

Detailed representations

1. Clarify that definition of ‘undertaking’ in section (s.) 2(19AA) covers hiveoff of business through divestment of shares of operating subsidiary

Background

- ▶ S. 47(vib)/(vid) of the Income tax Act (‘Act) provides for exemption from capital gains taxation to the resulting company as well as the shareholders in case of a ‘demerger’ where resulting company is an Indian company.
- ▶ Similar exemption is also provided in s.47(vic) w.r.t. capital gains arising from transfer of shares of an Indian Company or shares of a foreign company deriving substantial value from shares of an Indian company, held by the demerged foreign company to the foreign resulting company.
- ▶ For this purpose, the term ‘demerger’ is defined in s. 2(19AA) to mean a transfer of one or more ‘undertakings’ by the demerged company to a resulting company subject to satisfaction of conditions specified therein.
- ▶ Explanation 1 to s. 2(19AA) defines ‘undertaking’ to include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole but specifically excludes individual assets or liabilities or any combination thereof not constituting a business activity.

Issue

- ▶ In many cases, businesses are housed in an operating subsidiary company for regulatory or commercial reasons.
- ▶ For instance, extant RBI or IRDA or SEBI guidelines do not permit banking, NBFC, insurance or AMC business to be undertaken along with any other business activity under the same legal entity. Any business group desiring to enter any such regulated business is required to set up a separate SPV/subsidiary to undertake such business.
- ▶ Similarly, in infrastructure sector, separate SPVs are required to be set up for executing individual infrastructure projects due to mandate of tender conditions issued by NHAI.
- ▶ Even commercially, business groups find it more expedient to commence any new business within the fold of a new subsidiary for diverse reasons like protection of existing business from risks of new business, invite PE investors, ease of divestment, etc.

- ▶ In this regard, it may be noted that, while the business/ project may be housed in a separate subsidiary/SPV, the holding company and its management are actively involved in the business of the SPV. The holding company raises borrowing for the SPV through its own credentials. The financial parameters of the holding company and other subsidiaries like turnover, net worth, work experience, past performance, etc. are considered for granting new projects to SPV. The operating subsidiary is virtually identified as extension of business group.
- ▶ S.2(19AA) refers to transfer of an 'undertaking' from one company to another. There is an ambiguity whether it encompasses ownership of business through operating subsidiary and transfer of shares of such operating subsidiary as a mode of transfer of business.
- ▶ More particularly, in regulated businesses, it is difficult to transfer the business from one legal entity to another. Even the acquiring business group is required to house the business activity in a separate company. Hence, the transfer of shares of the operating subsidiary is a more efficient mode of hive off of business.
- ▶ This also resonates with divestment programme of Government where Government transfers shares representing controlling interest in an operating company (like Air India) to successful bidder from private sector instead of transferring the business from the legal entity.
- ▶ S. 2(19AA) already has protective conditions in respect of court approved scheme, continuity of business in the form of transfer of all assets and liabilities, going concern requirement, 75% of shareholders of demerged company becoming shareholders in resulting company, etc. Further, it requires consideration for transfer to be paid in the form of issue of shares of resulting company to shareholders of demerged company.
- ▶ If the definition of 'undertaking' is expressly clarified to include shares representing controlling interest in operating subsidiary, it will clear the ambiguity in the matter and enable business groups to undertake demerger of operating subsidiary in a tax efficient manner. There is no revenue loss to the Government since the resulting company and shareholders of demerged company inherit the same tax cost as demerged company. The tax cost of shares of operating subsidiary in the hands of the demerged company will become tax cost in hands of resulting company (Refer, s.49(1)(iii)(e)). In the hands of shareholders of demerged company, the tax cost of demerged company shares is prorated on the basis of net book value of assets and split between shares of demerged company and shares of resulting company (Refer, s.49(2C)/(2D)).

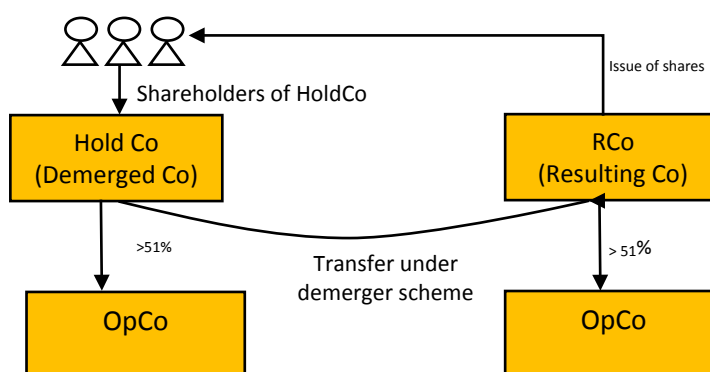
- ▶ For transfer of business undertaking in demerger, s.72A(4) permits transition of business loss and unabsorbed depreciation relating to the demerged undertaking to the resulting company. In case of transfer of shares of operating subsidiary, there will be no requirement to transition such loss or unabsorbed depreciation since the losses/unabsorbed depreciation remain within the fold of subsidiary company. However, a consequential amendment is required in s.79 to protect the carry forward of business loss in the hands of the operating subsidiary, being a closely held company, in view of change in shareholding beyond 49%.

Recommendations

- ▶ It is recommended that S. 2(19AA) be amended to expressly clarify that shares of operating subsidiaries qualify as eligible undertaking capable of being demerged in a tax-neutral manner under a court-approved scheme.
- ▶ Furthermore, a consequential amendment be also made to s.79 to protect the carry forward of business loss in the hands of the operating subsidiary, being a closely held company, in view of change in shareholding beyond 49% by such court approved demerger.

Illustration to demonstrate ability of existing tax framework to ensure that ‘tax neutrality’ granted to hiveoff of business through divestment of shares of operating subsidiary does not result in tax leakage

Below is a simple illustration which shows that once such amendment is made, the existing framework of demerger related provisions in the Act ensure that the transaction is tax neutral for demerged company, its shareholders and resulting company.



Assume that Hold Co (Demerged company/DCo) holds more than 51% shares in OpCo which is an operating subsidiary in a regulated business. The transaction of demerger involves transfer of shares in OpCo to RCo (Resulting company) under NCLT approved demerger scheme in consideration of which RCo issues its own shares to shareholders of DCo. All three companies DCo, OpCo and RCo are Indian companies.

All other conditions of 'demerger' u/s. 2(19AA) are fulfilled as follows :-

1. Entire shareholding in Opco is transferred by DCo to RCo which results in transfer of all the assets and liabilities of regulated business carried on by OpCo getting transferred to RCo by virtue of demerger
2. The transfer of shares of OpCo is at value in compliance with clause (iii) of s.2(19AA)
3. In consideration of demerger, RCo issues its own shares to shareholders of DCo on a proportionate basis
4. Shareholders holding not less than 75% of value of shares in DCo become shareholders in RCo by virtue of demerger
5. The control over regulated business carried on by OpCo is transferred on a going concern basis through the medium of transfer of shares

The Balance Sheet of DCo prior to demerger is as follows :-

Liabilities		Rs. in Cr	Assets	Rs. in Cr
Share Capital (A)	500		Shares of OpCo	1000
General Reserves (B)	1500		Other Assets	2000
Net worth (A + B)		2000		
Liabilities (unrelated to OpCo shares)		1000		
Total		3000	Total	3000

RCo will issue its own shares to shareholders of DCo on proportionate basis based on fair exchange ratio as determined by registered valuers/merchant bankers and approved by shareholders and creditors of both DCo and RCo, NCLT and other regulatory authorities like RBI, IRDA, SEBI, etc.

One of the shareholders of DCo is Mr. X who holds 20% in DCo. The cost of such shares in his hands is Rs. 100. By virtue of demerger, he gets proportionate shares of RCo.

Tax implications in hands of DCo (Demerged company)

1. The transfer of shares of OpCo to RCo will be exempt from capital gains u/s. 47(vib)
2. The transfer of shares of OpCo of Rs. 1000 will be reduced from Reserves of DCo. But it is clarified by s.2(22)(v) that such reduction does not constitute 'dividend' in the hands of shareholders of DCo.

Tax implications in hands of RCo (Resulting company)

1. The tax cost of OpCo shares in hands of RCo will be same as cost of acquisition in the hands of DCo i.e Rs. 1000. (Refer, s. 49(1)(iii)(e) r.w.s 47(vib)).

2. Furthermore, the holding period of shares of OpCo in hands of RCo will include the period for which shares were held by DCo. (Refer, Exp 1(b) to s. 2(42A)r.w.s 49(1))
3. The receipt of shares of OpCo does not trigger 'gift tax' implications in hands of RCo u/s. 56(2)(x) in view of clause (IX) of proviso to s.56(2)(x) in terms of which transaction exempt u/s. 47(vib) is excluded from the applicability of s.56(2)(x)

Tax implications in hands of OpCo

1. There is no tax implication in hands of OpCosince there is mere change in its shareholding. However, if OpCohas brought forward losses, it may lapse due to change in shareholding beyond 49% for which it is represented that consequential amendment may be made in s.79 to protect carry forward and set off of such losses.

Tax implications in hands of Mr. X – shareholder of DCo

1. Mr. X gets shares of RCo in addition to holding in DCo. It is clarified by s.2(22)(v) that such receipt does not constitute 'dividend' in hands of Mr. X
2. The transaction of receipt of shares of RCo is not regarded as 'transfer' u/s. 47(vi)
3. The receipt of shares of RCo is protected from 'gift tax' implications u/s. 56(2)(x) in view of clause (IX) of proviso to s.56(2)(x) in terms of which transaction exempt u/s. 47(vi)/(vii) is excluded from the applicability of s.56(2)(x)
4. The cost of acquisition of shares of DCo of Rs. 100 will be split between shares of DCo and RCo in the proportion of net book value of assets of DCo to 'net worth' (i.e share capital + general reserves) of DCo. The split will be as follows :-

Particulars	Prior to demerger	Ratio of net book value to net worth	Post demerger	Section
Cost of shares of RCo	-	1000 (50%)	50	49(2C)
Cost of shares of DCo	100	2000	50	49(2D)
Total	100		100	

Furthermore, the holding period of shares of RCo will include period for which shares of DCo were held by Mr. X (Refer, Exp 1(g) to s.2(42A))

In future, if Mr. X sells shares of RCo, the cost of acquisition will be taken at Rs. 50