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Definition of 'Amalgamation' under the Income Tax Act: Some Practical Aspects Regarding the Qualifying Conditions

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ABSTRACT

Nature of payment of merger consideration is a key aspect with respect to the tax neutrality of mergers. This manuscript briefly examines the concept of amalgamation under the Income-tax Act, 1961, and the immediate implications arising if the specific conditions prescribed under the Act are not fulfilled. It is observed that the tax neutrality of an amalgamation appears to hinge largely on clause (iii) of Section 2(1B) of the IT Act. If an amalgamation does not qualify this clause, the tax neutrality of the transaction may be impacted. Hence, the share swap ratio needs to be computed appropriately to ensure that there are no adverse tax implications to any of the parties in the merger.

Keywords: *Merger; Amalgamation; Income Tax Act.*

1.0 Introduction

Mergers in India are typically structured as tax-compliant transactions. This ensures that none of the stakeholders have any adverse tax consequences on account of the transaction. Further, tax compliant mergers allow some successor entities to avail the benefit of setting off accumulated tax losses of the predecessor company[1]. However, in certain scenarios like a third-party acquisition, minority squeeze out etc., stakeholders may consciously choose to not comply with the tax provisions, making the merger non-compliant for tax law purposes. This may be achieved if the transaction does not qualify as an "amalgamation" under the Indian Income-tax Act, 1961 ("the IT Act").

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The term "amalgamation" means the action, process, or result of combining or uniting. Synonyms of "amalgamation" include combination, union, merger etc[2]. The Black's Law Dictionary defines amalgamation as "*union of different races, or diverse elements, societies, unions, associations, or corporations, so as to form a homogeneous whole or new body; interfusion; intermarriage; consolidation; merger; coalescence; as, the amalgamation of stock*"[3] Thus, the terms 'merger' and 'amalgamation' may be interchangeably used in common parlance.

Generally, in the Indian context, a company that merges or amalgamates is known as an 'amalgamating company' or 'transferor company'. A company into which an amalgamating or transferor company merges or amalgamates is known as an 'amalgamated company' or 'transferee company'.

Despite the common parlance meaning of the term "amalgamation", the Indian income tax law defines the term in a specific manner. The objective of this article is to examine the meaning of "amalgamation" specifically in the context of Section 2(1B) of the IT Act. The said section defines "amalgamation" and the conditions that need to be fulfilled for an "amalgamation" to be tax neutral. Further, this article will also briefly touch upon the potential tax consequences for the parties, in case an amalgamation does not qualify the definition under Section 2(1B).

2.0 What is an Amalgamation under the IT Act?

Section 2(1B) of the IT Act defines the term "amalgamation". The conditions stipulated under the definition are required to be fulfilled for a merger to be tax neutral[4]. The broad conditions are:

i. All properties of the amalgamating company become properties of the amalgamated company;
ii. All liabilities of the amalgamating company become liabilities of the amalgamated company;
iii. Shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation;

At the outset, let us examine the first two conditions. When two companies are amalgamated, the amalgamating company loses its identity, and the National Company Law Tribunal (NCLT)[5] has the power (under company law) to pass orders relating to

dissolution of the amalgamating company without being wound up. The scheme of amalgamation once sanctioned by the NCLT also usually provides for all assets and liabilities of the amalgamating company to get vested in the amalgamated company, without any further action. In *CIT v. T.V. Sundaram Iyengar & Sons (P.) Ltd.*[6] the Madras High Court held that an order of amalgamation is intended to facilitate reconstruction and amalgamation of companies expeditiously in a manner which is beneficial to the companies and shareholders of the two companies, so long as such amalgamation is not opposed to public interest. Neither the provisions of the Companies Act providing for amalgamation, nor any other provision in the IT Act, confer immunity from payment of liabilities on either of the entities, which are parties to the order of amalgamation. That is the reason why the scheme of amalgamation invariably includes a provision for taking over of all liabilities and assets of the amalgamating company, by the amalgamated company. Consequently, it may be an impossibility of performance therefore to leave behind any properties or liabilities of the amalgamating company, since the amalgamating company itself gets dissolved and the amalgamated company by law becomes the succeeding entity, along with all the assets and liabilities of the amalgamating company. Hence, the first two conditions of Section 2(1B) may be easily satisfied under a typical scheme of amalgamation.

However, we may need to examine the third clause in detail, since it is pertinent to understand the meaning of "three-fourth in value of shares". The IT Act does not define the term "value" for the purposes of Section 2(1B). Again, one may rely on common parlance, to understand the word "value", which means rate, price etc. Separately, the term share has been defined in the Companies Act, 2013 to mean "*a share in the share capital of a company and includes stock*"[7]. This indicates that "value of shares" could be interpreted as "value of share capital" of a company. Thus, "value" may have to be determined on a case-by-case basis through an independent and commercially acceptable valuation mechanism.

Various judicial precedents have held that it is a well settled principle that since valuation is a technical subject, the courts while considering a scheme for amalgamation under Companies Act, ought to rely on the reports prepared by independent experts in this field. The courts are not interested in ascertaining the arithmetical accuracy of valuation, which is not a precise science. The court's role is limited to examining whether the valuation is fair, and carried out as per the principles of law, thereby respecting the commercial wisdom of the makers of the scheme and ensuring that it is approved[8] by the requisite majority[9]. In addition, listed[10] and unlisted companies also seek fairness opinions by appointing separate merchant bankers to bless the valuation report obtained, thereby protecting shareholders' interests and

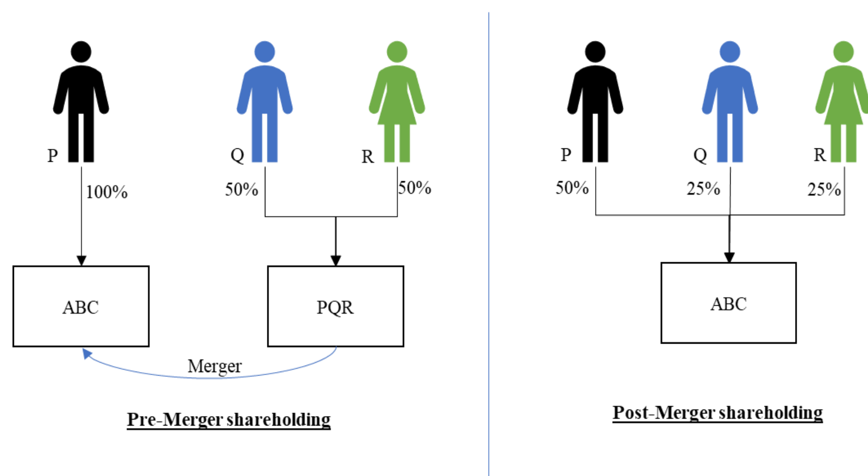
board of directors' fiduciary obligations.

Usually, a scheme of amalgamation sets out the consideration that would be discharged by the amalgamated company to the shareholders of the amalgamating company, basis the independent valuation. The consideration is typically expressed as a ratio of the number of shares held by the shareholders of the amalgamating company, to the number of shares issued as consideration by the amalgamated company referred to as 'share exchange ratio' or 'share swap ratio'. This is worked out basis relative valuation of the transferor and the transferee companies as on the valuation date. i.e., share exchange ratio = value per share of the transferor-company/value per share of the transferee-company.

Given that the IT Act does not specifically define 'value' or prescribe any 'valuation' mechanism for the purposes of Section 2(1B)[11], the valuation as arrived at for the purpose of the scheme of amalgamation under Companies Act ought to suffice. In a typical amalgamation, the likelihood of the valuation being questioned by the income tax authorities in the context of Section 2(1B) may be remote. Accordingly, under the third condition, the three-fourth in value of shares can be surmised to mean that Section 2(1B) merely requires that 75% of shareholders of an amalgamating company should become shareholders in the amalgamated company, basis the share swap ratio arrived at under the Companies Act[12].

Let us examine an example to understand the above in detail:

- P, Q and R, are shareholders tax resident in India
- P holds 100% stake in ABC Co. Q and R hold 50% each in in PQR Co
- As part of a group restructuring, it is proposed to merge PQR Co with ABC Co.



In the facts set out above, upon merger of PQR Co with ABC Co, ABC Co would be obliged to issue shares to Q and R, under Section 2(1B) of the IT Act, for the transaction to be a qualifying merger. Assuming a share exchange ratio of 2:1 (i.e., for every 2 shares held in PQR Co, 1 share of ABC Co), Q and R would hold 25% stake each in ABC Co, while P would be diluted to 50%. Such a swap ratio would be compliant with Section 2(1B) since 75% of PQR Co shareholders have become shareholders in ABC Co, and hence, the merger would qualify as tax neutral.

Now, what if Q and R were to be issued preference shares in ABC Co? Given that Section 2(1B) merely uses the term "shares", the term may include both equity and preference shares, which together constitute the paid-up capital of a company. Accordingly, even in a case where Q and R, are issued preference shares[13], the merger ought to qualify as tax neutral. Alternatively, if Q and R were issued a combination of shares and debentures together (say, for every 2 shares held in PQR Co, 1 share and 4 debentures of ABC Co), would clause (iii) be satisfied? In this context too, since shareholders of PQR Co become shareholders in ABC Co on amalgamation, technically, the condition would be met, and the merger ought to be tax neutral. However, if Q and R were to be issued debentures or paid cash (in which case, they would cease to be shareholders in ABC Co), the merger would not be tax neutral.

It is to be noted that where there is a merger of say a wholly owned subsidiary (WOS) with its parent company, there will likely be no fresh issuance of shares. In such scenario, the parent company cancels the shares it holds in the subsidiary. Thus, no valuation or share exchange ratio is arrived at in such a case. Clause (iii) to Section 2(1B) provides that the requirement of three-fourth in value of shareholders of amalgamating company becoming shareholders in amalgamated company is applicable in cases "*....**other than** shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary*" (emphasis added). The use of the words "*other than shares already held…immediately before amalgamation*" indicate that the three-fourth in value of shareholding would be determined only vis-à-vis the shareholders to whom shares are actually issued and not vis-à-vis total shares issued *and* cancelled. The reason behind this exception appears to be because the amalgamated company cannot issue its own shares to itself. Reference may be drawn to Finance Act, 2012 ("**FA12**"), where a similar exception was inserted into Section 47(vii) of the IT Act, in the context of capital gains tax exemption in case of amalgamation. The explanatory memorandum to FA12 stated as follows[14]:

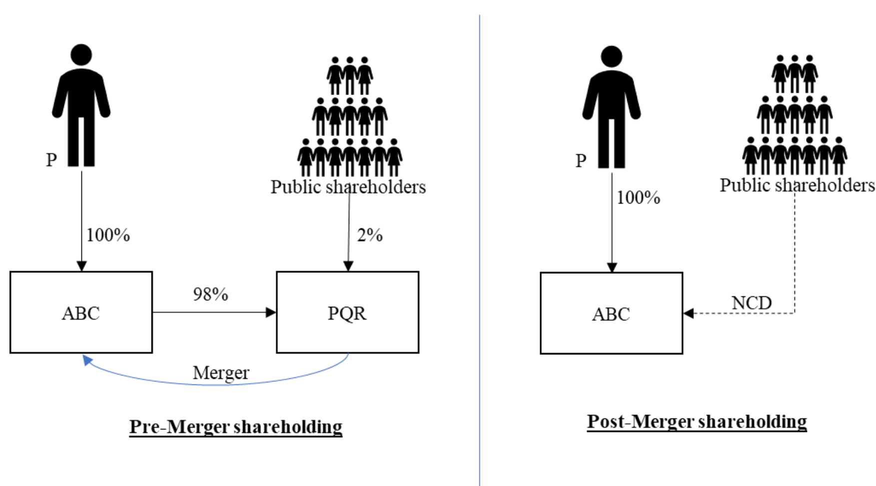
"*In a case where a subsidiary company amalgamates into the holding company, it is not possible to satisfy one of the conditions…, i.e., that the amalgamated company (the holding company) issues shares to the shareholders of the amalgamating*

company (subsidiary company), since the holding company is itself the shareholder of the subsidiary company and cannot issue shares to itself. Therefore, it is proposed to amend the provisions of section 47(vii) so as to exclude the requirement of issue of shares to the shareholder where such shareholder itself is the amalgamated company. However, the amalgamated company will continue to be required to issue shares to the other shareholders of the amalgamating company" (emphasis added).

Therefore, cancellation of amalgamated company's shareholding in the amalgamating company upon amalgamation ought not to impact the tax neutrality of the amalgamation. Accordingly, in cases of merger of WOS with parent, no shares are issued by the parent[15]; yet the merger continues to be tax neutral (assuming clauses (i) and (ii) of Section 2(1B) will anyway be satisfied).

As an important corollary to the aforesaid exception, one may therefore surmise that in case of an amalgamation involving subsidiaries/associates (other than WOS), where there is a cancellation of shares held by the amalgamated company in the amalgamating company, the three-fourth in value of shares needs to be computed only with reference to new shares issued by the amalgamated company. The cancelled shares in the amalgamating company ought not to be considered. Let us consider another example:

- P holds 100% in ABC Co. ABC Co holds 98% stake in PQR Co and remaining 2% stake in PQR is held by various public shareholders.
- It is proposed to merge PQR Co with ABC Co. In consideration for merger, ABC Co would issue non-convertible debentures (NCDs) to the 2% public shareholders of PQR Co.



In the above fact pattern, since the 'three-fourth in value' condition ought not to be applicable to shares held by ABC Co in PQR Co "immediately before the amalgamation", the condition can only be tested vis-à- vis the public shareholders holding 2% stake. Since only NCDs, and no 'shares' are being issued to the public shareholders in the instant case, clause (iii) of Section 2(1B) would not be satisfied. Had 75% of the 2% public shareholders of PQR Co been issued shares by ABC Co, then clause (iii) of Section 2(1B) may perhaps have been satisfied. Accordingly, the amalgamation under the instant case, is likely to be non-tax compliant.

3.0 Tax Implications for Parties to a Non-tax Compliant Merger

While the IT Act clearly sets out the tax exemptions available to the shareholders, amalgamating company, and amalgamated company, in case of a compliant merger, there is absolutely no clarity as to what the implications will be in case a merger does not comply with the "amalgamation" definition under Section 2(1B). Set out below are the likely immediate consequences:

a. *Amalgamating company*: Since the amalgamating company would cease to exist and will not receive any consideration or assets, there may be no adverse tax consequences for the amalgamating company.
b. *Shareholders of the amalgamating company*: The shareholders of the amalgamating company may be liable to capital gains tax since no exemptions will apply where 'amalgamation' is not compliant with the Section 2(1B) definition. Separately, in case shareholders receive consideration in the form of shares or debentures, they may be put 'out of pocket' to pay the tax liability, which may act as a major deterrent in obtaining requisite shareholder approvals under the Companies Act.
c. *Amalgamated company*: In a case where the amalgamated company does not hold any shares in the amalgamating company, there may not be any adverse capital gains tax consequences. If the amalgamated company is a shareholder (in which case the amalgamated company will not issue shares to itself), the Indian tax authorities attributing capital tax liability cannot be entirely ruled out, basis a landmark Supreme Court ruling.[16]However, in the absence of any consideration being received by the amalgamated company, the capital gains tax computation mechanism itself may fail[17]. In such a scenario, one cannot put it past aggressive Indian tax authorities from alleging that the amalgamated company received assets from the amalgamating company, without paying any consideration, in cases where the assets include cash, shares, land etc.[18].

4.0 Conclusion

As may be evident from the above discussions, the tax neutrality of an amalgamation appears to hinge largely on clause (iii) of Section 2(1B) of the IT Act. If an amalgamation does not qualify this clause, the tax neutrality of the transaction may be impacted. Hence, the share swap ratio needs to be computed appropriately to ensure that there are no adverse tax implications[19] to any of the parties in the merger. Of course, in certain scenarios, like a third-party acquisition, minority squeeze out etc., stakeholders may consciously choose to not comply with the said provision, by paying consideration in the form of non-share instruments or cash to shareholders of the amalgamating company. Further, there are certain specific benefits like availability of potential cost-step up to amalgamated company for assets of amalgamating company, availability of goodwill depreciation[20] etc., which may be achieved in case of a non-compliant amalgamation. On the downside however, there may be potential capital gains tax implications for the parties, should the amalgamation not comply with Section 2(1B). Additionally, protracted litigation on other aspects like cost of acquisition of amalgamated company shares/debentures in the hands of the transferor shareholders, tax implications under Section 56(2)(x) of the IT Act, valuation, etc., cannot be ruled out. Detailed cost- benefit, and factual analyses need to be undertaken before zeroing in on the appropriate transaction structure.

Endnotes

1. This is subject to fulfilment of prescribed conditions under the tax law
2. Accessed www.thesaurus.com on 04 June 2021
3. Black's Law Dictionary (6th ed. 1990)
4. Per Section 47 of the IT Act, amalgamations that fulfil conditions set out under Section 2(1B), will ensure capital gains tax exemptions for the parties. While the IT Act does not define the term "tax neutral", the term may be understood in this article's context as a transaction that does not attract any tax outflow for any of the parties involved.
5. Section 230-232 of Companies Act, 2013
6. [1999] 238 ITR 328
7. Section 2(84) of Companies Act, 2013
8. The Companies Act, 2013 inter alia sets out the requirements with respect to shareholder approvals
9. Hindustan Lever Employees' Union v. Hindustan Lever Ltd. [1994] 2 SCL 157 (SC), Re. Maknam Investments Ltd., In re [1995] 6 SCL 93 (Cal.), Hindustan General Electric

Corporation Ltd., In re AIR 1959 Cal. 672, Miheer H. Mafatlal v. Mafatlal Industries Ltd. [1996] 10 SCL 70. In Mrs. Renuka Datla v. Solvay Pharmaceuticals B.V. [2003] 117 Comp. Cas. 585 (SC) it was held that a court could however still intervene if the valuation was made on a fundamentally erroneous basis, or a patent mistake had been committed by the valuer, or that the valuation was vitiated by a demonstrably wrong approach or a fundamental error going to the root of the valuation

10. The Securities and Exchange Board of India (SEBI) mandates listed companies engaged in an amalgamation to obtain a fairness opinion under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015
11. The IT Act, read with the Income-tax Rules, 1962 prescribe detailed valuation methodologies to be followed in cases of specified asset transfers. No valuation methodologies are prescribed for amalgamations.
12. In a tax neutral amalgamation, where all the stipulated conditions are fulfilled, the valuation itself may not directly impact tax attributes for any of the parties to the transaction, as long as the swap ratio fulfils the 3/4th shareholding condition
13. Reliance can also be placed on the decision of the Delhi High Court in Telesound India Ltd., In re [1983] 53 Comp. Cas. 926 in which it was held that preference shares can be issued in a scheme of amalgamation
14. Clause 15 of explanatory memorandum to Finance Bill, 2012 available at https://www.indiabudget.gov.in/budget2012-2013/ub2012-13/mem/mem1.pdf accessed on 04 June, 2021
15. In Mahaamba Investments v IDI Limited [2001] 105 Comp Cas 16 (Bom) the Bombay HC recognising the absence of share issuance by parent company observed that the parent company need not file a petition for sanction as no shares are sought to be issued to the shareholders of the parent company.
16. CIT v. Grace Collis 248 ITR 323 (SC)
17. CIT v. BC Srinivasa Setty 128 ITR 294 (SC)
18. Per Section 56 (2)(x) of the IT Act, where any person receives any sum of money, without consideration, the aggregate value of which exceeds INR 50,000, or receives any asset without consideration or at a value which is less than the fair market value, then the sum so received or the difference between the fair market value and amount of consideration paid would be liable to tax in the hands of the recipient.
19. As discussed previously, parties to the amalgamation are eligible for capital gains tax exemptions in case of Section 2(1B) compliant amalgamations. It may however be noted that the Delhi HC ruling in CIT v. Nalwa Investment Ltd. [2020] 118 taxmann.com 278 (Delhi) has sought to differentiate between shares held as capital asset and stock-in-trade. The HC held that where shares are held as stock in trade, the shares received by the shareholder would not be eligible for an exemption and would be liable to tax as business income. This distinction may also be considered by shareholders before embarking on an amalgamation transaction, since the rate of tax as business income may range from 15% to 40% (excluding

applicable surcharge and cess), depending on the attributes of the shareholder concerned like annual revenue threshold, tax residency, etc.

20. Depreciation on goodwill in light of the landmark ruling in CIT v. Smifs Securities Ltd 348 ITR 302 (SC) may no longer be available given the recent amendment introduced under Finance Act, 2021, which denies the Depreciation on goodwill.