TAX IMPLICATIONS OF REVERSE MERGERS

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DEFINITION OF REVERSE MERGER

'Reverse merger' is a commercial term that is not found in any statute. Traditionally the phrase reverse merger has been used to describe a merger of a healthy unit into a sick unit. Before 1977 the healthy unit would merge with the sick unit and the sick unit would survive. After taking advantage of its accumulated losses and allowances for depreciation of the sick unit, the sick unit's name would be changed to that of the healthy unit. This was because until Section 72A was inserted by the Finance Act, 1977[1] into the Income Tax Act, 1961, it was not possible for a new company formed out of the merger of two other companies to set off its profits with the accumulated loss of the companies that merged to give birth to it, or take advantage of their allowances for depreciation. The reason for this was that a company could set off its profits only with its own losses and not with the losses of any other company. So if a healthy company A Ltd merged with a sick company B Ltd to form company C Ltd, C Ltd could not set off its profits with the accumulated losses of B Ltd or utilise the allowances for depreciation of B Ltd. So A Ltd would merge into B Ltd and B Ltd. would survive. A year or two after the accumulated losses and allowances for depreciation of B Ltd were used to set off the profits of A Ltd, the name of B Ltd would be changed to A Ltd (since A Ltd would have greater good will).

Section 72A was inserted into the Act to encourage reverse mergers. It allows the accumulated loss and allowance for depreciation of an amalgamating company to be treated as that of the amalgamated company. Hence A Ltd and B Ltd can merge to form C Ltd and the accumulated loss and allowance for depreciation of B Ltd will be treated as that of C Ltd. The same applies if A Ltd merges into B Ltd and B Ltd survives or B Ltd merges into A Ltd and A Ltd survives. The companies that exist prior to the amalgamation are called amalgamating companies and the company formed out of the amalgamation is called the amalgamated company.

PREREQUISITES FOR BENEFITTING UNDER SECTION 72A

Section 72A uses the term amalgamation and not merger. Hence the merger between the healthy unit and the sick unit, must fall within the definition of amalgamation given in section 2(1B) of the Act. This requires the merger to be in such a way that:

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1 Hereinafter called the Act.

- All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation.

- All the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation.

- Shareholders holding not less than nine tenth 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.

Section 2(1B) of the Act specifically clarifies that fulfilment of the above conditions by sale of the property of one company to another or by the distribution of the property of a company on its winding up to another company will not amount to an amalgamation.

After a merger fulfils the requirements of section 2(1B) of the Act and is termed as an amalgamation, the Central Government has to be satisfied that the following conditions are fulfilled:

- The amalgamating company was not, immediately before such amalgamation, financially viable by reason of its liabilities, losses and other relevant factors.

- The amalgamation was in the public interest.

- Any other condition specified by a notification in the official gazette, to ensure that the benefits under this section is restricted to amalgamations which would facilitate the rehabilitation or revival of the business of the amalgamating company.

Once these conditions are fulfilled, the Central Government will make a declaration of its satisfaction of such fulfilment. After this is done, the accumulated loss and unabsorbed depreciation of the amalgamating company shall be deemed to be the loss, or as the case may be allowance for depreciation of the amalgamated company for the previous year in which amalgamation was effected. However, clause 2 of section 72A lays down further conditions for obtaining the benefits provided for by clause 1. It requires the following conditions to be fulfilled.

- During the previous year for which set off is claimed the business of the amalgamating company should be carried on by the amalgamated company, without any modifications except those approved by the Central Government.

- The amalgamated company furnishes along with its return of income, a certificate from the specified authority to the effect that adequate steps have been taken by that company for the rehabilitation or revival of the business of the amalgamating company. This certificate will be necessary for all the assessment years when the carry forward and set off of unabsorbed loss and allowance for depreciation of the amalgamating company is claimed by the amalgamated company.[2]

In the case of *CIT v. Mahindra and Mahindra Ltd.*,[3] the Supreme Court reiterated that the three statutory conditions of Section 72(A)(1) of the Act are to be fulfilled for benefits prescribed therein to be available to the amalgamated company. In *Atlas Cycle Industries v. Union of India*,[4] the Delhi High Court held that the Central Government and the specified authority are required by Section 72A of the Act to see whether the amalgamating company had the resources, or was in a position to obtain resources from any avenue to carry on its business prior to the amalgamation.

According to the guidelines issued by the Central Government,[5] the specified authority, while taking a view on financial non viability of the amalgamating company, has to take the following factors into account: losses incurred during each of the three years proceeding amalgamation; accumulated losses on the date of amalgamation as compared to the paid up capital reserves and surpluses; repayment of term loans and interest thereon during three years preceding amalgamation; status of cash credit and excess drawings, if any during three years preceding amalgamation; extent and nature of liabilities in relation to the value and composition of assets on the date of amalgamation; projected future profits in case of undertakings which have commenced production five years prior to amalgamation.

CONCEPT OF PUBLIC INTEREST

One of the three conditions given in Section 72A(1) of the Act for obtaining a declaration of satisfaction from the Central Government is that the amalgamation must be in *public interest*. The term *public interest* has not been defined by the Act. However, the following guidelines[6] have been given by the government to decide on whether the amalgamation is in public interest: amalgamation in the context of industrial policy in general and the policy with regard to the industry to which the sick unit belongs to in particular; basic liability of the sick unit; need for tax benefits for revival of the sick unit; how effectively the resources generated through tax benefits under Section 72A of the Act as

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2 Circular No. 350, dated September 29, 1982.

3 [1983] 15 Taxman 1 (SC).

4. [1983] 14 Taxman 254 (Delhi).

5 Press note from Ministry of Industry dated 23.2.1981, *c.f.* Verma, *Corporate Mergers and Take Overs* 216 (1993).

6 Press note from Ministry of Industry dated 23.2.1981, *c.f.* Prasad, *Direct Taxes: Law and Practice* 470 (1995).

supplemented by other resources that may be required, are made available by the amalgamated company for revival of the business of the amalgamating company's undertaking; nature of product manufactured by the sick unit; employment generated by the sick unit; location of the sick unit; consequences of closure of the sick unit on the industry, ancillary linkages, if any, employment in the region and creditors.

In view of the above the Calcutta High Court ruled in the case of *Duncan Agro Industries Ltd. v. Secretary, Department of Industrial Development*,[7] that the point to be determined is whether the said purpose or interest would be in the general interest of the community as distinguished from the private interest of an individual.

PROCEDURES FOR OBTAINING BENEFITS UNDER SECTION 72A

Applications for obtaining approval of amalgamation of companies for purposes of Section 72A are required to be made in the prescribed form and addressed to the Secretary, Department of Industrial Development, Government of India. If this specified authority is satisfied that the requirements of Section 72A(1) are fulfilled, it recommends the Central Government to make the declaration mentioned in Section 72A(1). The application to the specified authority can be made even before the amalgamation has been effected in order to find out whether the specified au hority will be recommending to the Central Government to make the declaration. This is provided for by clause 3 of Section 72A of the Act. However, even if the application to the specified authority is made prior to the amalgamation, the specified authority will make its recommendation to the Central Government only after the amalgamation has been effected.

After the Central Government makes the declaration, another application has to be made to the specified authority to obtain a certificate that the amalgamated company has taken adequate steps for the rehabilitation on revival of the business of the amalgamating company. This application should also be addressed to the Secretary, Department of Industrial Development, Government of India giving all relevant information regarding: steps that are required to be taken to rehabilitate and revive the business of the amalgamating company; action taken so far on each of the steps; reasons for any delay in taking action, if any.

This application must be signed by the Managing Director of the company and should be accompanied by a certificate from the statutory auditors of the company.[8] In the case of *Atlas Cycle Industries Ltd. v. Union of India*,[9] the Delhi High Court held that the specified authority under Section 72A cannot reject the

7 [1983] 144 ITR 94 (Cal.).

8. 3 Sampath Iyengar, *The Laws of Income Tax* 2963 (1990).

9 [1983] 14 Taxman 254 (Delhi).

application on the ground that the amalgamating company is a subsidiary of the amalgamated company and the amalgamation will not bring any additional management expertise.

SHOULD SECTION 72A BE RETAINED?

A merger is a method by which under-utilised assets can be potentially put to full utilisation, and inefficiency can be turned into efficiency. However in the case of intragroup mergers, a reverse merger is a convenient way of cutting down on tax liability. It is common knowledge that the books of accounts can be maintained on acceptable accounting standards and still show continuous book losses. When accumulated losses correspond to the norm of the definition of a sick unit, a merger with a profitable unit is the same group of companies that can yield rich dividends.[10] Usually a genuinely sick unit will find it very difficult to find a profit making unit willing to merge with it due to the simple reason that a sick unit implies huge liabilities to bankers and creditors which in absolute turns can be more than the value of its assets. Hence reverse mergers are usually intra-group and mainly for the purpose of tax avoidance.

The main loophole in Section 72A is that it does not take into account the fact that after a reverse merger, there can be a de-merger of the company that was formed by the merger. If companies A Ltd. and B Ltd. had merged to form C Ltd, then company C Ltd. may form a subsidiary company D Ltd. and transfer the assets of company B Ltd. to it.[11] If company A Ltd. was the healthy unit and company B Ltd. the sick unit, the new company C Ltd. will enjoy the tax benefits from the unabsorbed loss and allowance for depreciation of company B Ltd. for an assessment year or two and then demerge.

However doing away with Section 72A of the Act would be too drastic a step. If such reverse mergers were not encouraged through tax concessions as Section 72A of the Act does, the only way out for sick units would be to close down or to be taken over by the Government. Closure of a sick unit has many social ramifications and a takeover of all sick units by the Government is not feasible either. The Raja Chelliah Committee Report on tax reforms has acknowledged the practice of buying losses through the acquisition of loss making companies. However it has stated that in the larger interest of the economy, the tax benefits for reverse mergers given in S. 72 is necessary. It has noted that in the case of several sick undertakings, the only hope for their revival is through new promoters replacing those who have failed before. The entry of such new promoters would automatically involve substantial change in shareholding. If there is denial of the benefits of carry forward and set off of accumulated losses and allowances for depreciation, no healthy unit will be tempted to merge with a sick one. Hence it can only be concluded that Section 72A must not be deleted.

10 Kumar & Parchure, *Mergers and Takeovers in India* 22 (1990).

11 K.R. Sekar, *Demerger - Tax Issues - A Case Study*, 94 Taxman 245 (Magazine).

What must be ensured is that the scrutiny of any proposed amalgamation by the specified authority is made more stringent. It must see to it that the sick unit is revived or rehabilitated by the merger. In case of a demerger, there must be provision for imposing a fine that will be equivalent to the tax benefits enjoyed as a result of the reverse merger, if it can be shown that the merger was solely for purposes of tax avoidance. It is imperative that the government should insert a provision into the Income Tax Act, 1961 that provides guidelines that can be used in case of a demerger to see if the earlier merger was solely for purposes of tax avoidance. If it is found to be so, a fine equivalent to, or greater than the quantum of tax avoided as a result of the merger should be imposed on the amalgamating company that benefitted from the merger. Such a provision is needed in view of the Supreme Court decision in *Mc Dowell and Co. Ltd. v. Commercial Tax Officer*.[12] In his decision Chinnappa Reddy, J., came down heavily on tax evasion through colourable tax planning devices. It was ruled that in a welfare state like India, it is the obligation of every citizen to pay taxes without subterfuges. The earlier view that a person could arrange his affairs in such a way as to avoid taxation was expressly overruled.[13]

12 (1985) 3 SCC 230.

13 *Cape Brandy Syndicate v. Inland Revenue*, (1921) 1 KB 64 at 71.