Tax Hotline

May 26, 2022

NCLT APPROVES SCHEME OF AMALGAMATION AND REJECTS TAX DEPARTMENT'S OBJECTION ON LOSS OF TAX REVENUE AND INVOCATION OF GAAR

- The Scheme was being implemented for business consolidation and operational synergies and the tax benefits were merely consequential;
- The provisions of the ITA providing for tax neutrality and carry forward and set off of losses are sufficient to protect the interest of revenue;
- The issues concerning carry forward of losses, and invocation of GAAR may come up for consideration at the time of assessment proceedings.

Recently, the National Company Law Tribunal, Chandigarh Bench ("**NCLT**") approved the Scheme of Amalgamation ("**Scheme**") between Panasonic India Private Limited ("**Transferor**") and Panasonic Life Solutions India Private Limited ("**Transferee**") (collectively referred as "**Petitioner Companies**").[1] The Income Tax Department ("**ITD**") made certain representations before the NCLT *inter-alia* stating that the Scheme is not at arm's length, the main objective is to take benefit of the carry forward of losses of Transferor and the provisions of the General Anti-avoidance Rule ("**GAAR**") should be invoked. However, the NCLT did not find substance in the representations made by the ITD and approved the Scheme ("**Ruling**").

BACKGROUND

The Transferor and the Transferee filed an application praying for sanctioning of the Scheme before the NCLT. As per provisions of the Companies Act, 2013[2] and directions of the NCLT, notice of hearing was served upon (a) Ministry of Corporate Affairs, (b) Competition Commission of India, (c) Registrar of Companies, (d) Official Liquidator and (e) ITD. All the authorities (except the ITD) did not have any adverse observations in respect of the Scheme. However, the ITD made certain observations, which have been detailed below.

REPRESENTATIONS AND RESPONSES

Representations by the ITD

- The effective ownership of the Petitioner Companies was held with M/s Panasonic Corporation, Japan ("**Panasonic Japan**").
- The Scheme was not at arm's length and could not be termed as a prudent acquisition on any commercial terms and all the benefits accrued to Panasonic Japan only.
- The main objective of the Scheme was to transfer the accumulated losses of INR 14,375 million (~USD 185 million) from the books of the Transferor to the Transferee, which will be eligible for set off in future periods for the Transferee and result in huge tax losses.[3] The ITD also alleged that there will be a loss of tax revenue on account of possible non–payment of capital gains realizable by the shareholders of the Transferor while selling shares of the Transferee, as these shareholders are residents of Singapore and the Netherlands, and will enjoy the benefit of the respective tax treaties.
- The Scheme was a vehicle to achieve the tax benefit in form of transfer of accumulated losses of Transferor to Transferee, hence, GAAR provisions should be applicable.
- Although there were huge accumulated losses in the books of the Transferor and it was having a negative net worth, the shareholders of the Transferor would be benefitted as they will receive 25,91,034 shares of the Transferee (which is a profit-making company) worth INR 10 each.

Response by the Petitioner Companies

- The Scheme was entered into for various commercial reasons which include reduction in operating and marketing costs, economies in procurement, increased value to customers, offering holistic customer solutions, and enhancing shareholder's value.
- The Income-tax Act, 1961 ("**ITA**") contains provisions providing for the tax neutrality of the merger in the hands of the transferor company[4] and its shareholders[5]. Hence, if the conditions for tax neutrality provided in the ITA are fulfilled, then the ITD cannot argue that the Scheme will be prejudicial to interest of ITD.

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- On the valuation aspect, that the shareholders of the Transferor were getting shares in the Transferee against the negative net worth of the Transferor, it was argued that the swap ratio was based on the computation done by the registered valuer. Further, the imputed value of INR 25.91 million (2.59 million shares of INR 10 each), was the face value of each share, and not the actual value.
- The ITA provides for certain conditions which the Petitioner Companies need to fulfil for carrying forward and set-off of unabsorbed business losses and unabsorbed depreciation of the Transferor in the hands of the Transferee.[6] The assessing officer ("**AO**") can verify if these conditions were fulfilled at the time of completion of the assessment.
- The non–resident shareholders of the Transferor would anyways not have any obligation to pay capital gains tax on the transfer of shares of the Transferor if the amalgamation did not take place, as they would be eligible for relief under India's tax treaty with the Netherlands and Singapore.
- The Petitioner Companies objected to the invocation of GAAR stating that the amalgamation is not an 'impermissible avoidance arrangement' ("**IAA**")[7] and its main purpose is not to obtain tax benefits. Further, reliance was also placed on the Supreme Court decision in case of *Vodafone International Holdings BV vs UOI*[8] wherein it was held that the ITD cannot disregard a transaction unless its sole motive is to avoid tax, which otherwise does not lack business/commercial substance.
- The Petitioner Companies also objected to reliance by the ITD on Mumbai NCLT's ruling in Gabs Investment and Ajanta Pharma[9] and in the NCLAT's decision in Wiki Kids[10], as the facts of these cases are distinguishable. In both the cases, the transferor companies did not have any business activity and were merely holding shares of the transferee companies which were listed entities. The rationale for amalgamation in both cases was merely simplification of the shareholding which was beneficial only to a few promoters, and there was no benefit to the public shareholders at large.

RULING

The NCLT approved the Scheme and observed the following:

- The facts of the instant case are distinguishable from the facts in case of *Gabs Investment and Ajanta Pharma (supra)* and *Wiki Leaks Ltd (supra)*. In the present case, the Petitioner Companies have spelt out the operational synergies, which in the opinion of the NCLT justify the claim of the Petitioner Companies that the Scheme was for business consolidation and the tax benefits were merely consequential.
- The ITD was unable to point out any adverse issue concerning the valuation of shares after the copy of the valuation report and the exchange ratio report was provided to the ITD.
- The treatment of carry forward and set off of a loss in amalgamation or demerger is provided under the ITA with additional conditions regarding a change in the shareholding pattern.[11] The NCLT opined that these conditions were sufficient to protect the interest of the ITD in any case of amalgamation or demerger.
- Further, even if the Scheme is approved by the NCLT, it does not override the provisions under the ITA. Hence, the issues concerning carry forward of losses, and invocation of GAAR may come up for consideration at the time of assessment of the Petitioner Companies, and the AO may deny any benefit to the Petitioner Companies as per the provisions under the ITA.
- In so far as invocation of GAAR is concerned, the ITD is at the liberty to invoke the provisions if the AO during the course of assessment or reassessment proceedings believes that GAAR should be invoked but GAAR provisions will have to be invoked as per the procedure provided in the ITA[12].

ANALYSIS

Indian tax authorities have challenged scheme of arrangements by alleging applicability of GAAR at NCLT level, in the past as well. The Ruling is a positive signal to taxpayers considering that the NCLT noted that as long as the conditions specified under ITA for tax neutrality and carry forward and set off of losses are satisfied, the interest of revenue can be considered to be protected.

GAAR provisions under the ITA came into effect from April 1, 2017.[13] The GAAR provisions enable tax authorities to declare an arrangement to be an Impermissible Avoidance Arrangement ("**IAA**") and provide broad powers to tax authorities to determine tax consequences by disregarding any structure, reallocating or recharacterizing income, denying treaty relief, etc.[14] Since the introduction of GAAR, taxpayers have been concerned regarding aggressive approach which may be taken by tax authorities, however, until recently, GAAR provisions were not been invoked by the tax authorities under the ITA.[15]

The Central Board of Direct Taxes ("**CBDT**") clarification on implementation of GAAR provides that where NCLT has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.[16] In the instant case, while the NCLT had considered tax implications of the Scheme under the ITA, it did not discuss whether the Petitioner Companies were fulfilling these conditions. Therefore, one may argue that NCLT has not explicitly and adequately considered the tax implication of the Scheme. This also seems to be in line the NCLT observation that issues with respect to carry forward of losses and GAAR etc. will come for consideration before the AO in the course of the assessment proceedings.

Having said this, it is important for tax authorities to be mindful that GAAR provisions cannot be invoked merely to protect the interest of revenue (as alleged by the ITD in the instant case). As per the provisions of the ITA, GAAR can be invoked only when the main purpose of an arrangement is to obtain tax benefit[17] and it satisfies one of the four tainted element tests.[18] The scope of 'primary' or 'main' purpose in the context of GAAR has been examined in several international judicial precedents. For instance, the Federal Court of Appeal in Canada, in *The Queen v. Spruce Credit Union*,[19] has observed that a mere fact that tax implications played an important role does not lead to the conclusion that the primary purpose is to obtain a tax benefit and that such transaction should be characterized

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as an avoidance transaction. In order to ensure tax certainty and stability, the threshold for invoking GAAR should be high and it should be invoked in cases where there is no apparent commercial rationale for undertaking the transaction.

Another important aspect to be considered by taxpayers is the interplay of specific anti-abuse rules ("**SAAR**") and GAAR provisions. The CBDT has clarified that the provisions of GAAR and SAAR can co-exist as SAARs may not address all situations of abuse. Therefore, in addition to satisfying the existing SAARs under the ITA, it is important to have considerable commercial substance and justification (corroborated by appropriate documentation) to ensure that there is sufficient ground to challenge application of GAAR (if invoked by tax authorities).

– Vibhore Batwara & Ipsita Agarwalla

You can direct your queries or comments to the authors

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[1] Panasonic India Private Limited and Panasonic Life Solutions India Private Limited, CP (CAA) No.8/Chd/Hry/2021

[2] Section 230(5) read with Section 232(1) of the Companies Act, 2013

[3] In this regard, the ITD placed reliance on the NCLT Mumbai bench's decision in case of *Gabs Investment and Ajanta Pharma (CSP No.995 and 996 of 2017 and CSA No.791 and 792 of 2017)* wherein the NCLT Mumbai did not sanction the amalgamation of Gabs Investment into Ajanta Pharma primarily based on the objection from the ITD that huge tax liability was avoided and the scheme was not in the public interest.

[4] Section 47(vi) of the ITA exempts any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company

[5] Section 47(vii) of the ITA exempts 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, if— (a) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company except where the shareholder itself is the amalgamated company, and (b) the amalgamated company is an Indian company

[6] Section 72A of the ITA read with Rule 9(C) of the Income Tax Rules, 1962.

[7] Section 96 of the ITA.

[8] Vodafone International Holdings B.V. Vs. Union of India & Anr. (41 ITR 1).

[9] Supra note 3

[10] Wiki Kids Ltd. and Ors. Vs. Regional Director, South East Region and Ors. in Company Appeal (AT) No.285 of 2017 decided on 21.12.2017.

[11] Section 79 of the ITA provides that the accumulated business losses of a company may not be carried forward and set off, if on the last day of the previous year, pursuant to a change in shareholding, shares representing at least 51% of the voting power of the company are no longer *beneficially* held by persons who beneficially held shares representing 51% of the voting power of the company on the last of day of the year in which the losses were incurred.

[12] Section 144BA provides for procedure for invoking the GAAR:

i. If the AO having regard to the material and evidence available to him at the time of assessment or reassessment, consider it necessary to invoke GAAR provisions, then he should make a reference to the Principal Commissioner or Commissioner.

ii. On receipt of the reference, if the Principal Commissioner or Commissioner is of the opinion that the GAAR provisions are required to be invoked, he may provide an opportunity of being heard to the assessee.

iii. (a) If the assessee does not furnish any objection to the notice, the Principal Commissioner or Commissioner may invoke the GAAR provisions.

(b) In case the assessee objects, and the Principal Commissioner or Commissioner after hearing the assessee in the matter is not satisfied by the explanation of the assessee, then, he shall make a reference in the matter to the Approving Panel for the purpose of invoking GAAR.

iv. The Approving Panel, on receipt of a reference from the Principal Commissioner or Commissioner, shall issue such directions, as it deems fit, in respect of invoking the GAAR provisions.

[13] Chapter X-A of the ITA (Section 95 to 102 of the ITA)

[14] Section 98 of the ITA.

[15] Recently, the Approving Panel has approved the invocation of GAAR in a case as per section 96(1)(d) and a Writ Petition against such approval has been admitted before the Telangana High Court (Writ Petition No 21210 of 2022)

[16] Response to question no. 8 in Circular no. 7 of 2017.

[17] Section 102(10) of the ITA defines the term 'tax benefit' *inter-alia* includes a reduction or avoidance or deferral of tax or other amount that would be payable under the ITA, or an increase in refund of tax or other amount under the ITA, or a reduction in total income or an increase in loss

[18] Section 96 of the ITA

[19] 2014 FCA 143
