

Tax Flash News

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Amalgamation route was used as a device to avoid taxes and therefore payment to the shareholder of amalgamating company was held as undisclosed income

Executive summary

Recently, the Madras High Court in the case of Dadha Pharma Private Limited¹ (the taxpayer) dealt with the taxability of amalgamation transaction where the amalgamated company had paid huge cash amounts to the substantial shareholder of amalgamating company (the taxpayer) prior to such amalgamation. The High Court observed that cash was paid against transfer of shares prior to the amalgamation transaction. Actual transaction was of transfer of shares which was disguised by taking a route of amalgamation to avoid the taxes. The amalgamation was devised to create a smoke screen in the eyes of the tax department to evade tax on the amounts transferred in cash without proper accounting. Details of payment of cash prior to amalgamation were not provided before the Courts which have sanctioned the amalgamation scheme. Thus, the payment to the shareholder of amalgamating company i.e., taxpayer was held as undisclosed income and it was to be taxed under the Income-tax Act, 1961.

Facts of the case

- Tamil Nadu Dadha Pharmaceuticals Ltd. (TNDPL) was incorporated as a Joint Venture between the Dadha Group (DG) and Tamil Nadu Industrial Development Corporation Ltd. (TIDCO).
- About 25 per cent of the shares in TNDPL were held by DG and 26 per cent of the shares were held by TIDCO. As per the Memorandum of Understanding (MOU), DG had a preemptory right to purchase the shares in TNDPL, if TIDCO wants to disinvest its holdings in the latter.
- SPIL was apparently interested in acquiring the shares in TNDPL. However, SPIL could not directly acquire the 26 per cent of the shares in TNDPL held by TIDCO. Therefore, SPIL funded the DG to acquire 26 per cent of shares held by TIDCO in TNDPL. Consequently, DG acquired 26 per cent shares held by TIDCO in TNDPL. Subsequently, TNDPL was merged with SPIL.
- By virtue of this acquisition, SPIL and its group companies paid a sum of INR 168.56 million to the members of DG between 1 July 1997 and 1 January 1999 at the rate of INR 290 per share. Further, for delayed payments, DG received interest from SPIL.
- The AO held that the funds received by DG from SPIL through its various companies for sale of shares or the interest on delayed payments found in search on SPIL were undisclosed income and should be taxed under Section 158BD². The AO observed that SPIL paid huge cash amounts to DG. DG had not offered these amounts to tax assuming that the transaction is exempt under Section 47 (treating it as amalgamation). Consequently, the block assessment provisions were invoked to tax 'undisclosed income'. The transaction of amalgamation was created to avoid tax. The transfer of shares to SPIL was taxed as capital gains.
- The Tribunal while holding in favour of the taxpayer observed that the amount cannot be taxed as capital gains because there was no transfer, and the transaction was covered under Section 47.

¹ CIT v. Dadha Pharma Private Limited (TCA Nos. 1925 of 2008 and 648 of 2009) (Mad) – Taxsutra.com

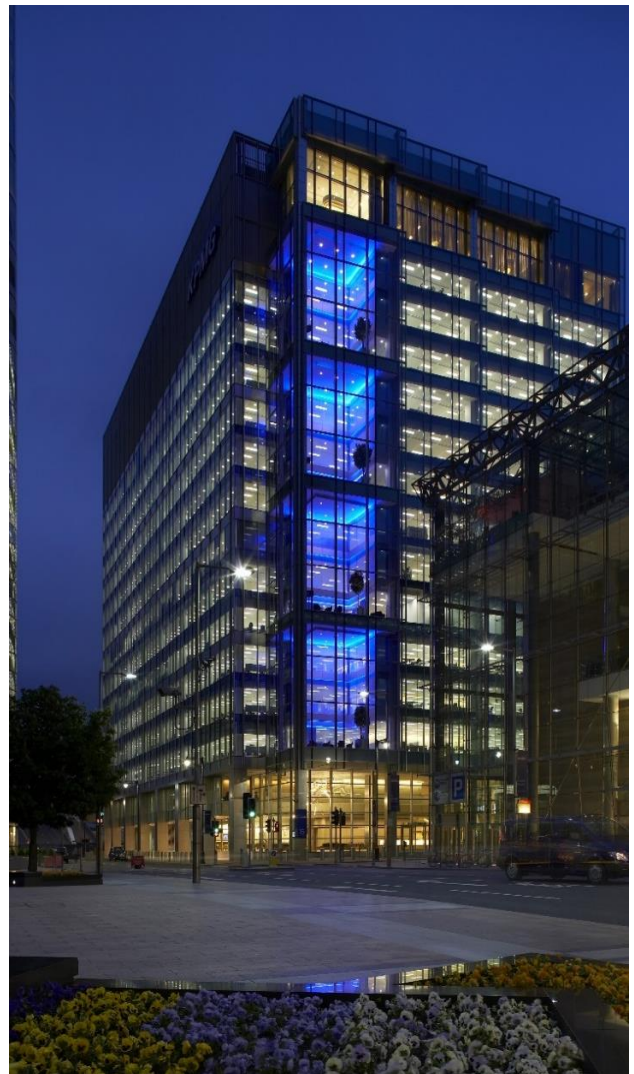
² Undisclosed income of any other person in case of search

High Court's decision

- Amalgamation can result only in the shares being allotted in the transferee company namely, SPIL as per the share exchange ratio in the schemes of amalgamation. Unless the scheme of amalgamation itself contemplated a cash component, there would be no question of payment of amounts in cash.
- In this case, payment of cash was independent of the amalgamation and prior to the amalgamation and thus amalgamation was used as a device to avail the benefit of Section 47.
- Details of payment of cash prior to amalgamation was not provided before the Courts which have sanctioned the amalgamation scheme.
- There were only notional allocations based on the number of shares before and after acquisition that were held and allegedly transferred prior to the amalgamation. None of the documents relating to the allocation of shares prior to the amalgamation were filed. Share registers of TNDPL were also not produced before the AO.
- Ordinarily, in an amalgamation, there was no question of amounts being paid when there was an amalgamation simplicitor.
- The amounts received by DG were nothing but undisclosed income in the hands of members of DG and therefore liable to assessment under Section 158BA.
- Merely because some of the cases filed by the tax department against the taxpayer were disposed in the light of the litigation policy of the tax department will not impel to dismiss the petitions filed by the tax department.
- In this case, the amalgamation was devised to create a smoke screen in the eyes of the tax department to evade tax on the amounts transferred in cash without proper accounting.
- The High Court directed to conduct a fresh assessment based on the records instead of notional allocation of amounts received.

Our comments

Normally, business reorganisation transactions are tax neutral under the Income-tax Act. Such transactions are approved by the High Court and thus question of doubting the same may not arise. However, in the instant case, the High Court observed that the transaction was designed for tax evasion. Accordingly, the tax exemption available for genuine amalgamation transactions have not been granted to the taxpayer in this case. Important reason for disregarding the amalgamation transaction was payment of cash amounts to the substantial shareholder of the amalgamating company before filing the scheme of amalgamation with the High Court. Further, the taxpayer had not disclosed these details to the High Courts who have sanctioned the scheme of amalgamation.



KPMG in India addresses:

Ahmedabad

Commerce House V, 9th Floor,
902, Near Vodafone House, Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru

Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh

SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai

KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram

Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad

Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally
Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur

Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi

Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytila, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata

Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai

2nd Floor, Block T2 (B Wing),
Lodha Excelus, Apollo Mills Compound, N M
Joshi Marg, Mahalaxmi, Mumbai- 400011
Tel: +91 22 3989 6000

Noida

Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune

9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara

Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada

Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

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KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000

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