CORPORATE TAKE-OVERS
IN INDIA
CHAPTER II
CORPORATE TAKE-OVERS IN INDIA

INTRODUCTION

Mergers are an important features of modern capitalism. The growth and history of modern big corporations is a testimony to the importance attached to mergers in the corporate world. Mergers represent resource allocation and reallocation processes in the economy with firms responding to new investment and profit opportunities arising out of changes in economic conditions and technological innovations impacting industries. Mergers rather than internal growth may sometimes expedite the adjustment process and in some cases be more efficient in terms of resource utilization.

Major illustrations of mergers during the eighties involved investment exceeding $145 billions by the parent companies. The Indian corporate sector had not witnessed much activity in this regard until recently.

According to a study conducted by Indian Institute of Management of Kolkatta, there were a mere 15 instances of corporate mergers in 1988. This had gone up to 114 in 1993. In 1995 there were more than 50 reported instances.¹

While mergers are a constant feature in the modern business world, the activity seems to be greater when business activity and the growth of industries are accelerating.

¹ Subbaramaiah Gupta, N., Evaluation of Mergers, IFMR, 1996 P.1
**WHY MERGER?**

Mergers and amalgamations are generic terms referring to different types of business combinations where in two or more firms combine to form one legal entity. A merger is an investment in a future growth opportunity. In merger proposals plant is ready and market acceptance, clear and well established. In this connection, three other terms are also used, acquisition, leveraged buy out and take-over. Abroad the terms mergers and acquisitions (M & A) are commonly used. The phenomenon of leveraged buy out manifested in the U.S.A. in early eighties where management as an investor group bought out public stock holders with borrowed funds. Take over is another term used especially in our country under the sick industries rehabilitations. Mergers, amalgamations, acquisitions and takeovers whatever the name used are likely to become a common feature of the emerging industrial scene in India.²

Merger denotes the combinations of two or more companies in such a way only one survives while the other is dissolved.

**NATURE OF MERGERS**

Mergers are normally congeneric where the business interests of two firms are related. The congeneric mergers can be further classified into horizontal, vertical and conglomerate.

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² Machiraju., H.R., Merchant Banking Principles and practice, New age international publishers Ltd. 1995 p.276
HORIZONTAL MERGER

A horizontal merger involves two firms operating and competing in the same kind of business activity, forming a larger firm to have the benefit of economics of scale.

Horizontal mergers are regulated by the government for their potential negative effects on competitions. The number of firms in an industry is decreased by horizontal mergers and this may make it easier for the industry members to collude for monopoly profits. Horizontal mergers are also believed by many as potentially creating monopoly power on the part of the combined firms enabling it to engage in anti competitive practices.

e.g. Tomco’s merger with Hindustan Lever
     Lipton’s merger with Brooke Bond

VERTICAL MERGER

Vertical mergers occur between firms in different stages of production operation.

There are many reasons why firms might want to be vertically integrated between different stages.

i. Technological economics
ii. Transaction with in a firm may eliminate costs of searching for prices.
iii. Reduction in costs of communication and coordination and
iv. Improvement in inventory and production

The Efficiency and affirmative rationale of vertical integration rests primarily on the cost lines of market exchange and contracting.

e.g. Polyolefins with NOCIL
     Reliance Petro chemicals with Reliance
CONGLOMERATE MERGER

Conglomerate mergers involve firms engaged in unrelated types of business activity. Among conglomerate mergers, three types have been distinguished. Product extension mergers broaden the product lines of firms. These are mergers between firms in related business activities and may also be called concentric mergers. A geographical market – extension merger involves two firms whose operations have been conducted in non-overlapping geographic areas. The other conglomerate mergers which are often referred to as pure conglomerate mergers involve unrelated business activities. These would not qualify as either product-extension or market-extension mergers.

e.g Max India merger with Maxxon India.
Brooke Bond Lipton (India) merger with Hindustan Lever Ltd.

THE ROLE OF THE INDUSTRY LIFE CYCLE IN MERGERS

This concept is used as a frame work for indicating when different types of mergers may have an economic basis at different stages of an industry’s development.

DEVELOPMENT STAGE

At the start of a new product or industry, an introduction period may be required. Time and money may be related to inform consumers of the nature and uses of the new product. Product development problems may also be involved. The introduction stage of a new product may be associated with losses to the innovating producers.
**GROWTH STAGE**

When consumer acceptance has been achieved, sales may expand rapidly. In this stage a reservoir of demand can be drawn on since a new product has by now either created a new demand or is substituting for an old product for which demand already existed. The explosive growth in sales is associated with high profitability. Additional capacity is attracted into the industry.

**MATURITY STAGE**

Near the end of the growth stage or at the beginning of the maturity stage of development in industry, the growth rate of sales slows down. The additions to capacity, stimulated by the record of high profits, may reach their peak as the growth rate of sales begins to slow. Excess capacity in the industry may develop. Prices and profits decline. It is at this point of the cycle that the analysis becomes particularly relevant for merger policy.

The only firms that can survive are those which can reduce prices to the levels required by the adverse sales to capacity relations, otherwise mergers may take place. Larger firms with in the industry or from other industries are likely to be the acquirers. The existing firms may have represented the efforts of a small number of individuals with great competence on areas such as research, production, sales or advertising. In a rapidly growing industry, possession of one strong management attribute may be sufficient for success. However as competitive pressure increases, the need increases for a full range of management capabilities. Individual firms may some times extend their range of capabilities or combine with other small firms having complementary skills. But selling out to a larger firm which possesses a full range of managerial skills may be most profitable to smaller firms.
DECLINE STAGE

The development of substitute products starts new industry, life cycle for the products. But new products substitute at least in part for existing products. As substitute products are successfully introduced, they begin to erode the sales of the other older product lines and growth rates for the older firms decline.

MERGERS AND INDUSTRY LIFE CYCLE

INTRODUCTION STAGE

Newly created firms may sell to outside larger firms in a mature or declining industry. This results in related or conglomerate mergers. The smaller firms may wish to sell because they want to convert personal income to capital gain and because they do not want to place large investments in the hands of managers who do not have a long record of success. Horizontal mergers between smaller firms may also occur, enabling such firms to pool management and capital resources.

EXPLOITATION STAGE

Mergers during the exploitation stage are similar to mergers during the introductory stage. The impetus for such mergers is reinforced by the more visible indications or prospective growth and profit and by the larger capital requirements of a higher growth rate.

MATURESTAGE

Mergers are undertaken to achieve economies of scale in research, production and marketing in order to match the low cost and price performance
of other firms, domestic or foreign. Some acquisitions of smaller firms by larger firms takes place for the purposes of rounding out the management skills of the smaller firms and providing these with a broader financial base.

DECLINE STAGE

Horizontal mergers are undertaken to ensure survival. Vertical mergers are carried out to increase efficiency and profit margins. Concentric mergers involving firms in related industries provide opportunities for synergy and carry-over. Conglomerate acquisitions of firms in growth industries are undertaken to utilize the accumulating cash position of mature firms in declining industries whose internal flow of funds exceeds the investment requirements of their traditional lines of business.

VALUATION METHODS

POOLING AND PURCHASE METHODS

A merger or amalgamation is treated as a purchase or pooling of interest. The purchase of the acquired company is an investment. In a purchase goodwill arises if the acquirer pays more than the book value of the assets of the company acquired. Goodwill should be reflected in the buyer’s balance sheet and amortized against future income. Premium would lead to reduction of future earnings.

In poolings, the balance sheets are combined. The total assets of the combined companies will not be enlarged. There is no goodwill and no future charge. Reported earnings will be higher. Pooling is preferred to purchase by acquiring firms especially when the goodwill being acquired is substantial. But

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3 International Accounting Standard 22 on Accounting for Business Combinations. Page 99
circumstances of the merger and the rules of accountancy practice stipulate the restricted conditions. Where merger can be treated as pooling of interests.

First the companies should be autonomous in the sense that no one owns more than 10 percent of the share capital for at least two years prior to pooling and the merger should be completed in a single transaction or within one year. Acquiring company can only issue shares for 90 percent or more of the shares of the other company and surviving company must not retire or reacquire shares issued in connection with merger, must not enter into any agreement for the benefit of the former share holders and should not dispose off the assets of the merged company for at least two years.

In a purchase an important part of one or more of the ownership interests is absorbed and the other tests of pooling of interest are not met. The significance of the restriction between purchase and pooling of interest as stated above relates to the creation of goodwill. In purchase, the excess over book value of the net worth purchased is set up as goodwill and the capital surplus is increased accordingly. In pooling of interest any premium over book value is charged against capital surplus. If the purchase transaction is taxable, the surviving company can claim a larger depreciation which in turn enhances cash flows. If the objective is to maximize accounting earnings, goodwill must be recorded and the purchase method is not attractive. It may however, be noted that under Indian tax laws, even if the purchase price exceeds written down value, the acquiring company is permitted depreciation only on the basis of written down value of the company acquired.

**IMPACT ON EARNING PER SHARE**

In evaluating a possible acquisition, the acquiring firm must consider the effect of the merger on earnings per share of the surviving company. The impact on earnings per share would depend upon
i. The difference in price earnings ratio and

ii. The relative size of the two firms as measured by total earnings.

The higher the price earnings ratio of the acquiring company than the company being acquired and the larger the earnings of the acquired company than the acquiring company, greater the increase in earnings per share of the acquiring company. The company with lower earnings ratio will suffer earning dilution.

Merger decisions should be based not only on the initial impact on earnings per share but also future growth arising out of merger. The higher expected earnings may be on account of higher earnings of the new company or any synergistic effects result from the fusion of two companies. Any initial earning dilution may be offset by the improved earnings of the combined operations.

**MARKET VALUE**

In merger negotiations emphasis should be laid on ratio of exchange of market prices per share. Market prices reflect earnings potential dividends, business risk, capital structure, asset value and other factors that bear upon valuation. The ratio of exchange of market prices is

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\frac{\text{Market price per share of acquiring company}}{\text{Market price per share of acquired company}} \times \text{No. of shares offered}
\]

The acquiring company has to offer a price in excess of market price to induce it. But in the absence of synergism, improved management or under pricing of the shares of the bought company, price in excess of bought company's market price should not be offered.

The only exception is the case of a "bootstrap", increase in earnings per share through acquisition as in the case of the company with high price earnings ratio acquiring one with a low ratio although a premium is paid with respect to market value exchange ratio. If price earnings ratio of the acquiring company remains the same. It would be able to show a steady growth in earnings per share. It is however, unlikely in reasonably efficient capital markets, that the price earnings ratio of such companies will remain constant. Otherwise companies will only acquire others. Actually the acquiring company must allow for price earnings ratio changing with an acquisition. If there are no market imperfection and no synergism or improved management is anticipated, price earnings ratio of the acquiring firm should approach the weighted average of the two previous price earnings ratios. The shareholders of the acquired company would benefit if the market price exchange ratio is more than one. If merger is likely to result in synergism, share holder wealth of the acquiring firm could be increased.

**VALUATION METHODS IN VOGUE IN INDIA**

Valuation of the shares is necessary when there is a transfer of shares. In amalgamation it is necessary to value the shares of the company to be merged and continuing company because the shareholders of the acquired company are to be given shares in the continuing company. The price that the acquiring company pays to the owners of the other company is arrived at by four alternative methods. These are
1. Balance sheet or break up value approach;
2. Market value method;
3. Profit earning capacity method and
4. Price earning ratio method.

**Balance Sheet or Break Up Value Method**

In the balance sheet or break up value method, the net worth of the assets of the company is arrived at after deducting outside liabilities. Assets are valued on historical or replacement basis. But historical method may not reflect the true market value of company's net worth. Further, inflation has reduced the historical cost to unrealistically low level especially in the case of old companies. In the case of sick units the book value would give negative net worth. They are, however, sought after on account of the tax benefits under section 72(1) of the Income Tax Act.

Revaluation of assets has its own disadvantages in case of machinery which is subject to high level of technological obsolescence. Valuation of goodwill again is difficult because it has to be written off with an adverse effect on future earnings.

**Market Value Method**

It may be noted that in our stock markets, share prices are governed more by sentiment than fundamentals of the company. In case of unlisted companies or thinly traded shares of companies, a reliance is placed on break up value method and profit earning capacity method.
PROFIT EARNING CAPACITY METHOD

The earnings per share (Net income after taxes divided by the number of shares outstanding) of both companies are capitalized by profit earnings ratio (profit earning ratio is the price per share of a firm’s equity divided by earnings per share), or a figure reflecting expectations of investors. The method is useful for new companies which are yet to realize their full potential.

PRICE EARNING (PE) RATIO METHOD

On the basis of PE ratios of two companies, exchange ratio for shares of two companies is determined. Assuming that earnings of both companies are unchanged, merger could result in an increase in earnings per share of the surviving company.

In practice, multiple methods of valuation are undertaken before arriving at a final value. Analysis of the reasons for divergence of value under different methods would help in deciding appropriate value of the unit to be taken over. It is, however, important to note that a company is more than a mere collection of physical assets. Market values of physical assets are irrelevant because they have no value unless they produce income. Intrinsic value, which is the present value of all future cash flows that a shareholder may expect to receive considerably exceeds the liquidation value of the firm’s physical assets.

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TAKEOVERS IN INDIA

Apart from phrases such as mergers, amalgamation and acquisitions, the phrase takeover has gained wide currency. Takeover, of course, represents acquisition of substantial shares for the purpose of seeking management control of the company. First, is "takeover" by merger of a good acquirer with a sick company to avail of the benefits of the tax shield under section 72-A of the Income Tax Act. Secondly, "takeover" is by acquisition of shares through direct negotiations with one who owns controlling interest or through open offer or market purchase of an adequate level of voting capital to change the management of the company.

Under the Sick Industrial companies (special provision) Act 1985 good acquirer companies are encouraged to takeover and merge a sick unit to take advantage of the tax benefits under section 72-A of Income Tax Act. Unabsorbed losses and depreciation of the sick company are allowed to be set off against profits of the acquirer company.

The corporate group for takeover or acquirer is selected by concerned financial institution after a bidding process involving at least three parties who present their own revival scheme for the sick company. Selection of the acquirer is based on the quantum of relief and concessions requested in the revival package by the bidder and the ability and commitment of bidder to bring the fresh capital into the sick company for implementing revival scheme. New management is not allowed to buy out the shares of the existing promoters. Instead, the sick company would issue fresh capital to the acquirer who has an option at a later stage to buy out existing promoters, shareholding and also shares from small share holders.

The objectives of these conditions are to ensure that funds are deployed for revival than buy out, to keep the presence of existing promoters available during difficult period of revival and help the acquirer to buy out after revival.

As a financial specialist, one must have a way to evaluate mergers and acquisitions. In finance literature, the emphasis is on price paid for an acquisition and whether the wealth of the shareholders is enhanced or not. The real issue is to underline what is meant by 'wealth of shareholders'. There are several methods based upon different views of 'wealth of shareholder'. Some have very strong roots in theoretical finance whereas others have evolved out of practices in the market place. Both are important; in fact, several of these may have to be applied before a balanced view can be taken. While financial techniques do provide a facility to tackle 'hard data', the final decisions are tempered with judgments born out of experience and intuition. While there is no simple framework to analyze.

Judgments and their significance cannot be underestimated in strategic decisions such as these. To that extent it should be realized that the tools and techniques for evaluation of mergers supplement executive judgement and political processes in corporations.

When a company wants to acquire another company (called a target), its shareholders must pay a consideration to the shareholders of the target company. This consideration is the value of the target company’s assets or shares transferred to the acquiring company. In a competitive market situation, the current market value is a correct estimate of the target company’s value, before merger acts as the minimum price for a merger deal. A seller (target company) would expect the offered price to be more than the value of the assets or shares foregone. A merger is said to have occurred at a premium when the offered price is higher than the target company’s pre-merger market value.

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value. Premium may be paid because of shares of the target company may be under-valued. It may also give as an incentive to shareholders of the target company to be willing to sell their shares so that the acquiring company is able to obtain controlling voting rights of the target company.

The acquiring company (the buyer) can appraise merger as a capital expenditure decision. The company incurs a cash outlay now in the expectation of a stream of cash flow benefits in the future. The merger (or acquisition) decision would be accepted provided the present value that would accrue to the acquiring company is higher than the cost of acquisition (i.e. price paid to the buying company).

In practice, the evaluation of mergers and acquisitions is governed by a number of considerations. The markets for mergers and acquisitions may not be competitive. There may be only a few buyers and sellers. There are also regulations enforced by the State. Under such situations, the buyers and the sellers must have a way to relate the acquisition prices with value foregone/received by their respective shareholders.

There are two important steps involved in the analysis of mergers and acquisitions:\(^8\)

- Planning
- Search and screening

Planning

The buying firm should review its corporate objective of acquisition in the context of its strengths and weaknesses and goals. This would help in indicating the product-market strategies that are appropriate for the company.

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The company would also be evaluated to identify those business units that should be dropped and those that are to be added.

The planning for acquisition would require the analysis of industry specific and company specific information. The company would need industry data on market growth, nature of competition, ease of entry, intensity of capital and labour, degree of regulation, etc. and the company data on quality of management, market share, size, capital structure, profitability etc.

**Search and Screen**

Search focuses on how and where to look for suitable candidates for acquisition. Screening process shortlists a few candidates from many available. Detailed information about each of these candidates is obtained.

A merger objective may be achieved in a variety of ways. The alternatives for merger to attain higher growth, or to improve profitability, or to improve managerial effectiveness are joint venture, or elimination of inefficient operations and cost reduction, or hiring of capable managers. If merger is considered to be the best alternative, the acquiring company must satisfy itself that this is the best available option.

**LEVERAGE D BUY-OUTS**

A leveraged buy-out (LBO) is an acquisition of a company in which the acquisition is substantially financed through debt. Debt typically forms 70-90 per cent of the purchase price and it may have a low credit rating. In the USA, the LBO’s shares are not bought and sold in the stock market, and the equity is concentrated in the hands of a few investors. Debt is obtained on the basis of

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9 Brealy and Myers, op.cit., P. 842.
the company's future earnings potential. LBOs generally involve payment by cash to the seller.

When the managers buy their company from its owners employing debt, the leveraged buy-outs is called management buy-out (MBO). LBOs are very popular in the USA. It has been found there that in LBOs, the seller requires very high premium, ranging from 50 to 100 per cent. The main motivation in LBOs is to increase wealth rapidly in a short span of time. A buyer would typically go public after four or five years, and make substantial capital gains.

Which companies are targets for the leveraged buy-outs? In LBOs, a buyer generally looks for a company which is operating in a high growth market with a high market share. It should have a high potential to grow fast, and be capable of earning superior profits. The demand for the company's product should be known so that its earning can be easily forecasted. A typical company for a leveraged buyout would be one which has high profit potential, high liquidity and low or no debt.

Why is a lender prepared to assume high risk in a leveraged buy-out? A lender provides high leverage in a leveraged buy-out because he may have full confidence in the activities of the managers-buyers to fully utilize the potential of the business and convert it into enormous value. His perceived risk is low because of the soundness of the company and its assumed, predictable performance. He would also guard himself against loss by taking ownership position in future and retaining the right to change the ownership of the buyers if they fail to manage the company. The lender also expects a high return on his investment in a leveraged buy-out since the risk is high. Hence may, stipulate that the acquired company will go public after four or five years. A major portion of his return comes from capital gains.

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10 Weston and Capeland, T.E., Managerial Finance, Dayden. 1986 P. 925.
TENDER OFFER

A tender offer is a formal offer to purchase a given number of a company’s shares at a specific price. The acquiring company asks the shareholders of the target company to “tender” their shares in exchange for a specific price. The price is generally quoted at a premium in order to induce the shareholders to tender their shares. Tender offer can be used in two situations. First, the acquiring company may directly approach the target company for its takeover. If the target company does not agree, then the acquiring company may directly approach the shareholders by means of a tender offer. Second, the tender offer may be used without any negotiations, and it may be tantamount to a hostile takeover. The shareholders are generally approached through announcement in the financial press or through direct communication individually. They may or may not react to a tender offer. Their reaction exclusively depends upon their attitudes and sentiments and the difference between the market price and the offered price. The tender offer may be or may not be acceptable to the management of the target company. In USA, the tender offer have been used for a number of years. In India, one may see only one or two instances of tender offer in the recent years.

The management of the target company generally do not approve of tender offers. There are many reasons for this resistance.

i. The acquiring firm may fail to understand the culture and problems of the target company.

ii. Future plans may not be in the interests of the target company’s shareholders.

iii. Acquiring company may replace the present management with a new management.

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11 Weston and Capeland, op.cit., P.901-903.
The management can try to convince the shareholders that they would not tender their shares since the offer value is not enough in the light of the real value of shares, i.e. the offer is too low comparative to it is real value. The management may use techniques to dissuade its shareholders from accepting tender offer. For example, it may lure them by announcing higher dividends. If this helps to raise the share price due to psychological impact or information content, then the shareholders may not consider the offer price tempting enough. The company may issue bonus shares and/or rights shares and make it difficult for the acquirer to acquire controlling shares.

The target company may also launch a counter-publicity programme by informing that the tender is not in the interest of shareholders. If the shareholders are convinced, then the tender offer may fail. The target company can follow delay tactics and try to get help from the regulatory authorities such as the Securities and Exchange Board of India (SEBI) the Stock Exchanges, etc. in India.

**DEFENSIVE TACTICS**

A target company in practice adopts a number of tactics to defend itself from hostile takeover through a tender offer. These tactics include a divestiture or spinoff, poison pill, green mail, white knight, crown jewels, golden parachutes, etc.\(^{13}\)

> **Divestiture.** In a divestiture the target company divests or spins off some of its businesses in the form of an independent, subsidiary company. Thus it reduces the attractiveness of the existing business to the acquirer.

\(^{13}\) Samuels, et.al.cit., pp.624-629, and Brealey and myers, op cit., p.839 – 840.
- **Crown Jewels.** When a target company uses the tactic of divestiture it is said to sell the crown jewels. In some countries such as the UK, such tactic is not allowed once the deal becomes known and is unavoidable.

- **Poison pill.** An acquiring company itself could become a target when it is bidding for another company. The tactics used by the acquiring company to make itself unattractive to a potential bidder is called poison pills. For example, the acquiring company may issue substantial amount of convertible debentures to its existing shareholders to be converted at a future date when it faces a takeover threat. The task of the bidder would become difficult since the number of shares to have voting control of the company will increase substantially.

- **Green mail.** Green mail refers to an incentive offered by management of the target company to the potential bidder for not pursuing the takeover. The management of the target company may offer the acquirer for its shares at a price higher than the market price.

- **White knight.** A target company is said to use a white knight when its management offers to be acquired by a friendly company to escape from a hostile takeover. The possible motive for the management of the target company to do so is not to lose the management of the company. The hostile acquirer may replace the management.

- **Golden parachutes.** When a company offers hefty compensations to its managers and if they get ousted due to takeover, the company is said to offer golden parachutes. This reduces their resistance to takeover.
**REGULATION OF Mergers AND TAKEOVERS IN INDIA**

Mergers and acquisitions may degenerate into the exploitation of shareholders, particularly minority shareholders. They may also stifle competition and encourage monopoly and monopolistic corporate behaviour. Hence most countries have legal framework to regulate the merger and acquisition activities. In India, mergers and acquisitions are regulated through the provisions of the Companies Act 1956, the Monopolies and Restrictive Trade Practice (MRTP) Act 1969, the Foreign Exchange Regulation Act (FERA) 1973, the Income Tax Act 1961, and the Securities and Contracts (Regulations) Act 1956\(^{14}\) and the SEBI Act.

**Legal Measures Against Takeovers**

The Companies Act restricts an individual or a company or a group of individual for acquiring shares, together with the shares held earlier, in a public company to 25 percent of the total paid-up capital. Also, the Central Government needs to be intimated whenever such holding exceeds 10 per cent of the subscribed capital. The Companies Act also provides for the approval of shareholders and Central Government when a company, by itself or in association of an individual or individuals purchases shares of another company in excess of its specified limit. The approval of the Central Government is necessary if such investment exceeds 10 percent of the subscribed capital of another company. These are precautionary measures against the takeover of public limited companies.

**Refusal to Register The Transfer of Shares**

In order to defuse situation of hostile takeover attempts, companies have been given power to refuse to register the transfer of shares. If this is done, a

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\(^{14}\) Bhattacharyya, H.K., Amalgamation and Take-Over\(^{*}\), Company News Notes, 1988, pp.1-11.
company must inform the transferee and the transferor within 60 days. A refusal to register transfer is permitted if,

- A legal requirement relating to the transfer of shares have not been complied with; or
- The transfer is in contravention of the law; or
- The transfer is prohibited by a court order; or
- The transfer is not in the interests of the company and the public.

**TAKEOVER OF PROFIT MAKING COMPANIES**

These involve acquisition of controlling interest from the promoter group of foreign collaborators. These are friendly negotiated takeovers done in low key in terms of disclosure and protection of interest minority share holders of the target company.

Purchase of shares from market or through open offer by the acquirer in respect of companies whose assets can be better utilized and which have good potential for growth are hostile takeovers which may involve protected legal battle.

**TAX ASPECTS OF MERGERS AND AMALGAMATIONS**

**Definition of Amalgamation**

The term amalgamation in relation to a company has been defined under section 2 (1A) of Income Tax Act 1961. This definition was introduced by the Finance Act (No. 2) of 1967, with effect from 1st April, 1967. According to the definition, the expression "amalgamation" in relation to companies, means the
merger of one or more companies with another company or the merger of two of more companies to form one 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 the amalgamation;

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

iii. Shareholders holding not less than 90 percent in value of the shares in the amalgamating company or companies 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 the distribution of such property to the other company after the winding up of the mentioned company. The company which merges with another company is known as the amalgamation company and the company into which it so merges or is formed as a result of the merger of two existing companies to form a new company is known as the amalgamated company.

The definition of the "amalgamation" given in the Income Tax Act includes also cases of mergers and the amalgamated company might be an existing company or a company newly formed as result of the amalgamation. Thus, amalgamation for tax purposes covers both the merger of one company into another company and the combined merger of different companies to form one new company. It is however, essential that all the three conditions mentioned above must be fulfilled in order that the amalgamation falls within this scope of the definition given in the Income Tax Act. This is because of the fact that the conditions are cumulative and not alternative in their application. This, in effect, makes it essential for the scheme of amalgamation to provide
specifically that every item of assets and liabilities must necessarily become the asset and liability respectively of the amalgamated company and that too, by virtue of the amalgamation but not otherwise.

The companies Act does not, however, contain any definition of the term "amalgamation" and the courts (in India and Abroad) have defined "amalgamation" from time to time. An "amalgamation" may be defined as an arrangement whereby the assets of two companies become vested in or under the control of, one company (which may not be one of the original two companies), which has as its shareholders all, or substantially all the shareholders of the two companies. An amalgamation is effected by the shareholders of one or both the amalgamating companies exchanging their shares (either voluntarily or as result of a legal operation) for shares in the other or a third company. The arrangement is frequently effected by means of a takeover bid by one of the companies for the shares of the other, or of a takeover bid by a third company for the shares of both.

**PROVISIONS UNDER INCOME TAX**

The basic approach of the tax provisions is to ensure that amalgamation confers neither a benefit nor a cost. There is no charge of tax on the coming together of two companies. Similarly, there is no benefit in terms of savings in tax. The amalgamated company would be liable to the same tax as that would be payable if it had been charged separately on the two companies.

The written down value to the transferee company of the capital assets is taken to be the same as it would have been in the case of merged companies. This would be so irrespective of the value placed on those assets for the purpose of amalgamation scheme.

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\(^{16}\) See palkhivala N.A. and Palkhivala op.cit., p.294
UNABSORBED DEPRECIATION BECOMES A CAPITAL LOSS

The unabsorbed portion of the depreciation allowance granted to the amalgamating company which it could not adjust against its income due to losses or inadequacy of profit would become a dead loss and can not be either assigned to, or claimed to be carried forward by, the amalgamated company. Consequently the general principle that the unabsorbed depreciation could be carried forward indefinitely by the assessee would not apply in cases where an amalgamation take place.

Like unabsorbed depreciation, business losses and also losses under the head ‘capital gains’ which are incurred by amalgamating company can not be carried forward by the amalgamation since the law does not permit the transfer of the right to carry forward of losses by one assessee to another.

In cases of amalgamation, the right of carry forward of unabsorbed depreciation and unabsorbed losses would be lost once and for all and the right can not be exercised either by the successor company or by the predecessor company. The amalgamating company is not also entitled to carry forward such losses because the company itself ceases to exist after the amalgamation and it does not carry on the business in which the loss were incurred particularly because the right of carry forward is subject to the condition that the assessee continues to carry on the business in which the loss was incurred. Hence, even if the time limit of eight years had not elapsed, the right of carry forward of these losses would not be available in cases of amalgamations.

TAX BENEFITS FOR LOSS INCURRING COMPANY

Instead of the profit-making company absorbing the loss incurring company, it would be advantageous to arrange the scheme of amalgamation in
such a way that the loss incurring company acquires the business of the profit making company or the profit making company merges with the loss incurring company so that the right of carry forward of the losses is not affected. An example of a profitable company being merged with non-profitable one is the merger of the profit making Dalmia Industries into Gujarat Heavy chemicals.

The idea that the loss incurring company should take over profit making company may, however, be difficult to be put into effect in cases where

i. The court does not accord its approval to such a scheme of amalgamation: or

ii. The loss incurring company is required to merge with a profit making company under the orders of the Government in a scheme for re-organizing sick industries: and

iii. The loss- incurring company does not have sufficient authorized share capital for issuing shares to the shareholders of the amalgamating company (i.e., the profit making company). The problems arising in the first and second cases would not be capable of being solved easily and the assessee will have to comply with the orders of the court or the Government and forego the right of set off and carry forward of losses. The difficulties arising in the third case can, however, be got over by issuing shares to the extent the authorized capital of the company permits and treat the balance of consideration payable as loan due from the amalgamated company to its shareholders carrying interest at an agreed rate. Interest payable in such a case would be deductible in computing the business income of the amalgamated company.

iv. It would be necessary to ensure that, as far as practicable the amalgamated company is an Indian company in which the public are substantially interested.
AMORTISATION OF OTHER CAPITAL EXPENSES

The amalgamated company is entitled to amortise the cost of assets representing capital expenditure on scientific research, 35(5) (ii), capital expenditure for the promotion of family planning amongst the employees [Section 36 (ix)], the cost of patents and copy rights taken over by it from the amalgamating company [35 A 6 (ii)], and the unabsorbed portion of the preliminary expenses [(Section 35 D 5(ii))], these benefits of amortization are available in cases of amalgamating in view of the specific provisions contained in the respective Sections for the purpose of granting these allowances to the amalgamating company in the same way as they would have been granted to the amalgamating company if the amalgamation had not taken place.

EXEMPTION IN RESPECT OF CAPITAL GAINS [SECTION 47(vi)] AND GIFT [SECTION 45 (b)] TAXES

The amalgamating company would not be liable to any capital gains tax and also gift tax in respect of the value of the assets transferred by it to the amalgamated company, provided the conditions specified in section 47(vi) of the Income Tax Act under section 45(b) of the Gift Tax Act are fulfilled. In order to claim exemption from liability to capital gains tax and also gift tax, it is, however, essential that the amalgamated company must be an Indian company although the amalgamating company may or may not be an Indian company.

EXEMPTION TO SHAREHOLDERS IN RESPECT OF CAPITAL GAINS TAX [SECTION 47 (VII)]

The shareholders of the amalgamating company would not be liable to any capital gains tax. If they get shares in the amalgamated company in lieu of
the shares held by them in the amalgamating company in their own right and not as nominees of amalgamating company, as part of the scheme of amalgamation the number, value and amount and also the nature of the shares would be immaterial for these purpose. The exemption to the shareholders is also subject to the condition that the amalgamated company is an Indian company. But in cases where the shareholders who do not feel inclined to join the scheme of amalgamation transfer their shareholding to any other person in the same company or outside, the benefit of tax exemption would not be available. The shareholder’s entitlement to get tax exemption is not depending upon their only shares in the amalgamated company. For example, they may receive bonds or debentures in addition to shares from the amalgamated company in lieu of the shares they held earlier.17

ALLOWANCE OF DEVELOPMENT REBATE AND INVESTMENT ALLOWANCE [SECTION 32A(6) AND SECTION 33(3) AND 33(4)]

The unabsorbed portion of development rebate, and investment allowance allowable is available to the amalgamating company. They can be carried forward by and allowed to the amalgamated company within the time limit of 8 years specified in respective sections. It is obligatory for the amalgamated company to comply with the various requirements in regard to the sale or transfer of the assets and also the creation and utilization of the development rebate reserve, investment allowance reserve in the same manner as the amalgamating company would have done if the amalgamation had not taken place. Any failure on the part of the amalgamated company in regard to the compliance with these requirement would result in the withdrawal of the development rebate, development allowance and investment allowance as the case may be which was previously allowed to it or to the amalgamating company.

17 Palkhivala N.A. and Palkhivala op. cit., p.773
In cases where the assets in respect of which development rebate, or investment allowance is granted are transferred as part of the scheme of amalgamation, the amalgamating company would not be treated as having sold or otherwise transferred the assets in violation of the requirements contained in the section and consequently these allowances would not be withdrawn to the amalgamating company in cases of transfers as part of the scheme of amalgamation.

**AMALGAMATION OF SICK INDUSTRIAL COMPANIES**

They facilitate revival of sick industrial companies, a new section 72-A was inserted in the Income Tax Act by Finance (No.2) Act, 1977. It relaxes the provisions of section 72 and enables an amalgamated company to carry forward and set-off accumulated losses and unabsorbed depreciation allowance, provided the following conditions are fulfilled to the satisfaction of the Central Government, based on the recommendations of the specified authority.

a. The amalgamating company before its amalgamation, was not financially viable;

b. The amalgamation was in the public interest;

c. Any other condition notified by the Central Government in the official Gazette to ensure that the amalgamation would facilitate rehabilitation or revival of amalgamating (sick) company;

d. The proposed scheme is submitted to the specified authority and it makes its recommendation to the Central Government;
e. The previous year for which the set-off is claimed, the business of the amalgamating company is carried without any modifications or with such modifications as approved by the Central Government; and

f. Every year for which the set-off is claimed, the amalgamated company furnishes, along with its return of income a certificate from the specified authority that the adequate steps have been taken for rehabilitation or revival of the business of amalgamating company (sick) industrial unit.

The benefits available are:

i. The unabsorbed depreciation of the amalgamating company becomes the unabsorbed depreciation of amalgamated company and can be carried forward ad infinitum as provided in section 32;

ii. The accumulated loss becomes the current loss of the amalgamated company and can be set-off against the income of amalgamated company under any head of income;

iii. Irrespective of the number of years for which the sick unit has carried forward the loss, it can be carried forward for next 8 assessment years; and

iv. The unabsorbed amount of investment allowance, development rebate and development allowance can be carried forward for 8 years from the year in which it became eligible.
Committee on Industrial sickness and corporate Restructuring (Dr. Omkar Goswami Committee) in its report to Government of India in July 1993 observed that mergers and acquisitions are the dominant route of industrial and corporate restructuring the world over.¹⁸ The successes of BIFR according to the committee have been the merger cases under Section 17(2) of sick Industrial companies (Special provisions) Act (SICA) and not rehabilitation schemes sanctioned under Section 18(4).

Given the importance of mergers, the committee recommended that the Central Board of Direct Taxes (CBDT) must play a more facilitating and positive role. Merger proposals that are indigenously designed and passed under Section 17(2) of SICA must get all the benefits under Sections 41(1) 72 A, 79 and 115 of the Income Tax Act and should enjoy overriding status of SICA as do the schemes under section 16(4).