DO INDIA'S AMALGAMATION REVISIONS PREVENT MISUSE OF ACCUMULATED LOSSES?

Author
CA Anjali Kukreja

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CA Anjali Kukreja is a manager at R.N. Marwah & Co LLP, a leading Indian accounting firm headquartered in New Delhi. She is experienced in the field of international tax with a focus on mid-market global M&A.

INTRODUCTION

India's Finance Act, 2018 addressed a tax planning device intended to reduce or eliminate the imposition of the Dividend Distribution Tax ("D.D.T."), which applies when a corporation exercises the right to distribute dividends to shareholders. The D.D.T. serves as a dividend withholding tax. However, because it is imposed on the Indian company paying the dividend and not on the shareholder, favorable income tax treaty provisions are not applicable. This article compares the prior law to two possible interpretations of the amendment and examines the intent of the amendment.

INDIAN TAX LAW BEFORE THE AMENDMENT

The D.D.T. Mechanism

Section 115O of the Income-tax Act, 1961 ("Act") provides for the D.D.T. It is imposed at the rate of 15% plus applicable surcharge and cess[1] whenever a dividend is declared, distributed, or paid by a domestic company. The term "dividend" covers a deemed dividend.[2] It also includes any distribution to shareholders in a reduction of capital3 when a company possesses accumulated profits, even if capitalized. Accumulated profits[4] include all profits of the company up to the date of distribution for the purpose of section 2(22)(d) of the Act.

Strategy to Avoid D.D.T. on Payments to Shareholders in Capital Reductions

In order to avoid D.D.T., certain unlisted companies, mainly multinationals resort to the "Purchase Method"[5] of amalgamation[6] wherein a profit-making company with substantial accumulated profits is amalgamated with a company having significantly lower profits, or even losses. Fixed assets (including bank accounts and cash) of

[1] A cess is an additional income tax, leviable over and above, the basic tax rate and surcharge (if applicable). Currently, the rate of the cess is 4%.

[2] Section 2(22)(e) of the Act.

[3] Section 2(22)(d) of the Act.

[4] Explanation 2 to section 2(22) of the Act.

[5] Assets and liabilities are purchased at a mutually agreed value ("purchase price"). This is different from an amalgamation under the "Pooling of Interest Method" where there is a line-by-line addition of book values.

[6] "Amalgamation" in relation to companies, means a merger of two or more companies to form one company.

the "Amalgamating Company"[7] are transferred to the "Amalgamated Company."[8] Accumulated profits of the Amalgamating Company are not recorded or accounted for in the books of the Amalgamated Company (*i.e.*, the assets lose their identity). The books of the Amalgamated Company contain its accumulated losses as well as its assets (as held prior to the amalgamation) with the addition of newly acquired cash, bank balances, or other assets.

After amalgamation, the Amalgamated Company reduces capital to write off the accumulated losses by resorting to any of the following:

- Cancelling paid-up share capital against accumulated losses
- Distributing cash to the shareholders for paying off any paid-up share capital that is in excess of the wants of the company[9]

Upon this distribution of cash on capital reduction, the company circumvents payment of D.D.T. under section 2(22)(d) of the Act, as the D.D.T. is applicable on a distribution of cash only to the extent of accumulated profits and the Amalgamated Company typically does not have any such profits.

AMENDMENT IN INDIAN FINANCE ACT, 2018

> In the case of an amalgamated company, the accumulated profits, whether capitalized or not, or loss, as the case may be, shall be increased by the accumulated profits, whether capitalized or not, of the amalgamating company on the date of amalgamation [emphasis added].[10]

Interpretations of the Amendment

What does the amendment mean? Two contrasting viewpoints have been expressed.

View 1

In cases where the Amalgamating Company has accumulated losses, they will not be recorded in the books of the Amalgamated Company. Only in cases where the Amalgamating Company has accumulated profits will they be added to the accumulated profits or losses of the Amalgamated Company.

View 2

Accumulated profits or accumulated losses (as the case may be) of the Amalgamating Company will be recorded in the books of the Amalgamated Company. The omission of the expression "or losses, as the case may be" in the context of the Amalgamating Company is not deliberate.

[7] Transferor company (which is merged inside the other company) is referred to as the Amalgamating Company.

[8] Transferee company (which is formed as a result of the merger) is referred to as the Amalgamated Company.

[9] Section 66 of the Companies Act 2013 allows reduction of share capital through cancellation against paid up share capital as well as cash.

[10] Inserted vide Explanation 2A to section 2(22) of the Act.

Analysis of the Viewpoints

A literal reading of the exact words of the amendment would mean that in the case of an Amalgamated Company,

- accumulated profits . . . , **or losses**, as the case may be,
- "shall be increased by"
- "the accumulated profits" of the Amalgamating Company.

Exact interpretation to mean that

- the Amalgamated Company can either have accumulated profits or loss, and
- the accumulated profit or loss of the Amalgamated Company will be increased by the accumulated profits of the Amalgamating Company.

A bare reading of the plain language suggests that, only in cases where the Amalgamating Company has substantial accumulated profits, such accumulated profits would be added to the accumulated profits or losses of the Amalgamated Company.

The language clearly uses the expression "accumulated profits or losses as the case may be" for the Amalgamated Company, whereas it uses the expression "increased by accumulated profits of the amalgamating company." It is evident that the use of the word "losses" for the Amalgamated Company and its omission for the Amalgamating Company is conscious and intended.

Object of the Legislation

The language of the explanatory memorandum to Finance Bill 2018 clarifies that the intent of introducing this amendment is to prevent abusive arrangements for tax avoidance through amalgamations. The relevant extract is reproduced below:

> Instances have come to light whereby companies are resorting to abusive arrangements in order to escape liability of paying tax on distributed profits. Under such arrangements, companies with large accumulated profits adopt the amalgamation route to reduce capital and circumvent the provisions of sub-clause (d) of clause (22) of section 2 of the Act. With a view to preventing such abusive arrangements and similar other abusive arrangements, it is proposed to insert a new Explanation 2A in clause (22) of section 2 of the Act to widen the scope of the term 'accumulated profits' so as to provide that in the case of an amalgamated company, accumulated profits, whether capitalized or not, or losses as the case may be, shall be increased by the accumulated profits of the amalgamating company, whether capitalized or not, on the date of amalgamation [emphasis added].[11]

The law aims to target the misuse of amalgamation arrangements wherein the Amalgamating Company has substantial accumulated profits and the intent of the amalgamation is to distribute these profits by way of a capital reduction without paying D.D.T.

[11] Clause 3 of the Memorandum Explaining the Provisions of Finance Bill, 2018.

An inverse arrangement (*i.e.*, wherein the Amalgamating Company has substantial accumulated losses and the Amalgamated Company has substantial accumulated profits) is not intended to be covered by this amendment. This would mean that post amalgamation, by virtue of the amendment (under View 2), the Amalgamated Company may record losses (due to addition of substantial accumulated losses to the profits of the company). On applying this interpretation, we come back to square one, as the Amalgamated Company, on reduction of its capital, may now be able to circumvent the provisions of section 2(22)(d) of the Act. This interpretation renders the amendment ineffective when the Amalgamating Company has losses.

> ***"The intent of introducing this amendment is to prevent abusive arrangements for tax avoidance through amalgamations."***

Parallel Provision

The arrangement is reminiscent of section 72A of the Act introduced vide Indian Finance Act, 1977. This section relates to the carry forward and set off of accumulated loss and unabsorbed depreciation allowance in an amalgamation or demerger. Section 72A aims to prevent tax avoidance under an amalgamation arrangement where the Amalgamating Company is a loss-making company and the intent of the amalgamation is to avoid tax payment by the profit-making Amalgamated Company – as under such an arrangement, the profit-making company would be able to reduce taxes by taking advantage of the business losses and unabsorbed depreciation of the Amalgamating Company. Therefore, this section limits the tax benefit under artificial amalgamation arrangements (*i.e.*, undertaken without honest business considerations). This section also contains conditions whereby genuine business amalgamations do not suffer and companies are able to revive or expand their business.

CONCLUSION

If the Amalgamating Company is a loss-making company and the amalgamation is aimed at genuine revival of business under due commercial considerations, the interpretation under the View 1 (*i.e.*, that Amalgamated Company only gets accumulated profits and not losses of Amalgamating Company) allows the Amalgamating Company to leave behind the losses. After amalgamation, if the Amalgamated Company is a profit-making company, it would be in a better position to raise money from investors or arrange credit or loans to fund and revive its business operations. This interpretation seems to be in alignment with intent of the Indian government in preventing misuse of accumulated losses through amalgamations between loss-making and profit-making companies. At the same time, it also keeps the door open for the revival of loss-making companies through amalgamation arrangements. Furthermore, the Indian government does not aim to adversely affect genuine amalgamation arrangements taken for honest business expansion or revival purpose. The intent of the Indian government is to only block artificial arrangements. Mostly such an amendment would cover arrangements wherein two companies not engaged in the same or similar businesses join together so that available accumulated losses can be used strategically (for undue income tax benefit). This amendment is effective from April 1, 2018 (*i.e.*, the Indian financial year comprising the period from April 1, 2017 to March 31, 2018) and this will be the first year of implementation, only the time will tell whether the changes are effective. Has the Indian government achieved its goal of preventing the misuse of accumulated losses? Will this provision lead to increased litigation? Or will the affected taxpayers devise new methods of avoiding tax using amalgamation or merger arrangements?

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