Direct Tax Alert

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NCLT rejects scheme as Income Tax Authorities invoke GAAR

The Mumbai Bench of National Company Law Tribunal ('NCLT') rejected an application filed for the Scheme of Amalgamation of an investment holding company ('Transferor Company') with a listed entity ('Transferee Company')[1] ('Scheme').

The Scheme was primarily rejected owing to the adverse observations raised by the Income Tax Authorities, terming the Scheme as an 'Impermissible Avoidance Arrangement' under the General Anti Avoidance Rules ('GAAR'). The NCLT did not approve and sanction the proposed Scheme, citing it to be unfair, unreasonable, not in the public interest and resulting in a huge tax loss to the government.

Background and Facts

- The Transferor Company holds 83,92,262 equity shares (~ 9.53%) in the Transferee Company. The Transferee Company is a specialty pharmaceutical company engaged in development, production and marketing of branded and generic formulations.

- Pursuant to the merger being approved, investments of the Transferor Company in the equity shares of the Transferee Company would stand cancelled. The Transferee Company shall issue to the shareholders of the Transferor Company, the same number of new equity shares as held by the Transferor Company.

- All the shareholders of the Transferor Company are also the promoters of the Transferee Company.

[1] Scheme of Amalgamation between Gabs Investments Private Limited and Ajanta Pharma Limited – CSP No. 995 of 2017 and CSP No. 996 of 2017 in CSA No, 791 & 792 of 2017

Rationale of the Scheme

- Simplification of the shareholding structure and reduction of shareholding tiers;
- Demonstrating promoter group's direct commitment to and engagement with the Transferee Company;
- Streamlining promoters' holding in the Transferee Company; and
- Greater efficiency of promoter shareholding in the Transferee Company and removal of one unnecessary layer of companies.

Objections raised by the Income Tax Authorities

The Income Tax Authorities, submitted a detailed report of their objections, post a prior approval of Principal Commissioner of Income Tax. The summary of their objections is as detailed below:

- Issue of equity shares to the shareholders of the Transferor Company equivalent to the number of shares held by the Transferor Company in the Transferee Company is a direct transfer and distribution of assets to the shareholders of the Transferor Company without paying taxes as under:
  - As per the objects mentioned, the Transferor Company is in the business of investment and dealing in equity shares. The Transferor Company is avoiding income tax payable on business profits it would have made, if the equity shares were sold in the market. The tax (Minimum Alternate Tax) so payable would have been ~ ₹ 287.50 crores.
  - Further, on distribution of profit after tax to shareholders, the Transferor Company would have paid a dividend distribution tax of ~ ₹ 134.16 crores.
- In view of the above, the Scheme is a deliberate measure to evade tax by using the media of NCLT and is purely an Impermissible Avoidance Agreement under the provisions of GAAR which are applicable w.e.f. April 1, 2017.

Observations of the NCLT

The NCLT concurred with the objections as raised by the Income Tax Authorities and relying on the recent National Company Law Appellate Tribunal ('NCLAT') ruling[2], held that if a scheme is not in public interest, the same can be rejected by the NCLT. A summary of the NCLT's observations is as outlined below:

[2] Wiki Kids Ltd. v. Aventel Ltd. – Company Appeal (AT) No. 285 of 2017

- The fact that the Transferor Company is a group holding company with the sole object of holding investments in the Transferee Company is incorrect. The Transferor Company has been purchasing shares of the Transferee Company in the open market since 2008-09.

- The rationale presented in the Scheme is without any justification. Any transfer of property from one entity to other has to be treated as sale/ transfer and the same has to comply with applicable provisions of law including applicable tax liability and stamp duty.

- By way of the proposed Scheme, on investment of ~ ₹ 48.70 crores in the Transferor Company, the promoters would get shares of the Transferee Company worth ~ ₹ 1,477.50 crores without paying any income tax, stamp duty, etc. By this Scheme, shareholders of the Transferor Company and the Transferor Company are avoiding full tax liability.

- The Scheme would benefit only the common promoters of the Transferor Company and the Transferee Company and it does not serve any public interest.

- Promoters who receive the shares of the Transferee Company are required to comply with open offer obligations as specified in the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011 ('SEBI Takeover Code'). However, no provision is made in the Scheme with regard to the provisions of SEBI Takeover Code being violated.

In view of the above observations, the NCLT proceeded to reject the application, holding the Scheme to be unfairly advantageous to the shareholders of Transferor Company i.e. the promoters.

Dhruva Comments

The scheme involving the merger of promoter holding companies with the listed companies have been implemented in the past with objectives of rationalising holding structure, efficient succession planning, removal of additional layers and reduction of administrative costs. It is pertinent to note that in the past various High Court(s) and recently different benches of the NCLT have sanctioned scheme(s) with similar fact patterns.

The Bombay High Court[3] has specifically dealt with similar objections raised by a shareholder, wherein the High Court held that there was nothing illegal or unlawful or dubious in the scheme and the same was a perfectly legitimate scheme and permissible by law.

It is interesting to note that although the Petitioner Companies relied on the aforesaid ruling, the NCLT rejected the same on the ground that in the judgements relied upon, the objector

[3] In the matter of AVM Capital Services Pvt. Ltd.; CIT v. Sesa Goa Ltd.Company Application No. 17/ 2012

had raised issue to implead the Income Tax Authorities as a necessary party. However, in this case the Income Tax Authorities suo-moto filed their objections.

Other rulings of NCLT(s) with similar fact patterns

In the scheme of amalgamation before the Chennai Bench[4], the Transferor LLP having investments in the Transferee Company as the only asset, got merged into the Transferee Company and the partners of the Transferor LLP received the shares of the Transferee Company. The Chennai Bench approved the scheme of amalgamation, although maintaining reservations on any tax exemptions on such arrangement.

Further, the same bench of Mumbai NCLT sanctioned scheme(s) with similar fact patterns where the Transferee Company has given undertaking to comply with all the applicable provisions of the Income-tax Act, 1961 and all tax issues arising out of the scheme will be met and answered in accordance with the law.

However, in the present case, the Mumbai Bench was of the view that it was advisable to settle the crucial issue of huge tax liability raised by the Income Tax Authorities before sanctioning the scheme by the NCLT rather than disputing the same at a later stage after the scheme is sanctioned.

Scheme of Arrangements in GAAR scenario

While a commercial rationale for a restructuring scheme was always a pre-requisite, the ruling throws light on requirement of some strong rationale required in GAAR scenario, wherein the Income Tax Authorities may deem the arrangement as an Impermissible Avoidance Arrangement and a means to avoid tax.

The facts of this case are peculiar, as the actual transaction of sale of shares (where a tax liability could arise) is not part of the Scheme and may or may not happen. Hence, alleging tax avoidance and invoking GAAR when the amalgamation by itself does not result in any tax savings is quite absurd and arbitrary. Companies cannot be prohibited from simplifying their structures just because there could be a tax benefit in the future which is contingent upon a future uncertain and imaginary transaction. GAAR also can be invoked only when the main purpose is obtaining a tax benefit, when here clearly the main purpose was to simplify the corporate structure. A right to simplify the corporate structure cannot be denied in this manner.

It is also pertinent to evaluate a position that till the pendency of approval from the NCLT, whether a scheme be considered as an ‘arrangement’ under the GAAR provisions, as a scheme involving arrangement would be binding only on approval of the NCLT. Irrespective of the case if the scheme is considered as an arrangement or not, the Income Tax Authorities in the instant case were required to follow the laid-down procedure to invoke GAAR provisions, which require the matter to be referred to the Approving Panel followed by

[4] Scheme of Amalgamation between M/s. Real Image LLP with M/s. Qube Technologies Pvt. Ltd. and their respective partners, shareholders and creditors

an opportunity of being heard given to the assessee. Accordingly, it is likely that this ruling would be challenged in the NCLAT.

Exemption under the SEBI Takeover Code

While the NCLT has regarded the Scheme as being non-compliant with the SEBI Takeover Code, it has not considered the availability of exemption under Regulation 10(1)(d)(ii) of the SEBI Takeover Code (exemption from the open offer if shares of the listed company are acquired pursuant to a scheme of the merger).

ADDRESS

Mumbai
1101, One IndiaBulls Centre,
11th Floor, Tower 2B,
841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai - 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate Road,
Ahmedabad - 380 015
Tel: +91-79-6134 3434

Bengaluru
Prestige Terraces, 2nd Floor
Union Street, Infantry Road,
Bengaluru - 560 001
Tel: +91-80-4660 2500

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana - 122 002
Tel: +91-124-668 7000

Pune
305, Pride Gateway,
Near D-Mart, Baner,
Pune - 411 045
Tel: +91-20-6730 1000

Singapore
Dhruva Advisors (Singapore) Pte. Ltd.
20 Collyer Quay, #11-05
Singapore 049319
Tel: +65 9105 3645

Dubai
WTS Dhruva Consultants
U-Bora Tower 2,
11th Floor, Office 1101
Business Bay P.O. Box 127165
Dubai, UAE
Tel: +971 56 900 5849

Bahrain
WTS Dhruva Consultants
Bahrain Financial Harbour, East Tower - Floor 23,
Office 2301, Building 1398, Road 4626, Block 346.
Manama, Kingdom of Bahrain
Tel: 973 1663 1921

New York
Dhruva Advisors USA, Inc.
340 Madison Avenue, 19th Floor, New York,
New York 10173 USA
Tel: +1-212-220-9494

Silicon Valley, USA
Dhruva Advisors USA, Inc.
5201 Great America Parkway,
Santa Clara, California 95054
Tel: +1 408 930 5063

KEY CONTACTS

Dinesh Kanabar (Mumbai)
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Vishal Gada (Ahmedabad)
vishal.gada@dhruvaadvisors.com

Ajay Rotti (Bengaluru)
ajay.rotti@dhruvaadvisors.com

Krishan Malhotra (Delhi / NCR)
krishan.malhotra@dhruvaadvisors.com

K. Venkatachalam (Pune)
k.venkatachalam@dhruvaadvisors.com

Mahip Gupta (Singapore)
mahip.gupta@dhruvaadvisors.com

Pratik Shah (Dubai)
pratik.shah@dhruvaadvisors.com

Lawrence Zlatkin (USA)
lawrence.zlatkin@dhruvaadvisors.com

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