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TAX FLASH NEWS

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Transferor company held taxable even in respect of part sale consideration directly received by its shareholders under a scheme of arrangement for transfer of business

Background

Recently, the Delhi High Court (the High Court) in case of Salora International Ltd[1] (the taxpayer) held that 'part consideration' for business transfer received directly by the transferor company's shareholders under a scheme of arrangement would form part of the total consideration accruing to the transferor company for the purposes of computing capital gain tax.

The High Court held that the transferred undertaking was owned by the transferor company and not by its shareholders and the fact that at its instance a part of the consideration is diverted to the shareholders would not absolve the transferor company from recognising the entire consideration. Further, a court order approving the scheme of arrangement under Section 391-394 of the Companies Act, 1956 would not alter the nature of the transaction or the incidence of tax on such transaction.

Facts of the case

- Pursuant to the Scheme of Arrangement approved by the Court, the Panasonic division of the taxpayer (transferred undertaking) was transferred to a new company, Matsushita Television & Audio India Ltd (the transferee) for an agreed consideration of INR50.12 crore which was discharged in the following manner:-
  - The shareholders of the taxpayer were issued equity shares of INR17.64 crore by the transferee (based on swap ratio of 2: 1 provided in the scheme).
  - The taxpayer was entitled to a consideration of INR32.48 crore which was discharged partly through allotment of shares of the transferee and partly in cash.
- The taxpayer, in its return of income for Assessment Year (AY) 1997-98, declared that it had received a sale consideration of INR 32.48 crore during the year. Further, for the purpose of computing capital loss on transfer, it had considered the cost of fixed assets and the book value of current assets and liabilities as the cost of acquisition.
- The Assessing Officer (AO) however computed short-term capital gains on transfer by adopting the full value of consideration at INR50.12 crore as per the terms of the scheme. The AO further adopted the written down value (WDV) of the fixed assets instead of their historical cost of acquisition for the purpose of determining the capital gains on transfer.
- The taxpayer's appeal was rejected by the Commissioner of Income-tax (Appeals) [CIT(A)]. The Income-tax Appellate Tribunal (the Tribunal) however allowed the taxpayer's appeal and held that the amount given to the shareholders was a diversion of income at source and hence not taxable. The Tribunal further concurred that the WDV could not be adopted as the cost since it was not a transfer of individual depreciable assets and hence Section 50 of the Income-tax Act, 1961 (the Act) was not applicable.

[1] CIT v. Salora International Ltd dated (ITA 12/2003, 13 May 2016) – Taxsutra.com

- Aggrieved, the tax authorities filed an appeal before the High Court wherein it only pressed the question regarding the quantum of consideration on transfer. Hence, the question of applicability of Section 50 of the Act in respect of the cost of assets has not been considered by the High Court.

Taxpayer's contentions

- Referring to the decision of Supreme Court in the case of Sadanand S. Varde v. State of Maharashtra[2], the taxpayer contended that after approval by the Court, the Scheme of Arrangement acquires statutory recognition, and since the parties of the scheme are bound by its terms, it could not be considered that the taxpayer had voluntarily diverted its income in favour of shareholders.

- It was further submitted that the taxpayer was not liable to be taxed on the part consideration paid to the shareholders since it was never received by or accrued in the hands of the taxpayer as per the terms of the scheme. Relying on Supreme Court ruling in the case of Sitaldas Tirathdas[3], it was argued that amount given to shareholders under the terms of the scheme was a diversion at the very source and could not be considered to be the application of income by the taxpayer.

Tax department's contentions

- It was contended that the scheme of arrangement as well as the Director's report indicated that the total consideration was INR50.12 crore which was diverted by the Board of Directors partly to the shareholders of the taxpayer. In such circumstances, the consideration received by the shareholders could not be excluded from the income of the taxpayer.

- It was further argued that the transferred undertaking was owned by the taxpayer, and therefore, it was entitled to receive the entire consideration on sale of the undertaking which in the present case was specifically diverted to the shareholders through an arrangement.

- The tax authorities, referring to the judgment passed in case of Miheer H. Mafatlal v. Mafatlal Industries Ltd[4], argued that sanction of the scheme by the court was merely an approval of an arrangement already arrived at by the shareholders.

High Court ruling

- At the outset, it was clarified that, though the present case pertains to a year prior to the introduction of Section 50B of the Act; the High Court was not called upon to decide the issue whether, in case of a transfer of business undertaking as a going concern, capital gains can be computed under Section 48 of the Act. Further, the tax authorities have also not pursued the question on the computation of cost of acquisition upon transfer of business. Hence, only the question on the value of consideration has been examined by the High Court.

- The High Court observed that mere sanctioning of the Scheme under Section 391-394 of the Companies Act, 1956 would not alter the character of the scheme or the nature of the transaction embodied therein and that there should not be any material difference, in so far as the incidence of tax is concerned, between a court-approved scheme or any other binding agreement for transfer of undertaking. Further, it was clear from the scheme that the transaction was in respect of the transfer of the transferred undertaking from the taxpayer to the transferee for a total consideration of INR50.12 crore.

- Relying on the ruling of the Supreme Court in case of Bacha F. Guzdar[5], the High Court observed that the shareholders own the shares in the company and have no interest in the assets of the company. Accordingly consideration as reflected in the scheme was clearly for the transfer of title to the assets of the transferred undertaking which was owned by the taxpayer and not by its shareholders.

- The High Court in its judgement also referred to the 'look at' principle applied by the Supreme Court in the case of Vodafone International Holdings B.V[6]. The High Court further observed that the expression 'accruing' as used in Section 48 of the Act, is synonymous to entitlement. Accordingly, it was held that the taxpayer would be entitled to the entire consideration for the sale and the fact that at its instance a part of the consideration was diverted to a third party would not absolve the taxpayer from recognising the entire consideration.

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[2] Sadanand S. Varde and Ors. v. The State of Maharashtra and Ors [2001] 247 ITR 609 (Bom)
[3] CIT v. Sitaldas Tirathdas [1961] 41 ITR 367 (SC)
[4] Miheer H. Mafatlal v. Mafatlal Industries Ltd. [1997] 1 SCC 579
[5] Bacha F. Guzdar v. CIT, Bombay [1955] 27 ITR 1 (SC)
[6] Vodafone International Holdings B.V v. Union of India [2012] 341 ITR 1 (SC)

Our comments

The High Court while dealing with the question around the full value of consideration under Section 48 of the Act has dealt expressly with the principles of diversion of income by overriding title. The High Court has re-affirmed the position that where there is no charge or obligation by which the income is diverted before it reaches the assessee; it cannot be excluded from the income of the assessee. In arriving at its conclusion; the High Court has held that a scheme of arrangement is ultimately a mutual arrangement between the parties to the scheme and the nature of the transaction, and its tax impact does not change only on account of the statutory force behind a court order approving the scheme.

Applying the ruling of the High Court, any merger or demerger which does not comply with the tax neutrality provisions laid out in the Act can be questioned on the contention that the consideration issued to the shareholders of the transferor company is the full value of consideration accruing to the transferor company itself. In the instant case the provisions of Section 2(22) of the Act were not examined as there being no question on the same.

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