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TAX FLASH NEWS

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Waiver of interest in the hands of amalgamating company needs to be set off against the accumulated losses in the hands of amalgamated company – Supreme Court

Background

Recently, the Supreme Court of India in the case of Mcdowell & Company Ltd[1] (the taxpayer) held that waiver of interest due by amalgamating company to financial institutions is taxable in the hands of the amalgamated company under Section 41(1) of the Income-tax Act, 1961 (the Act). Through the scheme of amalgamation, the taxpayer was allowed to set off the losses of amalgamating company under Section 72A of the Act. When the taxpayer is allowed the benefit of accumulated losses, while computing those losses, the income which accrued to it, had to be adjusted and only thereafter net losses could have been allowed to be set off.

Facts of the case

- Hindustan Polymers Limited (HPL), a sick industrial company, owed money to banks and financial institutions. In its books of accounts, the interest which had accrued on the loans given by such financial companies were shown as the money payable on account of interest to the said banking companies and was reflected as expenditure. Further, proceedings in respect of HPL were pending before the Board for Industrial and Financial Reconstruction (BIFR) under Sick Industrial Companies Act (SICA).

- Petitions under Section 391 and 392 of the Companies Act, 1956, were filed in the Bombay and Madras High Court for the amalgamation of HPL with the taxpayer. Both the High Courts approved the scheme of amalgamation with effect from 1 April 1977.

- The taxpayer had approached the central government, before moving to the High Court, with the scheme of amalgamation for getting benefits of Section 72A of the Act. The central government had made a declaration under Section 72A of the Act granting the benefit of the said provision to the taxpayer.

- Under the scheme of amalgamation, which was approved by the High Court, the banks which had advanced loans to HPL agreed to waive off the interest which had accrued prior to 1 April 1977. This interest was claimed as expenditure by HPL in its return of income.

- In the return filed by the taxpayer for the Assessment Year 1983-1984, the taxpayer claimed a set off of the accumulated losses which it had taken over from HPL under the provisions of Section 72A of the Act.

- The Assessing Officer (AO) while allowing the aforesaid benefit to the taxpayer observed that the income which had accrued under Section 41(1) of the Act had not been set off against the accumulated losses. The AO treated the aforesaid income in the hands of the taxpayer and adjusted the same from the accumulated losses.

- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. However, the Tribunal held that the aforesaid income under Section 41(1) of the Act was not chargeable in the hands of the taxpayer but it may be treated as income of HPL, and since HPL was a different taxpayer and a different entity, the taxpayer was not liable to pay any taxes on the said income.

[1] Mcdowell & Company Ltd. v. CIT (Civil Appeal No. 3893 of 2006) – Taxsutra.com

- The High Court held the decision in favour of the tax department.

Supreme Court's decision

- Relying on the decision of Saraswathi Industrial Syndicate[2] the taxpayer contended that since HPL was a different taxpayer, interest income could not be held to be the income of the amalgamated company under Section 41(1) of the Act. However, the Supreme Court rejected the taxpayer's arguments holding that similar arguments were also raised before the High Court. The High Court observed that the taxpayer had taken over the sick company through the scheme of amalgamation and by virtue of amalgamation, HPL ceased to have any identity as it did not remain a 'person' either in fact or in law after amalgamation. However, rights are determined in terms of the scheme of amalgamation, and since the benefit of interest had accrued after the company had ceased to exist, it was, in fact, availed off by the taxpayer.

- The most important fact is that the taxpayer was allowed to set off the losses of HPL. This was the benefit which accrued to the taxpayer under the provisions of Section 72A of the Act. When the taxpayer is allowed the benefit of the accumulated losses, while computing those losses, the income which accrued to it had to be adjusted and only thereafter net losses could have been allowed to be set off by the taxpayer. Calculations to this effect are given by the AO, and there is no dispute about the same.

- The decision relied on by the taxpayer in the case of Saraswathi Industrial Syndicate Ltd. is distinguishable on facts of the present case. It deals with the provisions of Section 41(1) of the Act per se and Section 72A of the Act was not the subject matter of the said decision. Therefore, the principle laid down in the said case is not applicable to the facts of the present case. Though these losses were suffered by the amalgamated company, they were deemed to be treated as losses of the taxpayer by virtue of Section 72A of the Act.

- In the present case, it cannot be said that the taxpayer would be entitled to take advantage of the accumulated losses, but while calculating these accumulated losses in the hands of the amalgamated company, the income accrued under Section 41(1) of the Act in the hands of HPL would not be accounted for. That had to be necessarily adjusted in order to see what are the actual accumulated losses, the benefit whereof is to be extended to the taxpayer.

- Accordingly, the Supreme Court agreed with the High Court in its analysis of Section 41(1) along with Section 72A of the Act.

Our comments

The Supreme Court in the case of Saraswathi Industrial Syndicate Ltd. held that in order to attract the provisions of Section 41(1) of the Act, the identity of the taxpayer in the previous year and the subsequent year must be the same. If there is any change in the identity of the taxpayer, there would be no tax liability under the provisions of Section 41 of the Act. It was observed that the true effect and character of the amalgamation largely depends on the terms of the scheme of the merger. When two companies amalgamate and merge into one, the transferor company loses its entity as it ceases to have its business. Their respective rights or liabilities are determined under the scheme of amalgamation, but the corporate entity of the transferor company ceases to exist with effect from the date the amalgamation is made effective. Accordingly, the amalgamating company ceased to exist in the eyes of the law. Therefore, the taxpayer was not liable to pay tax.

However, the Supreme Court in the instant case distinguished the decision in the case of Saraswathi Industrial Syndicate Ltd. and observed that through the scheme of amalgamation, the amalgamated company was allowed to set off the losses of the amalgamating company. When the taxpayer is allowed the benefit of the accumulated losses, while computing those losses, the income which accrued to it had to be adjusted and only thereafter net losses could have been allowed to be set off by the taxpayer. Therefore, waiver of interest in the hands of the amalgamating company is taxable in the hands of the amalgamated company under Section 41(1) of Act.

[2] Saraswathi Industrial Syndicate v. CIT [1990] 53 Taxman 92 (SC)

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