



File photo of attendees at the Comic-Con International convention in 2015. (Photographer: Patrick T. Fallon/Bloomberg)

The Wrath Of GAAR Falls On Schemes

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If company law schemes are designed to benefit a few large shareholders and do not serve a larger public interest, the wrath of General Anti-Avoidance Rules (GAAR) may fall upon them. That's the message from the National Company Law Tribunal which recently refused to sanction a scheme of amalgamation between public listed company [Ajanta Pharma Ltd.](#) and promoter entity Gabs Investment.

Scheme Design

The proposed scheme entailed the merger of Gabs Investments with Ajanta Pharma. The Agrawal family, as promoters of Ajanta Pharma, hold 61.17 percent in the company and 100 percent in Gabs Investment. Gabs Investment in turn

holds 9.54 percent in Ajanta Pharma. Post the merger, it was proposed that Ajanta Pharma would issue shares to Gabs Investment's shareholders. This would've led to an increase in the shareholding of individual members of the Agrawal family.

Gabs approached NCLT Mumbai to sanction the scheme of merger with the rationale that it would simplify the shareholding structure of the promoters. The scheme was approved by Ajanta Pharma and 99.9 percent of its shareholders.

Tax Concerns

The Companies Act, 2013 requires the NCLT to notify the tax department when a scheme of arrangement is proposed. The department objected to this merger on grounds that it's a deliberate measure to avoid tax and is an impermissible avoidance agreement that violates GAAR. These are rules that seek to plug tax avoidance.

The tax department argued that the merger would lead to a revenue loss of Rs 421 crores based on the following assumptions -

- Since Gabs Investment is a separate legal entity, its assets cannot be transferred to the shareholders without any tax liability.
- If the assets (shares of Ajanta) are sold to the promoters and the income distributed as dividends, then it would attract a 20 percent dividend distribution tax. If the merger is approved, this tax would not come into play.
- Also, the business profit on the sale of Ajanta Pharma's shares by Gabs Investment would attract an income tax of 30 percent. This because Gabs was in the business of dealing in equity shares. If Gabs Investment chose another method of computing this income, then 20 percent Minimum Alternate Tax would be payable. This, again, would be lost if the merger is approved.

NCLT View And Impact

The Mumbai bench of the NCLT agreed with the tax department's concerns. It pointed out that any transfer of property from one entity to another has to be treated as sale or transfer that has to comply with all applicable laws, including any tax liability. It also pointed out that as a result of this merger, the promoters

will acquire additional shares above the prescribed limit i.e. 5 percent of voting rights within a financial year, triggering a mandatory open offer under SEBI's Takeover Regulation. And since the scheme fails to contemplate one, it falls foul of the regulations .

The proposed merger is devised to benefit only the common promoter shareholders and doesn't serve any public interest, the tribunal concluded. In doing so, it relied on the National Company Law Appellate Tribunal's ruling in Wiki Kids case. The NCLAT had held that if a scheme of amalgamation is not fair to all shareholders and only in the interest of the promoters, it cannot be approved.

Further, the NCLT also pointed out that the Agrawal family holds a stake in Ajanta Pharma not only through Gabs Investment but also through other promoter entities like a trust. And so, the proposed rationale for the scheme, to make promoters direct shareholders in Ajanta Pharma, has no justification.

This is a very unusual approach and very different from how high courts and the Supreme Court have looked at schemes of arrangements, Rajesh Simhan, head of the international tax practice at Nishith Desai Associates told BloombergQuint. So far, courts have held that the scheme must not be against public policy – it's a negative test- and not that a scheme should be in the interest of public policy, which is a positive test.

“The NCLT, in its reasoning, has not even distinguished its opinion from the precedents that were cited. For instance, in Mafatlal's case, the Supreme Court has clearly laid down that courts cannot sit in judgment of the commercial wisdom of the parties. And when the shareholders of both the companies had approved the scheme and the registrar of companies hadn't filed any objection, it's surprising that the NCLT is sitting in judgment over it.”

Rajesh Simhan, Head- International Tax Practice, Nishith Desai Associates

The courts have also held that if the revenue department has tax concerns, those can be addressed and pursued as part of the assessment; nothing precludes the authorities from doing so, he added.

Under the provisions of income tax law, GAAR can be invoked by a tax officer subject to an approval by the concerned Commissioner of Income Tax and finally by the GAAR approving panel headed by a retired high court judge, Sanjay Sanghvi, senior tax partner at law firm Khaitan & Co. explained. ‘ Without the approval of the panel, GAAR provisions cannot be applied,’ he added.

Daksha Baxi, a partner at law firm Cyril Amarchand Mangaldas concurred. A merger of two companies has been recognised and permitted as a legitimate corporate transaction, she pointed out.

“The tax department is within its legitimate right to raise GAAR. However, for invoking GAAR, the statute has provided a process. It is fair to expect that when GAAR is invoked, this process is complied with. Perhaps the NCLT could have noted that the scheme is not tax neutral in view of the objections of the tax department. ”

Daksha Baxi, Partner, Cyril Amarchand Mangaldas

The NCLT decision will fetter promoters’ ability to simplify their shareholding through schemes and while it’s likely that the Supreme Court will take a taxpayer-friendly view, there would be a lot of litigation in the interim, especially since the NCLAT has taken a similar stance in Wiki Kids case, Simhan pointed out.