Even if the composite scheme of arrangement is not a ‘demerger’ under the Income-tax Act, the scheme shall be approved and liable to appropriate tax implications

Background

Recently, the Bombay High Court (the High Court) in the case of the ‘Composite Scheme of Arrangement and Amalgamation’ between A Ltd. and B Ltd./C Ltd. (collectively referred to as petitioners) and their respective shareholders and creditors held that if a scheme of arrangement, which is otherwise permissible both under the Companies Act, 1956 (the Companies Act) and the Income-tax Act, 1961 (the Act) but does not amount to ‘demerger’ within the meaning of the Act, may have certain tax implications but cannot be prohibited. Further, the High Court observed that the sanction of the scheme, does not in any way bind the tax department to take any particular view of such scheme, insofar as the tax implications of the transactions are concerned.

The High Court has approved the present scheme even though the consideration for transfer of the undertaking is issued in the form of shares of a company other than the transferee company since the consideration is accepted by the shareholders is not against the public interest and does not contravene the provisions of the Companies Act.

Facts of the case

- The petitioners are companies incorporated under the provisions of the Companies Act and have their registered office in India.
- The petitioners filed petitions before the High Court to seek sanction of a composite scheme of arrangement and amalgamation of A Ltd. which is a transferor company, with B Ltd. which is a resulting company and C Ltd. which is another resulting company and their respective shareholders and creditors.
- The transferor company, i.e. A Ltd, is a listed public company engaged in the business of vacation ownership and leisure hospitality. The two transferee or resulting companies, namely, B Ltd. and C Ltd., are respectively engaged in the business of corporate agency for travel insurance, and integrated travel and travel related services.
- The scheme consists of two parts, one of which consists of the demerger of an undertaking of A Ltd. pertaining to the time share and resort business on a going concern basis from A Ltd. and its transfer and vesting in B Ltd. The other part consists of an amalgamation of the residual undertaking of A Ltd. with C Ltd. as a going concern.
- After demerger and amalgamation as aforesaid, the scheme envisages dissolution of A Ltd. on and with effect from the effective date. The consideration of the demerger and amalgamation, respectively, is the allotment of certain equity shares of C Ltd. in lieu of the equity shares of A Ltd.
- The transferee companies have presented this scheme petition for sanction of the High Court under Sections 391 to 394 of the Companies Act.

Objections by the Regional Director of the Ministry of Corporate Affairs

- The Regional Director of the Ministry of Corporate Affairs opposed the scheme on the ground that having regard to the provisions of Section 394 of the Companies Act, only a transferee company can allot shares towards consideration of transfer.
In the present case, for demerger and transfer of the undertaking of the resort business of A Ltd. the shares have been allotted by C Ltd which is a parent company of the transferee company, namely, B Ltd. Further, B Ltd. which is the resulting company, as far as the demerger part is concerned, is not issuing any shares and therefore, the scheme is not in consonance with the provisions of the Companies Act.

Further the scheme is also against the provisions of the Act having regard to the definitions of ‘demerger’ and ‘resulting company’ contained in Section 2(19AA) and 2(41A) read with Section 2(19AAA) of the Act.

Non-compliance with the provisions of the Act

- If a scheme of arrangement, which is otherwise permissible both under the Companies Act and the Act, does not amount to ‘demerger’ within the meaning of the Act, it may have certain tax implications for the companies in question. However, there is no prohibition contained in the Act to a scheme such as in the present case.

- There is a provision in the present scheme that a part of the scheme, namely, the demerger, has been drawn up to comply with the conditions relating to a demerger as specified under Section 2(19AA) of the Act.

- The scheme indicates that if any terms or provisions of the scheme are inconsistent with the provisions of Section 2(19AA) of the Act, such provisions shall prevail and the scheme shall stand modified to that extent. Accordingly, the framing of the scheme and the corresponding sanction by this court do not in any way prejudice the application of Section 2(19AA) of the Act.

- Also, by sanctioning the present scheme, this court is not in any way accepting the company’s case that the scheme, as framed, complies with the provisions of ‘demerger’ within the meaning of Section 2(19AA) of the Act.

- Further, the High Court clarifies that the sanction of the scheme, as proposed by this court, does not in any way bind the tax department to take any particular view of the scheme of arrangement sanctioned by this court insofar as the tax implications of the transaction are concerned.

Non-compliance with the provisions of the Companies Act

- The provisions of Section 394(1)(i) to (vi) of the Companies Act, which the court may make whilst sanctioning a scheme, are merely enabling provisions. The said provisions are not in the nature of conditions for the exercise of the power of the Company Court under Section 394 of the Companies Act. These enabling provisions, therefore, cannot be construed as compulsory in any sense.

- The said provisions provide that if and to the extent the compromise or arrangement provides for allotment or appropriation by the transferee company of any shares, debentures, policies or other like interests in that company as part of the consideration of the scheme, the Company Court while sanctioning the scheme may make appropriate provisions in respect of such allotment or appropriation.

- It is not that in every case the consideration for transfer of an undertaking as part of a scheme of arrangement must come in the form of an allotment of shares of a transferee company or for that matter allotment of any shares.

- The consideration for such transfer can be any legitimate consideration, which the transferor is entitled to accept for a contract of transfer. The scheme may, thus, not provide for any allotment of shares at all or provide any other appropriate consideration including allotment of shares of a holding company of the transferee company.

- Acceptance of any particular consideration is part of the commercial wisdom to be exercised by the shareholders of the transferor company. As long as such consideration is not against public interest or in any other manner illegal or inappropriate, it is not for the Company Court to accept or reject such consideration. The same has been held by the Supreme Court in the case of Miheer Mafatlal vs. Mafatlal Industries Ltd. 1

- There is no harm to public interest insofar as the present scheme is concerned. Also, this court cannot reject the consideration, which is accepted by the shareholders of the transferor company, who are parties to the present arrangement.

- This court as well as other High Courts have accepted several schemes where the consideration for transfer of an undertaking is issued in the form of shares of a company other than the transferee company2.

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1 Miheer Mafatlal v. Mafatlal Industries Ltd. [1997 (1) SCC 579]
2 Pantaloon Retail (India) Limited [Company Scheme Petition No. 338/2010 decided on 24 August 2010 (Bom)], Keva Aromatics Private Limited [Company Application No.455/2013 decided on 10 December 2013 (Bom)], Seven Wonders Holidays Private Limited [Company Petition Nos.184 & 185 of 2010 decided on 1 August 2010 (Del)], M/s. IVRCL Limited [Company Petition Nos.58, 59, 60 and 61 of 2012 decided on 2 July 2012 (AP)]

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Accordingly, the objections raised by the Regional Director were quashed.

Our comments

In line with this decision, the Bombay High Court in another case held that the sanction of the scheme does not in any way bind the tax department to take any particular view of the scheme of arrangement sanctioned insofar as the tax implications of the transaction are concerned. Referring to the provisions of the Companies Act, the High Court also held that the consideration may not necessarily come in the form of allotment of shares of a transferee company and it may well be in the form of shares of a holding company of the transferee company.

It would be interesting to understand the view of the tax authorities on the meaning of the term ‘Resulting Company’ under Section 2(41A) of the Act read with Section 2(19AA) of the Act.
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