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Tax alert: Capital reserve generated on amalgamation of indirect WOS, not taxable

7 January 2025

The Mumbai Bench of the Income-tax Appellate Tribunal has held that, based on facts, the merger of an indirect wholly-owned subsidiary into the taxpayer qualifies as an 'amalgamation' under section 2(1B) of the Income-tax Act, 1961 (ITA). Consequently, all exemptions provided in the ITA are available to the merger. Further, capital reserve (recorded on amalgamation) cannot be treated as income under section 28(iv) of the ITA.

In a nutshell

The taxpayer was ultimate holding company owning the shares of B Co through its 100% subsidiary along with its nominees, which after the amalgamation, led to direct ownership of the assets in the taxpayer's name. The entire process, neither benefitted nor affected the taxpayer. Thus, the first condition of section 28(iv) of the ITA i.e., receipt of a benefit or perquisite, was completely absent.

Recording a reserve in consequence to an amalgamation order, is required for the limited purpose of balancing the accounts based on the double entry system employed and thereby, cannot give rise to any benefit or perquisite in the course of the business.

The only relationship between two companies was that of indirect holding between them. It could not be said that the amalgamation reserve arose out of any business activity of the taxpayer. Thus, the reserve created on account of amalgamation was capital in nature and not created on account of business activity. Hence, the provisions of section 28(iv) of the ITA were not applicable.

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Background:

- The taxpayer[1] is a company engaged in the business of real estate. The taxpayer (along with its nominee) held the entire share capital of a company (A Co) which in turn (along with its nominee) held the entire share capital of another company (B Co). In other words, B Co was an indirect wholly-owned subsidiary of the taxpayer.
- During the Financial Year (FY) 2017-18, corresponding to Assessment Year (AY) 2018-19:
  - B Co had raised capital by issuing equity shares.
  - Further, with an intent to simplify the group structure, rationalise the administrative overhead and to achieve greater administrative efficiency, B Co was amalgamated with the taxpayer as per the scheme of amalgamation. In accordance with the scheme, an amount of INR X was credited to capital reserve.
- Since the taxpayer was the ultimate holding company of B Co, therefore, on merger, the said shares were cancelled and no shares were issued by the taxpayer to the shareholders of B Co as consideration for the merger in view of the provisions of section 19 of the Companies Act, 2013.
- During the course of audit proceedings, the Assessing Officer (AO), amongst others, observed the following:
  - At the end of FY 2017-18, A Co had shown nil assets or investment. A Co had booked an amount of INR X of diminution in the value of the assets. Therefore, the said transaction generated capital reserve in the books of the taxpayer of INR X.
  - The taxpayer had received assets without consideration and therefore, the same was taxable under section 28(iv) [relating to taxability of benefit or perquisite arising out of business or profession] of the ITA.
- Aggrieved, the taxpayer filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)] who deleted the addition made by the AO.
- Aggrieved, the Revenue filed an appeal before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

Relevant extract of section 2(1B) of the ITA

*" '**amalgamation**', in relation to companies, means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that…*

*…(iii) shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies (**other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary**) become shareholders of the amalgamated company by virtue of the amalgamation..."*

Relevant extract of section 28(iv)[2] of the ITA

***"**The following income shall be chargeable to income-tax under the head "Profits and gains of business or profession"…*

…(iv) the value of any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession"

[1] DCIT v. Samagra Wealthmax Private Limited [ITA No. 2165/MUM/2023] (Mumbai ITAT)

[2] Prior to amendment vide Finance Act 2023

Decision of the ITAT:

The ITAT noted /observed the following:

Amalgamation under section 2(1B) of the ITA

- One of the conditions for a merger to qualify as an 'amalgamation' as per the provisions of section 2(1B) of the ITA, is that shareholders holding not less than three-fourths in value of the shares in the amalgamating company should become shareholders of the amalgamated company by virtue of the amalgamation.

  However, section 2(1B)(iii) of the ITA provides an exception in case the shares of the amalgamating company are already held by the amalgamated company or its subsidiary. Thus, the merger of B Co into the taxpayer qualified as an 'amalgamation' under section 2(1B) of the ITA and consequently, all the exemptions provided in the ITA were available to the merger.

Taxability of reserve as benefit or perquisite under section 28(iv) of the ITA

- In order to tax any amount under section 28(iv) of the ITA, the following prerequisites need to be satisfied:
  - There must be benefit or perquisite arising to the company,
  - It must arise out of the business or profession carried on by the recipient, and
  - It must be revenue in nature.
- In the case under consideration, there was absolutely no benefit or perquisite arising out of the scheme of amalgamation. The taxpayer was ultimate holding company having the shares of B Co through its 100% subsidiary along with its nominees which after the amalgamation led to the direct ownership of the assets in the taxpayer's name.

  In the whole process, the taxpayer neither became richer nor poorer. Thus, the first condition of section 28(iv) of the ITA i.e., receipt of a benefit or perquisite, was completely absent (as a sine qua non of the same was that the recipient had gained as a consequence of the transaction).
- Further, recording a reserve in consequence to amalgamation order was required to be passed for the limited purpose of balancing the accounts based on the double entry system employed and thereby, could not give rise to any benefit or perquisite in the course of the business.

  The only relationship between two companies was that of indirect holding between them. It could not be said that the amalgamation reserve arose out of any business activity of the taxpayer. The scheme of amalgamation could not be regarded to be the one carried into during the course of carrying on the business. Thus, the reserve created on account of amalgamation was capital in nature and not created on account of business activity.

In view of the above, the ITAT held that the capital reserve could not be treated as an income under section 28(iv) of the ITA.

Comments:

An amalgamation of companies may be tax neutral subject to satisfaction of certain conditions. Further, in case the amalgamation is non-tax neutral then, taxability would need to be considered under different provisions of the ITA. This ruling, based on the facts of the case, has held the following:

- The merger of B Co (i.e., indirect wholly owned subsidiary of the taxpayer) into the taxpayer qualified as an 'amalgamation' under section 2(1B) of the ITA.
- The taxpayer was ultimate holding company owning the shares of B Co through its 100% subsidiary along with its nominees, which after the amalgamation, led to direct ownership of the assets in the taxpayer's name. The entire process, neither benefitted nor affected the taxpayer. Thus, the first condition of section 28(iv) of the ITA i.e., receipt of a benefit or perquisite, was completely absent.

- Recording a reserve in consequence to an amalgamation order, is required for the limited purpose of balancing the accounts based on the double entry system employed and thereby, cannot give rise to any benefit or perquisite in the course of the business.
- The only relationship between two companies was that of indirect holding between them. It could not be said that the amalgamation reserve arose out of any business activity of the taxpayer. Thus, the reserve created on account of amalgamation was capital in nature and not created on account of business activity. Hence, the provisions of section 28(iv) of the ITA were not applicable.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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