CHAPTER-V
TAXATION ASPECTS OF MERGERS
AND ACQUISITIONS

5.1. Introductory

While framing a scheme of merger or amalgamation, a company has to fulfill the conditions prescribed under the company law as already discussed, but it has also to look after one very important aspect i.e. taxation aspect. Its importance can be highlighted by taking the following illustration.

The CEO’s of two prominent multinational companies are meeting to finalise the deal for the merger of the two companies. Exhaustive negotiations and due diligence have taken place, particularly around economic issues believed to relate to the customer base, the financial issues involved, the share exchange ratio, the post integration issues etc. Synergies between the businesses have been identified and redundancies have been rationalised. In short, the deal has been analysed, scrutinised and agreed upon; a plan has been developed to maximise the value of the combined businesses.¹ But nobody paid attention to tax issues. The result was that without proper tax planning, company had to pay huge taxes due to which synergies which were expected from the deal were greatly reduced. Far too often, deal makers do not attempt to identify tax strategies and risks that could seriously affect the price at which a transaction is undertaken. The deal makers often neglect an area that could significantly affect the value realised from a transaction. Thus tax is an important issue in any merger and acquisition transaction.

The focus on the tax aspects of corporates is intensifying as tax becomes even more important to deal processes and valuations. In a survey conducted by Ernst and Young, 57 percent of the tax directors surveyed said that their companies place more importance on tax issues as part of the process of doing deals compared to three years ago.² Despite recent uncertainty and instability of global financial markets, it appears

that concerted massive government intervention has assisted in strengthening the world economy. Countries with unsustainable budget deficits continue to focus on closing tax loopholes, increasing tax revenue and reducing spending.

With the focus of global economic activity rapidly shifting east, the prospect for growth in Asia continues to be strong. As M&A transactions provide unique tax planning opportunities, M&A is becoming a more important strategic tool in Asia. However potential tax risks need to be properly managed.3

As regards India, with which our research is concerned, various international surveys and assessments suggest that India remains among the top five most favoured investment destinations in the world for almost a decade which is reflective of the confidence of the investing community in the strength of Indian economy and its future outlook in times of global uncertainty.4 While India provides significant opportunity for investment to both domestic and foreign investors, the complexity of its regulatory and tax regime means that due consideration will need to be paid to the breadth and depth of the existing laws. Transaction costs, such as tax liabilities, provisions of Income Tax Act, transfer taxes like stamp duty, etc, can often make or break a deal, if not addressed appropriately, irrespective of whether the transaction is a cross-border, M&A deal or an internal reorganisation.5 Therefore income tax and stamp duty implications of mergers amalgamations and acquisitions will be dealt in here in this chapter.

5.2. Tax and Amalgamations/Mergers in India

India Inc. is increasingly adopting permutations and combinations in the form of mergers and amalgamations route in a bid to enhance value, consolidate businesses and achieve the elusive synergy of operations. Amalgamations, being a business combination, attracts special treatment in the various fiscal statutes. The very word ‘amalgamation’ signifies the creation of an entity which either took in its fold the existing business of other entities or the creation of a new entity by pooling the business

4 Ibid.
of various entities. This change—a legal metamorphosis—brings into focus certain new paradigms that normally arise when legal entities undergo a physical change.\(^6\)

Given the historical perspective of the concept of amalgamation, the fiscal statues, right from the beginning contained special provisions so as to minimise the ambiguities in ascertaining tax liabilities of the combined entity.\(^7\) And, moreover, income tax is vital amongst all tax laws which affect the amalgamation of companies from angle of tax saving and treatment of the same in books of accounts.

### 5.3. Implications under the Income Tax Act, 1961 of Mergers and Amalgamations

In any scheme of amalgamation, tax considerations, as already mentioned, predominate and inevitably direct the manner in which the entire scheme has to be designed. Any failure to take proper account of the tax implications might make the concerned companies and their shareholders repent later when they will not be in a position to retrace their steps. Thus tax planning in cases of amalgamations of companies is perhaps the most vital aspect of decision-making involved in framing of the scheme of amalgamation.\(^8\) The requirements under Company law are by and large procedural in nature and although it is the fulfillment of those requirements that results in the scheme of amalgamation being legally allowed to materialise, it is the framing of the scheme of amalgamation with a special emphasis on tax considerations which would determine in the long run the success or failure of the scheme.

Lord Tomlin in *IRC v. Duke of Westminster*,\(^9\) held that ‘every man is entitled to do what he can to order his affairs so that the tax attaching under appropriate acts is less then it otherwise would be.’

Thus, the amalgamating and the amalgamated company as well as their shareholders are entitled to so arrange their affairs and transactions (which form an integral part of the scheme of amalgamation) as to ensure that either the liability to tax is not attracted or the tax liability which is attracted is the least. This is because of the fact that no tax

---


\(^7\) *Id.*, p. 915.


\(^9\) (1936) AC 1.
payer has the statutory or moral obligation to pay the state the maximum amount the
taxes that he can; he is lawfully entitled to arrange his financial affairs in such a manner
as to keep the brunt of taxation to the maximum so long as he does not violate or
infringe the statutory provisions of the tax laws.\textsuperscript{10}

As the tax implications have direct and far-reaching financial impact on the companies
and the shareholders, both in the immediate future and in the long run, special care
should be taken to see that none of the tax considerations is ignored and/or given less
importance than what they deserve unless there are overriding considerations which
make it imperative for those who frame the scheme of amalgamation either to ignore
them or to give a secondary importance to them.

\textit{5.3.1. Meaning of Amalgamation for Tax Purposes}

According to section 2(1B)\textsuperscript{11} of the \textit{Income Tax Act, 1961} (hereinafter referred to as the
‘Act’), amalgamation in relation to 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:

\begin{itemize}
  \item All the property of the amalgamating company or companies immediately
before the amalgamation becomes the property of the amalgamated company by
virtue of amalgamation;
  \item All the liabilities of the amalgamating company or companies immediately
before the amalgamation become the liabilities of the amalgamated company by
virtue of amalgamation;
  \item Shareholders holding not less than 3/4\textsuperscript{th} in value of the shares in amalgamating
company or companies (other than shares held therein immediately before the

\textsuperscript{10} These principles have been well settled by the decisions in the following cases: \textit{CIT v. Raman & Co.}
(1968) 67 ITR 11 (SC), \textit{CIT v. Calcutta Discount Co. Ltd.} (1973) 91 ITR 8 (SC), \textit{Aruna Group of
69 ITR 420 (Mad.).

\textsuperscript{11} Clause (1A) to section 2 inserted by the Finance Act, 1967, (20 of 1967), it was renumbered as
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 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 first mentioned company.

The Income Tax Act has only defined the word amalgamation and not merger or acquisition. The Supreme Court has very well explained the scope of the word amalgamation for tax purposes in its landmark judgement of *Saraswati Industrial Syndicate v. CIT*.\(^\text{12}\)

“In an amalgamation, two or more companies are fused into one by merger or by one taking over the other. Reconstruction or amalgamation has no precise legal meaning. Amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company become substantially the shareholders in the company which is to carry on the blended undertakings. There may be amalgamation either by the transfer of two or more undertakings to a new company or by the transfer of one or more undertakings to an existing company. Strictly, ‘amalgamation’ does not cover the mere acquisition by a company of the share capital of the other company which remains in existence and continues its undertaking but the context in which the term is used may show that it is intended to include such acquisition.\(^\text{13}\) Two companies may join to form a new company, but there may be absorption or blending of one by other and both amount to amalgamation. When two companies are merged and are so joined as to form a third company or one is absorbed into other or blended with the other, the amalgamating company loses its identity.

The High Court was in error in holding that, even after amalgamation of the two companies, the transferor company did not become non-existent but instead it continued its entity in a blended form with the appellant company. The High Court’s view that, on amalgamation, there is no complete destruction of the corporate personality of the transferor

\(^{12}\) AIR 1991 SC 70.

company but instead there is a blending of the corporate personality of one with another corporate body and its continues as such with the other is not sustainable in law. The true effect and character of the amalgamation largely depends on the terms of the schemes of the merger. But there cannot be any doubt that, when two companies amalgamate and merge into one, the transferor company loses its entity as its ceases to have its business. However, their respective rights and liabilities are determined under the scheme of amalgamation but the corporate entity of the transferor company ceases to exist from the date the amalgamation is made effective."

Thus, the authoritative pronouncement of the Supreme Court clarifies the legal effect of amalgamation. In the case of an absorption, the transferor company ceases to exist in the eyes of law once the amalgamation process is complete and there is a complete destruction of the corporate personality of the transferor company.

The definition is elaborated hereunder for further clarity. The third requisite needs further clarity. Shareholders holding 75 percent or more in value of the shares in the transferor company (excluding shares already held immediately before the amalgamation by the transferor company or its subsidiaries or its nominees) become shareholders of the transferee company and to clarify further, let’s take a simple illustration, A Ltd. merges with B Ltd. in a scheme of amalgamation and immediately before the amalgamation, B Ltd. held 20 percent of shares in A Ltd. The above mentioned condition will be satisfied if shareholders holding not less than 75 percent in the value of remaining 80 percent of shares in A Ltd. i.e. 60 percent thereof become shareholders in C Ltd. (company formed after amalgamation) by virtue of amalgamation.14

The above must be achieved by virtue of the merger and not by way of acquisition of properties by one company from another or by way of distribution of properties pursuant to the winding up of a company concerned. Moreover, all the tangible and intangible assets of the merging or amalgamating company must be taken over by the amalgamated company and the existing as well as contingent liabilities of the merging

company must be taken over by the merged-the amalgamated company. In case even a negligible part of the assets or liabilities is not taken over by the amalgamated company, it could not be amalgamation as per section 2(1B) referred to above and accordingly would not qualify for the exemption or concessions detailed herein below.\textsuperscript{15}

An important aspect to be noted is that the definition of the expression ‘amalgamation’ under section 2(1B) does not contain any specific provision regarding treatment of inter-company transactions and inter-company assets and liabilities between the amalgamating company and the amalgamated company just before the process of amalgamation takes place. Unlike the specific provision included in section 2(1B) for excluding of shares held by the amalgamated company in the amalgamating company for counting the 75 percent criteria, there is no such provision for excluding the inter-company assets and liabilities. The result would be that, it would not be possible for the concerned companies to fulfill the condition regarding acquisition or taking over all the assets and liabilities of the amalgamating company.

It is, therefore, essential that in all such cases the inter-company transactions are squared off before the scheme of amalgamation is put through.\textsuperscript{16} Because the basic motive of giving this definition is that the benefits/concessions under Income Tax Act, 1961 shall be available to both amalgamating company and amalgamated company only when all the conditions, mentioned in the said section, are satisfied. An amalgamation which satisfies the above pre-requisites is considered to be a tax neutral amalgamation, else a non-tax neutral amalgamation.\textsuperscript{17} Another point which needs consideration is that to achieve tax-neutrality for the amalgamating companies, the amalgamated company should be an Indian company.\textsuperscript{18}

\textbf{5.3.2. Circumventing the Definition under Section 2(1B)}

The amalgamated company can only avail benefits and concession under Income Tax Act, only if it satisfies or fulfills the definition of amalgamation under section 2(1B).

\textsuperscript{15} Darshan Kumar, “Amalgamation of Companies”, \textit{Taxation}, April 1976, Vol. 43, pp. 1-11, p. 5.
\textsuperscript{16} \textit{Ibid.}
\textsuperscript{17} Ernst and Young, 2012, p. 25.
According to this definition, all the assets and liabilities of the transferor company should be transferred to the transferee company. But sometimes it is not profitable to transfer all the assets as there is no synergy with respect to those assets. Let us take an illustration.

If amalgamation is proposed between these two companies, then there may not be any synergy in combining the electronics business of the transferor company. It would be profitable to combine the textiles business of both the companies. But then the benefits of taxation under the Income Tax Act will not be available as the conditions prescribed under the definition will not be fulfilled.

The two alternatives available in such a situation are:

1. Merge both the companies and then later demerge the electronics business. The alternative was adopted in the case of merger of Hyderabad Allwyn Ltd. with Voltas Ltd. Under the scheme, it was proposed that with effect from 1 April, 1993, Hyderabad Allwyn Ltd. would be merged with Voltas. Hyderabad Allwyn Ltd. was carrying three lines of business.

   - Fabrication of bus bodies (auto division).
   - Manufacture and sale of refrigerators and steel furniture.
   - Manufacture and sale of wrist watch.

   In this scheme, all the three business of Hyderabad Allwyn Ltd. were merged with that of Voltas Ltd. But simultaneously on 7 April 1993, the watch undertaking was demerged and transferred to Allwyn Watches limited. The scheme also provided for leasing out the auto division to Allwyn Auto Ltd. for a

---

period of five years. In this way, the Voltas Ltd. could take benefits under the Income Tax Act.

2. Demerge first the sugar business or the business which transfersee company does not want to acquire by spinning off into a separate company and only later merge both the companies. For the second alternative, we can see the examples in the Sarabhai Group cases. The Sarabhais mixed both the ‘merger’ and ‘demerger’ techniques almost year after year, creating in the process legal precedents all the way.\(^\text{20}\) Most of the times they separated out the undertakings by forming wholly-owned subsidiaries which later merged with another company. The main advantage of the route was that the group derived substantial tax savings as it could fulfill the conditions of the definition of amalgamation under the Income Tax Act.

5.3.3. Tax Reliefs and Benefits in Case of Amalgamation

If an amalgamation takes place within the meaning of section 2(1B) of the Income Tax Act, 1961, the following tax relief and benefits shall be available.

5.3.3.1. Exemption from Capital Gains Tax on Transfer: An important issue that arises in the context of amalgamation is the incidence of capital gains tax at the time of amalgamation. Under the provisions of the Income Tax Act, a capital gain will arise when a capital asset is ‘transferred’. The word ‘transfer’ is defined under the Income Tax Act in section 2(47). Primarily, the word ‘transfer’ means the sale, exchange or relinquishment of the asset or the extinguishment of any rights therein or the compulsory acquisition thereof under any law.\(^\text{21}\)

As far as ‘amalgamation’ is concerned, the important question is whether there is a transfer of asset from the amalgamating company to the amalgamated company. The answer to this question is in the negative because of section 47 as section 47 lists out transactions which are not regarded as transfer and hence would not attract capital gains tax. The three clauses of section 47 give specific exemption with respect to transactions involving amalgamation.

\(^{21}\) Id., pp. 924-925.
Section 47 explicitly states that the following transfers are exempt from the provisions of section 45. They are:

(1) Exemption for the Amalgamating (Transferor) Company: The transfer of a capital asset in a scheme of amalgamation by the amalgamating company to the amalgamated company is not regarded as transfer and is exempt from tax on capital gains, provided the amalgamated company is an Indian company.

International Restructuring: The transfer of capital asset being a share or shares held in an Indian company by the amalgamating foreign company to amalgamated foreign company is not regarded as transfer and hence exempt from capital gains tax, if the following two conditions are satisfied:

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

(2) Exemption to the Shareholders of the Amalgamating Company: Any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company will not be regarded as transfer and hence exempt from capital gains tax, provided the following two conditions are satisfied:

- The transfer is made in consideration of the allotment to him of any share or shares in the amalgamating company; and
- The amalgamated company is an Indian company.

Even the learned author, Shri N.A. Palkhivala in his book ‘The Law and Practice of Income Tax Act’ in his own usual style rules out the incidence of capital gains tax in the following manner:

---

22 Section 45 of the Income Tax Act, 1961 is the charging provision for tax on capital gains.
Where company A amalgamates with and merges into company B and the shareholders of company A are allotted shares in company B in their own right and not as nominee of company A, question arises as to whether those share-holders are liable to tax under the head ‘Capital Gains’… It is clear that such amalgamation does not involve any transfer or sale of the shares of company A. It does not involve any exchange either within the legal meaning of that term. Whereas the allotment of shares by company B to the shareholders of company A does not involve a transfer of property by either of the two parties to the other. There is no transfer of assets by the shareholders of company A to company B; the transfer of assets of company A cannot be regarded as a transfer by its shareholders. Nor is there any transfer by company B when it allots its share capital to the shareholders of company A. The allotment of shares by the company cannot be regarded as transfer of property by that company.

The merger does not involve ‘relinquishment of the asset’ because relinquishment postulates the continued existence of the asset over which the rights of its holder are relinquished or surrendered, whereas upon amalgamation the shares in company A cease to exist. The amalgamation does involve extinguishment of the asset, viz. shares in company A; but the better view is that it does not involve ‘extinguishment of any rights therein’ which expression seems to indicate the continued existence of the capital asset over which the rights of its holder are extinguished. Section 2(47) refers to the extinguishment of any rights in the capital asset; it does not use the expression ‘the extinguishment of the capital asset or of any rights therein’. It seems, therefore, that such amalgamation would not involve a transfer within 2(47) and no tax under the head ‘Capital Gains’ would be payable by the shareholders of company.

From the above passage, it is clear that there is no capital gains incidence either in the hands of the shareholders of either the transferor or the transferee company; and also between the companies.

5.3.3.1.1. Capital Gains Tax in Case of Cross-border Mergers: Capital gains tax is exempted in case of international mergers if certain conditions stipulated under clause (via) of section 47 of income tax act are followed. Clause 47(via) explained above has wide repercussions in the context of global mergers. As evident from the clause, there
could be cases where a capital gain incidence may arise on a foreign company holding shares in an Indian company. This situation can be avoided/minimised by following any one of the methods:²⁷

1. By taking advantage of the relevant provisions in the Double Taxation Avoidance Agreement (DTAA) if any entered between the foreign country and India.

2. By not directly holding shares in the Indian company, but instead through another investment company situated in any other foreign country where there will be lesser incidence of capital gains tax.

3. By setting up transnational subsidiaries in typical tax haven countries like Mauritius where there is a capital gains tax on the sale of any movable property of a resident irrespective of the situs of the property.

5.3.3.1.2. Judicial Interpretation on Exemption from Capital Gains Tax: The most prominent ruling on this aspect is of the Authority of Advance Ruling (AAR) in the case of Star Television Entertainment Ltd., In re.²⁸ The brief facts of the case are as follows: There have been three amalgamating companies all of which are non-resident foreign companies. The first two are the companies incorporated under the laws of the British Virgin Islands (BVI). The third company was incorporated under the laws of the U.A.E. These three companies owned channels Star Plus, Star Gold, Star One or Star Utsav. Star India Private Limited (SIPL) is a company in India engaged, inter alia, in the business of marketing of the channels in the course of which it derives subscription and advertisement revenues. It is the amalgamated company. It was resolved that the three companies should be amalgamated with and merged into SIPL, an Indian company which would in turn issue shares to the shareholders of the amalgamating companies in accordance with the share exchange ratio arrived at by a professional valuation report. The shares in SPIL were held by two Mauritius based companies.

While the scheme was pending for approval by Bombay High Court, an application was made to advance ruling authorities. The main question before the authority was that: Whether the amalgamation of foreign companies with SIPL, an Indian company, would

²⁷ Id., p. 926.
result in any tax liability in India under the Income Tax Act, 1961 in the hands of SIPL and their shareholders? On the facts stated the Authority ruled:

“That it admitted of no doubt that the transfer of assets from the amalgamating foreign companies to the amalgamated Indian company and transfer of shares held by the shareholder in the amalgamating company in consideration of the allotment to it of shares in the amalgamated company pursuant to the ‘amalgamation’ as defined in section 2(1B) of the Income Tax Act, 1961, were exempt from capital gains tax in India, as all the following requisite conditions for attracting section 47(vi) read with section 2(1B) were satisfied: (i) all the property as well as the liabilities of the amalgamating company immediately before the amalgamation would become the property of the amalgamated company by virtue of the amalgamation, (ii) shareholders having not less than three-fourths of the value of the shares of the amalgamating company (after excluding common shareholding) would become shareholders of the amalgamated company, i.e. SIPL, by virtue of the amalgamation; and (iii) the amalgamated company was an Indian company. Viewed from the point of view of the shareholders of the amalgamating company, the conditions stipulated in clause (vii) of section 47 were satisfied because the transfer of the shares (in the sense of extinguishment of the rights therein) held by the shareholders in the amalgamating company would be in the course of or pursuant to a scheme of amalgamation and such transfer would be in consideration of allotment of shares in the amalgamated company which was an Indian company.”

Moreover, viewed from any angle, it has to be held that benefit of section 47(vi) and (vii) of the Income Tax Act, 1961 could not be denied to the applicants on the ground that the transfer pursuant to amalgamation was a legally impermissible step adopted by the applicants only with a view to avoid or evade the income tax without there being any commercial or business purpose. Therefore, no tax liability arises under Income Tax Act in respect of transfer of shares pursuant to part of terms of amalgamation.

Further, in the case of Tata Tea Ltd., In re,29 it was held that avoidance of capital gains cannot be a reason for refusing sanction to a scheme which is otherwise lawful particularly when there is no allegation of fraud or illegality.

---

29 (2008) SCL 170 (Cal.).
Transfer of Capital Assets under Amalgamation is not Transfer

In *Shaw Wallace and Co. v. CIT*, it was pointed out by Calcutta High Court that under the scheme of amalgamation, the amalgamating companies, transferred their capital assets to the amalgamated company. The scheme of amalgamation further provided that the amalgamating companies would be subsequently dissolved. It was held that the transaction could not be classed as a transfer, or of any capital gain or loss resulting there from, even though there may be extinguishment of rights. Similarly, any allotment of shares as a result of amalgamation would not be treated as involving a transfer in the hands of shareholders.

This decision coincides exactly to the intention of law behind the exemption granted under clauses (vi), (via) and (vii) of section 47 of the Act in the cases of amalgamation where the amalgamating company merges itself in the amalgamated company and thereby dissolves itself without winding up. The shareholders in the transferor company (i.e. amalgamating company) are allotted in lieu of their original shares, a certain number of shares in the transferor company (i.e. amalgamated company) which continues the undertaking of both the companies. In such a case, there is no question of capital gains tax arising to the transferor company (amalgamated company).

Scope of Capital Gains Exemption if Shareholder Receives Shares in Exchange

Here, we will discuss the judicial view on section 47(vii). The Supreme Court held in *CIT v. Madurain Mills Company Ltd.*, that no transfer is involved on getting shares from transferee company on amalgamation. In another case, before the Apex Court in *CIT v. R.M. Amin*, where a shareholder has received moneys in respect of his shares on the distribution of the net assets of a company in liquidation, the Supreme Court has held that there was no transfer of capital assets within the meaning of section 2(47). The court further held that there is no transfer of capital asset within the meaning of section 2(47) resulting in sale, exchange or relinquishment of the capital asset or the extinguishment of any right therein when a shareholder ceases to hold shares in the amalgamating company. It was further pointed out that the shareholder must be

---

30 (1979) 119 ITR 399 (Cal.).
31 (1973) 89 ITR 45(SC).
32 (1977) 106 ITR 368(SC).
regarded as having received the money in satisfaction of rights which belonged to him by virtue of his holding the shares.

**Scope of Capital Gains Exemption if the Shareholder gets Shares and Bonds in Exchange of Shares**

With the new types of financial instruments being invented and used commonly by all, there arises a doubt as to whether in an amalgamation scheme if shares are exchanged for shares and bonds in the amalgamated company, the exemption will be available or whether there will be any capital gains incidence? Mr. N.A. Palkhivala, the learned author feels that the exemption under section 47(vii) will continue to apply. This precise question came up in the following three cases:

**CIT v. Master Raghuveer Trust**

The facts of the case are: the assessee Trust held shares in S Bank which was amalgamated with the Industrial Credit and Development Syndicate (ICDS) after the nationalisation of banks in 1969 as per the scheme approved by the High Court under Section 394 of the Companies Act. Consequently, the assessee received equity shares, advance call deposit certificates, debentures and redeemable bonds in lieu of the shares held by the assessee in S Ltd. for the assessment year 1974-75. The assessee claimed exemption of the capital gains realised from the said scheme of amalgamation, *inter alia*, on the ground that there was no transfer involved as required under section 2(47). The court held that:

“Even if it was assumed that in the process of amalgamation of companies, there would be transfer of assets of the amalgamating company to the amalgamated company in as much as there would be extinguishment of rights in the shares held by the assessee in the amalgamating company, there was no consideration for such extinguishment which would be paid to the assessee. In the first place, the assessee was not an *eo nomine* party to the amalgamation or to any transaction by which its assets were transferred to the ICDS. Secondly,

---

34 (1985) 151 ITR 368 (Kar.).
by the process of amalgamation, the shares held by the assessee in S Ltd. had become useless or valueless and S Ltd. was struck off from the register as required under section 394(1) (iv) of the Companies Act. And thirdly, the assessee, as a member of the amalgamating company, S. Ltd. was entitled to some shares, bonds, etc., from the ICDS. This was neither in satisfaction of its rights nor as a consideration for the transfer. The allotment of shares, etc. to the assessee could not, therefore, be considered as a transfer for consideration within the meaning of section 2(47).”

The special leave petition filed by the income-tax department in this case was rejected by the Supreme Court.\textsuperscript{35}

\textit{CIT v. Goutham Sarabhai Trust}\textsuperscript{36}

However there was a contrary decision rendered by the Gujarat High Court in this case. The court opined that the exemption under the clause contemplates that the transfer of a share or shares in the amalgamating company should be in consideration of allotment of shares in the amalgamated company. If the consideration for such transfer is a share or shares and something else, such as bonds or debentures, it cannot be said that the consideration is a share or shares in the amalgamated company and the exemption would not be available.

\textit{CIT v. Leena Sarabhai}\textsuperscript{37}

The Gujarat High Court corrected itself in this case and decided the case in favour of the assessee by holding that there is no transfer as defined under section 2(47) when the assessee receives shares and bonds in exchange of shares because of amalgamation. A similar view in favour of the assessee was also taken in \textit{CIT v. M.Ct. M. Corporation Pvt. Ltd.}\textsuperscript{38}

Thus, it is evident that in a typical case where shares and bonds (including convertible) are allotted in exchange of shares, there is no capital gains liability.

\textsuperscript{35} See, 187 ITR Statute 45as quoted in S. Ramanujam, 2012, p. 927.

\textsuperscript{36} (1988) 173 ITR 216 (Guj.).

\textsuperscript{37} (1996) 221 ITR 520 (Guj.).

\textsuperscript{38} (1996) 221 ITR 524.
Incidence of Capital Gains Tax when 100 Percent Subsidiary Merges with the Parent Company

This issue was discussed in the case of *Shaw Wallace and Co. Ltd. v. CIT*. The Calcutta High Court held that on amalgamation of a 100 percent subsidiary with the holding company, the undertaking of the subsidiary becomes vested in the parent company not in consideration for extinguishment of the parent company’s rights in the share capital of the subsidiary, but in satisfaction of realisation of its rights as the holder of such share capital. Consequently, there is no liability to capital gains tax on the subsidiary even apart from the specific exemption granted in section 47(v).

Thus, from the above it is clear that the investment of the parent company in subsidiary alone is restated consequent to the merger of the subsidiary with the parent company. This decision was also followed by Bombay High Court in *Forbes Forbes Campbell and Co. Ltd. v. CIT*.

5.3.3.1.3. Computation of Capital Gains: The above decisions enable us to come to the conclusion that there is no ‘transfer’ in the event of amalgamation but it does not mean that the assets acquired or shares exchanged in the process do not have a ‘cost’. These assets acquired or shares exchanged do have a ‘cost’ which will be necessary to place these assets in proper perspective. The question of ascertaining the cost of shares of the transferee company in the hands of the shareholder becomes relevant when the shareholder subsequently transfers these shares. In order to compute capital gains at the time of future transfer, one would need to ascertain the cost of the shares acquired pursuant to amalgamation.

Since the shareholders are exempt from capital gains taxation on amalgamation, the Act has provided that there would be no upward alignment in the cost of acquisition of the shares in the transferee company. In other words, the cost of the shares of the transferee (amalgamated) company would be regarded to be equal to the cost of the shares of the

---

39 (1979) 119 ITR 399.
42 Ernst and Young, 2012, p. 29.
amalgamating company,\textsuperscript{43} in accordance with section 49(2) of the Income Tax Act. Similarly, section 2(42A), which defines short-term capital assets, also specifically provides that in case of amalgamation as contemplated in section 47(vii), the period of holding of shares in the amalgamating company will also be counted for determining whether the asset is a short term capital asset or not. In the case of \textit{CIT v. Grace Collins},\textsuperscript{44} the rights of the assessee in the shares which they held in the amalgamating company stood extinguished upon the amalgamation of the amalgamating company with the amalgamated company and therefore, there was transfer within the meaning of section 2(47). It was, therefore, a transaction to which section 47(vii) applied and, consequently, the cost to the assessee of the shares in the amalgamated company had to be determined in accordance with the provisions of section 49(2); the cost of the shares in the amalgamated company which were sold, was deemed to be the cost of acquisition of the assessee of their shares in the amalgamating company.

In case of transfer of shares, the rate of capital gains tax is dependent on the period of holding of the shares. If the shares are held for more than 12 months before the transfer, the gains are treated as long term and otherwise the gains are treated as short-term. Long term capital gains are taxable at a rate lesser than short term capital gains.\textsuperscript{45} Similarly, as is the case with shares, in case of transfer of capital assets for determining whether the assets or the shares are short term or long term for the levy of capital gains tax in the event of sale of these assets at a future date after amalgamation, the period for which assets were held by the amalgamating company would be taken into account.\textsuperscript{46}

\textbf{5.3.3.2. Exemptions to the Amalgamated Company:} Continuity of deduction of specific expenses incurred by amalgamating (transferor) company for computing taxable profits of amalgamated company:

\textit{(1) Capital Expenditure on Scientific Research [Section 35(5)]:}\textsuperscript{47} The term ‘scientific research’ means “any activity for the extension of knowledge in the fields of natural or

\textsuperscript{43} Ibid.
\textsuperscript{44} (2001) 248 ITR 323 (SC).
\textsuperscript{45} Ernst and Young, 2012, p. 29.
\textsuperscript{46} Sections 2(42A), 49(1), 47(vi) and 47(via) of the Income Tax Act, 1961.
\textsuperscript{47} Inserted by the Finance Act, 1967 (20 of 1967).
applied sciences including agriculture, animal husbandry or fisheries. Section 35(5) of the Act allows deduction of expenditure incurred on scientific research after transfer of assets on amalgamation so as to maintain continuity of the allowances after amalgamation. In terms of section 35(5) where in a scheme of amalgamation, an amalgamating company transfers any asset representing expenditure of capital nature on scientific research, the provisions of section 35 shall as far as may be applicable to the amalgamated company as they would have applied to the amalgamating company if the latter had not sold or otherwise transferred the asset. Consequently, unabsorbed capital expenditure on scientific research of the amalgamating company will be allowed to be carried forward and set off in the hands of the amalgamated company.

Thus, amalgamation, does not in any way effect the allowance towards amortisation of capital expenditure on scientific research except that on amalgamation, the amalgamated company steps into the shoes of the amalgamating company for claiming this deduction. The amalgamated company would accordingly be entitled to carry forward indefinitely and without any time limit the unabsorbed portion of the capital expenditure, if any and set off the same against its business income.

An important thing to be noted is that the above concession is, however, subject to the conditions that:

- The amalgamated company is an Indian company and
- The asset continues to be used by it for the purpose of scientific research relating to the business carried on by it.

(2) Expenditure on Acquisition of Patent Rights or Copyrights [Section 35A (6)]: Where the amalgamating company sell or otherwise transfers to the amalgamated company (being an Indian company) any capital assets of the nature of patent rights or copyrights, the amalgamated company will be entitled to amortise the capital cost of

---

50 Darshan Kumar, 1976, p. 8.
51 Inserted by the Finance Act, 1967 (20 of 1967).
such assets against its profits under the relevant provisions of the Income Tax Act i.e.
section 35A in the same manner and to the same extent as the amalgamating company
would have been if it had not sold or transferred the asset to the amalgamated company.
However, the amalgamated company should continue fulfilling the conditions i.e. the
rights should be used for business purposes, the profits of which are being computed.
This expenditure is normally allowed to be written off by the assessee in fourteen equal
installments.\textsuperscript{52} It is to be written off in fourteen previous years as specified in sub-
section (1) of section 35A. Another point to be noted is that where such rights are later
on sold by the amalgamated company, the treatment of deficiency/surplus will be same
as would have been in case of the amalgamating company.\textsuperscript{53} However, if such
expenditure is incurred by the amalgamating company after 31-03-1998,\textsuperscript{54} deduction
under section 35A is not allowed, as such expenditure will be eligible for depreciation
as intangible asset. In such case, provisions of depreciation shall apply.

\textbf{(3) Expenditure on know how [Section 35AB (3)]:}\textsuperscript{55} In regard to expenditure on know
how,\textsuperscript{56} sub-section (3) of section 35AB states that where there is a transfer of an
undertaking under a scheme of amalgamation or demerger and the amalgamating or
demerged company is entitled to a deduction under this section in respect of such
undertaking to the same extent and in respect of the residual period as it would have
been allowable to the amalgamating company or the demerged company as the case
may be had such amalgamation or demerger not taken place. An important point to be
noted is that the deduction under section 35AB is available only if expenditure is
incurred before 1 April 1998. If expenditure on acquisition of technical know how is
incurred after 31 March 1998, depreciation is available under section 32.

\textsuperscript{52} J.C. Verma, 2009, p. 576.
\textsuperscript{53} For example, if the sale price of patents or copy rights exceeds the cost of acquisition the difference
will be treated as capital gains which would be taxed in the hands of the amalgamated company.
\textsuperscript{54} It is clearly mentioned in sec 35(A)(1) that to claim deduction, expenditure should be incurred after
28 February 1966 but before 1\textsuperscript{st} day of April 1998.
\textsuperscript{55} Inserted by the Finance Act, 1999 (27 of 1999), S. 17 (w.e.f. p. 1.4.2000).
\textsuperscript{56} Explanation to section 35AB of the Income Tax Act defines “know how” as any industrial
information or technique likely to assist in the manufacture or processing of goods or in the working
of a mine, oil well or other sources of mineral deposits (including the searching for, discovery or
resting of deposits or the winning of access thereto).
(4) **Expenditure for Obtaining Licence to Operate Telecommunications Services** [Section 35ABB(6)]: In terms of provisions of section 35ABB(6), where in a scheme of amalgamation, the amalgamating company sells or otherwise transfers the licence to operate telecommunication services to the amalgamated or resulting company being an Indian company, the provisions of this section shall, as far as may be, apply to the amalgamated or resulting company as they would have applied to the amalgamating company if the latter had not transferred the licence.

- The payment will be allowed as deduction in equal installments over the period starting from the year in which such payment has been made and ending in the year in which the licence comes to an end.\(^\text{57}\)

- The expenditure on acquisition of licence, not yet written off, shall be allowed to the amalgamated company in the same number of balance installments.\(^\text{58}\)

- Where such licence is sold by the amalgamated company, the treatment of the deficiency/surplus would be same as would have been in the case of amalgamating company.

(5) **Deduction of Certain Preliminary Expenses (Section 35D):** Section 35D as inserted by the Taxation Laws (Amendment) Act, 1970 with effect from 1.4.1971 for allowing deduction of certain preliminary expenses to the companies which commence new business Expenses incurred at the following two stages are qualified for deduction under section 35D.

- Before commencement of business, if the expenses are incurred for setting up any undertaking or business.

- After commencement of business if the expenses are incurred in connection with extension of an undertaking or in connection with setting up a new unit.

*Amount of Deduction:* Section 35D is enabling provision which enables an assessee to amortise preliminary expenses. According to section 35D(1), one-fifth of the qualifying


expenditure is allowable as deduction in each of the five successive years beginning with the year in which the business commences, or as the case may be, the previous year in which the extension of the industrial undertaking is completed or the new industrial unit commences production or operation.\footnote{In the case of \textit{CIT v. Mahindra Ugine and Steel Co. Ltd.}, it was held that where any expenditure has been incurred for the purpose of amortisation against profits over a 5-year period, such expenditure will not qualify for deduction under any other provisions of the Act for the same or any other assessment year. Section 35 would apply only in respect of expenditure which is otherwise not allowable under the law, for example, capital expenditure.}

In the case of \textit{CIT v. Mahindra Ugine and Steel Co. Ltd.},\footnote{\textit{CIT v. Mahindra Ugine and Steel Co. Ltd.}, (2002) 120 Taxman 250 (Bom.).} it was held that where any expenditure has been incurred for the purpose of amortisation against profits over a 5-year period, such expenditure will not qualify for deduction under any other provisions of the Act for the same or any other assessment year. Section 35 would apply only in respect of expenditure which is otherwise not allowable under the law, for example, capital expenditure.

\textbf{Consequences in Case of Amalgamation:} The benefit of amortisation of preliminary expenses under section 35D are ordinarily available only to the assessee who incurred the expenditure. The benefit is, however, not lost in a case where the undertaking of an Indian company which is entitled to amortisation is transferred to another Indian company in a scheme of amalgamation within the 5 year period of amortisation. In that event, the deduction in respect of previous year in which the amalgamation takes place and the following previous year within the 5 year period will be allowed to the amalgamated company not to the amalgamating company.\footnote{Vinod K. Singhania and Kapil Singhania, 2009, p. 306, para 121.7.}

\textit{(6) Deduction of Expenditure Incurred in Effecting Amalgamations (Section 35DD):} In terms of section 35DD, where an assessee, being an Indian company, incures any expenditure wholly and exclusively for the purposes of amalgamation or demerger, the assessee shall be allowed deduction of an amount equal to one-fifth of such expenditure for each of the five successive previous years beginning with the previous year in which the amalgamation or demerger takes place.\footnote{N.R. Sridharan and P.H. Arvind Pandian, 2010, pp. 448-449.} However, following conditions need to be fulfilled:\footnote{Karan Gupta, “Income Tax Aspects of M&As”, Taxation Law Reports, (Journal Section), July 2006, Vol. 48, No. VII, pp. 753-766, p. 760.}

\begin{footnotesize}
\begin{itemize}
\item \footnote{The amount of deduction is one-tenth in 10 years in case of expenses incurred before 1 April 1998. It is 1/5\textsuperscript{th} in 5 successive years in case of expenses incurred on or after 1 April 1998 introduced vide, \textit{The Finance Act, 1998} (21 of 1998), section 14(a) (w.e.f. 1.4.1999).}
\item \footnote{Vinod K. Singhania and Kapil Singhania, 2009, p. 306, para 121.7.}
\item \footnote{N.R. Sridharan and P.H. Arvind Pandian, 2010, pp. 448-449.}
\end{itemize}
\end{footnotesize}
The entity making the expenditure shall be an Indian company.

The expenditure shall be incurred on or after 1.4.1999.

However, the entire section 35DD was inserted by the Finance Act, 1999 with effect from 1-4-2000. Some of the major items of cost incurred for implementing a scheme of amalgamation include stamp duty, court fees, professional fees etc. An important judicial precedent on expenses incurred in effecting amalgamation is that of CIT v. Bombay Dying and Manufacturing Co. Ltd.\textsuperscript{64} In this case, professional charges paid by the assessee transferee company to its solicitors for effecting amalgamation i.e. for services rendered in connection with such amalgamation were considered as expenses incurred in course of carrying on assessee’s business, and therefore deductible as business expenditure. So after this landmark judgement of Supreme Court in 1996, a provision which expressly provides for deduction of such expenses was added by the Finance Act, 1999.

\textit{(7) Deduction of Expenditure for Prospecting for Minerals or Development of Mines (Section 35E Read with the Seventh Schedule):} Section 35E provides for the amortisation of expenditure incurred wholly and exclusively on any operation relating to prospecting or extraction or production of any mineral or group of associated minerals or on the development of mine or other natural deposit of any such minerals or group of associated minerals specified in the Seventh Schedule.\textsuperscript{65}

Such deduction is allowed only in the case of Indian companies and resident assesses other than companies. The benefit of amortisation is not available to a foreign company even if such company declares its dividends in India. Indian companies engaged in operations for prospecting for or for extraction or commercial production of minerals are entitled to deduct preliminary expenses incurred by them on such operations in the year of starting commercial production or any four preceding years over a period of ten years, in installment of one-tenth of such expenditure each year.\textsuperscript{66}

\textbf{Consequences in the Case of Amalgamation:} The amortisation under section 35E is available only to the assessee who incurs the expenditure. However, in the case of an

\textsuperscript{64} (1996) 3 SCC 496; AIR 1996 SC 3309.
\textsuperscript{66} Sections 35E(1) and 35E(2) of the Income Tax Act, 1961.
Indian company, the benefit of amortisation is preserved where the undertaking of the company is transferred to another company under the scheme of amalgamation within the 10-year period. In such an event, amortisation of outstanding installments in respect of the previous year in which the amalgamation takes place and the remaining previous years of the 10-year period will be allowed to the amalgamated company as it would have been allowed to the amalgamating company as if the amalgamation had not taken place.67

(8) Deduction for Bad Debts of Amalgamating Company [Section 36(1)(vii)]: The amalgamating/transferor company may have bad debts which form part of its provision/liability and have not been allowed as a deduction to the said company.68 An issue that arises here for consideration is that whether such bad debts will be allowed as a deduction to the amalgamated company. The only judicial precedent available here is in the context of the partnership firms. The Hon’ble Supreme Court in CITv. Veerabhadrarao, K. Koteswararao and Co.,69 has ruled that in the context of partnership firms, if a debt has been taken into account in computing the income of the predecessor firm and it has subsequently been written off as irrecoverable in the accounts of the successor firm,70 but when the firm was converted to company, the latter was entitled to deduction of the amount written off.

Though this decision was rendered in the situation of a company taking over the business of another partnership firm, the ratio of this decision is equally applicable in the context of amalgamation of companies. This exemption is not only available to the assessee, but it is also available to the succeeding assessee in as much as ‘the assessee’ referred to in section 36(2)(i) need not be the ‘same assessee.’71

(9) Expenditure on Family Planning [Section 36(1)(ix)]: Where the asset representing the capital expenditure on family planning is transferred by the amalgamating company to the Indian amalgamated company, in a scheme of amalgamation, the provisions of

---

68 Ernst and Young, 2012, p. 36.
69 (1985) 155 ITR 152 (SC).
70 One need not have to prove that the debt has become bad, mere writing off in the books of account is sufficient. This provision was introduced vide amendment of the Income Tax Act with effect from 1.4.1989.
section 36(1)(ix) shall become applicable to the amalgamated company in the same manner as they would have applied to the amalgamating company. The deduction for capital expenditure on family planning is one-fifth in the previous year in which the expenditure is incurred and balance thereof shall be deducted in equal installments for each of the four immediately succeeding previous years.\footnote{First proviso to section 36(1)(ix) of the Income Tax Act, 1961.} In case of amalgamation of companies during this 5-year period, the capital expenditure on family planning not written off shall be allowable to the amalgamated company in the same number of balance installments.

\textbf{(10) Special Provisions for Deduction in the Case of Business for Prospecting etc, for Mineral Oil (Section 42):} The profits of business of prospecting for or extraction or production of petroleum or natural gas and commercial production or refining of mineral oil are computed in accordance with the provisions of section 42 viz. the expenses specified in any agreement between the assessee and the Central Government are allowed in addition to or in lieu of those admissible under the Act. Where such business is transferred, proceeds of the transfer are less than the expenditure remaining allowed, a deduction will be allowed for expenditure remaining unallowed as reduced by proceeds of transfer, where such proceeds are more than the amount of expenditure, then the excess will be chargeable as profits and gains of the business in the previous year.\footnote{Section 42(2) of the Income Tax Act, 1961.}

\textbf{Consequences in Case of Amalgamation:} Where in a scheme of amalgamation, the amalgamating company sells or otherwise transfer the business to the amalgamated company being an Indian company the provisions of this sub-section shall not apply to the amalgamating company. Further, as far as may be possible, this sub-section shall apply to the amalgamated company as they would have applied to the amalgamating company if the latter had not transferred the business or the interest in the business.\footnote{Proviso to sec. 42(2) of the Income Tax Act, 1961.}

\textbf{(11) Tax Holiday Benefits:} In order to facilitate economic development in certain areas/sectors/states, the Income Tax Act grants tax holiday benefits by providing for a deduction from taxable income of the taxpayer for a specific period known as the tax

holiday period. Instances of these specific sectors or areas are provision of infrastructure facility, telecommunication services, industrial parks, power generation, software technology parks, free trade zone, special economic zones, export oriented undertaking, hospitals in rural areas, industrial undertaking set up in certain special category of states, etc.

**Consequences in Case of Amalgamation:** If a company which is entitled for deduction under sections 80-IA, 80-IB, 80-IC, 10A, 10AA, 10B is transferred on amalgamation, the benefit should not be lost for the unexpired period of the tax holiday. Purportedly with this intention, the Act provides for continuity of tax holidays in the hands of the amalgamated company.

It is provided that where any undertaking which is entitled to tax holiday is transferred before the expiry of tax holiday period pursuant to amalgamation, then:

- Deduction under section 10A, 10B, 80IA, 80IB, 80-IC for tax holiday benefit would be available to the amalgamated company for the unexpired period (including the previous year in which amalgamation takes place).

- Similarly, deduction under section 10AA shall be allowable in the hands of the amalgamated company for the unexpired period. But there is one difference that no deduction shall be admissible under this section to the amalgamating company in the previous year in which the amalgamation takes place.

- This benefit is available only when both transferor (amalgamating) and transferee (amalgamated) company are Indian companies.

**(12) Carry Forward and Set off of Accumulated Loss and Unabsorbed Depreciation Allowance in Amalgamation (section 72A):** Due to various reasons, both controllable

---

and non-controllable, a company may become sick and may need financial, managerial, technological and marketing support of a healthy unit on a sustained and long term basis.\textsuperscript{85} We have discussed in chapter-I, the reasons for mergers. One of the most commonly projected reasons for amalgamation is the revival of a sick company which has become financially non-viable by reason of its liabilities, losses and other relevant factors. The Supreme Court has clearly held in \textit{CIT v. Mahindra and Mahindra Ltd.},\textsuperscript{86} that the expression financial non-viability is to be construed in the manner in which persons of business and commerce think it. That is to say, that where all the three parameters-profitability, liquidity, solvency-show negative figures, the unit is sick. Further, it has to be considered with respect to the ‘net worth’ of the assets, where only the excess of book value of assets over liabilities is relevant.

For encouraging revival and rehabilitation of techno-economically viable but financially weak companies, specific provisions were embodied by insertion of section 72A in the Income Tax Act, 1961 by the Finance Act 1977 with effect from 1.4.1978, Section 72A was reframed and substituted by the Finance Act, 1999 w.e.f. 1.4.2000. Specific provisions ever embodied in section 72A of the Income Tax Act, 1961 whereby the accumulated losses and unabsorbed depreciation of the amalgamating sick company shall be deemed to be the loss, or as the case may be, allowance for depreciation of the amalgamated company (i.e. the healthy company) for the previous year in which the amalgamation was effected provided certain conditions are fulfilled. In this process, the amalgamated company (i.e. the healthy transferee company) can reduce its taxable profit to the extent of accumulated loss and unabsorbed depreciation of the amalgamating sick company. Thus the healthy company avoids paying huge taxes to the exchequer.

Sickness among industrial undertakings is matter of grave national concern. Closure of any sizable manufacturing unit in any industry entails social costs in terms of loss of production and employment and also waste of valuable capital assets. Experience has shown that taking over of such units by government is not always the most satisfactory


\textsuperscript{86} (1993) 144 ITR 25(SC) Affirming the Decision of Delhi High Court in \textit{Mahindra and Mahindra v. Union of India}, (1983) 141 ITR 174 (Del.).
or the most economical solution. To save the government from social costs in terms of loss of production and employment and relieve the government of the uneconomical burden of taking over and running sick industrial units, a more effective course suggested was to facilitate the amalgamation of sick industrial units with sound ones by providing incentives and removing impediments in the way of such merger. To achieve this objective so as to facilitate the merger of sick industrial units with sound one, the general rule of carry forward and set off of accumulated losses and unabsorbed depreciation allowance of amalgamating company by the amalgamated company was statutorily related. By a deeming fiction, the accumulated loss or the unabsorbed depreciation of the amalgamating company is treated to be the loss or as the case may be, allowance for depreciation of the amalgamated company for the previous year in which amalgamation was effected. A number of companies in our country have merged to take advantage of this provision. Here example can be given of takeover of Sidhpur Mills by Reliance in 1979. The carry-forward losses and unabsorbed depreciation of Sidhpur Mills amounted to Rs. 2.47 crores which lead to substantial tax savings for Reliance.

Sections 72A, 72AA and 72AB of the Act provides that the accumulated loss and the unabsorbed depreciation, of the amalgamating company shall be deemed to be loss/depreciation of the amalgamated company for the previous year in which the amalgamation is effected provided the following conditions are satisfied:

**Condition One:** Amalgamated company will get the above benefit in the following cases.

(a) Amalgamation of a company owning industrial undertaking. For this purpose, industrial undertaking includes the following:

- Company engaged in manufacture or processing of goods.

---

88 Id., p. 290.
90 Unabsorbed depreciation includes unabsorbed capital expenditure on scientific research/family planning-ITO v. Mahyco Vegetable Seeds Ltd., (2008) 25 SOT 46 (Mum.).
91 In CIT v. Apollo Hospitals Enterprises Ltd., (2008) 171 Taxman 397 (Mad.) it was held that hospital is not an industrial undertaking.
- Company engaged in the manufacture of computer software.
- Company engaged in the business of generation or distribution of electricity or any other form of power.
- Company engaged in the business of mining.
- Company engaged in the construction of ships, aircrafts or rail systems.
- Company engaged in the business of providing telecommunication services whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet services.

(b) Amalgamation of company owning a ship.

(c) Amalgamation of company owning a hotel.

(d) Amalgamation of a banking company with a specified bank.\(^92\)

(e) Amalgamation of public sector company engaged in the operation of aircraft into another public sector company engaged in similar business.

(f) Amalgamation of a co-operative bank with another co-operative bank.\(^93\)

**Condition Two:** The amalgamating company has been engaged in the business,\(^94\) in which that accumulated loss occurred or depreciation remains unabsorbed for three or more years.

**Condition Three:** The amalgamating company has held continuously as on the date of the amalgamation at least three-fourths of the book value of fixed assets held by it two years prior to the date of amalgamation.

**Condition Four:** The amalgamated company continues to hold at least three-fourths in the book value of fixed assets of the amalgamating company which is acquired as a result of amalgamation for five years from the effective date of amalgamation.

---

\(^{92}\) “Specified Bank” means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955) or any subsidiary of SBI or a corresponding new bank constituted under section 3 of the Banking Companies (Acquisitions and Transfer of Undertakings), Act, 1977 and 1980.


\(^{94}\) In *CIT v. Gujarat Nre Coke Ltd.*, (2008) 25 SOT 46 (Kol.), it was held that Section 72A(2) (i) clearly uses the words ‘engaged in business’ and there is no requirement of starting of production to be eligible for deduction.
Condition Five: The amalgamated company continues the business of the amalgamating company for a minimum period of 5 years from the date of amalgamation.

Condition Six: The amalgamated company, which has acquired an industrial undertaking of the amalgamating company by way of amalgamation, shall achieve the level of production of at least 50 percent of the installed capacity of the said undertaking before the end of 4 years from the date of amalgamation and continue to maintain the said minimum level of production till the end of 5 years from the date of amalgamation. However, the Central Government, on an application made by the amalgamated company may relax this condition.

Condition Seven: The amalgamated company shall furnish to the Assessing Officer a certificate in Form No. 62, duly verified by an accountant, with reference to the books of account and other documents showing particulars of production, along with the return of income for the assessment year relevant to the previous year during which the prescribed level of production is achieved and subsequent assessment years relevant to the previous years falling within 5 years from the date of amalgamation.

Consequences when the above Conditions are Satisfied: If the above conditions are satisfied, then accumulated business loss and unabsorbed depreciation of the amalgamating company shall be loss and depreciation of the amalgamated company for the previous year in which amalgamation is effected.

Consequences when the above Conditions are not Satisfied After Adjusting Loss/depreciation: In the case, the above specified conditions are not fulfilled, then that part of brought forward of loss and absorbed depreciation which has been set off by the amalgamated company shall be treated as income of the amalgamated company for the year in which the failure to fulfil the conditions occurs.

5.3.4. Carry forward and Set off of Losses in Case of Closely Held Transferee Company

Section 79 of the Income Tax Act provides that where there is change in the shareholding of a closely held company in a financial year, no business loss incurred in any prior financial year shall be carried forward and set off against the income of the
financial year in which the shareholding has changed, unless the same person beneficially held 51 percent of the voting rights of the company as on the last day of the financial year as well as on the last day of the financial year when the losses were incurred.

**Applicability of the Restrictions:** Thus, section 79 provides that where there is a change in shareholding in a specific previous year, no business loss incurred in any year prior to that previous year can be carried forward and set off against the income of the same previous year. Accordingly, the Madras Tribunal in *Saravanabava Mills (P.) Ltd. v. ITO*,\(^95\) has held that the aforementioned restrictions in regards to the carry forward and set off of business losses are applicable only to the previous year in which the change in the shareholding takes place and thus in the subsequent years the carried forward business losses could be set off against future income.

However, according to a prevalent contrary view, it could also be contended that given that the company is not allowed to carry forward loss in one year, as per the application of the restrictive provisions, it may not be possible for the company to carry forward and set off the restricted business losses in any subsequent year either. In *CIT v. Shri Subhlaxmi Mills Ltd.*,\(^96\) the Gujarat High Court held that section 79 cannot be read in isolation and that had to be read with other provisions of the Act relating to carry forward and set off of business losses. Accordingly, once the company was not allowed to carry forward loss in one year due to the application of the provisions of section 79, it may not be possible for it to argue that in the next year it could carry forward and set off the same loss.

**Applicability of the Aforesaid Provisions to the Indian Subsidiary of a Foreign Listed Company:** The aforesaid provisions of section 79 are not applicable to companies in which the public is substantially interested i.e. listed companies and public limited companies that satisfy the condition laid out under section 2(18) of the Income Tax Act.

\(^{95}\) (1977) 4 TTJ 1072 (Mad. ITAT).
\(^{96}\) (1983) 143 ITR 863 (Guj.).
In simple terms, the subsidiary of a company listed on a recognised stock exchange in India would be regarded as a ‘company in which the public is substantially interested’. Accordingly, while the Indian subsidiary of an Indian listed parent company would be treated as a company in which the public is substantially interested, the Indian subsidiary of a foreign parent company listed on a foreign stock exchange would not. Under the current laws it is not possible for a foreign company to be listed in India and therefore, the Indian subsidiary of a foreign parent company would always be at a disadvantage when compared to the Indian subsidiary of an Indian listed parent company. However, where India has a tax treaty with the host country of the listed foreign parent company and tax treaty contains a non-discrimination clause, it may be possible to contend that Indian subsidiaries should be regarded as companies in which the public is substantially interested and accordingly the restrictions on carried forward of losses should not be applicable.\footnote{97} In \textit{Diamlerchrysler India (P.) Limited v DCIT},\footnote{98} the Pune Tribunal held that there was no rationale for the different treatment. The Tribunal further held that in light of the non-discrimination clause of the India-Germany Tax Treaty, the losses of the Indian subsidiary of the German listed parent company would not be impacted by the provision of section 79 of the Income Tax Act.

There has been vehement criticism of this section and it has been pointed out by all that this section comes in the way of rehabilitating sick private companies even though there are many entrepreneurs willing to take up the challenge. Keeping the criticism aside, let us analyse the position of a sick private limited company being amalgamated with another company (whether private or public). As per section 2(1B), the definition of amalgamation will be satisfied only if shareholders holding not less than nine-tenths in value of the amalgamating company become shareholders in the amalgamated company by virtue of amalgamation. If this definition is satisfied, then because of the change in the shareholding of more than 51 percent, section 79 will get attracted, denying in the process the right to carry forward and set-off the losses incurred in the previous years. This is a paradox and it is hoped that the government will scrap section 79 altogether.\footnote{99}

\footnote{97} Ernst and Young, 2012, p. 208.  
\footnote{98} (2009) 120 ITJ 803 (Pune ITAT).  
An important aspect to be kept in mind by the tax planners merging listed company with unlisted company or merging two unlisted companies is that the loss referred in this section represents only the business loss and not any unabsorbed depreciation. Accordingly, there are no restrictions on carry forward and set-off the unabsorbed depreciation in the event of change of shareholding. This view was upheld by Supreme Court in *CIT v. Shri Subhulaxmi Mills Ltd.*

5.3.5. Other Implications

**Profits Chargeable to Tax:** In terms of section 41(1)(b), where deduction has been made in the assessment for any year in respect of loss, expenditure or trading liability incurred by the assessee, and then subsequently during any previous year, the successor in business obtains, whether in cash or in any other manner any amount in respect of which loss or expenditure was incurred by the first mentioned person, or the successor receives some benefit in respect of trade liability referred above by way of remission or cessation thereof, the amount obtained by the successor in business or the value of benefit accruing to the successor in business shall be deemed to be profits or gains of the business or profession and accordingly chargeable to income tax as an income of that previous year. Clause (1) to Explanation 2 clarifies and makes it abundantly clear that successor in business means where there has been an amalgamation of a company with another company, the amalgamated company.

Earlier, this position was not abundantly clear. That is why in the landmark judgement of *Saraswati Industrial Syndicate v. CIT,* the Supreme Court held otherwise. In this case, as a result of amalgamation between the holding company and the subsidiary company, the holding company stood dissolved. It was held that in order to attract the provisions of section 41(1) for enforcing the tax liability, the identity of the assessee in the previous year and the subsequent year must be the same. If there is any change in the identity of the assessee, there would be no tax liability under the provisions of section 41. The Hon’ble Court further held that in amalgamation, two or more

---

100 (2001) 249 ITR 795 (SC).
101 AIR 1991 SC 70.
companies are fused into one by merger or by taking over by another. The true effect and character of the amalgamation largely depends on the scheme of merger. But there cannot be any doubt that when two companies amalgamate and merge into one, the transferor company loses its identity as it ceases to have it business.

Further, where the company which had been allowed certain amount as trade liability in previous year was subsequently amalgamated with the assessee company and under the terms of amalgamation, the trade liability was taken over by the assessee company. If some benefit is obtained by assessee in respect of such trading liability in subsequent year, it would not be liable to pay tax under section 41(1) on the amount taken over as the amalgamating company to whom the amount was allowed loses its identity after amalgamation. Thus, upon amalgamation, the transferor company does not exist in the eyes of law, the transferee company which was a separate entity was not liable to tax.

To overcome the impediment created by this decision, section 41 was specifically amended by the Finance Act, 1992 with effect from 1.4.1993 to provide for the taxability in the successor’s hands by substituting the then existing section 41(1) in an elaborate manner.

5.3.6. Meaning and Significance of Appointed Date

Every scheme of amalgamation has to necessarily provide a date with effect from which the amalgamation shall take place. In the case of amalgamation of running companies it is the ‘appointed date’ which segregates the liabilities of the transferor and transferee companies. This date assumes a great importance on account of the following factors:

1. It is from this date that all the assets and liabilities of the transferor company vest with the transferee company.

2. The exchange ratio of both the companies is worked out on the basis of the assets and liabilities position on the appointed date.

3. The appointed date acts as a cut off date and even though the scheme of amalgamation is approved at later date, it takes effect from the appointed date.
The Case Laws Discussed Below Highlight the Significance of the Appointed Date

*Union of India v. Ambalal Sarabhai Enterprises Ltd.*

Under the original scheme of amalgamation between the two companies, the appointed date was fixed as 1 July 1981. Under the modified scheme the appointed date was shifted to be effective from 1 April 1980. The transferor company incurred a loss during the year 1980-81. The modified scheme was approved by all the shareholders. The income tax department objected to the scheme and filed a petition before the High Court contending *inter alia* that by shifting the date to 1 April 1980, the transferee company wanted to take advantage of provisions of section 72A as by pre-poning the date, it could set of the losses of the transferee company against its profits. As after amalgamation, the losses of the transferor would become part and parcel of the transferee company.

The High Court dismissed the objection of the Income-Tax Department by holding as follows:

“The transferor company was in existence since last many decades. It was not brought into existence with some ulterior purpose or for the purpose of evading tax. It is true that incidentally as a result of the shifting of the date, the transferee company will get the advantage of setting-off the loss suffered by the transferor company as this loss will be treated as loss of the transferee company but that could hardly be considered to be a good or sufficient ground for refusing to sanction the modified scheme. A tax payer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon the considerations of morality, but on the operation of the income-tax act. It is open to the transferor company and the transferee company to shift the date so that the arrangement is found to be mutually satisfactory and reasonable. When the transferee company is taking over liabilities alongwith the assets of the transferor company there is nothing wrong if the transferee company evolves a scheme so as to take as much advantage as possible as may be permissible according to law. Thus, the impunged contention was not sustainable.”

---

The Special Leave Petition against this judgment by the department was dismissed by the Supreme Court. Thus, this judgment brings into focus the importance of fixing the appointed date and also the effect of profits and losses of the transferor company after the appointed date.

*Marshall Sons and Co. (India) Ltd. v. ITO*[^103^]

The Supreme Court observed as follows:

“Every scheme of amalgamation has to necessarily provide a date with effect from which the amalgamation/transfer shall take place. The scheme concerned herein does so provides, viz., 1.1.1982. It is true that while sanctioning the scheme, it is open to the court to modify the said date and prescribe such date of amalgamation/transfer as it thinks appropriate in the facts and circumstances of the case. If the court so specifies a date, there is little doubt that such date would be the date of amalgamation/date of transfer. But where the court does not prescribe any specific date but merely sanctions the scheme presented to it, as has happened in the case, it should follow that the date of amalgamation/date of transfer is the date specified in the scheme as ‘the transfer date’. It cannot be otherwise. It is equally relevant to notice that the courts have not only sanctioned the scheme in this case but has also not specified any other date as the date of transfer/amalgamation. We are therefore of the opinion that the notices issued by the ITO were not warranted in law. The business carried on by the transferor company (subsidiary company) should be deemed to have been carried on for and on behalf of the transferee company. This is the necessary and the logical consequence of the court sanctioning the scheme of amalgamation as presented to it. The order of the court sanctioning the scheme, the filing of the certified copies of the orders of the court before the Registrar of companies, the allotment of shares, etc., may have all taken place subsequent to the date of amalgamation/transfer, yet the date of amalgamation in the circumstances of this case would be 1.1.1982.”

5.3.7. Role of Judiciary in Checking Tax Evasion in a Scheme of Amalgamation

A merger, the only object of which is to derive a tax benefit or if we use a more appropriate expression, to eliminate tax liability that would otherwise arise, is unlikely

to be considered by a court a proper case of sanction. However, if the sole purpose of amalgamating two or more companies is to avoid payment of tax, then the courts may not approve the amalgamation scheme. This principle was enunciated by Gujarat High Court in *Wood Polymer Ltd., In re*. In this case, the only purpose for the merger was to avoid capital gains tax through transfer of an asset to a paper company which was later intended to be merged with the transferee company. The court held that it distinctly appeared that the provision for such scheme of amalgamation was utilised only for the avowed object of defeating tax and therefore court refused to sanction the scheme. It observed:

“Ordinarily, corporate personality is to be respected but when a benefit is misused the court is not powerless and it can lift the ‘veil of corporate personality’ to see the realities behind the veil because in so doing the court sub-serves the important public interest, namely, to arrest the abuse of benefit conferred by law. One such field in which court lifts the veil and looks behind the realities is the field of taxation.

If the party seeks assistance of the court only to reduce tax liability, the court should be the last instrument to grant such assistance or judicial process to defeat a tax liability or even to avoid tax liability. The court is charged with a duty before it finally confirms burial-cum-cremation of the transferor company, to peep into its affairs to ascertain whether they have been carried on not only in a manner not prejudicial to its members but in even public interest.

The court also discussed the moral and legal aspects of tax avoidance and came to the conclusion that tax avoidance can hardly ever be treated as in public interest. In fact, it is the very negation of it. The court cannot lend its assistance to such undermining of public interest by sanctioning a scheme of amalgamation and thereby polluting judicial process by accepting devices and subterfuges.”

This decision of Gujarat High Court was endorsed by the Supreme Court in *McDowell & Co. Ltd. v. CIT*. The majority judgement in the case held that tax planning may be legitimate provided it is within the framework of law. In the latter part, it held that

---

105 (1977) 47 Com Cases 597 (Guj.).
“colourable device cannot be a part of tax planning and it is wrong to encourage the belief that it is honourable to avoid payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes without resorting to subterfuges.”

5.4. Tax Perspective in Cross-Border Mergers and Acquisitions

Mergers and acquisitions (M&A) play a major role in the materialisation of globalisation. With increasing importance on globalisation of businesses, cross-border transactions have become the quickest way of achieving the objective. In an endeavor to geographically expand the utilisation of their competitive advantages, M&A allow the firms to do so in a fast, effective and supposedly cheap manner.\(^{107}\)

Many countries have some tax rules that grant certain benefits to M&A transactions, usually allowing some deferral of the tax otherwise imposed on the owners of some of the participating parties upon the transaction. On the other hand, once M&A transaction cross borders, countries are much less enthusiastic to provide tax benefits to the involved parties, understanding that, exemption from tax means MNCs taking away their resources without paying anything for it. The boom in the cross-border M&As has made the study and understanding of complex tax consequences of international expansion indispensable.

While structuring mergers and acquisitions transaction, tax plays a crucial role. A number of important issues arise in structuring a cross-border M&A deal to ensure that tax liabilities and cost will be minimised for the acquiring company. Structuring of any transaction commences with understanding the objective of the transaction. Whilst most equity investments (whether by private equity funds or venture capital funds) are being made through investments by Mauritius based entities, we find that most M&As are being made directly from the country of origin. This is because as the objective of M&As is long-term synergy and business development, finding an investment route which is taxation efficient at time of exit is not essential or important. However, if the objectives are more short-term and exit driven, then finding an investment route which is taxation efficient at time of exit is of immense importance.\(^{108}\)


An optimal structure will require a combination of legal, tax and accounting considerations. Often there may be tax advantages in using a Mauritius acquisition vehicle or holding company structure as well as structures with more novel features than a simple share purchase.\textsuperscript{109}

The tax components in a M&A deal can be segregated into the following:

\textbf{5.4.1. Tax Treaty Considerations}

In case of cross-border acquisitions in India, investment through intermediate jurisdictions like Mauritius, Cyprus, Netherlands etc. are the most common mode of acquisition. These intermediate jurisdictions bring along with them several benefits like tax deferral, assisting in availing benefits under tax favourable treaties and thus effectively reducing cost, providing future restructuring flexibility and so on. Further, investment through holding company helps in consolidation of different ventures under one company while providing oversight functions for the entire group, leverage on the group strength, raise capital and at the same time achieve overall group tax rationalisation. Thus, in case of cross-border merges and acquisitions, relevant tax-treaties with various jurisdictions become very important.

According to section 90 of the Income Tax Act, the Central Government may enter into an agreement (tax treaty) with the government of any country outside India for granting relief of/avoidance of double taxation of income in India and in that country. The Act,\textsuperscript{110} further provides that where any such agreement exists, the provisions of the Income Tax Act shall apply to the extent’ they are more beneficial to the assessee to whom such agreement applies. Thus if the provisions of the tax treaty are more beneficial to the assessee, it may choose to be governed by the provisions of such treaty. India has entered into Double Taxation Avoidance Agreement (DTAA) with several countries with the objective of minimising dual tax levy in international transactions between residents of India and the relevant country and for extending certain beneficial rates of taxation.\textsuperscript{111}

\textsuperscript{109} Ibid.
\textsuperscript{110} Section 90(2) of the Income Tax Act, 1961.
The acquirer should evaluate the tax implications under the existing DTAA of India with the acquirer’s country to structure the M&A deal in the most tax efficient manner. So far as India is concerned, the most glaring tax treaty is treaty between India and Mauritius. When there is a favourable tax treaty between India and Mauritius say compared to treaty between India and US, it would be a natural desire of the contracting parties to execute the transaction through Mauritius subsidiary and not directly from the US. This is generally called ‘treaty shopping’ i.e. to shop for the most favourable tax treaty.

Under the Double Taxation Treaty of India with Mauritius, any capital gains earned by an entity that is resident of Mauritius on shares held in an Indian company are subject only to the Mauritius tax regime and are not subject to taxes in India. As per the existing domestic tax provisions of Mauritius, capital gains are exempt in Mauritius. This lead to increase in acquisitions through the Mauritius route. But such methods can sometimes be controversial and the Indian revenue authorities had initiated steps to curb such practices. Like is 1990s, following McDowell’s principles, the revenue authorities lifted the corporate veil of many Mauritius entities to determine their place of management and actual place of residence which happened to be Europe or North America, therefore these entities had to pay capital gains tax. Responding to FII distress calls, the Central Board of Direct Taxes issued Circular no. 789 in 2009. The validity of this circular was upheld by the Supreme Court in *Azadi Bachao Andolan Case*. This circular provided that a certificate of residence issued by the Mauritius Government to a Mauritius Company was sufficient for the Mauritius company to establish residence and beneficial ownership under the India-Mauritius tax treaty. The companies incorporated in Mauritius were liable to tax under the laws of Mauritius and therefore, were deemed to be residents of Mauritius for the purposes of the treaty. Accordingly, such companies would not be taxable in India on income from capital gains. The Delhi High Court has

---


113 McDowell’s principles are taxation principles laid down by the Supreme Court in its landmark judgement of *McDowell and Co. Ltd. v. CIT* (1985) 154 ITR 148 (Discussed in brief in earlier topic of ‘Role of Judiciary in Checking Tax Evasion in a Scheme of Amalgamation’).

quashed the circular as violative of the Income Tax Act. But the Supreme Court upheld its validity as a device of legitimate tax planning.

The Supreme Court’s reasoning in *Azadi Bachao Andolan Case* was not held to be applicable in 14 July 2011 decision of the Bombay High Court in the *Aditya Birla Ltd. v. DDIT*.¹¹⁵ The Court agreed with the Indian tax authorities and concluded that the sale of shares of an Indian company by a Mauritius company is taxable in India because AT&T Mauritius was not the beneficial owner of the shares that were sold, but rather was a permitted transferee of its US parent-company under the JVA (Joint Venture Agreement). In arriving at this conclusion, the High Court observed that, although the shares of Idea Cellular were allotted to AT&T Mauritius (the seller), all rights in respect of the shares vested in AT&T USA. Consequently, AT&T Mauritius is not the beneficial or real owner of the shares but only a permitted transferee. As AT&T USA is the real owner of the shares of ICL (Idea Cellular Ltd.), hence benefit of India-Mauritius DTAA is not applicable in the given case. Hence, income earned by AT&T Mauritius on sale of shares of ICL is in substance income of AT&T USA and hence would be subject to tax in India.

To sum up, we can say that in certain cases the courts and revenue authorities have allowed the assessees to take benefits of India-Mauritius DTAA and in certain cases, they have lifted the corporate veil so as to find out who is the beneficial owner of these shares. This has created a lot of uncertainty in Indian cross-border M&A. Recent amendments to the Income Tax Act, aiming to restrict the benefit of DTAA to legitimate tax residents of foreign countries have now made it mandatory to obtain a Tax Residency Certificate (‘TRC’) in the prescribed form from the Government of the foreign country or territory for the purposes of seeking any relief or benefit under applicable DTAA.¹¹⁶ However, while the amendments make the obtaining of a TRC mandatory, it has been clarified that a TRC only will not be sufficient to successfully claim any relief or benefit under a DTAA.¹¹⁷ The memorandum explaining the above provisions or amendments have been made by the Finance Act, 2012 to recognise the

¹¹⁷ Ernst and Young, 2012, p. 211.
concept of substance over a form. However, it is feared that the same may lead to huge litigation and will raise substantial questions over validity of decision of Hon’ble Supreme Court in *Azadi Bachao Andolan Case*.

The intention to bring overseas M&As within the Indian tax net is further fortified by specific proposals in the draft Direct Taxes Code. Given the potential tax implications of such deals, tax payers need to consider the risk and potential pitfalls to avoid unintended consequences.\(^\text{118}\)

### 5.4.2. Transfer Pricing Considerations

Rapid advances in technology, transportation and communication have given rise to a large number of Multinational Enterprises (MNEs) which have the flexibility to place their enterprises and activities anywhere in the world.\(^\text{119}\) The fact is that a significant volume of global trade now-a-days consist of intra-group transactions between associated enterprises (component parts of MNEs, such as companies, are also called associated enterprises in the language of transfer pricing). Transactions between associated enterprises are determined by market forces and group driven common interest. ‘Transfer pricing’ refers to the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises.\(^\text{120}\) Arm’s length price is the price of international transaction between companies that are not associated and operate independently i.e. unrelated parties, engaged in the same or similar transactions under the same or similar conditions in the open market. Transfer price comes under the scrutiny of tax authorities when it is different from the arms length price.

According to law, all cross-border deals between group companies need to be at arms length, that is, as if it was with an unrelated company.\(^\text{121}\) Transfer pricing by itself does not necessarily involve tax avoidance. It is where the pricing do not accord with


\(^{120}\) *Ibid.*

applicable norms internationally like the arms length’s principles, or at domestic law that is the issue of tax avoidance and evasion arise. Because, the aim of MNEs is to reduce group’s worldwide taxation by shifting profits from associated enterprises in higher tax countries through either under-charging or over-charging the associated enterprise for intra-group trade. Transfer pricing is a mode by which Multinational Enterprises (MNE’s) makes huge profits by increasing the price of the products or services in low tax jurisdictions and decreasing the price in high tax jurisdictions thereby shifting profits especially in a scenario wherein more than 60 percent of international trade is done intra-group. Transfer Pricing thus provides for huge loss to the public exchequer as they are prevented from taxing a product or service or on the other hand are prevented from realising the real tax at which a product was to be taxed in a country. It is at this juncture that we need a strict Transfer Pricing Regulation to prevent the MNE’s from evading tax and reaping huge profits left unaccounted.

The economic reforms of the Indian economy in the early nineties have opened the door for globalisation and the consequential entry of many MNEs in our country. There was a growing feeling in the mind of Indian legislators that MNEs pay less than domestic companies by shifting their profits to less tax countries or tax havens by adjusting the transfer price. That’s why, a comprehensive legislation on transfer price was introduced in the Finance Act, 2001 by amending section 92 and incorporating new sections 92A to 92F in the Income Tax Act, 1961 and also new rules 10A to 10E were prescribed. These provisions came into existence from the methods and principles set forth in the Organisation for Economic Co-operation and Development’s Report on Transfer Pricing and Multinational Enterprises.

These sections provide in detail about the computation of income from international transaction having regard to arm’s length price, meaning of associated enterprise.

---

122 Arm’s length principle is the international standard mutually agreed by the members of the Organisation for Economic Co-operation and Development (OECD) and is used for determining the taxability by multinational enterprises and tax authorities.


international transaction,\textsuperscript{127} computation of arm’s length price,\textsuperscript{128} safe harbour rules,\textsuperscript{129} advance pricing agreement,\textsuperscript{130} maintenance and keeping of information and documents by person entering into international transaction,\textsuperscript{131} specified domestic transaction,\textsuperscript{132} reference to transfer pricing officer,\textsuperscript{133} etc.

5.4.2.1. Transfer Pricing Considerations in Mergers and Acquisitions: In the complex global business environment, size dominates. MNE’s in order to compete in this cut throat competition indulge in M&A activities to widen the scope of their business and bring efficiency improvements. Any M&A that takes place, leads to a restructuring of an existing business of the concerned MNE which will eventually lead to an internal as well as external reallocation of functions, transfer of assets (both tangible and intangible) and risks within the MNE group. M&As were typically accompanied by reallocation of profits among the members of the MNE group, immediately as well as after restructuring over a few years. This gives potential avenues for erosion of tax base in cross border situation.\textsuperscript{134} This gives rise to transfer pricing considerations in a M&A transaction. Thus, M&A deals are swarmed with transfer pricing implications, not only in the bringing together of potentially inconsistent transfer pricing systems, but also in the integration objective and financing needs of the acquirers.

5.4.2.2. Areas of Concern in Transfer Pricing Issues in Mergers and Acquisitions: Pursuant to M&As, MNEs may face any of the following situations relating to transfer pricing implications that may also attract the attention of revenue authorities.

(I) Financing Structure of the Proposed Transaction: Transfer pricing can play an important role in selecting the financing structure of the proposed transaction particularly where the allocation of total debt used in financing the transaction may be

\textsuperscript{128} Section 92C of the Income Tax Act, 1961.
\textsuperscript{129} Section 92CB of the Income Tax Act, 1961.
\textsuperscript{130} Sections 92CC and 92CD of the Income Tax Act, 1961.
\textsuperscript{131} Section 92D of the Income Tax Act, 1961.
\textsuperscript{132} Section 92BA of the Income Tax Act, 1961.
\textsuperscript{133} Section 92CA of the Income Tax Act, 1961.
constrained by transfer pricing considerations and in particular, the cash flows anticipated by the surviving company.

(2) Debt Push-Down: In case the acquirer intends to allocate debt, financing fees and other acquisition costs to an acquired entity, the cash flows generated by the entity as a result of its transfer pricing policy should be carefully scrutinised so as to ensure that the entity is able to meet its allocated debt obligations. The potential problem here is whether the prevailing transfer pricing regime will allow payment of interest by entities if the profits of affiliates are reduced by revision of transfer pricing policies post M&A. Affiliates that are profitable at the operating level, but record losses after substantial interest expense, could attract unwelcome tax authority attention and increase the group’s overall transfer pricing risk profile.\textsuperscript{135}

Secondly, the post-deal integration period may be a sensible time for MNEs to engage in strategic supply chain planning activities, such as the centralisation of procurement functions, warehousing and product logistics functions and inter company services, such as research and development (R&D) and product oversight and quality control activities.\textsuperscript{136}

(3) Supply Chain Structures: Transfer pricing issues may also arise due to shift in profits as a result of change in supply chain structures resulting in change in profit centres pursuant to a scheme of M&A.

Other areas of potential transfer pricing exposure include:\textsuperscript{137}

- Risk of additional local country examinations to challenge the reduced profit levels
- Potential exit charges when a tax authority claims valuable functions were removed from its tax base

\textsuperscript{135} Ibid.
• The inability of the company’s accounting systems to provide the data needed to implement and test the new arrangements

• The deductibility of new inter-company charges.

5.4.2.3. The Indian Experience with Transfer Pricing Regulations: As already discussed, the law on transfer pricing came into force in 2001 but the transfer pricing audits beginning effectively from 2003. Till date, seven rounds of transfer pricing audit have been completed resulting in total adjustment of income of approximately US$ 20 billion.\textsuperscript{138} The Indian legislators have expressly included Business Restructuring transactions with the purview of ‘international transactions’ in section 92 by the Finance Act 2012 with retrospective effect from April 2001 to provide clarity on this issue.

As transfer pricing manipulations reduce the critical tax revenue for the government and in turn reduce the funds available for the country’s development, the Indian Revenue authorities have started getting extremely aggressive on transfer pricing issues, therefore, a certain do-list for corporates undertaking M&A activities in India.

1. While undertaking due diligence in M&A transaction, TP risk management should begin along with that so that possible areas of transfer pricing exposures can be disclosed along with.

2. Tax payers should maintain a early and robust documentation of transfer pricing policy to clearly bring out roles, responsibilities of the newly formed entity (both pre and post the restructuring) as well as describe the functions, assets and risk of the concerned entities clearly. This would assist the tax-payer to define the appropriateness of its new business model and mitigate against potential transfer pricing adjustments.\textsuperscript{139}

3. An early transfer pricing analysis right at the time of initiation of the change can allow the new business to integrate transfer pricing into its business plans by anticipating difficulties in the near future and preparing itself accordingly.\textsuperscript{140}

\textsuperscript{138} Ibid.
\textsuperscript{139} Ibid.
\textsuperscript{140} Ibid.
4. A comparison and evaluation of the profits of the Indian tax payer before and after the deal is beneficial as it acts as a strong audit defense in case of any M&A transaction. Thus, security checks on account of transfer pricing should be both pre-and post transaction.\(^{141}\)

5. A tax payer planning any M&A transaction should also consider and analyse the local laws of jurisdiction where the entities with whom he is planning to undertake M&A transaction are located. He should obtain complete knowledge of transfer pricing regulations prevalent in that country. In case, it is feasible he may enter into advance pricing agreement,\(^{142}\) with authorities of his country as well as target’s country.

6. Since, now it is explicitly required under the Indian transfer pricing regulations to test whether transactions between the two entities (which obtain the status of associated enterprises under the Indian transfer pricing regime of the Indian Income Tax Act) involving movement of the functions, assets and risks are at arms length price.\(^{143}\) Therefore, Indian entities are required to formulate policies and documents concerning transfer pricing keeping in mind the restructuring transactions under M&As, the function, assets and risk involved in it and the expected benefits and synergies available from the M&A transaction.

5.4.2.4. Final Words on Transfer Pricing: Transfer pricing has evolved as one of the most debated issue of the decade in the international taxation community. As globalisation of Indian economy continuous to accelerate, transfer pricing persists to be on the high priority of the tax authorities in the near future. MNCs have been implementing innovative transfer pricing policies to optimise revenues and minimise tax costs. Now the revenue authorities across the world are also increasingly adopting aggressive positions in an effort to tax the maximum possible income arising in course

\(^{141}\) Ibid.

\(^{142}\) Concept of Advanced Pricing Agreement has been introduced recently in India through insertion of section 92CC in the Finance Act, 2012 where the board enters into an agreement in advance with any person determining the arm’s length price or specifying the manner in which it is determined.

of international transaction in their respective jurisdiction.\textsuperscript{144} Indian revenue authorities, too, have not lagged behind in jumping on the transfer pricing bandwagon. They have also started getting extremely aggressive on transfer pricing issues. This has lead to increase in transfer pricing litigation. Therefore, it would be prudent for Indian companies undertaking M&A to conduct an exhaustive transfer pricing analysis and revisit their transfer pricing strategies beforehand.

### 5.5. General Anti-Avoidance Rule and Mergers and Acquisitions

*“The avoidance of taxes is the only intellectual pursuit that carries any reward”*

\textit{John Maynard Keynes}\textsuperscript{145}

Internationally, tax avoidance has been recognised as an area of concern and several countries have expressed concern over tax evasion and avoidance. This is also evident from the fact that most of the nations have legislated or are legislating doctrine of General Anti-Avoidance Rule (GAAR) in their tax code.\textsuperscript{146} India has not lagged behind and has introduced GAAR through the Finance Act, 2012 in the Income Tax Act, 1961. Tax payers adopt various methods to reduce their tax liability. We can broadly put these methods in four categories:

- Tax evasion
- Tax avoidance
- Tax mitigation
- Tax planning

Tax mitigation is a situation where the tax payers uses a fiscal incentive available to him in the tax legislation by submitting to the conditions and economic consequences that the particular tax legislation entails.\textsuperscript{147} Tax mitigation and planning are allowed

\textsuperscript{146} \textit{Ibid.}
under the tax statute. Tax evasion is unlawful and is the result of illegality, suppression, misrepresentation and fraud and hence unacceptable. Tax avoidance is the outcome of actions taken by the tax payer, none of which is illegal or forbidden by the law. It is an arrangement entered into solely or primarily for the purpose of obtaining a tax advantage.\textsuperscript{148} Tax avoidance through artificial structures is economically undesirable and hence GAAR is enacted to check tax avoidance. It is a set of rules that empower the tax authority of any country to investigate and examine the transactions done with the objectives of tax avoidance.\textsuperscript{149} GAAR is an anti avoidance measure which empowers tax authorities to call a business arrangement or a transaction ‘impermissible avoidance arrangement’ and thereby denying tax benefits to the parties.\textsuperscript{150} In India, till recently SAAR was in vogue i.e. laws were amended to plug specific loopholes as and when they were noticed.\textsuperscript{151} But no one can predict the future, similarly no law can anticipate all the circumstances. That’s why GAAR was enacted GAAR is based on the doctrine of ‘substance over form’ which means that the tax authorities ignore the legal form of an arrangement and they look into its actual substance to prevent artificial structures from being used for tax avoidance purposes.\textsuperscript{152} GAAR is a concept which generally empowers the revenue authorities in a country to deny the tax benefits of transactions or arrangements which do not have any commercial substance or consideration other than achieving the tax benefit.

GAAR was introduced by the Finance Act, 2012 by insertion of chapter X-A (consisting of sections 95 to 102) in the Income Tax Act. The procedural provisions relating to mechanism for invocation of GAAR and passing of the assessment order in consequence thereof are contained in section 144BA. These provisions permitted the Indian Revenue Authorities to disregard in assessing a taxpayer’s liability any agreement, structure or device employed not for bonafide commercial reasons but rather ‘to obtain, directly or indirectly, a tax benefit’. GAAR was initially introduced in India

\begin{footnotes}
\item[148] \textit{Ibid.}
\item[151] Rajesh Goyal, “GAAR-what is GAAR”, retrieved from \url{http://www.allbankingsolutions.com/BankingTutor/GAAR-what-is.htm}, accessed on 8 September 2013 at 4.17 pm.
\end{footnotes}
through Direct Tax Code Bill 2009 and retained in Direct Tax Code Bill 2010. But Direct Tax Code got deferred from time to time and therefore, GAAR provisions were introduced by the Finance Act 2012 to be effective from 1 April 2014. But the draft was heavily criticised and market forces reacted negatively. It attracted strong opposition from Indian businesses, foreign investors and even select foreign governments, such as the government of Mauritius, which argued that the GAAR would violate benefits secured under that country’s tax treaty with India. Consequently, Prime Minister Dr. Manmohan Singh, constituted an Expert Committee under the leadership of Dr. Parthasarathi Shome (the ‘Shome Committee’) to review the GAAR and make recommendations for its modification and application.\(^{153}\) The Expert Committee’s recommendations included suggestions for legislative amendments, formulation of rules and prescribing guidelines for implementation of GAAR. The Shome Committee played a crucial role in laying out the guiding principles for applying GAAR. Some of the suggestions of the Committee were incorporated into the law. A brief outline of provisions on GAAR according to Finance Act, 2013 are discussed here under:

**5.5.1. Scope of Provisions**

GAAR as envisaged in the Finance Act, 2013 seeks to tax an ‘impermissible avoidance arrangement’ which may be a step, a part or whole of an arrangement herein referred to as ‘transaction’. The main premise of invoking GAAR is that any transaction or step in a transaction which has its main purposes i.e. the obtaining of a tax benefit, should be disregarded, or dealt with in such a manner so as to protect the right of the revenue to taxes. An impermissible avoidance arrangement means an arrangement, the main purpose of which is to obtain a tax benefit and it:\(^{154}\)

- Creates rights and obligations which are not normally created between persons dealing at arm’s length; or
- Result directly or indirectly in the misuse of the provisions of the Act; or
- Lack commercial substance in whole or in part; or


• Be entered into or carried out, by means or in such a manner which are not ordinarily employed for bonafide purposes.

In addition to obtaining tax benefits, the arrangement needs to satisfy at least one of the above four additional tests, to come under the net of GAAR:

5.5.2. Lack of Commercial Substance

An arrangement shall be deemed to lack commercial substance if:

1. The substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

2. It involves or includes:
   - Round trip financing;
   - An accommodating party;
   - Elements that have effect of offsetting or cancelling each other; or
   - A transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of fund which is the subject matter of such transaction; or

3. It involves the location of an asset or of a transaction or of the place of residence of any party which would not have been so located for any substantial commercial purpose other than obtaining tax benefit for a party.

4. It does not have a significant effect upon the business risks or net cash flows of any party to the arrangement.

5.5.3. Consequences if GAAR Triggered

Once treated as an impermissible avoidance arrangement, look through is permitted by:

- Disregarding or combining any step of the arrangement.

---

• Ignoring the arrangement for the purpose of taxation law.
• Disregarding or combining any party to the arrangement.
• Reallocating expenses and income between parties to the arrangement.
• Relocating place of residence of a party or location of a transaction or situs of an asset to a place other than provided in the arrangement.
• Considering or looking through the arrangement by disregarding any corporate structure.
• Re-characterising equity into debt, capital into revenue etc.

If a transaction is regarded as an avoidance transaction, it could be disregarded, combined with any other step in the transaction or re-characterised, or the parties to the transaction could be disregarded as separate persons and treated as one. The provisions are drafted in a manner to permit the application of principles relating to lifting of corporate veil, substance over form test, economic substance test and thin capitalisation rules such as re-characterisation of debt into equity or vice-versa.\(^{161}\)

**5.5.4. Impact on Reconstruction Exercises such as Mergers and Acquisitions**

Indian economy is going through one of its toughest phases with GDP plunging to nearly a decade low. Its facing deficit on both current account and fiscal. Inflation is on a relentless increase, high interest rates taking a toll on industrial activity and investor’s sentiment. In this environment, where recession is impacting all the major economies of the world, India could not be left behind. But the Government of India has introduced ‘big ticket reforms’ like FDI in multi-brand retail, aviation, broadcast, insurance and pension sectors to get the Indian economy out of its current position. But on the other hands with measures like retrospective tax amendments in Vodafone case (discussed later) and GAAR, it is sending negative signals to the investors abroad as tax climate in the investing jurisdiction is a critical determinant for inbound investment.

---

With introduction of GAAR, inbound investment through M&A is definitely going to suffer. GAAR provisions in the Income Tax Act are substantially overriding in nature and would impact all restructuring through M&As. It is one of those proposals which is facing maximum criticism from within as well as outside India. That’s why, Government has accepted the Shome Committee Recommendations, and deferred its implementation till 01.4.2016 by the Finance Act, 2013. It has made certain modification in GAAR provisions by the Finance Act, 2013 as well as notification of CBDT to address the concerns expressed by various stakeholders but still certain concerns are emerging which are becoming boost dampener for M&As and are discussed here under:

(1) Very Wide Scope: The scope of GAAR provisions is very wide as they cover all arrangements which have an element of ‘tax benefit’. The principle condition of obtaining ‘tax benefit’ test along with four additional test laid down in section 96 have the effect of bringing every transaction which lowers the tax liability for the tax payer under the preview of GAAR. Even if one of the steps of otherwise bonafide transaction falls within the test of ‘tax benefit’ GAAR can be invoked.

(2) GAAR v. Treaty Provisions: It has been proposed under the law that the GAAR provisions would apply to a tax payer irrespective of the fact that the treaty provisions are more beneficial. But unilateral enactment of a new domestic tax law, which is contrary to an existing treaty, without an amendment in treaty could possibly be regarded as violation of international law and is generally known as ‘treaty override’. But despite this, limited treaty override provisions are theoretically in line with ‘substance over form rule’ or ‘economic substance rule’ (as envisaged under the OECD Commentary and Global Practices for Anti-avoidance Measures), but it will create uncertainty as to how tax authorities will balance this interplay between tax treaty

---


163 Notification of Central Board of Direct Taxes dated 23.09.2013 as quoted in “GAAR to come into Effect from 1 April 2016”, The Tribune, 27 September 2013, p. 15.

provisions and domestic override provisions. For instance, if a particular transaction is eligible for tax treaty relief (especially where the tax treaty already has a limitation of benefit clause), could the domestic anti-avoidance rules still be invoked by the revenue to pierce the corporate veil and deny tax treaty relief.\textsuperscript{165} This is going to create lot of uncertainty and litigation. This uncertainty will distract foreign investment through M&A in India.

\textbf{(3) Wide Powers of Tax Authorities in Invoking GAAR:} Tax authorities are given very broad powers to invoke GAAR by using only one of the criteria laid down under the Act. There is no level of accountability for tax authorities. Therefore, need of the hour is to lay down an objective criteria and specific guidelines for tax authorities which will guide them in invoking GAAR.

\textbf{(4) Onus of Proof:} As per section 96 as amended by the Finance Act 2013, the onus of proving that the arrangement has not been entered into for the main purpose of obtaining a tax benefit, is on the assessee. This move when it will become effective from 1.4.2016 will cause anxiety and uncertainty among the tax payers. This area of concern needs to be taken care of.

\textbf{5.5.5. Final Words on GAAR}

GAAR usually consists of a set of broad rules which are based on general principles to check the potential avoidance of the tax in general, in a form which cannot be predicted and thus cannot be provided at the time when it is legislated. GAAR empowers the revenue authorities to deny the tax benefits of transactions or arrangements which do not have any commercial substance or consideration other than achieving the tax benefit. Whenever revenue authorities question such sham transactions, it lead to conflict and litigation.\textsuperscript{166} Thus GAAR was enacted by various countries like Australia, Germany, France, Canada, New Zealand, South Africa etc.

India too opted for GAAR in the Finance Act, 2012. But GAAR is one of the proposals which is facing maximum criticism from within as well as outside India. The issue is

\textsuperscript{165} Ibid.

not that India should have GAAR or not, but the issue is more around possibility of its misuse and ineffective implementation given that the provisions for GAAR in our Act are too broad and wide and without adequate safeguards. To add fuel to the fire, this is accompanied by the time consuming dispute resolution system in India (e.g. Vodafone dispute which started of in 2007 and is still not finally settled) wide powers of Indian tax officials and more so their unpredictable assessment of a case. Thus, worry of international community and investors is completely understandable.

No doubt, the concept of GAAR is as such against the rule of law which requires law to be certain and predictable so that law abiding citizens are aware of what is permitted and prohibited. But still GAAR is important for our country so that our exchequer is not denied of precious tax revenues. Moreover, it is not humanly possible to make laws for each and every tax avoidance tool used by a creative taxpayer. But, seeing the current economic position of our country, the Indian legislators have rightly deferred its implementation till 2016. But when it comes into force from 1.4.2016, it should be accompanied with adequate safeguards, most of which were provided by Shome Committee. The further amendments to the GAAR provisions and safeguards required will be suggested by the researcher in the last chapter entitled ‘Conclusions and Suggestions’.

Finally, it can be said that the intent of the Indian law makers to legislate GAAR is progressive in so far as tax policy decisions are directed. But the success of GAAR lies in its judicious and sensible implementation. In the Indian context, considering the aggression of tax administration in some cases, the introduction of GAAR may be worrisome to a tax payer unless implemented in the balanced manner with adequate safeguards which are mentioned lateron for protecting the taxpayer.

5.6. Tax Implications in Case of Acquisitions

There are primarily two modes of strategic acquisitions:

- Business acquisition
- Share acquisition
Business acquisitions involves acquisition of assets and liabilities of a business in exchange of consideration which may be paid in cash or kind. Share acquisition means acquiring the shares of the target. This route enables buyer to gain effective control of the target Indian company.

A company planning to acquire another company has to decide the mode of acquisition to be adopted. Apart from commercial consideration, the mode of acquisition is influenced by key tax and regulatory measures. We have discussed the regulatory measures (other than tax in the previous chapter). So, here we shall focus on key tax considerations impacting acquisitions in India.

5.7. Tax Implication of Acquisitions in Case of Share Acquisition

Under the Income Tax Act, the taxability of any profits or gains arising on the sale of shares depends on whether, the shares are held as a ‘capital asset’ or a ‘trading asset’. There have been certain important pronouncement of the Supreme Court through which it has laid down judicial principles to help determine whether or not a share is being held as a capital or trading asset:

*CIT (Central), Calcutta v. Associated Industrial Development Co. Pvt. Ltd.*167

In this case, the Supreme Court held that whether specific shares were being held as an investment or as part of stock-in-trade was a matter which was within the knowledge of the assessee, who holds the shares and the assessee in normal circumstances, should be in a position to produce evidence from its records as to whether or not it had maintained any distinction between those shares, which were its stock-in-trade and those which were held as an investment.

*Raja Bahadur Kamakhya Narain Singh v. CIT*168

In this case, the Supreme Court held that profit made on the sale of shares acquired with the intention of obtaining control over the management of a company and not for dealing in them would be deemed as profit gained from a capital asset. The Supreme Court held that if the transaction was effected in the ordinary course of the assessee’s

---

167 (1971) 82 ITR 586 (SC).
168 (1970) 77 ITR 253 (SC).
business, then there would hardly be any difficulty in concluding that it was a trading transaction. However, where the transaction was not in the ordinary course of business the facts must be properly assessed to discover whether or not the transaction was in the nature of trade.

Based on judicial precedents, the CBDT issued a circular listing down the following principles for determining whether shares were held as capital assets or trading assets:\(^{169}\)

- Where a company purchases and sells shares, it must be shown that the company held the investment as stock-in-trade. The mere existence of the power to purchase and sell shares in the memorandum of association is not decisive of the nature of transaction.

- When determining the nature of the said transaction the important factors to be considered are the substantial nature of the transaction, its financial accounting treatment, the magnitude of the company’s purchases and sales, the ratio between the purchases and sales of the company and the holding periods of the shares in question.

- Ordinarily, the purchase and sale of shares with the motive of earning a profit would result in the profit being considered business income; but where the objective of investing in shares is to derive income by way of dividend, the profits accruing by the sale of such shares will be deemed to yield capital gains and not business income.

5.7.1. Tax Implications for the Seller

Assuming that the shares in a company are held as a capital asset, the tax implication for the seller are studied under.

5.7.1.1. Direct Acquisitions: The sale of shares is subject to capital gains tax in India. Additionally, Securities Transaction Tax (STT) may be payable if sale transaction for equity shares is through a recognised stock exchange in India. The STT has to be paid

\(^{169}\) Ernst and Young, 2012, p. 195, para 3.030.
by the purchaser/seller of securities. The purchase and sale of equity shares and units of equity-oriented mutual fund is taxed at the rate of 0.1 percent.\textsuperscript{170}

A person resident in India is subject to tax in India on their worldwide income.\textsuperscript{171} Accordingly, any capital gains arising to a resident seller, on the transfer of shares of an Indian or a foreign company, would be subject to tax in India. If the gains from sale of shares of a foreign company are also subjected to tax in the home jurisdiction of the foreign company, the resident seller may be entitled to credit for taxes so paid as per the relevant provisions of the Income Tax Act or any Double Taxation Avoidance Agreement with India (i.e. tax treaty). Such credit, however shall not exceed the amount of income tax payable in India, on the portion of income already subjected to tax in the foreign jurisdiction.

\textbf{5.7.1.1.1. Computation of Capital Gains:} Capital gains on the sale of shares is computed as under:

\textbf{Step 1:} First of all, determine the full value of consideration. The expression ‘full value’ means the whole price without any deduction what so ever. In \textit{CIT v. Gillanders Arbuthnot and Co.},\textsuperscript{172} the SC held that the expression ‘full value of the consideration’ cannot be construed as the market value but as the price bargained for by the parties to the sale. By the Finance Act, 2012, a new section 50D was inserted which clarifies that with regards to transfer of capital asset, where consideration cannot be ascertained or determined then, for the purpose of calculating the capital gains tax liability, the fair market value of the asset, calculated on the date of transfer, will be deemed to be the full value of consideration for the said transfer.

\textbf{Step 2:} Deduct the expenditure incurred wholly and exclusively in connection with such transfer. The expression ‘expenditure incurred wholly and exclusively in connection with such transfer’ means expenditure incurred which is necessary to effect the transfer. Even if an expenditure has some nexus with the transfer, it does not qualify for deduction unless it is wholly and exclusively in connection with the transfer.\textsuperscript{173} Any

\hspace{1cm} ^{170}$Seth Dua and Associates, \textit{Joint Ventures and Mergers and Acquisitions in India}, LexisNexis Butterworths Wadhwa, Nagpur, 2011, p. 464.

\hspace{1cm} ^{171}$Sections 5, 90 and 91 of the Income Tax Act, 1961.

\hspace{1cm} ^{172}$\textit{(1973) 87 ITR 407 (SC)}.

\hspace{1cm} ^{173}$\textit{Sita Nanda v. CIT} (2001) 119 Taxman 227 (Delhi).
amount, the payment of which is absolutely necessary to effect the transfer will be, ‘expenditure in connection with transfer’ In *V.A. Vasumathi v. CIT*,\(^{174}\) the Kerala High Court has held that the words ‘in connection with such transfer’ meant intrinsically related to the transfer.

**Step 3:** Deduct the cost of acquisition of shares. ‘Cost of Acquisition’ of an asset is the value for which it was acquired by the assessee. The word ‘cost of acquisition’ will be substituted for indexed cost of acquisition,\(^ {175}\) in case of long-term capital asset. But this indexation benefit is not available to foreign companies/non-residents while computing long-term capital gains arising on the transfer of shares of an Indian company. However, in case of listed securities and short term capital gains on unlisted securities, an adjustment on account of any exchange rate fluctuation is available while computing the gains.\(^ {176}\) The proviso to section 48 provides that in such cases of non-residents the capital gains arising from the transfer of shares of an Indian company shall be computed by converting the cost of acquisition, the expenditure incurred wholly and exclusively in connection with such transfer and the full value of the consideration received or accruing as a result of such transfer into the same foreign currency as was initially utilised in the purchase of the shares. The capital gains so computed are than to be reconverted with Indian currency. Foreign institutional investors are neither entitled to indexation benefit nor to foreign exchange fluctuation adjustment.\(^ {177}\) But the recent amendments to the Income Tax Act further clarify that with respect to non-residents, long term capital gains arising from the sale of unlisted securities will be subject to capital gains tax computed at 10 percent without any adjustment for indexation benefits or currency exchange rate fluctuations.\(^ {178}\)

**Step 4:** Deduct the cost of improvement.\(^ {179}\) Cost of improvement is capital expenditure incurred by an assessee in making any additions/improvement to the capital asset. In

---

\(^{174}\) (1980) 123 ITR 94 (Ker.).

\(^{175}\) Indexed cost of acquisition is the cost arrived after adjusting for inflation. The inflation adjustment is derived from the inflation indices produced by Government of India.

\(^{176}\) Ernst and Young, 2012, p. 198.

\(^{177}\) *Ibid.*

\(^{178}\) Section 112(1)(C)(iii) as inserted by the Finance Act, 2012, applicable w.e.f. 1 April 2012.

\(^{179}\) It’s indexed cost of acquisition in the case of long-term capital asset.
Industrial Credits and Development Syndicate Ltd. v. CIT,\textsuperscript{180} it was held by Karnataka High Court, to bring an expenditure within the meaning of ‘cost of improvement’, the expenditure in making the addition and alteration to the capital asset has to be an expenditure of capital nature. The balance after deducting the above from the full value of consideration is the capital gains.

5.7.1.1.2. Taxability of Capital Gains: In case the shares are held for more than 12 months, the gains are characterised as long-term capital gains or otherwise as short-term capital gains. The tables reproduced below shall highlight the tax rate of capital gains on sale of equity spares listed on a recognised stock exchange and otherwise.

1. Taxability of capital gains on the sale of equity shares, other than the sale of equity shares listed on a recognised stock exchange in India (‘listed shares’), where the sale takes place through a recognised stock exchange in India, is as under:\textsuperscript{181}

Table 5.1: Taxability of Capital Gains on the Sale of Equity Shares other than Listed Shares.

<table>
<thead>
<tr>
<th>Period of holding of the asset</th>
<th>Nature of capital gains</th>
<th>Tax treatment for corporates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Where shares are held by the transferor/seller for more than 12 months</td>
<td>LTCG</td>
<td>Taxable @ 20 percent for both domestic companies and foreign companies</td>
</tr>
<tr>
<td>Where shares are held by the transferor/seller for not more than 12 months</td>
<td>STCG</td>
<td>Taxable @ 30 percent for domestic companies and @ 40 percent for foreign companies</td>
</tr>
</tbody>
</table>

2. Taxability of any profits or gains arising on the sale of listed shares, where such sale takes place through a recognised stock exchange in India, would be determined as follows.\textsuperscript{182}

\textsuperscript{180} (2001) 251 ITR 720 (Kar.).
\textsuperscript{181} For further details, see, Ernst and Young, 2012, p. 199, Table 3.2.
\textsuperscript{182} Id., p. 201, Table 3.3, see, sections 10(38), 45, 48, 11A, 112, 115AD and 115E of the Income Tax Act, 1961.
### Table 5.2: Taxability of Capital Gains on the Sale of Listed Shares through a Recognised Stock Exchange.

<table>
<thead>
<tr>
<th>Period of holding of the asset</th>
<th>Nature of capital gains</th>
<th>Tax treatment (for corporates as well as individuals)</th>
</tr>
</thead>
</table>
| Where shares are held by the transferor/seller for more than 12 months | LTCG | Exempt from capital gains tax under the Income Tax Act if requisite STT has been paid.  
STT @ 0.1 percent each, on the buy and sell side, on delivery-based transactions, of sale consideration for both domestic and foreign companies. |
| Where shares are held by the transferor/seller for not more than 12 months | STCG | Taxable @ 15 percent.  
STT @ 0.1 percent each, on the buy and sell side, on delivery-based transactions, of sale consideration for both domestic and foreign companies. |

Sale of equity shares listed on a recognised stock exchange in India, which takes place through a recognised stock exchange in India is subjected in addition to capital gains tax to securities transaction tax (STT).

**5.7.1.2. Indirect Transfer or Acquisitions:** While direct acquisitions involves acquisitions of the target by the acquirer, indirect acquisition normally involves acquisition of shares of the parent entity or intermediate holding company of the target.\(^{183}\) Section 5 and 9 of the Income Tax Act say that income is taxable in India, if the income accrues or arises or is deemed to accrue or arise in India or received or is deemed to be received in India. The word ‘accrues’ and arises are used in contradistinction to the word ‘receive’. Income is said to be received when it reaches the assessee, when the right to receive the income becomes vested in the assessee, it is said to accrue or arise.\(^{184}\)

---


\(^{184}\) *CIT v. Ashokbai Chimanbhai* (1965) 56 ITR 42(SC).
Income which accrues or arises in India is taxable in India. Now there is certain income which accrue or arises outside India, but by the deeming provision of section 9, it is deemed to accrue or arise in India. However, where income is actually received or has accrued in India, resort to the deeming provision under section 9 is not warranted. In such a case, the provision contained in section 5(2) is sufficient to create a charge in respect of non-resident’s income.\footnote{185 Mustaq Ahmed, In re (2009) 176 Taxman 65 (AAR-New Delhi).}

In \textit{G. Krishnawami Naidu v. CIT},\footnote{186 (1966) 62 ITR 686 (Mad.).} the Madras High Court held that while the provisions of section 5 and 9 clearly proceed on the assumption that the income, profits or gains have situs in India, they do not however indicate how situs is to be determined. As a result, it was held that the situs of profits or income and where they accrue or arise will have to be determined according to the general principles of law and in light of the particular facts of each case. It was further held that ‘accrue or arise’ in section 4 of the Income Tax Act has more or less synonymous meaning to that in section 5 and 9 and income or profits are said to accrue or arise where the right to receive them along with a corresponding liability to pay them comes into existence. Where and when such a right or liability comes into existence is a question of fact or at best a mixed question of fact and law.

An important term which needs clarification here is the situs of shares. It is not defined in the Income Tax Act and will have to be clarified through the judicial point of view on this point. In \textit{Pfizer Corporation v. CIT},\footnote{187 (2003) 254 ITR 391 (Bom.).} the Bombay High Court held that situs of the shares is regarded as the place where the register of the shareholders is kept i.e. where its registered office is located. The sites of the share capital of the Indian company having its registered office in India would be at the place of its registered office i.e. in India.

Moreover, in the context of the Wealth Tax, Act 1958, the tax authorities have clarified vide circular that the shares of a company are said to be located at the place where the company is incorporated.\footnote{188 Circular No. 3-WT of 1957, 28 September 1957.} Thus, the shares of any Indian company will be regarded as
situated in India and gain arising on the transfer thereof would be deemed to accrue or arise in India. The judicial principles of the above judgement lead to the natural conclusion that shares of a foreign company should be regarded as situated outside India and any capital gain arising to a non-resident shareholder on the transfer of shares of a foreign company should not be deemed to accrue or arise in India. But this issue is not settled here. It has become the most controversial areas in taxation under the Income Tax Act, 1961 through the Vodafone controversy. Several important questions of law in the area of taxation of non-residents and indirect transfers were at issue in this controversy.

5.7.1.2.1. Vodafone Tax Dispute: The ongoing tax dispute between the Indian tax authorities and Vodafone in connection with taxability of the $11.2 billion Hutch-Vodafone deal is one of the biggest controversies in Indian multijurisdictional M & A history. The moot question before the court was whether Income Tax (IT) department can ask a foreign company to pay tax in India if it takes over another foreign entity that owns an Indian subsidiary, and, particularly so if the deal is made outside India. The case provides us a broad picture of modern corporate strategies and the legal responses thereto. The case was first filed by way of writ-petition before Bombay High Court by Vodafone against the decision of the Revenue Authorities. The Vodafone went on to appeal to the Supreme Court. Both these judgements provide a good case study of the interface between law and business strategies.

Material Facts of the Case: In 1992, Hutchison group of Hong Kong floated a joint venture with Essar Group of India by the name Hutchison. Max Telecom Ltd (HMTL). later renamed as Hutchison Essar Limited (HEL).HEL was an Indian company in which shares were acquired by Hutchison group of companies through a structural arrangement of holding and subsidiary companies incorporated in various foreign countries particularly in Mauritius. In 1998, Hutch Group through Hutchison Telecommunication Ltd., Hong- Kong (HTL) incorporated CGP Investment (Holding) Ltd in Cayman Islands with a single share equity capital. In 2004, Hutchison Telecommunication International Ltd, (HTIL) was incorporated. HTIL and its

downstream companies held interests in mobile telecommunication business in several countries including India. HTL transferred the single equity share of CGP to HTI (BVI) Holdings Limited which was a wholly owned subsidiary of HTIL. Thus, CGP became wholly owned subsidiary of HTIL, CGP held 52 percent shares in HEL. The Corporate Law of Cayman Islands, characterised CGP as an ‘exempted company’ since it did not have any operation in Cayman Islands. Its sole function was to manage its offshore investments in India. Hutchison also financed three Indian companies, namely Asim Ghosh group, Analjit Singh Group and IDFC to acquire 15 percent of shares in HEL with the condition that they would sell their shares to CGP whenever they were called to do so. Obviously, this was intended to comply with foreign investment limits in telecom sector, prescribed by Government from time to time.

In 2007, Hutchison Group concluded a sale purchase agreement (SPA) with Vodafone International Holdings, resident in the Netherlands, where under Hutchison sold its share in CGP to Vodafone for a consideration of $11.08 billion. As a result, CGP became a wholly-owned subsidiary of Vodafone. And in this way, Vodafone acquired control over HEL (which became VEL after this transaction). The Revenue Authorities took the stand that as a result of this transaction, there was ‘transfer of capital asset situated in India’ from Hutchison to Vodafone under section 9(1)(i) of the Income Tax Act, 1961 and therefore, capital gains tax was payable in India. The notice was issued to VEL as representative of Vodafone in India.\(^\text{190}\) The IT department held that Vodafone was liable for not deducting tax at source as required under section 195 from payment made to Hutchison and claimed around Rs. 12000 crore in tax and penalty in the deal. On the other hand, Vodafone International Holdings contended that as both the seller and the buyer were foreign companies and the deal was made outside India, the Indian authorities lack the jurisdiction to tax the above transaction.

**Decision of the High Court:** The Bombay High Court in *Vodafone International Holdings Case*,\(^\text{191}\) dismissed Vodafone’s plea challenging the IT department Rs. 12000 crore demand in tax and penalty on $11.08 billion takeover of Hutchison Telecom

---


\(^{\text{191}}\) *Vodafone International Holdings B.V. v. Union of India* (2010) 193 Taxman 100 (Bom.).
Justice D.Y. Chandrachud and Justice Devadhar followed look-through approach and held that the shares are a bundle of indivisible rights that cannot be separately transferred. These rights such as right to vote, right to call for and attend general meeting etc are inseparable from the ownership of the shares. These rights constitute the ‘capital assets’ under section 2(14) of the Act. This income is taxable in India under section 9(1) of the Act.

Though Justice Chandrachud did not use the expression ‘look-through’ as such, it was obvious that he adopted that approach to equate the share with capital asset underlying the share.\(^{192}\) To support his argument, he relied upon two things:

- Perception of the parties to the transaction;
- SPA concluded between the parties

Justice Chandrachud pointed out to the reports of Hutchison and Vodafone to show how exactly the parties had perceived the transaction.\(^{193}\) Hutchison in its report highlighted that it had generated a profit of $70502 million from the sale of telecom business in India and it declared a special dividend to its shareholders. Vodafone also expressed its enthusiasm in foraying into a lucrative market. It was obvious that the parties had perceived the transaction as sale of telecom business represented by HEL.

The judge also relied upon the elaborate SPA concluded between the parties to show that the transaction was more than mere transfer of a share. If it was just a transfer of share, such an elaborate agreement was not required. Along with transfer of shares, several other entitlements such as option to buy 15 percent of shares etc., which were necessary for smooth transition were also transferred. All these entitlements were capital assets situated in India,\(^{194}\) and therefore taxable under section 9(1) of the Income Tax Act. The High Court’s observation on the ‘principle of proportionally’ that a portion of the income would be chargeable to tax is a significant one. The High Court asked the assessing officer to do apportionment of the income between the income arising or deemed to arise directly or indirectly in India and the income that lies outside India.

---

\(^{192}\) A Jayagovind, 2012, pp. 74-75.
\(^{193}\) Para 123 and 124 of the judgement of the High Court in Vodafone’s Case.
\(^{194}\) Para 135 and 136 of the judgement of the High Court in Vodafone’s Case.
The transaction between HTIL and Vodafone BV had a sufficient nexus with Indian fiscal jurisdiction. The essence of the transaction was a change in the controlling interest in HEL which constituted a source of income in India. Accordingly, Indian tax Authorities have acted within their jurisdiction in initiating the proceedings against the petitioner for not deducting tax at source. The petitioner were liable to withhold tax under section 195 of the Act.

**Decision of the Supreme Court:** Against, the decision of the High Court, Vodafone moved to the Supreme Court challenging the decision of the High Court. The three judge bench, of the Supreme Court headed by Chief Justice Kapadia made the following observations while delivering the decision.

**(1) Separate Entity Principle and ‘Look At’ Test:** The fundamental principle of corporate law is that a company is distinct from its shareholders as was well-established in *Salmond v. Salmond & Co. Ltd.* This proportion holds good even when a single shareholder owns all shares of a company. In fact, the concept of a holding company and wholly-owned subsidiary is the logical extension of ‘one man corporation’ and multinational corporations have used this concept to the hilt as a business strategy. This case itself is a good sample for the exploitation of this concept to further business interests.

In nutshell, the separate entity principle states that the company is to be treated as a person separate from its shareholders. The said principal is also reflected in both the Indian corporate and tax laws. Companies and other entities are viewed as economic entities with legal independence vis-à-vis their shareholders/participation due to distinct entity principle. Further, generally as well as for the purposes of tax treaties, a subsidiary and its parent are considered as totally distinct tax payers. Also, given the fact that parent company exercises shareholders influence on its subsidiaries does not generally imply that the subsidiaries are to be deemed to be resident of the country in which the parent company resides. However, if the controlling foreign enterprise makes

---

196 Three judge bench comprised of Chief Justice Kapadia, Justice Swantantra Kumar and Justice Radhakrishnan.
197 (1895-99) All ER Rep 33: 1897AC 22.
an indirect transfer through ‘abuse of organisation form/legal form’ and without reasonable business purpose resulting in tax avoidance, then the revenue authorities can disregard the form of the arrangement, re-characterise the equity transfer according to the economic substance and impose tax on the actual controlling foreign enterprise. This would need to be determined by review of all facts and circumstances surrounding the transaction.

The Revenue may invoke ‘substance over form’ principle or ‘piercing the corporate veil test’ only after it is able to establish on the basis of facts and circumstances surrounding the transaction that the transaction is sham or tax avoidant. The Supreme Court reiterated the ‘look at’ principle enunciated in *W.T. Ramsey Ltd. v. Inland Revenue Commissioner*, 198 and *Craven v. White*, 199 in which it was held that the revenue or the court must look at a document or a transaction in a context to which it properly belongs to. It is the task of the Revenue/Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach. The revenue cannot start with the question as to whether the impugned transaction is a tax deferent/saving device but that it should apply the ‘look at’ test to ascertain its true legal nature.

The Supreme Court further observed that every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the revenue/courts should keep in mind the following factors:

- The concept of participation in investment;
- The duration of time during which the holding structure exists;
- The period of business operations in India;
- The generation of taxable revenues in India;
- The timing of the exit;
- The continuity of business on such exit.

---

198 (1981) 1 All ER 865.
199 (1988) 3 All ER 495.
In short, the onus will be on the revenue to identify the scheme and its dominant purpose. The Supreme Court also held that merely because at the time of exit capital gains tax does not become payable, the entire sale transaction would not become sham or tax avoidant.

The legislature has not used the words indirect transfer in section 9(1)(i). If the word ‘indirect’ is read into section 9(1)(i), it would render the express statutory requirement of the fourth sub-clause in section 9(1)(i) nugatory. This is because section 9(1)(i) applies to transfer of ‘capital asset’ situated in India would be rendered nugatory. This is one of the elements in the fourth sub clause of section 9(1)(i) and if indirect transfer of a capital asset is read into section 9(1)(i) them the words ‘capital assets’ situated in India would be rendered nugatory. Thus, the words directly or indirectly in section 9(1)(i) go with the income and not with the transfer of a capital asset. Lastly, it may be mentioned that the Direct Tax Code (DTC) Bill, 2010 proposes to tax income from transfer of shares of a foreign company by a non-resident, where at any time during 12 months preceding the transfer, the fair market value of the assets in India owned directly or indirectly, by the company, represents at least 50 percent of the fair market value of all assets owned by the company. Thus, the DTC Bill, 2010 proposes taxation of offshore share transactions. This proposal indicates in a way that indirect transfer are not covered by the existing section 9(1)(i). In fact, the DTC Bill, 2009 expressly stated that income accruing even from indirect transfer of a capital asset situate in India would be deemed to accrue on India. These proposals, therefore, show that in the existing section 9(1)(i) the word ‘indirect’ cannot be read on the basis of purposive construction. The question of providing ‘look through’ in the statute or in the treaty is a matter of policy. It is to be expressly provided for in the statute or in the treaty. Similarly, limitation of benefits has to be expressly provided for in the treaty. Such clauses cannot be read into the section by interpretation. For the foregoing reasons, it is to be held that section 9(1)(i) is not a ‘look through’ provision.

(2) Role of CGP and Situs of Shares of CGP: The Apex Court stated that genuine strategic tax planning in the Vodafone case could not be ruled against. The CGP

---

200 Para 71 of the judgement.
structure was in place since 1998 and it could not be said that this was a pre-ordained transaction. Further, it could not be said that CGP had no role to play, since apart from holding shares, it also assisted in smooth foundation of the entire structure. This was not a sham transaction or transaction aimed at avoidance of tax.

The revenue authorities contended that as CGP was a mere holding company, situs of CGP’s shares existed where the underlying assets were situated, which was India. However, the Supreme Court held that under the Indian Companies Act, 1956 the situs of shares is where the company is incorporated and the place, where shares can be transferred. In the instant case, as transfer of the CGP shares were recorded in the register of members kept in Cayman Island, the situs of shares was in Cayman and not in India, where underlying assets are situated.201

(3) Transfer of Controlling Interest—Whether A Separate Capital Asset:

- The Supreme Court held that controlling interest is an incident of ownership of shares in a company and its flows from holding of shares. Controlling interest is not an identifiable or distinct capital asset independent of holding of shares.
- Shares, and the rights which emanate from them, flow together and cannot be dissected.
- The Supreme Court also held that it was not open for the revenue authorities to split the payment for share sale into variety of different rights transferred due to share sale.
- The essential character of the transaction cannot be altered by the form of the consideration, the payment or the basis of consideration. The transaction in the instant case remained a contract of outright sale of the entire investment for a lump sum consideration.202

(4) Scope and Applicability of Sections 195 and 163 of the Act:

- The SC held that withholding provisions under section 195 of the Act would apply only if the transaction is subject to tax in India. In the present case, the

201 Para 82 of the judgement.
202 Para 88 of the judgement.
transaction was of transfer of capital assets between two non-resident entities on a principal to principal basis, through a contract situated outside India and for which consideration was also paid outside India. Hence, as the transaction was not taxable in India, no liability to deduct tax at source arose on Vodafone.

- Further, tax presence in India has to be viewed in context of the transaction and hence, Vodafone investment in Bharti Airtel cannot make all entities of Vodafone group subject to the Indian Income Tax Act, 1961. Tax presence has to be construed in a manner that brings the non-resident assessee under jurisdiction of Indian tax authorities.

- With regards to applicability of provisions of section 163 of the Act pertaining to representative assessee, the Supreme Court held that section 163 of the Act does not relate to deduction of tax. Further, section 163(1)(c) as well as section 9(1)(i) of the Act state that income should be deemed to accrue or arise in India. In the instant case, as there is no transfer of capital asset situated in India, section 163(1)(c) of the Act is not attracted and hence, no proceedings can be initiated on Vodafone as representative assessee even under provisions of section 168 of the Act.  

The Chief Justice and Justice Swantanter Kumar had ruled that the offshore transaction herein is a bonafide structured FDI investment into India which fell outside India’s territorial tax jurisdiction and hence not taxable. The said offshore transaction evidences participative investment and not a sham or tax avoidant preordained transaction. The said offshore transaction was between HTIL (a Cayman Islands Company) and VIH (a company incorporated in Netherlands) and its subject matter was the transfer of CGP (a company incorporated in Cayman Islands). Consequently, the Indian Tax Authority had no territorial tax jurisdiction to tax the said offshore transaction. In a separate but concurring verdict, Justice K.S. Radhakrishnan had said the capital gains tax slapped on the company amounted to ‘imposing capital punishment’ for capital investment since it lacks authority of law and stands quashed. The verdict further clarified the FDI flows

---

203 Para 89 of the judgement.
204 Para 90 of the judgement.
towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works.

Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for tax payers (including foreign investors) to make rational economic choices in the most efficient manner. Legal doctrines like ‘Limitation of Benefits’ and ‘Look Through’ are matters of policy. It is for the government of the day to have them incorporated in the treaties and in the laws so as to avoid conflicting views. Thus, the judgement of Supreme Court in Vodafone case has given many key principles for interpretation of legal statutes and tax treaties and which would serve as a guiding principle in all future cases.\textsuperscript{205} The implications of the Supreme Court verdict are immense. A large number of merger and acquisition deals -AT&T’s sale of stake in Idea cellular, SAB-Miller and Shantha Biotcal among them stand to benefit. According to media reports, some 300 such cases are pending in courts. This means a massive loss of revenue for a cash-strapped Government.\textsuperscript{206}

That’s why according to the Government, this decision will set a precedent that will jeopardise thousands of cross of potential revenue to the exchequer. It will encourage tax avoidance through artificial devices-holding companies, subsidiaries, treaty shopping and selling valuable properties indirectly by entering into a maze of framework agreements. This judgement will lead to loss of thousands of crores of revenue and will encourage innovative tax avoidance devices. This will lead to foreign companies being invited to loot our resources and even avoid paying taxes on their windfall gains from the sale of those resources.

According to the Government, despite the fact that the entire object and purpose of the transaction between Hutch and Vodafone was to transfer the shares, assets and control of the Indian telecom company to Vodafone, the Supreme Court declared in January 2012 that the transaction has nothing to do with the transfer of any asset in India. The Finance Minister, Pranab Mukherjee said this in his reply during the Finance Bill Debate in the Lok Sabha on 9\textsuperscript{th} May 2012:


\textsuperscript{206} “Victory for Vodafone: Tax Laws should be Unambiguous”, \textit{The Tribune}, 23 January 2012, p. 8.
“India was no tax haven and there would be no rethink on the proposal to allow authorities to tax older corporate deals. There cannot be a situation where somebody will make money on an asset located in India and won’t pay tax either in India or in the country of its origin.”

The Centre contended that there was a need for reconsidering the January 20 verdict, as the law involved in deciding the case involving the telecom major has not been correctly interpreted. The Government filed a plea for the review of the Supreme Court verdict. In its review petition, the Government had contended that the Supreme Court had failed to appreciate that the deal was nothing but an artificial avoidance scheme and that the IT department had the right to decide whether capital gains had been factually and legally assigned to a Mauritius entity or to a third party and whether the Mauritius company was a façade. But the Supreme Court dismissed the review petition. Even when its review plea was pending in the Supreme Court, the government sought to nullify the Supreme Court verdict by inserting in the Finance Act, 2012 following amendments with retrospective effect to levy capital gains tax on domestic asset acquisition through merger and acquisition deals involving foreign companies.

1. The term ‘capital asset’ has been defined in section 2(14) of the Income Tax Act to mean property of any kind excluding stock-in-trade, personal effects etc. But the Finance Act, 2012 has included an explanation to section 2(14), which says that ‘property’ in terms of the type referred when defining a capital asset, includes any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever. Thus, any sale of rights in relation to an Indian company including rights of management or control would be taxable under the head ‘Capital Gains’.

2. It is specifically clarified that the share or interest in a foreign company or entity will be deemed to have situs in India if such shares or interest derive their value, directly or indirectly, substantially from assets located in India. However, no specific guidance has been provided as to what constitutes ‘substantial value’.

---

207 “Voda says Disappointed Over no Change in Retro Tax Plan”, The Tribune, 10 May 2012, p. 18.
209 Explanation to section 2(14) as inserted by the Finance Act, 2012 applicable w.r.e.f. 1 April 1962.
210 Explanation 5 to section 9(1)(i) as inserted by Finance Act, 2012 applicable w.r.e.f. 1 April 1962.
3. There has been much debate as to whether the term ‘directly or indirectly’, as appearing in the provisions of the Income Tax Act, which provide for income deemed to accrue or arise in India, applies to income accruing or arising or to the holding and transfer of the capital asset situated in India. Recent amendments to the Income Tax Act have further stated that any income arising ‘by means of’, ‘in consequence of’ or ‘by reason of’ the transfer of a capital asset will be deemed to accrue or arise in India. This amendment thus broadens the scope of the type of income that falls within the jurisdiction of the Indian tax authorities to include income generated by both direct and indirect holdings.

4. It is also clarified that definition of ‘transfer’ shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India.

5. Further, amendments have been made by insertion of Explanation 2 to section 195, which clarifies that the obligation to withhold tax when making payments to a non-resident is applicable to all persons, resident or non-resident, irrespective of whether the non-resident payer has a place of business, a business connection, a residence or any other presence, in any other manner, in India.

In the light of the above amendments, indirect transfers with substantial underlying Indian assets will fall within the jurisdiction of Indian tax authorities.

The Direct Taxes Bill 2010 seeks to tax income of a non-resident arising from indirect transfer of a capital asset situated in India. But the provisions are not as broad as the amendments made to section 9 of the Income Tax Act that too with retrospective effect.

---

211 Explanation 4 to section 9(1)(i) as inserted by Finance Act, 2012 applicable w.r.e.f. 1 April 1962.
212 Explanation 2 to section 2(4) as inserted by Finance Act, 2012 applicable w.r.e.f. 1 April 1962.
213 As inserted by Finance Act, 2012 applicable w.r.e.f. 1 April 1962.
Concerns were raised on these retrospective amendments as these amendments besides widening the incidence of Indian tax laws also overruled the Supreme Court ruling on the issue of taxability in India of indirect transfers. For these reasons, this amendment in particular, caused apprehensions among the investor community and also raised questions regarding the certainty of tax positions in India. According to some business organisation and forums, that these provisions deviated so significantly from prevailing international policy and practice and created such substantial doubt about India’s commitment to fair treatment and the rule of law that they would have a real and lasting negative impact on the attractiveness of India as an investment location.

Amidst pressures from the various forums and industry groups and negative investor sentiment, Prime Minister constituted an Expert Committee under the chairmanship of Dr. Prathasarathi Shome (hereinafter referred to as the ‘Shome Committee’) to analyse the amendments introduced vide the Finance Act 2012 and provide its recommendation.

As a matter of policy, Government should avoid anything which comes as a surprise or unexpected to the taxpayers. Indeed, as is prevalent in several counties, there should be constitutional or statutory protection against retrospective application. Various countries have explicitly banned retroactive taxation.

Retrospective application of tax law should occur in exceptional cases as follows:

- To correct apparent mistakes/anomalies in the statute.
- To remove technical defects particularly in procedure which had vitiated the substantive law.
- To ‘protect’ the tax base from highly abusive tax planning schemes that have the main purpose of avoiding tax, without economic substance.

---

214 For details on the name of these organisations and forums, see [http://www.asifma.org/uploadedfiles/resources/2012-10-19-Coalation-Comment-on-Shome-Report](http://www.asifma.org/uploadedfiles/resources/2012-10-19-Coalation-Comment-on-Shome-Report), accessed on 3 September 2013 at 5.22 pm.
It should be confined to matters that are genuinely of a clarificatory nature, or to ‘protect’ the tax base by countering highly abusive tax planning schemes, rather than ‘expand’ the tax base.

In the Indian case, retrospective application of a tax law should occur only after exhaustive and transparent consultation with stakeholders who would be affected and in the rarest of rare cases. The provisions relating to taxation of indirect transfer as introduced by the Finance Act, 2012 are not clarificatory in nature. These provisions should be applied prospectively. This would better reflect global practice, as well as the principle of equity and probity in the formulation and implementation of commonly recognised taxation principles. Further, the Shome Committee has recommended that interest and penalty should not be levied when there is a tax demand due to retrospective amendments. But the Government of India decided not to adopt any of the Shome Committee’s recommendations regarding the taxation of indirect transfer of Indian entities.

So the uncertainty still prevails over the Rs. 11,200 crore withholding tax dispute India is facing severe criticism locally and globally for amending the law retrospectively and insisting that Vodafone pays taxes despite Supreme Court ruling in favour of the company. Now the Government and the Vodafone, both are willing for settlement through conciliation. But the mode of Conciliation is the point of dispute. While India wants conciliation talks under the Arbitration and Conciliation Act, Vodafone wants under the auspices of UNICTRAL (United Nations Commission of International Trade Law). And there is still no end to this tax dispute which is entering another phase and uncertainty in the law still prevails. Now the current situation is that Vodafone has sent a notice to the Indian Government for arbitration under the India-Netherlands bilateral investment protection treaty. India was willing for conciliation talks under the Arbitration and Conciliation Act. But the New Delhi decided to withdraw its conciliation when the company sought to club another tax dispute with this case. Thus, British telecom major Vodafone has dragged Indian Government to International Arbitration.

---

217 Ibid.
The Government’s move has hurt the country’s image as an investment destination at a time it desperately wants foreign funds due to slowing economic growth and wide current account fiscal deficit. The final outcome of this dispute will decide the inflows of FDI in India to a large extent as investors fear uncertain tax environment. These retrospective amendments strike at the root of the principle of providing certainty about taxation and will create doubts in the minds of prospective investors planning to invest in India.\textsuperscript{219} Even the proposals in 2013 budget on retroactive tax claims and GAAR, were met with wide criticism by worldwide investor communities. International trade Groups representing more than 2,50,000 companies had warned the then Prime Minister Manmohan Singh that new taxation proposals by his government had led foreign businesses to reconsider their investment in India.\textsuperscript{220}

5.7.2. Tax Implications for the Buyer

**Purchase of Shares at Less than Fair Market Value:** As per the Income Tax Act,\textsuperscript{221} if a person receives any shares form any person and the consequent consideration paid which is less than the fair market value of shares by an amount exceeding Rs. 50,000, the excess consideration (over and above Rs. 50,000 of the fair market value) will be taxable as ‘income’ in the hands of such a buyer. Thus, the purchase of shares at a price less than the fair market value may attract the aforesaid provisions and the purchaser may be subject to tax on the differential value.

5.7.2.1. Obligations of Buyer to Withhold Tax: As per section 195(1), any payment of a sum to a non-resident, where the sum would be chargeable to tax in India, is required to be made after withholding of appropriate taxes i.e. appropriate taxes must be deducted at the time of credit of the income to the account of the payee or at the time of payment thereof in cash or by the issue of cheque or draft, which ever is earlier.


\textsuperscript{220} For details, see, “Global Business Groups Warn India Over New Tax Proposals; The Tribune, 3 April 2012, p. 15.

\textsuperscript{221} Section 56(2)(vii) w.e.f. 01-10-2009 and section 56(2) (viia) of the Income Tax Act w.e.f. 01-06-2010.
1. Accordingly, any consideration payable by any person (Indian resident or non-resident) to a non-resident, for the acquisition of shares of an Indian company, would fall within the scope of the withholding tax provisions at the applicable rates. There are several judicial precedents that have upheld the principle that even a non-resident person, who is responsible for the payment of any sum to another non-resident, is liable to withhold tax, if the said sum is chargeable to tax in India.

2. Explanation 2 to section 195 of the Income Tax Act has clarified that the obligation to withhold tax when making payments to a non-resident is applicable to all person, resident or non-residents, irrespective of whether the non-resident payer has a place of business, a business connection, a residence or any other presence, in any other manner, in India.\(^\text{222}\)

3. Any person responsible of making any payment, on which income tax must be withheld/deducted, may, *suo moto*, also make an application to the Indian tax authorities for the grant of a certificate authorising him to pay such sum after the deduction of tax at lower rate or without deduction of tax at all.\(^\text{223}\)

4. Sub-section 7 to section 195 of the Income Tax Act provides with regards to payment made to specified persons or in specific cases post 30 June 2012, an application has to be mandatorily made to the tax authorities to determine the amount of tax that should be withheld. However, the specific cases and person have not yet been prescribed.

5. The tax authorities have consistently held that the buyer is required to either withhold tax or make an application to the tax authorities seeking the issuance of an appropriate withholding tax certificate. In *Transmission Corporation of AP Ltd. v. CIT*,\(^\text{224}\) the Supreme Court laid out the following principles with respect to the withholding of tax on payments made to non-resident:

   - The purpose of the provisions of the Income Tax Act for deduction of tax from any payment made to non-resident is to ensure that the buyer deducts tax at the

\(^{222}\) Ernst and Young, 2012, p. 205.
\(^{223}\) Section 195(2) of the Income Tax Act.
\(^{224}\) (1999) 239 ITR 587 (SC).
rates in force where such a sum is chargeable in India under the provisions of the Income Tax Act.

- The tax withholding provisions of the Income Tax Act are only applicable when some part of the payment made to a non-resident is subject to tax in India under the provisions of the Income Tax Act. Hence, taxability of the sum paid in India, in hands of the recipient is critical to triggering tax withholding.

- It is clear that the expression ‘any other sum chargeable under the provisions of this Act’ includes not only the amount the whole of which are taxable without deduction within the ambit of the withholding provisions, but also amounts of mixed composition where only a part of the total amount is taxable income and other disbursements which are in the nature of gross revenue receipts but are still classified as sums that are chargeable under the provisions of the Income Tax Act.

5.8. Tax Implications of Acquisitions in Case of Business Acquisition

Another mode of acquisition is acquisition of business which typically entails the acquisition of all or some of the assets and liabilities of a business for a consideration that can be paid in cash or kind. The consideration can either the allocated to individual assets and liabilities (i.e. itemised sale) or could be a lump sum consideration for the assets and liabilities (i.e. slump sale).

**Tax Implications on Transfer of Business:** When the business is transferred, it will result in capital gains. The computation of the tax liability arising from the capital gains resulting on the transfer of a business depends upon whether the business was transferred for a lump sum consideration viz. a slump sale or for a consideration specifically agreed for each individual asset and liability, viz. an ‘itemised sale’.

5.8.1. Slump Sale

To resolve the controversy regarding tax incidence upon sale of an undertaking by way of slump sale, the Finance Act, 1999 inserted section 2(42C) and 50(B) and amended section 43(6).

---

225 Ernst and Young, 2012, p. 268.
5.8.1.1. **Meaning of ‘Slump Sale’**: Until 1999, the term ‘slump sale’ was not defined under the Income Tax Act and the interpretation of the term evolved through various judicial precedents passed by the Tribunals, the High Courts and the Supreme Court. But the nature of the criteria adopted by these judicial forums was subjective which resulted in much litigation relating to the taxability of the slump sale. In order to resolve the prevailing ambiguity in the Income Tax Act, section 2(42C) was inserted with effect from the assessment year 2000-01. The definition reads as under:

‘Slump sale’ means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales. In order to come within the purview of the definitions one should satisfy the following conditions:

- Tax payer owns an undertaking;
- He transfers the undertaking by way of sale;
- The transfer is for lump sum consideration without assigning values to individual assets and liabilities. As regards the third point, the following points should be noted.

The determination of the value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities. Moreover, it was clarified by the Supreme Court in *CIT v. Artex Manufacturing Co.*, if the values of individual assets are determined for arriving at the purchase consideration, not being the case mentioned immediately above, the transaction would not be regarded as ‘slump sale’ even if the individual values are not mentioned in the agreement. Such determination of item-wise values may be regarded as assigning values to individual assets/liabilities.

**Transfer of an Undertaking under a Scheme of arrangement is ‘Slump Sale’ Taxable under Section 50B of the Income Tax Act**: The question came up for consideration before the Delhi High Court in *SREI Infrastructure Finance Ltd. v.*

---

226 *Id.*, p. 269.
In this case, the taxpayer had entered into a scheme of arrangement under section 391 to 394 of the Companies Act, 1956 pursuant to which it transferred its project finance business and assets based financing business to its subsidiary for a lump sum consideration. The scheme had been approved by the Calcutta High Court. The taxpayer has filed a writ petition challenging the order of the Settlement Commissioner stating the transfer of the project finance business as taxable under section 50B of the act as ‘slump sale’. But the Delhi High Court dismissed the writ petition and held that transfer under the scheme sanctioned by the Court is a sale under section 50B of the Act and rejected the contention of the taxpayer that section 2(42C) of the Act deals with a limited category of transactions being ‘sale’ and the broader and wider definition of the term ‘transfer’ under section 2(47) of the Act is not applicable to slump sales.

5.8.1.2. Tax Implication of Slump Sale:

5.8.1.2.1. Capital Gains Tax: For computation of capital gains in the case of slump sale, section 50B was inserted by the Finance Act 1999 which introduced special provisions to deal with the taxation of slump sales and the cost of acquisition when transferring an undertaking. Accordingly, in case of a slump sale, the full value of sales consideration that is more or in excess of the net worth (which is deemed to be the cost of acquisition) of the undertaking, will be the capital gains (subject to tax in the hands of transferor/seller). The provisions of section 50B, applicable for computation of capital gains in the case of slump sale are given below:

1. Any profits or gains arising from the slump sale effected in the previous year shall be chargeable as long-term capital gains and shall be deemed to be the income of the previous year in which the transfer took place. Where, however, any capital asset being one or more undertakings owned and held by the assessee for not more than 36 months is transferred under the slump sale, then capital gain shall be deemed to be short-term capital gain.

2. In the case of slump sale of the capital asset being one or more undertaking, the ‘net worth’ of the undertaking shall be taken as cost of acquisition and cost of

---

228 (2012) 207 Taxman 74 (Del.).
improvement. ‘Net worth’ for this purpose is the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in the books of account. Any change in the value of assets on account of revaluation of assets shall be ignored for the purpose of computing the net worth. The aggregate value of total assets of such undertaking or division shall be the written down value of block of assets determined in accordance with the provisions contained in sub-item (C) of section 43(6)(c)(i) in the case of the depreciable assets and the book value for all other assets.\textsuperscript{229} The benefit of indexation will not be available. The net worth of the undertaking is to be computed as follows:

\textbf{Table 5.3: Calculation of Net Worth of the Undertaking.}

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate value of assets</td>
<td>((A=B+C))</td>
</tr>
<tr>
<td>In case of depreciable assets, the written-down value of block of assets</td>
<td>B</td>
</tr>
<tr>
<td>In case of other assets, book value (revaluation to be ignored)</td>
<td>C</td>
</tr>
<tr>
<td>Aggregate book value of liabilities</td>
<td>D</td>
</tr>
<tr>
<td>Net worth</td>
<td>(A-D)</td>
</tr>
</tbody>
</table>

3. If net worth is negative, it is taken as equal to zero and the sale consideration will become capital gains as held in \textit{Zuari Industries Ltd. v. CIT}.\textsuperscript{230} Further, in \textit{DCIT v. Summit Securities Ltd.},\textsuperscript{231} the Mumbai Tribunal ruled that negative net worth cannot be ignored for the purposes of computing gains on slump sale of business under section 50B of the Income Tax Act. To contend that the cost or net worth can never be negative is too wide a proposition to be accepted in the case of a capital asset in the nature of an undertaking. If the amount of net worth is positive, that should be reduced from and if it is negative then it should be added to the full value of the consideration.

\textsuperscript{229} Vinod K. Singhania and Kapil Singhania, 2009, p. 1146, para 520.3.
\textsuperscript{230} (2006) 9 SOT 563 (Mum.).
\textsuperscript{231} (2012) 135 ITR 99 (Mum.).
4. Every assessee, in the case of slump sale, shall furnish along with the return of income, a report of a chartered accountant in form no. 3CEA indicating the computation of the net worth of the undertaking or division, as the case may be and certifying that the net worth of the undertaking or division, as the case may be has been correctly arrived at.

5.8.2. Itemised Sale

As discussed in the beginning of this chapter a business can be acquired/transferred via a slump sale or an itemised sale. An ‘itemised sale’ can be of two types:232

(i) Where the entire business undertaking is transferred as a going concern and the consideration is fixed and allocates for each asset and liability separately or;

(ii) Where individual assets or liabilities (through cherry picking) are transferred at a price fixed for each asset or liability separately.

5.8.2.1. Key Tax Implications of Itemised Sale: Transfer of capital asset pursuant to an itemised sale agreement is considered as transfer and is liable to capital gains tax in the hands of transferor. The capital gains would be long term in nature for the individual assets held for more than 36 months and short term in nature for assets held for less than 36 months and depreciable assets. In case of itemised sale, capital gains chargeable to tax,233 will need to be ascertained for each individual capital asset. Tax implications of itemised sale can be further categorised into the following sub-categories:

(1) Depreciable Assets Forming Part of a Block of Assets: On transfer of depreciable assets that form a part of a ‘block of assets’, capital gains would be calculated by subtracting the written down value (WDV) of the relevant block of assets from the sale proceeds of the relevant fixed assets.

Thus Capital Gains = Sale Consideration Received – WDV of the Block of depreciable assets.

(2) Non-depreciable Assets: The amount of the sale proceeds in excess of the actual cost of the asset would be chargeable to capital gains tax (either as short-term or long-term capital gains, depending on the period of holding).

---

232 Ernst and Young, 2012, p. 291.
Thus, Capital Gains = Sale Consideration Received – Cost of Acquisition of the Individual Assets.

(3) Intangible Assets (other than the assets on which depreciation is allowable under section 32 of the Income Tax Act): The amount of consideration allocated towards intangible assets, viz. goodwill of the business, trademark, brand name associated with the business, right to manufacture, produce or process any article or thing, right to carry on any business, tenancy rights etc. would be chargeable to capital gains tax (either as short-term or long-term capital gains, depending on the period of holding) after reducing the cost of acquisition, if any, of the asset.

While computing the taxable capital gains on the transfer of any of the intangible assets listed above, the cost of acquisition to be deducted is determined as follows:²³⁴

- If the intangible asset was acquired by the seller before being transferred via an itemised sale, then the price at which the seller acquired the asset would be deemed to be the cost of acquisition of the asset;
- In case of a self-generated intangible asset, the cost of acquisition would be nil.

5.9. Stamp Duty Implications in Mergers and Amalgamations

Since a merger or demerger inevitably entails some transfer of property, movable or immovable, it attracts the imposition of stamp duty which is essentially a form of revenue for the government arising out of taxation of various transactions governed under the Indian Stamp Act, 1899. The exposition of stamp duty is a vital aspect because it could substantially increase the costs of a mergers deal.²³⁵

In this exercise of corporate restructuring through amalgamation and merger, stamp duty planning assumes a significant role and all out efforts are made to pay as less a duty on such amalgamations as possible and yet proceed with the acquisitions through mergers and amalgamations. The incidence of stamp duty is an important consideration in the planning of any merger. In fact, in some cases, the whole form in which the

²³⁴ Ernst and Young, 2012, p. 292.
merger is sought to take place is selected taking into account the savings in stamp duty.\footnote{The Institute of Company Secretaries of India, Handbook on Mergers Amalgamations and Takeovers, 3\textsuperscript{rd} Edition, CCH India (Wolters & Kluwer (India) Pvt. Ltd.), New Delhi, 2010, p. 9.}

Apart from the vexed issues like share exchange ratio and offering a fair deal to the shareholders of the amalgamating/merging company, an important issue which concerns all amalgamations/merger is the issue of levy of stamp duty on the orders of the High Court sanctioning the amalgamation/merger under section 391 read with section 394 of the Companies Act 1956. Since there is no uniformity in this regard and since the duty levied on amalgamations or mergers differs from one state to another, there is disadvantage of effecting amalgamations in one state compared to another and therefore a lot of professional time and attention is devoted to work out the best method which can effect duty savings on such amalgamations or mergers.\footnote{Delep Goswami, “Supreme Court Confirms Levy of Stamp Duty on Amalgamation Orders by Bombay High Court”, \textit{Chartered Secretary}, January 2004, pp. 43-46, p. 43.} Moreover, the fact that, in India, stamp duty is substantially levied by the states has given considerable scope for savings in stamp duty. Apart from lack of uniformity in the rates of stamp duty across various states, the imposition of stamp duty itself is a contentious issue which has been challenged extensively before various High Courts and the Supreme Court. Therefore, this research work will focus on the major contentious issue of applicability of stamp duty in case of mergers.

5.9.1. \textit{The Indian Stamp Act, 1899}

One of the most important aspects which can make or break a merger or a demerger deal is the stamp duty payable, since it can run into high costs for the company. The Indian Stamp Act, 1899, a central legislation, lays down the law with regard to levy of stamp duty. It applies to whole of India except the state of Jammu and Kashmir. The Act through a schedule lays down the rate of stamp duty payable on different instruments. The Indian Stamp Act through, section 3, which is a charging section, levies stamp duty on an instrument. Almost all the states except states of Tamil Nadu, Assam and other eastern states have adopted the Indian Stamp Act, 1899 with suitable amendments for stamp duty. These states have separate rates whereas the states of
Tamil Nadu, Assam and North Eastern States have suitably amended rates of Indian Stamp Act wherever they thought it necessary. However, it must be noted that the States of Kerala, Karnataka, Gujarat and Maharashtra have made their own Acts in this regard with separate schedules and rates for various instruments. There are similar provisions like Section 3, the charging section of the Indian Stamp Act in the State Stamp Acts.

The Indian Stamp Act, 1899 requires payment of stamp duty on all instruments that purport to transfer immovable property. In amalgamation, the properties of transferor company are transferred to transferee company when the scheme of amalgamation is sanctioned by the competent High Court. The scheme of amalgamation becomes effective when the copy of the court’s order sanctioning the scheme is filed with the registrar of companies. The most important and pertinent question which arises when one studies stamp duty implications of mergers and amalgamations is whether the order sanctioning the scheme is an instrument liable to be stamped or not. This has been drawing the attention of courts and there are various conflicting judgements. Though the Supreme Court of India had conclusively held in *Hindustan Lever v. State of Maharashtra*, *that an order sanctioning amalgamation is an instrument liable to be stamped*, the Calcutta High Court in *Madhu Intra Ltd. &. Others v. Registrar of Companies*, had held it otherwise but the Delhi High Court in its recent judgement of *Delhi Towers Ltd. V. G.N.C.T. of Delhi*, has tried to put an end to controversy generated by Calcutta High Court. Again, several states in India specifically levy stamp duty on the order sanctioning amalgamation under their own State Stamp Act.

### 5.9.2. Nature of Such Transfer

In this part, we shall make an attempt to analyse nature of transfer in case of amalgamation or merger. The question that arises here is whether amalgamation is by operation of law or consent of the parties. This question is important because stamp

---

241 (2006) 130 Com Cases 510 (Cal.).
242 (2010) 97 CLA 106 (Del.); (2010) 103 SCL 447 (Del.).
duty is leviable only if amalgamation is with the consent of parties. In other words, transfer of property made inter-vivos i.e. contract between the seller and the buyer. This has been the most contentious issue as regards the applicability of stamp duty on a merger is concerned.

The earlier view prevalent on this issue was that since no instrument is executed for amalgamation of transferor-company with transferee-company, and the amalgamation occurs pursuant to the order of the competent High Court, the amalgamation is by virtue of operation of law and, thus, involuntary. This view is reflected in *Sailandra Kumar Ray v. Bank of Calcutta Ltd.*, 243 wherein it was held that transfer of assets of one company to another under a scheme of amalgamation sanctioned by a High Court under the Companies Act is a transfer by operation of law and that the order of the High Court cannot be regarded as an instrument of transfer. Therefore, it was held as not liable to stamp duty.

In legal parlance the action is said to be by operation of law where such an action takes place without the consent of either party to the transaction. The Black’s Law Dictionary defines the phrase ‘operation of law’ as ‘the means by which a right or a liability is created for a party regardless of the party’s actual intent.’ 244 A scheme of amalgamation could not be put forward as a proposal unless there is an agreement between the transferor and the transferee company. For example, the Madras High Court refused to give effect to the scheme that was rejected by the transferee company. 245 Thus it can be said that without the consent or agreement between the parties, amalgamation cannot take place. The change in the above view is significantly visible in *General Radio and Appliances Co. Ltd. v. M.A. Khader (Dead) by LRs.*, 246 wherein the Supreme Court held that since the amalgamation scheme had been approved by the Bombay High Court only on basis of the petition made by the transferor-company, it could not be said to be an involuntary transfer effected by the order of the court.

243 (1948) 18 Com Cases 1 (Cal.).
244 Zeenat Munir and Iftekhar Anees, 2012, p. 117.
245 *Union Services Pvt. Ltd., In re* (1973) 43 Com Cases 319 (Mad.).
246 AIR 1986 SC 1218.
Thus, it is well settled by the Supreme Court that there is no adjudication and therefore the sanction order passed by the court under which the transfer of properties took place is not by, the process of operation of law but under an inter-vivos contract between the parties.

5.9.3. Essentials for the Levy of Stamp Duty

Stamp duty is levied on instruments. Section 3 of the Bombay Stamp Act, 1958 specifies the following essentials for the levy of stamp duty:

1. There must be an instrument;
2. Such instrument is one of the instruments specified in Schedule-I;
3. Such instrument must be executed;
4. Such instrument must have either:
   (a) Not having been previously executed by any person is executed in the ‘State’ or;
   (b) Having been executed outside the state, relates to any property situated in the state or any matter or thing done or be done in the state and is received in the state.

5.9.4. Meaning of the Term Instrument

Stamp duty is payable on instruments enumerated in the schedule I to the Indian Stamp Act. The decision of the Supreme Court in Purshottam H. Judge and Others v. B. Potdar and Another, is the direct authority for the proposition that the meaning of the expression ‘instrument’ should be construed having regard to the context in which the expression is used.

Since the term ‘instrument’ is not defined in the General Clauses Act, one has to be guided by the meaning of the expression ‘instrument’ in the light of the above judgment of the Supreme Court having regard to the context in which the expression is used in the Act, Section 2(14) of the Indian Stamp Act defines instrument as: “Instrument

---

247 Section 3 of the Indian Stamp Act, 1899.
248 AIR 1966 SC 856.
includes every document by which any right or liability is, or purports to be, created, transferred, limited, extended, extinguished or recorded.’’

The states that had enacted their own legislation retained the main character of the above definition while excluding specific documents. As an illustration, we can point out the Bombay Stamp Act which in its section 2(1) defines ‘instrument’ as follows:

“Instrument includes every document by which any right or liability is or purports to be created, transferred, limited, extended, extinguished or recorded but does not include a bill of exchange, cheque, promissory note, bill of lading, letter of credit, policy of insurance, transfer of shares, debentures, proxy and receipt.”

The definition of instrument is an inclusive definition. Reference in this regard can be made to the case to Krishi Utpadan Mandi Samiti v. Shankar Industries where in it was held: “It is well settled rule of interpretation that where the legislation uses the words ‘means’ and ‘includes’, such definition is to be given a wider meaning and is not exhaustive or restricted to the items contained or included in such definition.”

It can be seen that as per the above definitions a documents creating or transferring a right is an instrument. If so, whether an order by court effectuating the transfer of property a document? This question was answered in the affirmative by the Supreme Court in the case of Haji SK. Subhan v. Madhorao where a decree of the court was held to be a document. Again in its prominent judgement of Hindustan Steel Ltd. v. Dilip Construction Co. the Apex Court held that an award of the court is an instrument within the meaning of the Stamp Act and the same is required to be stamped.

The questions more pointedly cropped up before the Supreme Court in Ruby Sales and Services (P.) Ltd. v. State of Maharashtra. In this case, in a suit for specific performance, the property was conveyed to the vendee by a consent decree. The question arose whether the consent decree is an instruments and liable to be stamped. The court held:

---

252 AIR, 1962 SC 1230.
254 (1994) 1 SCC 531.
“There is no particular pleasure in merely going by the label but what is
decisive is by the term of the document. It is clear from the terms of the
consent decree that it is also an ‘instrument’ under which title has been
passed over to the appellants/plaintiffs. It is a live document transferring
the property in dispute from the defendants to the plaintiffs.”

The aforesaid decree was based on an agreement between the parties. So is the case
with an order under section 394, which is also based on an agreement between the
transferor and the transferee.\textsuperscript{255}

An order under section 394 is also akin to the consent decree which has the effect of
transferring the properties, right and liabilities of the transferor company to the
transferee company. In other words, it conveys the title in the properties of the
transferor company to the transferee company. Hence, it is an instrument liable to be
stamped.\textsuperscript{256} The Bombay High Court in \textit{Li Taka Pharmaceuticals Ltd. v. State of
Maharashtra},\textsuperscript{257} said that:

“An order of the High Court under section 394 is founded and based on
the compromise or arrangement between the two companies for
transferring assets and liabilities of the transferor company to the
transferee company and that order is an instrument as defined in section
2(1) of the Bombay Stamp Act which includes every document by which
any right or liability is transferred.”

\textbf{5.9.5. Stamp Duty on Merger/Amalgamation}

It is obvious that transfer of property takes place between the transferor and the
transferee companies in an amalgamation. The Indian Stamp Act nowhere specifically
mentions ‘amalgamation’ in Schedule-I in which various Articles which are stampable
instruments are prescribed. One of such instruments which is subject to stamp duty and
is relevant in the context of amalgamation is conveyance.\textsuperscript{258} Therefore, in this regard
the definition of the term ‘conveyance’ becomes relevant and crucial.\textsuperscript{259} The term

\textsuperscript{255} Sunando Mukherjee, “Stamp Duty on Mergers and Amalgamations in India”, \textit{Corporate Law
\textsuperscript{256} T.K.A. Padmanabhan, “Stamp Duty on Merger and Amalgamation: Analysis of Gemini Silk Ltd.
Case”, \textit{Corporate Law Advisor}, 2003, Vol. 53, pp. 118-121, p. 120.
\textsuperscript{257} AIR 1997 Bom 7.
\textsuperscript{258} Ernst and Young, \textit{Master Guide to Mergers and Acquisition in India (Tax and Regulatory)}, Wolters
‘conveyance’ is defined in the Indian Stamp Act as follows: “Conveyance includes a conveyance on sale and every instrument by which property, whether movable or immovable is transferred inter-vivos and which is not otherwise specifically provided for by schedule I or schedule IA as the case may be.”\textsuperscript{260}

The definition has wide sweep. This definition is in three parts. The first part includes conveyance on sale and the second part includes every instrument under which transfer of property is made inter-vivos. The word ‘inter-vivos’ has not been defined in the Act or in the General Clauses Act. The meaning assigned to the word ‘inter-vivos’ in the Black’s Law Dictionary is:

“Between the living: from one living person to another. Where property passes by conveyance, the transaction is said to be inter-vivos, to distinguish it from a case of succession or devise. So, an ordinary gift from one person to another is called a gift inter-vivos.”\textsuperscript{261}

It was contended that since the transaction was not between the living beings, the same was not inter-vivos, as the transfer of property had not taken place between the living beings. But according to our Supreme Court,\textsuperscript{262} company or association or body of individuals, whether incorporated or not, have been included amongst the ‘living person’ in this section. It clearly brings out that a company can effect transfer of property. The word ‘inter-vivos’ in the context of Section 394 of the Companies Act would include within its meaning also a transfer between two ‘juristic persons’ or a transfer to which a juristic person is one of the parties. The transaction between a minor or a person of unsound mind with the other person would not be recognised in law though the same is between two living beings, as they are not juristic persons in the eyes of law who can by mutual consent enter into a contract or transfer of property. The company would be juristic person created artificially in the eyes of law capable of owning and transferring the property. Thus, where any property passes by conveyance the transaction would be said to be inter-vivos as distinguished from a case of succession or devise.\textsuperscript{263}

\textsuperscript{260} Section 2(10) of the Indian Stamp Act, 1899.
\textsuperscript{261} Delep Goswami, “Supreme Court Confirms Levy of Stamp Duty on Amalgamation Orders by Bombay High Court”, Chartered Secretary, Jan. 2004, pp. 43-46, p. 46.
\textsuperscript{263} Ibid.
In *Delhi Towers Ltd. v. Govt. of National Capital Territory of Delhi*, the Delhi High Court held that an approved scheme of amalgamation amounts to a transfer inter-vivos between two companies, who are juristic persons in existence at the time of passing of the order and sanctioning of the scheme, whereby right, title and interest in the immovable property of the transferor company is transferred to the transferee company. The transfer takes place in the present and is not postponed to any later date and is covered under the definition of ‘conveyance’ under section 2(10) of the 1899 Act. As regards the third part, it is very crucial. It states that the instruments should not have been specifically provided in the schedule I or IA, i.e. there should not be a specific Article covering these instruments. The effect of the definition is that, any instrument transferring property inter-vivos will be considered as ‘conveyance’ and accordingly stamp duty will be levied. If the instrument falls under any or the specific articles, say lease, transfer, licence, exchange of property, gift etc., such an instrument will not be considered as conveyance but will be considered under the specific description.

To end the legislative confusion of whether the transfer of property through a court’s order in a merger or amalgamation comes within the meaning of conveyance, Bombay Stamp Act was amended in 1985, to explicitly include in the Act what was already there in un-amended definition of ‘conveyance’. The amendment specifically defines ‘conveyance’ to include an order of court approving a merger. Conveyance has been defined under section 2(g) to include:

- A conveyance on sale;
- Every instrument;
- Every decree or final order of any civil court;
- Every order made by the High Court under section 394 of the Companies Act, 1956 in respect of amalgamation of companies.

So the states of Rajasthan, Maharashtra, Gujarat, Karnataka, Madhya Pradesh, Chhattisgarh and Andhra Pradesh have specifically included court order under section

---

265 Schedule I is the article specified by the Parliament. Schedule I-A is the schedule provided by the State, which adopt Indian Stamp Act.
394 in definition of ‘conveyance’ but state like Jammu and Kashmir and Kerala have not. The State Acts, under which amalgamation order was specifically included in the definition of ‘conveyance’ does not take away the basic inclusive character of the definition. The specific inclusion of the amalgamation order is, at the best, could be considered to be clarificatory in nature, as otherwise also such an order would have been covered by the definition.

The Bombay High Court in Li Taka Pharmaceuticals v. State of Maharashtra, and Supreme Court in its prominent judgement of Hindustan Lever Employees Union v. Hindustan Lever Ltd., have held that amendment to Bombay Stamp Act is merely declaratory in nature with a view to bring clarity of the doubts on levy of stamp duty on court order under section 391-394. Thus, we can conclude that High Court’s order sanctioning a scheme of amalgamation is a ‘conveyance’ chargeable to stamp duty.

5.9.6. Judicial Opinion

At present, the seven states of Maharashtra, Gujarat, Karnataka, Rajasthan, Chhattisgarh, Madhya Pradesh and Andhra Pradesh have included a High Court order approving a scheme of amalgamation under section 394 of the Companies Act within the definition of ‘conveyance’ in their stamp laws. As far as these states are concerned, the position regarding liability of stamp duty on arrangements is somewhat clear, although the rates of stamp duty as well as basis of computation differ even among states. To that extent, while there is little doubt regarding computation of stamp duty on schemes of arrangement among companies within a single such state, the issue can be some what compounded if the companies involved are registered in different such states.

Matters become further complicated when we examine other states that do not expressly include High Court’s orders on amalgamation within the definition of ‘conveyance’. The Indian Stamp Act, 1899, which applies to several states in India (other than those

---

266 AIR 1997 Bom 7.
267 AIR 1994 SC 470.
269 Ibid.
discussed in the preceding paragraph) is one such legislation without an express inclusion for a scheme of arrangement. Predictably, that has resulted in a great amount of uncertainty in cases that involve amalgamation of companies registered in states governed by the Indian Stamp Act. Multiplicity of High Court rulings pointing in different directions has only added to the confusion. In order to briefly set out the law of the land, it would be useful to examine some of the leading cases.

The landmark decision of Bombay High Court in \textit{Li Taka Pharmaceuticals v. State of Maharashtra},\textsuperscript{270} has serious implications for mergers covered not just by the Bombay Stamp Act, 1958 but also mergers covered by Acts of other states. The following are the major conclusions of the honourable court:

1. An amalgamation under an order of court under section 394 of the Companies Act, 1956 is an instrument under the Bombay Stamp Act.

2. States are well within their jurisdiction when they levy stamp duty on instrument of amalgamation.

3. Stamp duty would be levied not on the gross assets transferred but on the ‘undertaking’, when the transfer is on a going concern basis, i.e., on the assets less liabilities. The value for this purpose would thus be the value of shares allotted. This decision has been accepted in the Act and now stamp duty is leviable on the value of shares allotted plus other consideration paid.

Supreme Court confirmed the levy of stamp duty on amalgamation orders by Bombay High Court in \textit{Hindustan Lever Limited v. State of Maharashtra}.\textsuperscript{271} In this case, Tata Oil Mills Company Ltd. (TOMCO) was merged with the Hindustan Lever Ltd. (HLL). The state imposed stamp duty on the order sanctioning the scheme of merger. The demand was challenged by the company on two grounds that State Legislature is not competent to impose stamp duty on the order of amalgamation passed by a court and such order of the court is neither an instrument nor a document liable to stamp duty. The Supreme Court dismissed the appeal of the company for the following reasons:

\textsuperscript{270} AIR 1997 Bom 7.
\textsuperscript{271} (2003) 117 Com Cases 758 (SC).
The State Legislature would have the jurisdiction to levy the stamp duty under Entry 44 List III of the Seventh Schedule of the Constitution and prescribe rate of stamp duty under Entry 63 List II. As Entry 44 List III empowers the State Legislature to prescribe rates of stamp duty in respect of documents other than those specified in List I, thus it does not in any way impinge upon any entry in List I. By sanctioning of amalgamation scheme, the property including the liabilities are transferred as provided in section 394 of the Companies Act and on that transfer instrument, stamp duty is levied. It, therefore, cannot be said that the State Legislature has no jurisdiction to levy such duty.

The Supreme Court further held that the duty charged by the State Legislature is on the instrument and is on the execution of the instrument. The measure of charging stamp duty may be fixed or ad-valorem, which is to be determined by the Legislature. The basis for computation of stamp duty can be determined by the State Legislature and it may be on the basis of the market value of the property transferred or at a fixed amount. In this judgement, the Supreme Court further held that there is no question of encroachment on the field of Parliament under Entry 43 of List II.

The Supreme Court further held that section 2(g)(iv) of the Bombay Stamp Act does not in any way describe any alternate procedure as compared to the one appearing in section 394 of the Companies Act, 1956. The question of repugnancy of section 2(g)(iv) of the Bombay Stamp Act vis-a-vis section 394 of the Companies Act is therefore, irrelevant. The court also considered section 2(g) of the Bombay Stamp Act, 1958 which defines the term ‘conveyance’. It was observed that the scheme of amalgamation is a voluntary act intending transfer between the two contracting parties having all the trappings of a sale and the court has to examine whether the provisions of statute are being complied with. The court does not sit over the commercial wisdom of class of persons who with their own open eyes have given their approval to the scheme even if the court was of the view that a better scheme could be framed once all the parameters set out in section 394 have been made. Therefore, the Supreme Court found that an amalgamation scheme sanctioned by the court is an ‘instrument’ from the transferor company to the transferee company. It also took into account the definition of section 5 of the Transfer of Property Act, 1882 which defines ‘transfer of property’ as to mean an act by which a living person conveys property to one or more other living persons. The section also includes
associations, companies or bodies of individuals as living persons and the word ‘inter-vivos’ would include within its meaning two juristic persons or a transfer to which a juristic person is one of the parties. Hence, the Supreme Court came to the conclusion that the order of amalgamation is an ‘instrument’ in the context of section 2(g)(iv) of the Bombay Stamp Act. Since this judgement was in the context of Bombay Stamp Act, its applicability to stamp laws of other states is a debatable issue.

But the Bombay High Court clarified in *Li Taka Pharmaceuticals Ltd. v. State of Maharashtra*, that:

“Even prior to the amendment (in the Bombay Stamp Act expressly including an order of amalgamation), a conveyance would include every instrument by which the property is transferred to or vested in another persons inter-vivos and that the amendment was only with a view to set to rest any doubts and to clarify and explicitly state that an order of amalgamation was already included in the definition of conveyances by implication.”

The development of case law in West Bengal has been somewhat mixed. A single judge of the Calcutta High Court held in *Gemini Silk Limited v. Gemini Overseas Limited*, that an order sanctioning, a scheme of amalgamation under section 394 is covered by the definition of ‘conveyance’ under the Indian Stamp Act and is therefore liable to stamp duty. Subsequently, on the other hand a Division Bench of the Calcutta High Court adopted a contrary view in *Madhu Intra Limited v. Registrar of Companies*, where it was held that an order of amalgamation did not fall within the definition of a ‘conveyance’ and therefore not subject stamp duty. Moreover even if such an order were to be taken as a ‘conveyance’ or an ‘instrument’ the transfer of assets and liabilities effected thereby is purely by operation of law. The Division Bench even went to the extent of expressly setting aside the judgement in *Gemini Silk Case*.

It further held that notwithstanding the expression ‘instrument’ in section 2(14)(d) of the Indian Stamp Act, the said definition and the un-amended provisions of the Indian Stamp Act do not apply to an order under 394(1) of the Companies Act for the purpose

---

272 AIR 1997 Bom 7.
273 2003 53 CLA 328 (Cal.).
274 (2006) 130 Com Cases 510 (Cal.).
of the stamp duty. For this purpose, the Division Bench agreed with the views rendered by the Calcutta High Court in the case of *New Central Jute Mills v. Reverse Stream Navigation Co. Limited*.\(^{275}\) Under the circumstances, the Division Bench came to the conclusion that the transfer of assets and liabilities of the transferor company to the transferee company takes place on an order being made under sub-section (1) of section 394 by operation of sub-section (2) thereto. Hence, the Division Bench order reversed the single judge’s findings and even directed refund of the stamp duty, if paid.

The Rajasthan High Court (Jaipur Bench) in the matter of *Kusum Agro Tech Ltd. v. State of Rajasthan and Others*,\(^{276}\) by judgement dated 29-05-2009 considered the validity of imposition of stamp duty on an order of amalgamation under section 394. The court held that prior to amendment to the term ‘conveyance’ in 2004 it did not include an order under section 394. Hence on various considerations and including the observation of the HLL’s case it concluded that prior to amendment an order of High Court under section 394 was not liable to stamp duty.

More recently, the Delhi High Court in *Delhi Towers Ltd. v. G.N.C.T. of Delhi*,\(^{277}\) was not persuaded by the Division Bench ruling in *Madhu Intra’s Case*. The Delhi High Court instead adopted the previous reasoning in *Li Taka Pharmaceuticals and Gemini Silk Case*. The Delhi High Court has added to the controversy already prevailing on stampability of court orders in mergers/amalgamations. The court held that the role of court in proceedings under section 394 of the Companies Act is merely supervisory in nature and the order passed is based on the consent and voluntary act of the parties involved. The court is not empowered by the statue to consider the merits of the terms on which scheme of amalgamation is proposed by the consenting parties, and even a modification suggested by the court is required to have the approval of the shareholders and creditors before it can be incorporated in the scheme. The foundation or the basis for passing an order of amalgamation is the agreement between two or more companies. The court relied on the judgement of the Apex court in *Hindustan Lever Case* and held that the scheme of amalgamation has its genesis in an agreement between prescribed

\(^{275}\) AIR 1959 Cal 352.

\(^{276}\) Decided by Rajasthan High Court on 29.05.2009, as quoted in N.R. Sridharan and P.H. Arvind Pandian, 2010, pp. 548-549.

\(^{277}\) (2010) 97 CLA 106 (Del.): (2010) 103 SCL 447 (Del.).
majority of shareholders and creditors of the transferor company with the prescribed majority of shareholders and creditors of the transferee company. The transfer has all the trappings of a sale.

Section 2(10) of the 1899 Act contains an inclusive definition of ‘conveyance’. Interpretation of an inclusive definition clause in statute has fallen for consideration in several cases before the court. The Delhi High Court relied on those, and held that word ‘included’ is generally used in the interpretation clause to enlarge the meaning of the words so as to make them comprehend not only such things as they signify according to their natural import but also the things that are declared in the interpretation clause to be included.

Therefore, it accepted the submission that the amendment incorporated to Bombay Stamp Act by the Maharashtra Act No. 27 of 1985 was only with a view to set at rest any doubts and to clarify and explicitly state what was already included in the un-amended definition of ‘conveyance’. There can be no manner of doubt that even if the legislature has not effected the amendment and included the clause in clause (g) of section 2 of the Bombay Stamp Act, it would make no difference to the legal issue at all. A scheme of amalgamation approved by the court in exercise of jurisdiction under the Act and given effect to thereafter, where under property is conveyed from one company to another, is covered within the un-amended definition of the term ‘conveyance’ in the Bombay Stamp Act as well. The same would, therefore be eligible to stamp duty under section 3 of the 1899 Act.

Merely because the legislature has not amended the existing statutory provision as applicable to Delhi to specifically include transfer of property under an order approving of the scheme of amalgamation in the definition of ‘conveyance’ it is of no consequence at all. The same does not amount to exclusion from applicability of the 1899 Act and chargeability to stamp duty there on. The statutory definition of ‘conveyance’ under section 2(10) of the 1899 act is an inclusive definition of wide import which cannot be confined to specific instruments mentioned in the statue.

---

278 Dileworth v. Commission of Stamps (1899) AC 99 at p. 105.
280 Para 8.21 of the above judgement.
Nonetheless, the ruling of Delhi High Court assumes great importance in deciding the stamp ability of mergers in states which have not enacted their separate stamp legislation. Thus, its possible impact upon such states cannot be over emphasised. In its recent judgement of *Emami Biotech Ltd. In re*, the Calcutta High Court has held that:

“An order sanctioning a scheme of amalgamation or demerger under section 394, therefore, answers to the description of the words ‘instrument’ and ‘conveyance’ within the meaning of the Stamp Act applicable in the state and is accordingly eligible to stamp duty. No property transferred pursuant to any scheme of amalgamation or merger or demerger in the state would be effective unless appropriate stamp duty there on has been paid.”

5.9.7. Rates of Stamp Duty

“The fairer and lower tax rates are, the less tax evasion, avoidance and non-compliance there will be.”

Arthur B. Laffer

A review of stamp duties of states and Union Territories in India as compared to other countries of Asia indicates that stamp duty rates on conveyance in number of states is exceptionally high. These high rates impose high compliance costs on taxpayers which further leads to considerable evasion and fraud. Evidence indicates that the present high duty rates, coupled with poor implementation and administration, have lead to a situation where there is a considerable financial loss to the exchequer on account of understatement of sale proceeds, non-registration and consequent non-payment of stamp duty and avoidance of capital gains tax. It has been observed historically that lowering and rationalisation of direct and indirect tax rates generates superior revenues both in terms of generation and collection.

---

281 (2012) 112 SCL 33 (Cal.).
282 Propounder of famous Laffer Curve. The gist of the theory is that tax revenues would be zero if tax rates were either 0 percent or 100 percent, and somewhere in between 0 percent and 100 percent is a tax rate which maximises total revenue. Laffer’s innovation was to conjecture that the tax rate that maximises revenue was at a much lower level than previously believed: so low that current tax rates were above the level where revenue is maximised as quoted in Rahul Jain, “Need for Rationalisation of Stamp Duty Rates in India”, *SEBI and Corporate Laws*, 9-15 March 2009, Vol. 90, pp. 96-106, p. 96.
In this context, it is worthwhile to mention about the World Bank, Draft Report of 2000, which cites the example of the State of Rajasthan, which achieved a 36 percent increase in revenue between 1996-97 and 1998-99 by reducing stamp duty rates from 12 percent to 7 percent in 1996-97.\textsuperscript{285} In case of Delhi, when the stamp duty on immovable properties was reduced from 13 percent to 8 percent, there was an increase of 48 percent in the revenue between 2003-04 and 2004-05.\textsuperscript{286} Lowering of stamp duty rates will increase revenue in long run by promoting registration of properties and preventing illegal evasion of tax by understating the valuation of property. Moreover, it will have other benefits like encouragement in real estate investment, boost to FDI in India through investment by non-resident Indian and Foreign Institutional Investors and increase in M&A activity in India. Therefore, in addition to reduction in stamp duty rates, there is need for lowering and uniformity in stamp duty rates across India as varying rates creates confusion and proves a hindrance in M&A activity.

5.10. Conclusion

Despite continuing economic uncertainty and underlying concerns about a double-dip recession in many developed markets, M&A is still high on the agenda of large companies.\textsuperscript{287} The focus on the tax aspects in M&As is intensifying as tax becomes even more important to deal processes and valuations than it was before. A company planning a merger or a takeover, need to do intensive tax planning before finalising the deal to get the maximum tax concession and benefits in the deal. In India, law provides for ample benefits in the form of various provisions to companies going in for amalgamation. A very good incentive is provided for revival of sick units in the form of section 72A. With the introduction of section 72A in 1978, many mergers-look place to avail the tax benefits. But in today’s scenario, we can assert that the tax consequences are the off-shoot of the merger and not vice versa.


\textsuperscript{286} Rahul Jain, 2009, p. 98.

Tax laws in many countries tend to be complex, but with India beginning to occupy an increasingly important place on the world stage, the benchmark for comparison has to be changed.\textsuperscript{288} The Indian tax laws need to be made less complex, transparent and more certain. Certainty and stability form the basic foundation of any fiscal system. But this principle was totally disregarded by the retrospective tax amendments introduced by the Finance Act, 2012 with retrospective effect from 1 April 1962. The uncertainty created by these amendments and deviation from international practices prevailing had a negative impact on the investors sentiment and the Indian economy saw a rapid decline in FDI to India (almost 65 percent in April-June 2012).\textsuperscript{289} That’s why, Government constituted Shome Committee to provide for recommendations on taxation of indirect transfers. The recommendations (mentioned earlier) truly align with norms of certainty, predictability and stability of tax laws. But the Government did not follow the recommendations and the provisions regarding retrospective amendments of indirect transfer were retained. So the researcher, has given certain suggestions regarding this in the last chapter to make the law more certain, clear and predictable. If after five years of the deal, the laws can be suddenly amended with retrospective effect to bring the deal within the taxation net (as in Vodafone case), it is certainly going to shake investors confidence.

In addition to various benefits available to companies on amalgamations, tax implication of share acquisition and business acquisition are different and should be taken care of by the prospective buyer or the seller. In a country, where there is steep increase in financial transactions with large number of mergers and acquisitions happening, there is a need to post an efficient, reliable and transparent transfer pricing regime having regard to the implications it can have on the international trade. Though, we can be proud of having a more reliable transfer pricing provisions compared to other

\textsuperscript{288} Gaurav Goel, “Cross-border Mergers and Acquisitions-Addressing the Taxation Issues from an Indian Perspective”, retrieved from \url{http://www.cacclubindia.com/articles/cross-border-m-a-taxation-issue-2031.asp}, accessed on 12 June 2014 at 12. 10 pm.

countries, the need to emerge as a stronghold of the international trade, India has to reinvigorate its taxing procedures.\textsuperscript{290} No doubt, India has done so by introducing provision of Advance Pricing Agreement and further clarifying safe harbour provisions in its Finance Act, 2012, to further bring its transfer pricing regime according to international norms and standards and it should continue to do so.

Now, the most controversial of all-GAAR. After the positive policy recommendation on GAAR by the Shome Committee, it will have to be seen how many recommendations of the committee are incorporated in the rules which are to be made by the government. Given the inherent subjectivity involved in GAAR application, it does carry the risk of arbitrariness in tax administration. Therefore, GAAR need to be implemented judiciously and sensibly with adequate safeguards.

Let’s not forget to say few words on the uncertainty created in the Indian tax environment by the rulings of various judicial forums. But the recent trend seems to be that the Indian tax authorities will pierce the corporate veil to look into the real nature of a transaction to determine the capital gains chargeable to tax in India. Although the decision in \textit{Idea Cellular Case},\textsuperscript{291} is fact specific is nonetheless likely to have wide repercussions.\textsuperscript{292} The intention to bring overseas M&A within the Indian tax net is further fortified by the retrospective tax amendments in the Income Tax Act. Thus, given the potential tax implications of such deals, tax payers need to consider the risks and potential pitfalls to avoid unintended consequences.

Moreover, as regards implications of stamp duty in mergers and amalgamations, the researcher can conclude that the applicability of stamp duty on the court order approving the scheme of arrangement has been a keenly disputed issue for a considerable period of time owing to lack of preciseness in the Indian Stamp Act.

\textsuperscript{290} S. Madhu, “Implications of Transfer Pricing in India”, retrieved from \url{http://www.indialawjournal.com/volume1/issue3/articlebymadhu.html}, accessed on 5 September 2013 at 4.21 pm.

\textsuperscript{291} \textit{Aditya Birla Ltd. v. DDIT} (2011-T11-26 HC-MUM-INTL).

Initially, companies used to take a position that the court orders are not ‘conveyance’ as defined under the stamp duty law, therefore no stamp duty is payable on the same.

In order to overcome the above contention, some of the states amended their stamp duty provision and included a specific entry for court orders passed under section 394 of the Companies Act. But consequent to such amendments, companies started taking a position that stamp duty is payable only in the states that have a specific entry for the court orders.

Though, in the judgement of Hindustan Lever Ltd. Supreme Court laid down that the court order is a conveyance and therefore subject to stamp duty but the certain companies continued to take the position that since this judgement was in the context of Bombay Stamp Act, it is not applicable to the states that do not have any specific entry and even some states took the position since transfer of property in a scheme happens by way of vesting, pursuant to a court order, and therefore, cannot be regarded as an instrument. This view was particularly taken by Division Bench of Calcutta High Court in Madhu Intra case. Thus, multiplicity of High Court rulings pointing in different directions has created a lot of confusion. Therefore, it is submitted that the Indian Stamp Act be suitably amended to avoid such extensive litigations in future. To add to it the Indian Stamp Act is one such legislation without an express inclusion for a scheme of arrangement which has resulted in a great amount of uncertainty in cases that involve amalgamation of companies registered in states governed by the Indian Stamp Act. But recently, the Delhi High Court had tried to remove the above uncertainty by including court order under Section 394 in the definition of conveyance and hence stampable irrespective of a specific entry in the States Stamp Act. Nonetheless, the ruling of Delhi High Court assumes great importance in deciding stampability of mergers in states which have not enacted their separate stamp legislation. Thus, its possible impact upon such states cannot be over-emphasised.


The lack of uniformity of acceptance of a single standpoint throughout the country and differential stamp duty regime in different states has created acute confusion on the issue. It is high time that the Indian Stamp Act is amended to make this legal issue abundantly clear, so that unnecessary litigation is avoided. Such a pragmatic policy should be made possible without discrimination throughout the country.

In addition to uniformity of stamp law, stamp duty rate should also be lowered all over India. It should also be lowered down as lower rates of stamp duties translate into increased revenues for the government in the long run. Lower and rationalised stamp duty rates will promote M&A activity in India. It will encourage cross-border mergers as foreign companies will like to invest in India. In rest of Asia, rates are on an average 2-3 percent whereas in India, they are around 8-10 percent. Even the planning commission in its 10th Five Year Plan has stressed upon the legislature reforms for rationalisation and reduction of stamp duty rates in various states in India to 3-5 percent.\(^\text{295}\) In the views of the researcher, stamp duty rates should be reduced at around 3 percent so that other Asian Countries do not have an edge in attracting foreign investment than India. The above mentioned reforms in M&A activity should be carried out at the earliest to promote and smoothen the process of M&As in India.

To conclude, we can say that the tax laws face a huge challenge in the present scenario. A balance have to be maintained between the interest of both domestic and international investors and the revenue-authorities. India has to reinvigorate its tax laws in such a way that M&A are not negatively affected and tax avoidance and evasion is also checked. So, the current scenario presents this daunting task to the Indian legislators.