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Kolkata ITAT* denies exemption under section 47(vib) on a demerger, however holds transaction to be exempt from capital gains tax under general principles

** ITA No. 2038/Kol/2014*

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Facts of the case

- The taxpayer, Datex Ohmeda (India) Pvt. Ltd. was engaged in carrying on the business of trading and servicing of medical equipment through its following divisions - Trading and Distribution (T&D), Medical Engineering, and Corporate Headquarters.
- The taxpayer transferred its T&D division to Wipro GE Healthcare Pvt. Ltd. (Wipro) with effect from 1 April 2008 through a demerger scheme which was sanctioned by the Karnataka and Calcutta High Courts.
- The taxpayer claimed the capital gains tax exemption under section 47(vib) [read with section 2(19AA)] of the Income-tax Act, 1961 (the Act) in respect of the transfer of its capital assets to the resulting company Wipro. Section 2(19AA)(ii) requires that all the liabilities of the transferred undertaking immediately before the demerger, should be transferred to the resulting company by virtue of the demerger.
- The Tax Officer denied the above exemption under section 47(vib) on the grounds that there was a violation of section 2(19AA)(ii) as a certain part of the loan of the T&D division had not been transferred to the resulting company Wipro. The Tax Officer accordingly charged capital gains tax in the hands of the taxpayer on the transfer of the T&D division.
- On appeal by the taxpayer, the Commissioner of Income-tax (Appeals) [CIT(A)] ruled in favour of the taxpayer, on the grounds that the impugned part of the loan was already converted into share capital prior to filing the demerger scheme and hence there was no question of transfer of such amount of the loan to the resulting company Wipro. Further, the CIT(A) also accepted the taxpayer's alternative argument that the transfer of the T&D division was not chargeable to capital gains tax in the hands of the taxpayer even considering the "slump sale" provisions.
- Aggrieved, the Tax Department appealed before the Income-tax Appellate Tribunal (ITAT or Tribunal).

Key issues under consideration

- Whether the demerger was exempt from capital gains tax under section 47(vib) having regard to the condition under section 2(19AA)(ii)?
- Whether the transfer of the T&D division was chargeable to capital gains tax in the hands of the taxpayer under "slump sale" provisions or on general principles?

Ruling of the Tribunal

- On the first issue, the Tribunal observed that the loan was very much in existence as on 1 April 2008 (the appointed date of the demerger) as well as was shown as a liability of the T&D division as on 31 March 2018. The Tribunal accordingly held that the condition under section 2(19AA)(ii) was not satisfied and hence, upheld the Tax Officer's action of denying the taxpayer's exemption claim made under section 47(vib). The Tribunal also held that impossibility of satisfying the above condition as on the retrospective appointed date of the demerger, i.e., 1 April 2008 due to subsequent conversion of the impugned part of the loan into share capital, would not be relevant to adjudicate whether the condition of section 2(19AA)(ii) was met.
- On the second issue, the Tribunal noted that the transfer of the T&D division was not a "sale" of an undertaking (in the absence of a monetary consideration), and following the ratio laid down by the Bombay High Court in the case of Bharat Bijlee Ltd. (as well as certain other Tribunal rulings), the Tribunal held that the transfer of the T&D division was not chargeable to capital gains tax in the hands of the Taxpayer. In Bharat Bijlee's case, it was held that "slump sale" provisions (section 2(42C) and section 50B) could not be pressed into service if the transfer of an undertaking was not by virtue of a "sale", and in the absence of any rules prescribing "cost of acquisition" of an undertaking upon its transfer on a going concern basis in any other mode, on general principles, no capital gains tax could be charged in the hands of the transferor due to failure of the computation mechanism.

Conclusion

The Tribunal has ruled on this very controversial issue of whether a non-compliant demerger is chargeable to capital gains tax in the hands of the demerged company – the Tribunal has, applying general principles, held that there can be no charge of capital gains tax in the hands of the demerged company on transfer of an undertaking to a resulting company even in a demerger that does not comply with the conditions of section 2(19AA).

While this is a welcome ruling in the context of the demerged company, the tax positions in case of the resulting company and the shareholders of the demerged company continue to remain controversial.

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