax Implications on Mergers and Acquisitions

Mergers and acquisitions (M&As) are an accepted strategy for corporate growth. While they may create value, mitigate agency problems associated with a firm's free cash flow, enhance the firm's market power, or help utilize tax credits. The tax impact of properly structuring the disposition and acquisition of a company can have a very material impact on the economics of the transaction to both parties. , there are numerous tax planning opportunities that allow each party to obtain its specific tax and economic objectives without harming the other party.

### Capital Gains

Capital Gains refer to the spread between the cost of acquisition (here in after, CoA) and sale price resulting

from the ‘transfer’<sup>21</sup> of a ‘capital asset’<sup>22</sup> during the financial year. The spread is a gain where the sale price exceeds the CoA and such gain is per se liable to tax in the hands of the transferor, unless otherwise specified. These changes were heralded, inter alia, through the abolition of the managing agency system, the passage of the MRTP Act 1969, the nationalization of the banking system in 1969 and the announcement of new provisions granting tax relief in the Finance Bill for 1967.<sup>23</sup>

## A. Implications To Shareholders Of Amalgamating Company

### i) Capital gains tax liability on the shareholders of the amalgamating company

Shareholders of an acquired corporation can receive many forms of payment when they sell their shares as part of a merger or acquisitions. Such receipts may be deemed taxable or nontaxable. If they are taxable, then the shareholders must pay capital gains taxes on their gain over basis.

The question whether allotment of shares, debentures, or payment of cash etc. to the shareholders of the merging company attracts liability to the capital gains is debatable. One view is that this results in the exchange of shares in merging company for the shares in merged company. Therefore, it would attract liability to capital gains tax. The contrary argument is that there can be no liability to capital gains tax because there is no exchange of shares there are in effect two separate transactions.<sup>24</sup>

<sup>21</sup> Definition of Transfer under the Act is quite wide and includes the sale, exchange or relinquishment of a capital asset or a right therein.

<sup>22</sup>Capital asset is defined to include property of any kind whether fixed or circulating, movable or immovable, tangible or intangible. It expressly excludes stock-in-trade, consumables; personal effects (except jewellery); specified agricultural land and specified gold bonds

<sup>23</sup> The income tax Act, 1961 contains special provisions for some type of amalgamation and provides for some tax reliefs subject to certain conditions. The tax relief relates to development rebate and development allowance. The finance Act, 1967 extended the sphere of reliefs in tax matters in relation to an amalgamation. Under the Act, as amended, the issue of shares by the transferee company to the shareholders of the amalgamating companies will not by itself give rise to a liability to capital gain tax. The shares in the transferee company will be treated as the same as the shares in the amalgamating companies. It further appears that no part of the value of the shares received by shareholders in exchange under a scheme of amalgamation may be considered as dividend.

<sup>24</sup> Cancellation of shares of the merging company takes place when the company ceases to exist. Such cancellation of shares does not amount to transfer since the shares are extinguished. The expression “extinguishment of rights therein” in the

<sup>19</sup> S.47(vic) of the Act

<sup>20</sup> *Marshall Sons and Co. (India) Ltd. v. ITO* [(1997) 223 ITR 809]



This process presupposes the relinquishment of shares in amalgamating company held by shareholders thereof. It is important to determine whether this constitutes a transfer under section 2(47) of the ITA, which would be liable to capital gains tax. According to judicial precedents in this regard, including decisions of the Supreme Court till recently, this transaction did not result in a "transfer" as envisaged by section 2(47).

In the case of *Commissioner of Income Tax v. Mrs. Grace Collis and Another*<sup>25</sup>, the SC has held that "extinguishment of any rights in any capital asset" under the definition of "transfer" would include the extinguishment of the right of a holder of shares in an amalgamating company, which would be distinct from and independent of the transfer of the capital asset itself. Hence, the rights of shareholder of the amalgamating company in the capital asset, i.e. the shares, stands extinguished upon the amalgamation of the amalgamating company with the amalgamated company and this constitutes a transfer under Section 2(47) of the ITA.

The provisions of Section 45 relating to capital gains will not apply to any transfer by a shareholder when a shareholder in the scheme of amalgamation transfers the shares held by him in the amalgamating company if the following conditions are satisfied<sup>26</sup>.

- a) The transfer is made in consideration of allotment to him of shares in the amalgamated company; and
- b) The amalgamated company is an Indian company.

The question is whether in the absence of or on failure to satisfy the conditions specified in Section 47(vii), a shareholder receiving shares in the amalgamated company is liable to capital gains tax. No such tax would be payable unless amalgamation involves was a transfer within in the meaning of section 2(47)<sup>27</sup>. As a matter of

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definition of 'transfer' in section 2(47) denotes that the asset should continue to exist.

<sup>25</sup> [2001] 248 ITR 323 (SC)

<sup>26</sup> Section 47(vii)

<sup>27</sup> "transfer", in relation to a capital asset, includes,—

- (i) the sale, exchange or relinquishment of the asset; or
- (ii) the extinguishment of any rights therein; or
- (iii) the compulsory acquisition thereof under any law; or
- (iv) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment;] [or]
- [(iva) the maturity or redemption of a zero coupon bond; or]
- [(v) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882 (4 of 1882); or]
- [(vi) any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or

fact even in the absence of Section 47(vii) of the Act, a shareholder need not pay any capital gains tax, since an amalgamation does not involve exchange or relinquishment of the assets or the amalgamation of any right therein or the compulsory acquisition under any law. It does not involve any exchange either within the legal meaning of that term.<sup>28</sup> In the Act, neither the word "exchange" nor "relinquishment" is defined.<sup>29</sup> Thus merger does not involve an 'exchange'. The merger does not involve relinquishment of an asset because relinquishment postulates the continued existence of the asset

Amalgamation does not involve an exchange or relinquishment of shares by amalgamating company as held in *CIT v. Rasik Lal Manek Lal*<sup>30</sup>.

## B) Implications On Amalgamating Company

### Capital gains tax implication for the amalgamating (transferor) company

There will be no capital gains tax on transfer of a capital asset by the amalgamating company to the amalgamated company in the scheme of amalgamation if the amalgamated company is an Indian company.<sup>31</sup>

Charge of capital gains arises in respect of profits or gains arising from transfer of capital assets. Income is to be computed from the consideration for transfer. In other words if there is no consideration, capital gains cannot arise.<sup>32</sup> In case of merger, properties and liabilities of merging company vest in the merged company by virtue of a court sanctioned scheme.<sup>33</sup> The consideration for such vesting flows directly to the shareholders in the form of cash, equity shares and the like. Thus so far as company is concerned, since it would not receive any consideration, no capital gains would arise in the hands of company.

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any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property:

<sup>28</sup> Kanga, palkhivala and Vyas, *The Law and practice of Income Tax*, Butterworths, 9<sup>th</sup> Ed, Vol 1 at 1138

<sup>29</sup> The words exchange and relinquishment have not been defined in the Income tax Act. The word "exchange" contained in section 118 of the Transfer or Property Act, 1882. An exchange takes place when two persons mutually transfers the ownership of one thing for the ownership of another, nether thing or both things being money only.

<sup>30</sup> (I 974) 95 ITR 656

<sup>31</sup> As per Section 47(vi). This clause was inserted in section 47 by the Finance (No.2) Act,1967.

<sup>32</sup> Rania.H.P, *Corporate Taxation*, 6<sup>th</sup> Edition, Snow white publication, Mumbai, Vol.2 p.1466

<sup>33</sup> Under sections 391 to 394 Of Companies Act 1956.



There will be no capital gains tax on transfer of a capital asset by the amalgamating company to the amalgamated company in the scheme of amalgamation if the amalgamated company is an Indian company.<sup>34</sup>

#### **Exemption from capital gains tax to a foreign amalgamating company for transfer of capital asset, being shares in an Indian company**

There will be no Capital gain on transfer of shares held in an Indian company in a scheme of amalgamation by the amalgamating foreign company to the amalgamated foreign company if the following conditions are satisfied.<sup>35</sup>

- a. At least 25% of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company, and
- b. Such transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated.

In line with this approach, the Revenue authority recently issued notices to some companies who were engaged in deals in the recent past.

#### **Exchange/Sale of Shares**

##### **(i) Pursuant To Amalgamation**

Shareholders of the target company would become the shareholders of the amalgamated company by receiving shares in lieu of their existing shareholding. Conceptually such an 'exchange' is 'transfer'. However, Act does not regard it as a transfer, where the exchange is in consideration of allotment of shares in the amalgamated company and such company is an Indian company<sup>36</sup>. Whereas interestingly any cash or other benefit given, fully or partially, in exchange for the shares would result in taxable capital gains.

##### **(ii) Post Amalgamation**

##### **Computation Of Capital Gains Tax On Disposal Of The Shares Of Amalgamated Company<sup>37</sup>:**

This section contemplates a situation in which shareholders of the amalgamating company, having acquired the shares in the amalgamated company as a result of the amalgamation, now decide to sell off such amalgamated company's shares.

Accordingly, when these shareholders sell their shares in the amalgamated company, for computing the capital gains that would accrue to them as a result of the sale, the cost of acquisition would be the cost of their shares in the amalgamating company.

Also the period of holding for determining long term or short term gains would begin from the date the shares were acquired by the shareholders in the amalgamating company.

#### **Implications on Amalgamated Company**

- a) Cost of Acquisition, where a capital asset became the property of amalgamated company in a scheme of amalgamation, the cost of acquisition of the said asset to the amalgamated company shall be the cost for which the amalgamating company acquired it.<sup>38</sup>
- b) Written down value in the hands of amalgamating company.

Where in the scheme of amalgamation, any block assets is transferred by the amalgamating company to the amalgamated company being an Indian company, then the actual cost of the block of assets in case of amalgamated company shall be written down value of the block of assets as in the case of amalgamating company for the immediate proceedings as reduced by the amount of depreciation actually allowed in relation to the said previous year.<sup>39</sup> However, depreciation remaining unabsorbed in the hands of amalgamating company is not to be reduced as depreciation actually allowed because the amalgamating company would cease to exist on amalgamation and therefore, it cannot carry forward such unabsorbed depreciation.

- 1) Carry forward and Set off of accumulated losses and unabsorbed depreciation<sup>40</sup>

Companies often undertake M&A to get the benefit of carry forward and set off of operating losses or tax credit. The condition insisted upon is that the acquirer should continue to operate the pre-acquisition business of the company. Unabsorbed losses and unabsorbed depreciation of the amalgamating company can be claimed by the amalgamated company

Other than the asset values for purposes of depreciation as discussed above, the following may also be noted: Depreciation for the year in which amalgamation takes place.

Typically an amalgamation would take place during the course of a taxable year. Depreciation is allowable on a

<sup>34</sup> As per Section 47(vi)

<sup>35</sup> Section 47(via)

<sup>36</sup> S.47(vii) of the Act

<sup>37</sup> Section 49(2), ITA.

<sup>38</sup> Section 49(1) of the Act

<sup>39</sup> Explanation 2(B) to section 43(6), while computing the actual cost of the transferred assets in the hand of the amalgamated company, depreciation actually allowed to the amalgamating company has to be reduced from the actual cost to the amalgamating company, in pursuance to this explanation.

<sup>40</sup> Section 72A of the Act



pro-rata basis<sup>41</sup> to both the amalgamating and the amalgamated company in the ratio of number of days for which they use the assets.

### **(i) Unabsorbed Depreciation For Prior Years**

The conditions for claiming carry forward and set-off of unabsorbed depreciation<sup>42</sup> are same as for unabsorbed business losses. The same have been dealt together in the next para.

### **(ii) Treatment Of Unabsorbed Business Losses And Depreciation**

Subject to prescribed conditions<sup>43</sup>, the unabsorbed business losses and depreciation of the amalgamating company can be carried forward and set-off against profits of future years of the amalgamated company.

The conditions are specified for both the amalgamating and amalgamated companies. These are restrictive and rigid. For instance, the benefit is available in respect of an amalgamating company only in specified sectors, notably the service sector not being part of the list.

The Finance Bill, 2007, has extended the benefit of carry forward and set-off of accumulated business losses/ depreciation to a public sector undertaking engaged in the business of operation of aircraft with one or more public sector undertakings engaged in similar business. This proposal is intended to facilitate the merger of Indian Airlines and Air India.

### **Acquisition Of A Part Of Business (Demerger)**

A demerger is a reorganization of a company where the assets and liabilities of an undertaking or part of an undertaking are transferred to one or more additional entities, viz. resulting companies.<sup>44</sup> This transaction would not be regarded as 'transfer' provided the prescribed conditions under the Act are fulfilled. While there are no specific provisions under the companies act governing the demergers, transactions of this nature are effected through schemes of compromise or arrangement under

<sup>41</sup> dated October 9, 1967 issued by CBDT

<sup>42</sup> S.72A(7)(b) "unabsorbed depreciation" means so much of the allowance for depreciation of the predecessor firm or the proprietary concern or the amalgamating company or the demerged company, as the case may be, which remains to be allowed and which would have been allowed to the predecessor firm or the proprietary concern or amalgamating company or demerged company, as the case may be, under the provisions of this Act, if the reorganisation of business or amalgamation or demerger had not taken place.]

<sup>43</sup> S.32(1) fifth proviso of the Act

<sup>44</sup> Where a company has a business housed with other businesses under the same entity, the target business may be de-merged into a resulting company

sections 391 to 394 of the companies Act and these are sanctioned by the High Courts.

De-merger<sup>45</sup> means transfer in pursuance to the scheme of arrangement under section 391 to 394 of the Companies Act, 1956<sup>46</sup> by a De-merged Company (DM Co.) of one or more of its undertaking to a Resulting company (R Co.). The transfer should be in such a manner that

- a) All the property of the undertaking of DM Co. immediately before the de-merger, become the property of R Co. ;
- b) All the liabilities relating to the undertaking immediately before the de-merger, become the liabilities of R. Co. ;
- c) The transfer of properties and liabilities is at values as per the books of account
- d) R. Co. issues its shares to the shareholders of DM Co. on a proportionate basis in consideration of such transfer ; and
- e) Shareholders holding not less than 75% in value of its shares in DM Co. (other than shares already held therein by or through nominees, of R Co. or its subsidiary) become the shareholders of R Co. The following additional conditions are also required to be met:

### **Transfer of the undertaking of the DM Co. is on a going concern basis;**

De-merger is in accordance with the conditions, if any, notified by the Central Government. (No conditions are notified so far).

Mere acquisitions of assets or property of an undertaking of a company by another company is not contemplated as 'de-merger' under the Act. Properties and liabilities for this purpose, have also been defined.

### **Tax impact in the hands of De-Merged Company & its Shareholders**

#### **Gains on transfer of capital assets – Not liable to tax**

Any transfer of a capital asset by the de-merged company to the resulting company under the Scheme of demerger is exempt from capital gains tax<sup>47</sup>, if the resulting company is an Indian company.

#### **Issue/Allotment of shares – Not liable to tax**

<sup>45</sup> S.2(19AA) of the Act. Specific provisions relating to the taxation of demergers have been introduced in the Act by the Finance Act, 1999.

<sup>46</sup> S.79 of the Companies Act, 1956

<sup>47</sup> S.47(vib) of the Act





Under the Scheme of de-merger, the shareholders of de-merged company are issued shares in the resulting company on a proportionate basis.

Akin to amalgamation, the Act<sup>48</sup> provides that any transfer or issue of shares by the resulting company to the shareholders of de-merged company in consideration of the de-merger would not be liable to tax in the hands of the shareholders under the head capital gains.

The cost of acquisition of shares<sup>49</sup> in the resulting company shall be the amount, which bears to the cost of acquisition of shares held by the shareholder in the de-merged company, same proportion as the net book value of the assets of the undertaking bears to the net worth<sup>50</sup> of the de-merged company immediately before such de-merger.

### **Tax Impact On The Resulting Company Issue/Allotment of shares - whether liable to Dividend Distribution Tax (DDT)**

Pursuant to a de-merger, distribution of shares by the resulting company to the shareholders of the de-merged company (regardless of a reduction of capital in the de-merged company) shall not be treated as 'deemed dividend'<sup>51</sup>. Accordingly, the resulting company will not be liable to any DDT on such issue of shares.

### **Asset Values**

#### **(i) Actual Cost Of Assets**

Under the Scheme of de-merger, all the assets and liabilities of the de-merged company (relating to the undertaking or division) are transferred to the resulting company at book value. In consideration of acquisition of such assets, the resulting company issues shares to the shareholders of the de-merged company.

'Actual cost' is defined as actual cost of the assets to the owner reduced by cost met directly or indirectly by any other person or authority. Accordingly, the cost of the assets acquired by the resulting company would be the fair value of shares issued to the shareholders of the de-merged company.

In order to prevent step up without recognition of gain, the cost of the capital asset in the hands of resulting company is restricted to mean the cost actually incurred by the de-merged company<sup>52</sup> as if the de-merged compa-

ny had continued to hold the capital asset for the purposes of its own business.

#### **(ii) Cost Of Depreciable Assets**

Under the Scheme of de-merger, all the assets (including depreciable assets) of the de-merged company (relating to the unit/undertaking) are transferred to the resulting company.

The WDV of the block of assets acquired by the resulting company would be the WDV of such assets of the de-merged company immediately prior to the de-merger<sup>53</sup>.

#### **(iii) Depreciation Claims**

Depreciation under Act is allowed at prescribed rates with reference to WDV of the specified block of assets.

#### **(iv) Depreciation In The Year Of De-Merger**

In the year of de-merger, depreciation is allowable on pro-rata basis to the de-merged and resulting company in the ratio of number of days for which they use the assets.

### **Expenses In Connection With De-Merger**

Similar to the allowance for claim of the expenses on amalgamation, the resulting company may claim a deduction of 1/5th of the expenditure incurred wholly and exclusively for the purpose of de-merger, over a period of 5 successive years, beginning from the previous year in which the de-merger takes place<sup>54</sup>.

### **Treatment Of The Accumulated Loss And Unabsorbed Depreciation**

The accumulated loss and unabsorbed depreciation of the undertaking/unit of the de-merged company as belonging to the resulting company would be determined<sup>55</sup> as under

Accumulated loss and unabsorbed depreciation directly relatable to the undertaking or the division transferred of the de-merged company would be deemed to be those of the resulting company;

Where the accumulated loss and unabsorbed depreciation is not directly relatable to the undertaking or the division transferred, then the same would be allocated to the resulting company on a proportionate basis, viz., in the proportion of the assets of the undertaking retained by the de-merged company and transferred to the resulting company. The portion of accumulated losses/unabsorbed depreciation so allocated to the resulting company would be deemed to be those of the resulting company.

<sup>48</sup> S.47(vid) of the Act

<sup>49</sup> S.49(2C) of the Act

<sup>50</sup> Net worth means the aggregate of paid-up capital and general reserves as appearing in the books of account of the de-merged company immediately before the de-merger.

<sup>51</sup> S.2(22)(v) of the Act

<sup>52</sup> Explan 7A to S.43(1) of the Act

<sup>53</sup> Explan 2B to Section 43(6) of the Act

<sup>54</sup> S.35DD of the Act

<sup>55</sup> S.72A(4) of the Act



The term accumulated loss and unabsorbed depreciation have been defined to mean so much loss or depreciation which remains to be allowed, if de-merger had not taken place.

It may be noted that unlike amalgamation, there is no provision relating to de-merger which requires that the undertaking transferred should continue to be owned by resulting company.

### **Continuing Benefits In The Hands Of The Resulting Company**

The provisions relating to continuity of tax holidays in case of de-merger of specified undertakings/industrial undertakings are similar as is prescribed in the case of merger/ amalgamation. Relevant discussion section 2 may accordingly be referred.

### **Slump Sale**

A number of companies are going for restructuring in order to increase their profitability. In restructuring exercise the companies sell off their unprofitable business activities or the business activities as a whole along with their assets and liabilities. The term “slump sale<sup>56</sup>” means transfer of one or more undertakings by way of sale for a lump sum consideration, without values being assigned to the individual assets and liabilities.

‘Undertaking’ may either be a part of the undertaking or a unit or division thereof that can be regarded as a business activity in itself.

#### **A. Tax impact on the Transferor company**

Gains on transfer of the ‘undertaking’ – Liable to tax

Any profit and gain arising from the slump sale in the previous year, is chargeable to income-tax as capital gains arising from the transfer of the undertaking.<sup>57</sup>

Where the undertaking is owned and held by the transferor for 36 months or less immediately preceding the transfer, the undertaking would be regarded as short-term capital asset and the gains taxed accordingly. In other cases, the undertaking would be regarded as a long-term capital asset even though such undertaking may have acquired certain assets which are held for less than 36 months<sup>58</sup>.

The benefit of indexation of cost of acquisition is not available in case of transfers regarded as slump sale. The gain on transfer is computed by deducting the net worth<sup>59</sup> of the undertaking from the sale consideration.

<sup>56</sup> S.2(42C) of the Act the concept of slump sale has been introduced by Finance Act 1999 applicable with effect from assessment year 2000-2001

<sup>57</sup> S.50B provides for special provision for computation of capital gains in case of slump sale.

<sup>58</sup> Proviso to S.50 B (1)

<sup>59</sup> Net worth is the aggregate value, as per books, of the total assets as reduced by the total liabilities of the undertaking.

The value of depreciable assets is determined as the written down value as per the Act<sup>60</sup>, with book value being considered for other assets. Any upward or downward re-evaluation of assets is ignored; likewise, contingent liabilities are also ignored.

In a multiple undertaking entity which does not maintain undertaking-wise financial records, computing the net worth may pose considerable difficulty.

#### **Asset values**

The value of the block of depreciable assets is reduced by the tax WDV of the assets sold as part of the undertaking. Besides, the transferor may continue to avail the benefit of carry forward and set off of unabsorbed business losses and unabsorbed depreciation.

#### **B. Tax impact on the acquirer (transferee) company**

##### **Values of assets acquired**

##### **Cost of individual assets acquired by way of a lump sum price**

There is no specific provision for breakdown of the lump sum price into separate asset values for determining individual asset cost in the hands of transferee. It is judicially accepted that the lump sum price may be apportioned between the various assets on the basis of fair market values of the assets determined by a competent valuer. It may also be noted that the Act does not mandate maintaining symmetry in the methods to be followed by the transferor and transferee while attributing values to individual assets.

The connected issue of allocation of any proportion of the lump sum consideration towards good will and the claim of depreciation on the same will be dependent on the terms of the “slump sale” and the interpretation of tax law allowing depreciation on intangibles.

#### **C. Treatment Of Unabsorbed Business Losses And Depreciation**

The benefit of unabsorbed business losses and unabsorbed depreciation relating to the undertaking transferred shall not be available to the transferee company.

#### **D. Expenses Incurred On Purchase Of The Undertaking**

The Act specifically provides for deductibility in the hands of the transferee of the expenditure incurred wholly and exclusively for the purpose of amalgamation or de-merger. In the absence of any similar provision for acquisition of a unit/undertaking by way of ‘slump sale’,

<sup>60</sup> The WDV of the block of assets determined in accordance with the provisions contained in subclause(c) (i)(C) of S. 43(6) of the Act.

the expenditure may not be deductible and be treated as capital expenditure.

### **E. Tax Deduction For Interest On Borrowing**

Any borrowing by the acquirer to acquire a running business shall be treated as a borrowing for the purpose of business and interest of such borrowing therefore would be tax deductible.

The deduction of interest is allowed in the year in which the withholding tax on such interest is paid. Interest in the nature of premium payable on redemption of bonds is deductible over the duration of such bonds.

In a cross border financing from a country with which India has entered into a Double Tax Avoidance Agreement (DTAA), suitable structures may be used to leverage the rate of tax withholding on interest payable overseas leading to a reduction in tax liability in India as a result of the deductibility of interest.

### **Share Buyout**

Acquisition by purchase of shares is the simplest form of reorganisation. It involves take-over without following the Court procedure under section 391-394 of the Companies Act. The shares are sold and registered in the name of the purchasing company or on its behalf. The selling shareholders receive either cash compensation or shares in the acquiring company as consideration for their shareholding.

Typically, a foreign company buys out the shares of Indian company from the shareholders of the Indian company. Where the foreign company acquires 100 % of the shares in the Indian Company, it results in the Indian company becoming a wholly owned subsidiary of the foreign company. The relevant tax implications are as under:

#### **A. Gains On Transfer Of Shares - Taxability In The Hands Of The Shareholders**

The consideration for exchange of shares in the target company flows directly to the shareholders in the form of cash, equity shares, and the like. Any non-cash consideration in lieu of the shares transferred is taken at the fair market value. The exchange of shares would trigger a taxable gain, short-term or long-term, in the hands of the shareholders who would be liable to pay tax accordingly based on the period of holding of the shares transferred.

#### **B. Tax Implications On The Company After Change In Shareholding**

##### **B.1. Treatment Of Unabsorbed Losses**

A change in shareholding in certain circumstances disentitles a closely held company from carrying forward and

setting off its losses. The Act<sup>61</sup> provides that in case of a company not being a company in which public are substantially interested, where a change in shareholding has taken place in a previous year, no loss incurred in any year prior to such previous year shall be carried forward and set off against the income of the previous year unless on the last day of that previous year and on the last day of the previous year in which the loss was incurred, the shares of the company

Carrying not less than 51 % of the voting power was beneficially held by the same person.

The exceptions to the above rule are:

(a) Where a change in shareholding takes place on account of the death of a shareholder, or transfer shares by way of gift to any relative of the shareholder ; or (b) Any change in the shareholding of an Indian company, being a subsidiary of a foreign company, arising as a result of amalgamation or de-merger of the foreign company provided that 51% of the shareholders of the amalgamating or de-merged foreign company continue to remain the shareholders of the amalgamated or the resulting foreign company. The provision applies to all losses, including losses under the head 'capital gains'. However, it does not affect the set off of unabsorbed depreciation.

#### **C. Assets Values**

There would not be any change in cost of assets pursuant to the share buyout.

#### **D. Depreciation Claims**

Unabsorbed depreciation would be carried forward and be eligible for set-off, notwithstanding any change in the shareholding pursuant to the buyout. Further, there would not be any change in the depreciation claim to be made in the year of the share buyout.

#### **E. Expenses Incurred On Transfer Of Shares**

The expenses incurred on buy-out of the shares may have to be treated as capital expenditure.

#### **F. Takeover code**

Where the Indian company is a listed company, the foreign company would have to make a public offer for the acquisition of the shares under the guidelines prescribed under the SEBI Takeover Code.

### **Concluding Remarks:**

There are several different ways that a companies may reduce taxes through merger or acquisitions and the tax benefits can accrue at the both the corporate and the shareholder level. In these transactions, taxes are a criti-

<sup>61</sup> S.79 of the Act



cal element to consider while evaluating the design of the merger or acquisition structure

The Indian Income Tax act at the individual and corporate level imposes an extremely complicated set of provisions for mergers and acquisitions; the tax system is certainly not neutral in this area.

Tax issues have a major impact on the successful completion of transactions and post-deal integration. Early involvement and development of a tax efficient plan/structure will maximize the return on deal.

An M&A transaction present a unique opportunity to implement tax planning and create substantial synergies which are unlikely to have been taken into account when evaluating the merger. These opportunities are therefore all upside. Similarly, if not planned and implemented properly, a merger can create huge costs which were also not planned.

Prior to formal deals, letters of intent or commencement of due diligence, corporate should have developed a tax strategy that meets deal objectives. This strategy should include an identification of alternative structures and a high level understanding of potential tax issues and opportunities.

The Indian corporate sector has also accelerated the trend of M&A for repositioning to seize the opportunities and meet the challenges in the emerging scenario. The underlying object of corporate restructuring is efficient and competitive business operations by increasing the market share, brand power and operational synergy. Indian companies are gearing up for global size operations. 'Size of a company' has acquired central place as a strategy of survival and growth in the competitive economy.

There is no reason why the company and I-T laws should not be harmonized. M&A will be easier if the time-consuming processes under company law, like approaching the Company Law Board and the High Courts for approval, are either eliminated or made less cumbersome than at present.

The direct tax code (DTC) seeks to simplify and rationalize the scheme of taxation with respect to amalgamations, demergers and other forms of business reorganizations as also the sale of businesses.

The major legal battles including the Vodafone dispute which would decide the fate of a large chunk of Foreign Direct Investments into India is much awaited and the challenge lies in balancing the interest of the investors and the revenue authorities.

The boom in cross border mergers and acquisitions (M&A) has given new urgency to understanding and managing the complex tax consequences of international expansion. There are very little globally accepted norms regarding tax law legislations. *With India occupying an increasingly important place on the world stage, there is a need for India to mature in relation to administration of tax laws.*

The new direct tax code that the Government is planning to introduce, to replace the current Income-tax Act, is expected to emphasize transparency and taxpayer-friendliness.

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