Detailed representations

1. Clarify that definition of 'undertaking' in section (s.) 2(19AA) covers hive-off 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 pro-rated 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 relatable 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.

2. Extend carry forward and set off of accumulated business loss and unabsorbed depreciation on amalgamation to service sector

Issue

- Provisions of s. 72A of the Act permit carry forward of business loss and accumulated depreciation in case of amalgamation only to certain specific types of companies such as those owning an industrial undertaking, banking companies, etc. Moreover, the provision deems such losses to be incurred in the year of amalgamation thereby resetting the 8-year clock for set-off of business losses against profits of subsequent years in the hands of the amalgamated company.

- Companies in the service or organized retail/trading sector are generally not eligible for such benefits.

- The services sector has been the bulwark of the Indian economy contributing about 54% of the total GVA in FY21[1]. It has also attracted significant foreign investment totaling to more than 16%[2] of the total FDI inflows into India. This sector also contributes significantly to India's exports wherein India's service exports in 2020-21 were USD 208.8 billion (constituting 41.8% of total exports)[3]. The sector provides large scale employment. As per ILO estimates (2019), services sector in India contributed 32% of the total employment in the country, with industry's share only at 25% and manufacturing sector's share at merely 12%.

- However, with the advent of globalization and liberalization resulting in the influx of foreign entities into India, the increasing competition has resulted in a pressing need for small companies in the service and organised retail/ trading to consolidate their resources to survive. Moreover, several service sector companies shall be looking for optimizing the operations by amalgamation with other companies even due to unprecedented Covid-19 situation.

- With growing emphasis on the digitization of economy and major portion of Indian GDP being contributed by service sector there seems to be no rationale for treating the service sector differently than manufacturing sector and restricting the applicability of s.72A only to manufacturing sector and select service sector.

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[1] Ministry of Statistics and Programme Implementation (MOSPI)
[2] Finance, Banking, Insurance, Non-Fin / Business, Outsourcing, R&D, Courier, Tech. Testing and Analysis, Other
[3] Ministry of Commerce

- Even internationally, where transition of losses is permitted in major developed countries such as US, UK, Singapore or even developing countries such as China and Russia (which are members of BRICS),no such artificial distinction is made and transition of losses is permitted to companies in all sectors with the safeguards of continuity of business and/or continuity of ownership.
- While admittedly, safeguards to ensure continuity of business in case of manufacturing sector [in terms of achieving production of 50% of installed capacity and maintenance of 75% of assets post-merger] may not be feasible for service/ trading sector, safeguards inserted internationally may be illuminative:
  - United Kingdom – Transition of losses to amalgamated company is subject to there being no scale down of business or change in its nature or ownership for 5 years subsequent to merger
  - Singapore – Transition of losses to amalgamated company is permitted subject to shareholders holding 50% or more shares being the same and there being no break in continuity of the business
  - Hong Kong – Transition of losses is to amalgamated company is subject to bona fides. Where sole/ dominant purpose is utilization of losses and there is change in the nature of business such losses are lost.
  - China – Transition of losses to amalgamated company are permitted subject to satisfaction of the following conditions:
    - The amalgamation must have bona fide business purpose and must not be carried out with the primary objective of reducing, avoid or deferring tax payments.
    - At least 75% of equity interest in acquired company must be acquired in an equity acquisition or at least 75% of transferring company's assets must be acquired in an asset acquisition.
    - At least 85% of total consideration received must be in the form of shares.
    - There must be no change in the nature of activities for 12 months post amalgamation.
    - Shareholders holding atleast 20% of shares in the amalgamating company must continue to hold shares in amalgamated company for atleast 12 months post amalgamation.

- The extension of s.72A to service sector will enable tax efficient business reorganization of companies and thereby protect value for shareholders. It will enable stronger companies to absorb small/weak companies, protect jobs and also secure the interests of financial and operating creditors by avoiding liquidation of financially stressed companies. The revenue's interest can be protected by providing appropriate safeguard based on international precedence.

Recommendation

- Benefit of carry forward and set off of accumulated business loss and unabsorbed depreciation prescribed under s. 72A be extended to amalgamation of service and trading companies.

- Since the conditions relating to installed capacity may not be appropriate for all service sectors, different criterion may be introduced for service sector. Illustratively, and in addition to conditions specified under s. 2(1B) this may include:

    - No scale down of operations (in the form of continuity of customers, suppliers, all business locations, markets, etc.) for 3 years post-merger beyond specified limit (-say, 50%).

    - No divestment in assets and property beyond specified limit (- say, 50%) for 3 years post-merger.

    - No fall in head-count of employees for 3 years post-merger beyond specified limit (-say, 75%)