GAAR vis-à-vis Compromises or Arrangements under Companies Act

Contributed by CA Sri Harsha

Introduction:

It is observed from the recent judgments of National Company Law Tribunals (for brevity 'NCLT'/'Tribunal') that there is an ambiguity as to the extent the objections raised by Income Tax Department should be taken into consideration while the Tribunals sanction a scheme under the provisions of Section 230 – 232 of Companies Act (for brevity 'Companies Act').

Section 230(5) of Companies Act for instance stipulates that a notice with all the documents in the prescribed format has to be sent to the Central Government, the income tax authorities, the Reserve Bank of India, the Securities and Exchange Board of India, the Registrar of Companies, the respective stock exchanges, the official liquidator, the competition commission, if necessary, and such other sector regulators or authorities which are likely to be affected by the compromise or arrangement and shall require the representations to be made on the proposed scheme.

When the documents and other information are shared to the above authorities, the representations received from them, are taken on record before proceeding with the sanction or rejection of the scheme. In certain cases, it is observed that the Income Tax Department raises objections stating that there is a loss to the exchequer if the Tribunal sanctions the scheme and accordingly contends that such a scheme should not be sanctioned. This has increased after the advent of General Anti-Avoidance Regulations (for brevity 'GAAR').

Chapter XA of Income Tax Act deals with GAAR. The said chapter contains anti-avoidance measures which give power to tax authorities to declare an arrangement to be an 'impermissible avoidance arrangement' and decide the consequence of tax arising therefrom. In other words, if an arrangement falls under the ambit of 'impermissible avoidance arrangement' as specified in Section 96 of Act, then notwithstanding to anything contained under the other provisions of Act, such arrangement will be declared as impermissible and the tax consequence would be determined as if such arrangement has not taken place. The said provisions are applicable from Financial Year 2017-18.

Resorting to GAAR, the income tax department in certain cases have raised objections to the proposed schemes before the Tribunal. The Tribunals have agreed to the contentions raised by the Income Tax Department and have rejected the scheme. However, in certain matters, the scheme was approved though the department claimed that there is a tax avoidance and the scheme cannot be sanctioned. The real question that arises for determination is, to what extent the Tribunal is required to consider the objections raised by the Income Tax Department and in what circumstances, such objections can be based upon and the proposed scheme can be rejected. This is the aspect which we intend to deal in this article. Let us take two recent cases of Tribunals dealing with the scheme and bearing of the Income Tax Department objections on such scheme.

In Gabs Investments Private Limited vs. Ajanta Pharma Limited[1]:

An application for sanction of National Company Law Tribunal (for brevity 'NCLT'/'Tribunal') is sought under Section 230 to Section 232 of Companies Act, 2013 (for brevity 'Companies Act') to the Scheme of amalgamation and arrangement between the Gabs Investment Private Limited (for brevity 'transferor company'/Gabs') and Ajanta Pharma Limited (for brevity 'Transferee Company'/'Ajanta') and their respective shareholders.

Gabs is the group holding company and primarily holds shares in transferee company that is Ajanta, which is a speciality pharmaceutical company engaged in development, production and marketing of branded and generic formulations. The philosophy for the subject scheme as canvassed by Gabs is that, the merger will result in direct holding of promoter shares in the transferee company instead of through Gabs. This will lead not only to simplification of the shareholding structure and reduction of shareholding tiers but also demonstrate the promoter's group direct commitment to and engagement with the transferee company. The promoters would continue to hold the same percentage of shares in the transferee company, pre and post-merger and there would also be no change in financial position of the transferee company. Gabs stated that the scheme was approved by 99.99% shareholders of transferee company and unanimously consented by all its shareholders.

The Regional Director, the Official Liquidator and the Registrar of Companies have given their clearances for the scheme proposed by Gabs. However, the Income Tax Department has raised certain objections which became a reason for cancellation of the proposed scheme by Gabs. The objections of the Income Tax Department (for brevity 'ITD') were as under.

The ITD stated that the 61.17% of shares are held by Agrawal Family Members in transferee company and shareholding of Gabs is controlled by Agrawal Family Members only. ITD after considering the family tree of Agrawal Family, background of the scheme, salient features of the scheme, consideration payable, accounting treatments in the books of transferee company, financials of Gabs, financial implications of the scheme has articulated that Gabs being a private limited company has to be considered as separate entity and any 'assets' of private limited cannot be transferred and distributed directly. Hence, the Gabs has to pay the dividend distribution tax[2] at 20% amounting to Rs 134.16 Crores which will be a loss to the exchequer, if the scheme is approved. Further, if the scheme is approved, the ITD stated that it would also be a loss to the exchequer on the tax which the Gabs should have paid if the merger has not taken place and a normal route is adopted. In such vein, the ITD claimed that there would be a loss of Rs 421.66 Crores if the merger is approved by NCLT. The ITD further argued before NCLT that in view of GAAR provisions, the scheme of amalgamation is a deliberate measure to avoid tax burden by using the medium of NCLT and this scheme is purely impermissible avoidance arrangement and should not be allowed by NCLT. The ITD concluded by stating that the proposed scheme of arrangement is nothing but round trip financing which includes transfer of funds among the parties to the arrangements through the series of transactions.

The NCLT after going through all the objections of ITD has stated vide Para 37 that the rationale presented by Gabs is without any justification. By the scheme of amalgamation and arrangement Gabs/shareholders of Gabs are

[1] 2018 (12) TMI 739 – NCLT, Mumbai

[2] This judgment of NCLT Mumbai was during the period, where dividend was taxable in the hands of company instead of current model where it is taxable in the hands of shareholder.

avoiding full tax liability which is strenuously objected by the ITD. Accordingly, the NCLT has held the scheme can be sanctioned/approved only if it complies with all provisions of the Act, Rules and if the scheme is in the public interest, shareholder etc. Since, Gabs did not provide any details with regard to compliance of tax liability raised by ITD, their undertaking to pay the huge tax liability as pointed by ITD, the bench was of the opinion that it would be advisable to settle the important/crucial issue of huge tax liability before sanctioning the scheme rather than disputing the same at a later stage. NCLT stated that it is mandatory under Section 230(5) of Companies Act, a notice in prescribed form shall be sent to central government, income tax authorities and other notified regulators or authorities to receive their representations. Basis that, ITD has raised objections and the bench is inclined to agree with them.

In Panasonic India (P) Limited[3]:

Panasonic India Private Limited (for brevity 'transferor company') and Panasonic Life Solutions India Private Limited (for brevity 'transferee company') has applied for sanction of amalgamation under Section 230 to Section 232 of the Companies Act before the NCLT. The Tribunal has received representations from various authorities on the proposed scheme by transferor company. The Income Tax Department (for brevity 'ITD') has aired certain objections. The ITD states that the ownership of both the transferor and transferee is held by M/s Panasonic Corporation, Japan and the accumulated losses of transferor company for Assessment Year (for brevity 'AY') 20-21 is Rs 14,375 million, which is intended to be transferred to the transferee company under the guise of amalgamation. Hence, the ITD contended that the scheme is not at arm's length and could not be termed as a prudent acquisition on any commercial or business terms and the entire benefit accrued to one company, that is the M/s Panasonic Corporation, Japan. The ITD contended that the main objective of the scheme of amalgamation is to take benefit of accumulated losses which are eligible for set off in the future periods in the hands of transferee company. The total benefit that would arise to the transferee company and thereby loss to the exchequer is approximately to the tune of Rs 3,594 Million (25% of Rs 14,375 million). Apart from the above loss to the exchequer, the ITD contended that the revenue shall be deprived of the possible capital gain that would be accrued if the shareholders of transferor company sell shares to the transferee company but for this scheme. The ITD further contended that it appears that by issuing 25,91,034 shares of transferee company, the shareholders of transferor company will be benefitted inspite of having negative net worth. Finally, ITD by placing reliance on Gabs Investments (P) Limited (supra) has stated that the above scheme should be cancelled in light of the GAAR provisions.

The transferor and transferee (collectively called as 'petitioners') by referring to the provisions of Section 47(vi) and Section 47(vii) pleaded that the tax neutrality in the hands of the amalgamating company and the shares of the amalgamating company is conferred by the provisions of the Income tax Act and therefore no case can be made out of prejudice to revenue if compliances with the conditions mentioned in the above act are complied with. The petitioner further submitted before NCLT that the view taken by ITD that the transferor company has been allotted 25.91 million shares of transferee company as against the negative net worth of the transferor company is patently incorrect for the reason that the determination of swap ratio was on the basis of the share entitlement ratio issued by a registered valuer and it had duly captured the basis of computation of such valuation. The petitioners further contended that there are strict

[3] [2022] 138 taxmann.com 570 (NCLT- Chd)

conditions under Section 72A of Income Tax Act and also rules therein and only on such satisfaction of the conditions, the unabsorbed business losses and unabsorbed depreciation of the amalgamating company in the hands of the amalgamated company. The petitioners contend that the compliance with the conditions laid down under Section 72A can always be verified by the Assessing Officer at the time of completing the assessment of petitioners. Regarding the allegation that the loss of probable capital gain in the hands of shareholders of transferor company, the petitioner contended that there would be no tax liability even if the shares are independently sold because of the shareholders enjoy the benefit of respective Double Taxation Avoidance Arrangements (for brevity 'DTAA') and further the value with the shareholders of the transferor company remains the same both pre and post-merger transaction.

The petitioners contended that the provisions of GAAR cannot be invoked qua the scheme because the scheme cannot be called as impermissible avoidance arrangement and its main purpose is not to obtain a tax benefit. Further, relying on the decision of Supreme Court in matter of Vodafone International Holdings BV[4], the petitioners contended that if the arrangement, re-organization, restructuring, etc are undertaken for sound commercial and legitimate tax planning reasons, then the same could not be disregarded by Revenue. The petitioners tried to distinguish their matter from the facts of Gabs Investment (P) Limited (supra) by stating that Gabs did not have any business activity and was merely holding shares of a listed company and there was no commercial rationale for the proposed merger in Gabs case except for simplification of the shareholding of listed company which did not benefit the other public shareholders at large. After hearing the contentions of the petitioners, the tribunal has asked the petitioners to submit the pre and post shareholding and valuation reports to the ITD. The ITD has stated that after going through the additional information, there is nothing to add than what was stated earlier.

The Tribunal after considering the arguments stated that this matter is different from the facts of Gabs (supra), since the objective of the scheme under Gabs, was for simplification of shareholding structure. However, in the present case, the petitioner companies has clearly made out of a case of operational synergy between the amalgamating companies. The Tribunal also stated that the ITD could not point out in concrete terms any adverse issue relating to the valuation of shares made by petitioner companies after furnishing of the valuation report by the petitioners.

The Tribunal emphasized that the treatment of carrying forward and set off of accumulated loss and unabsorbed depreciation allowance in amalgamation or demerger etc of companies are clearly spelt out in the provisions of Income Tax Act and these provisions in their opinion are sufficient to protect the interest of ITD in any case of amalgamation or demerger etc. The Tribunal further stated that the provisions of income tax law does not override the scheme and ITD is at liberty to invoke the provisions of GAAR during the course of assessment proceedings after seeking requisite approvals. Accordingly, the Tribunal has held that there is no merit in the objections raised by ITD. It is important to note that in a recent decision in the matter of Cummins Sales & Services (I) Limited[5] has rejected the set off of brought forward loss and depreciation that vested with the assessee as a result of demerger. The assessee contended that since the scheme is sanctioned by the High Court, the same cannot be tested by any other authority including income tax authority. However, the Income Tax Appellate Tribunal has held that the sole motive behind the demerger being tax set off, the same

[4] [2012] 17 taxmann.com 202

[5] TS – 523 – ITAT – 2022 (Pun)

cannot be allowed, though the scheme is sanctioned by the High Court.

Point of View:

From the above two judgments, we can infer that there exists ambiguity as to what is the role of ITD and to what extent the Tribunal/NCLT should consider their representations, while sanctioning the scheme. Whether ITD can raise objection against every scheme stating that if the tribunal allows the scheme, there would be a loss to the exchequer and ask not to sanction? If yes, to what extent the tribunal is supposed to take into the consideration of ITD to decide upon the scheme. The answer to the above is not easy to reckon. However, let us try to examine the said question based on the other previous judgments in this context.

In the matter of AVM Capital Services Private Limited & Others[6], the Bombay High Court has an occasion to deal with a similar situation that we are occupied with. The facts of the case are that five companies (for brevity 'transferors') have sought to merger with one company (for brevity 'transferee'). Pursuant to the scheme, the entire undertaking of transferor companies would stand vested with the transferee company on obtaining the sanction from the High Court. There was an objection from a person (for brevity 'objector') who holds 750 shares in transferee company constitutes 0.001% of total share capital. The objector has raised an objection that the whole objective of scheme is to avoid capital gains tax that would have arisen if the transferor companies would have directly transferred their shares to the Promoters. It is alleged that the object of the scheme is not to help transferee company but to transfer shares to the promoter. The scheme is a colourable device to evade tax, since such a transfer could well have been effected through the stock market. The objector contended that the scheme in question involves pure transfer of shares without any benefit to the transferee company. The objector relied on the judgment of Honourable Supreme Court in the matter of McDowell and Company Limited[7] and contended that avoidance of tax was unethical and if a transaction is a device to avoid tax, it should not be permitted and since the current transaction is a device to avoid tax, the same should not be permitted. The Objector further contended that the judgment of Supreme Court in Azadi Bachao Andolan and Anr[8] is *per in curium* as it is contrary to the decision of Constitutional Bench in McDowell's (supra).

The Bombay High Court has rejected the arguments of the Objector by adopting the reasoning below. The High Court stated that the ratio of McDowell's (supra) has been considered by the Supreme Court in Azadi Bachao Andolan (supra), wherein the Supreme Court has reached a conclusion that McDowell's case cannot be read as laying down that every attempt at tax planning is illegitimate, or that every transaction or arrangement which is perfectly permissible under the law, but has the effect of reducing the burden of the assessee must be looked upon with disfavour. The Supreme Court in Azadi Bachao Andolan (supra) stated that there is nothing in the McDowell's judgment to infer that the majority has accepted the view of minority (the one canvassed by the objector) and hence the judgment in Azadi Bachao Andolan (supra) is in accordance with the law and not in *per in curium* as canvassed by the objector. The High Court held that grievance that the shares of the transferee company held by transferor companies which are purely tradeable and transferable without any restrictions cannot be transferred through the present scheme of arrangement is not right, since the promoters are not looking for an exit from the transferee company through divestment and have adopted one of the available methods for

[6] [2012] 23 taxmann.com 222 (Bombay)
[7] [1977] 154 ITR 148 SC
[8] 2004 10 SCC 1 (SC)

reorganizing their shareholding. The Court held that the purpose of the scheme is to provide long term stability and transparency in the transferee company. The scheme allows to hold the shares in transferee company directly instead of current mode of holding through transferor company. The Court held that the object of the scheme is no to avoid any tax and there is nothing illegal or dubious or colourful in the scheme and same is a perfectly legitimate scheme and permissible by law and therefore the objection of the objector has to be rejected.

In the matter of PIPL Business Advisors and Investment Private Limited[9] (petitioner), the Delhi Tribunal has rejected the objections of ITD, wherein it has raised the scheme proposed therein was with an intent to avoid tax and to be out of the ambit of provisions of Section 56(2)(x). The petitioner pleaded that in case where more than one option is available to tax payer to structure its transactions, it shall be free to choose that option which is more beneficial and tax efficient and that where tax planning is legitimate and permitted it cannot be looked into with suspicion as a tax evasion by placing reliance on Vodafone International Holdings[10] and Azadi Bachao Andolan (supra). The Tribunal has stated that before going into the merits of the contentions raised by ITD, it has to be definite as to the contours within which it is required to exercise its jurisdiction when considering a scheme coming before it for sanction, particularly when objections are put forth by revenue. The Tribunal referring to the decision of Vodafone Essar Limited[11] stated that the scheme can be struck down only being a situation where the scheme itself has only one purpose, which is to create a vehicle to evade the payment of tax, rather than mere avoidance of tax. Hence, as long as the scheme is not being a situation covered above and not against the framework of law and public policy, the scheme should be sanctioned. The Tribunal held that the since in the instant case the ITD has not proved that the entire essence of the scheme is to evade tax, the scheme needs to be sanctioned.

From the above, it is evident the scheme can be rejected by the Tribunal only in case where the Income Tax Department can prove that the entire purpose of scheme is to evade tax. In cases where the Income Tax Department fails to prove the same, the Tribunal is required to sanction the scheme. This was what the Tribunal has done in Panasonic India (P) Limited (supra). However, in Gabs (supra), we opine that the Tribunal has failed to examine the litmus test, whether the entire object of the scheme therein is to evade tax or not. They have just gone by the objections raised by the Income Tax Department. If one sees the facts in Gabs (supra) and AVM Capital Services Private Limited & Others (supra), they appear to be same and hence the Tribunal should have sanctioned the scheme in Gabs. As rightly pointed out by the Tribunal in the matter of Panasonic India (P) Limited (supra), though the scheme is sanctioned by the Tribunal, it does not override the provisions of Income Tax Act and therefore it will be open for the authorities to invoke the provisions during the assessment or reassessment. Hence, the provisions of GAAR cannot be straight away applied at the time of proposal for sanction of scheme unless the entire objective of the scheme is tax evasion. It is open to the tax authorities to reject the proposed scheme during the course of assessment or re-assessment if they find that the scheme fits into the definition of 'impressible avoidance arrangement' and the main purpose is to obtain tax benefit. There can be tax benefits qua a scheme and that cannot be sole reason to invoke the provisions of GAAR and reject the scheme.

[9] 2018 SCC Online NCLT 30762
[10] (2012) 341 ITR 1 (SC)
[11] CP No 334 of 2009