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Slump Sale or Demerger? – A Better Tax Efficient Business Reconstruction Tool

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ABSTRACT

After the amendment of Income-tax Act of 1961, the provisions have changed drastically. Most of which are driven by novel techniques employed by tax counsels and upheld/approved by appellate authorities. Even after such amendment, tax counsels backed by clients continue to employ tax methods that are not approved by the tax authorities, resulting in a litigation and, in most cases, law changes to help the tax authorities win the battle. Setting court decisions aside is often one-sided. Of fact, in unusual circumstances, despite being in their favour, certain legal rulings perplex taxpayers and other stakeholders. Rattha Citadines Boulevard Chennai (P.) Ltd v. Dy. CIT[2] *is an instance of such a ruling. In Sesa Goa Ltd v. Jt. CIT*[3]*, the court made several smart findings, such as comparing the Income-tax Act, 1922 with the Income-tax Act, 1961 when it was first passed. This article analyses the tax benefits provided on slump sales vs demergers, taking into account the Finance Act of 2021's latest modifications.*

Keywords: *Slump sale, Demerger, Finance Act 2021, Litigation, Tax authorities.*

I. INTRODUCTION

Business dynamics have changed dramatically in recent years, and they are continually shifting to adapt to changing social and economic conditions. Today's firms have become so multi-faceted that they operate under many brands/names in various industries. Even today, we find various segments or enterprises inside a single organisation, each with its own set of assets and liabilities, each focusing on a particular economic area. As a result, the practise of restructuring a firm by selling a portion or project is becoming increasingly popular. Business restructuring can take several forms, including mergers, demergers, slump sales, share acquisitions, and so on. Each mode has its own set of advantages and disadvantages, and can be chosen based on commercial and financial goals. A slump sale refers to the sale of a commercial venture.

The question of whether or not to tax slump sales has always been contentious. There was no

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[2] [2021] 430 ITR 7 (Mad.).
[3] [2020] 423 ITR 426 (Bom.).

particular provision in the Income Tax Act of 1961 ('Act') dealing with slump sales until 2000. The transaction was also exempt from taxation under Section 41(2) and Section 50 of the Act since the values were not attributed to individual assets and liabilities. As a result, until the year 2000, slump sales were not taxed. To plug in these loopholes, the Finance Act, 1999, inserted Section 50B and Section 2(42)(C) in the Act w.e.f. 1 April 2000 to provide for taxation of slump sale. Similar to slump sale, demerger is a also form of corporate restructuring which in undertaken by companies in order to promote specialization. Demerger allows a company to expand its operations in a very systematic manner. It allows a specific division or unit to grow as a separate and a focused entity, thereby increasing its efficiency and effectiveness. This research paper analyses the tax implication of both slump sale and demerger and would suggest the best mode of reconstruction a business can undergo to achieve efficacy in tax planning.

II. SLUMP SALE

Section 2 (42C) defines the phrase "slump sale". It refers to the transfer of one or more enterprises for a lump sum payment without assigning valuations to the various assets and liabilities in the transaction. The Finance Act of 2021 changed the terms 'as a result of sale' to 'by any means.' For the purpose of interpreting the definition of the term 'undertaking,' this section refers to Explanation 1 to Section 2(19AA).

According to Explanation 2 of this section, determining the value of an asset or obligation only for the purpose of paying stamp duty, registration fees, or other comparable taxes or fees is not considered assigning values to individual assets or liabilities.Explanation 3 was added to this section by the Finance Act of 2021, stating that the term "transfer" shall be understood in accordance with the definition in section 2(47). As a result, it has a broader scope than the term 'sale,' which was previously used.

According to Section 50B, all profits and gains from a slump sale made the previous year are taxed as capital gains originating from the transfer of long-term capital assets and are assumed to be the income of the preceding year in which the slump sale occurred. The proviso states that the capital gain will be classified as short-term capital gain if the enterprise has not been owned and held for more than 36 months prior to the date of transfer. As a result, a slump sell might result in a LTCG or STCG[4].

Section 50B was given a new sub-section (2) by the Finance Act of 2021. Even in the event of undertakings possessed for more than 36 months prior to the date of transfer, the 'net value' of

[4] Ghosh, Kaushik and Mukhopadhyay, Mayukh, ABB India Corporate Restructuring Process through Slump Sale, Journal of Insurance and Financial Management, Vol. 4, Issue 4 (2021)

the undertaking will be treated as the cost of purchase, and no indexation advantage will be given for the purpose of computing the capital gain. The taxpayer must acquire a report in Form No. 3CEAA from an accountant (as defined in section 288(2) of the Act) in order to calculate his or her "net worth."

Explanation 2 to section 50B of the Finance Act of 2021 specifies that the cost of acquisition of a capital asset that is goodwill of a company or profession is 'zero' if it has not been acquired by the assessee through purchase from any prior owner. As a result, section 50B allows for the use of WDV for depreciable assets and book value for other assets (rather than fair market value) for computing capital gain on slump sales.

The Finance Act of 2021 takes into account court judgements holding that the other modes of transfer indicated in section 2(47) were excluded, and that transfer by way of'sale' was previously solely covered by section 50B. Thus, slump sales by way of exchange, relinquishment, and other methods were not considered slump sales under section 50B before to the amendment, but would be regarded slump sales after the Finance Act of 2021.

The transferor's unabsorbed depreciation or business loss would be carried forward and set off in his assessment solely. Any unabsorbed depreciation or business loss of the seller engaged in the slump sale cannot be claimed by the taxpayer acquiring the enterprise. *Areva T & D India Ltd v. CIT*[5] is one of the recent rulings that may have motivated lawmakers to propose an adjustment to section 50B for consideration received other than via "sale".

III. CASE OF AREVA T & D INDIA LTD

The assessee in this case sold the enterprise to a subsidiary company through a plan of arrangement allowed by the Calcutta High Court under sections 391 & 393 of the Companies Act, 1956. The assessee calculated the capital gain and desired to reinvest it using section 54EC bonds. This was not possible since the Finance Act of 2007, which took effect on January 1, 2007, set a maximum investment cap Rs. 50 lakhs). As a result, the assessee took the alternative position that it is not due to tax as a slump sale, despite the fact that no such claim was made in its ITR.

The court had to first consider if the assessee may file a fresh plea that was not claimed in the ITR on file. It cited *CIT v. Bharat General Reinsurance Co Ltd*[6] and found that the assertion of basic legal principle is not barred by taxes rules. In this case, the assessee got 39 lakh equity shares of Rs. 10 each in full satisfaction of the consideration at a premium of Rs. 96 per share.

[5] [2020] 428 ITR 1(Mad.).
[6] [1971] 81 ITR 303 (Del)

Because it is not a'sale,' the assessee claims that it is not a slump sale.

The Income-tax Act of 1961 does not define the term "sale," according to the court. It is described as "transfer of ownership in exchange for price paid or promised, or part paid and part promised" under the Transfer of Property Act of 1882. Both the Income-tax Act of 1961 and the Transfer of Property Act of 1882 do not define the term "price." However, the Sale of Products Act of 1930 defines it as a monetary payment for the sale of goods. As a result, the court determined that when shares are issued, there is no monetary consideration to fulfil the phrase "sale," and thus the transaction is not covered by section 50B of the Act's "slump sale" provision.

Fortunately, the Finance Act of 2021, which amends sections 2(42C) and 50B, is prospective and applies from the assessment year 2021-22 onwards. The clause does not apply retroactively, despite the fact that it was intended to close a legal loophole that taxpayers had previously exploited.

For assessing the kind of capital gain (short-term or long-term) on transfer of undertaking, the assessee must consider the time during which the undertaking was owned by the assessee, not the period during which individual assets contained within were held in *CIT v. Equinox Solution (P) Ltd*[7]. Where the undertaking's 'net worth' is negative, whether it should be treated as 'nil' or the negative figure should be added to the sale consideration is still up for debate, as we have seen in *Zuari Industries Ltd v. Asstt. CIT*[8] and *Dy.CIT v. Summit Securities Ltd*[9].

IV. Demerger

Demerger is a disjoining or a separation of one or more units of a company to form a new company independent from the original one. Demerger, as defined in section 2(19AA), is a tax-free occurrence in which the taxpayer incurs no tax burden. It is, nevertheless, subject to the plan of arrangement set forth in sections 391 to 394 of the Companies Act of 1956. (Presently, sections 230 to 232 of the Companies Act, 2013). Personal taxpayers resorting to family settlement/arrangement is analogous to demerger. Though section 2 is intended to define the word 'demerger,' it is so detailed that it virtually serves as a border line for what constitutes a 'demerger' act.

It specifies a number of requirements that must be met. These circumstances should have been specified individually, either in Chapter III of the Income-tax Act of 1961 or in the middle of

[7] (2017) 393 ITR 566
[8] [2007] 105 ITD 569 (Mum-trib)
[9] [2011] 132 ITD 1 (Mum-trib) (SB)

laws dealing with capital gains computation, such as sections 47(xiii) or 47(xiiia) or 47(xiiib) (xiv).

It allows for the transfer of an undertaking by identifying the undertaking's property as well as its liabilities. The transfer must be at the values that appeared in the books of account immediately before demerger, while the proviso makes an exemption for firms covered by IND-AS (Indian Accounting Standard), where the values adopted may change from those in the books of account[10].

In the case of a demerger, the new business must issue proportional shares in consideration for the demerger to the demerged firm's shareholders. As a result, after the undertaking has been hived off, the demerged company will arrange for the successor business to issue shares to its (demerged company) shareholders. If the successor firm is an Indian company, the demerged business is not required to pay tax under section 47(vib). Similarly, if the resultant company issues shares to the demerged firm's shareholders in consideration of the undertaking's demerger, the transfer or issuance of shares has no tax consequences. However, shareholders who acquire shares from the resultant business must calculate their tax obligation using the cost of purchase of shares held in the demerged firm and the fair market value of shares received from the resulting company as a consequence of the demerger.

The subject of demerger was considered in *Coforge Ltd v. Asstt. CIT*[11] in addition to the deduction for expenses made thereon. The court determined that a demerger might be accomplished by a'spin-off' or a'split-off.' The undertaking is completely cut off and the demerged firm remains in the event of a'spin-off.' In the instance of a'split-off,' the demerged entity vanishes and two or more new entities arise. The court found that there is no restriction on who can claim the demerger expenditure so spent in the framework of section 35DD, which is intended for amortisation of demerger expenditures. According to the ruling, either the demerged firm or the new company can claim the expense under section 35DD.

V. SLUMP SALE VS DEMERGER

A slump sale isn't a tax-free purchase. The undertaking's net worth must be determined, and the fair market value of non-depreciable assets is not taken into account when calculating the net worth. The criterion is that it must be for a flat sum payment rather than allocating valuations to diverse assets and obligations. A capital gain might be either short-term or long-term. The selling consideration after the Finance Act of 2021 does not have to be money or

[10] V.K.Subramani, Slump Sale V. Demerger,133 taxmann.com 126 [2021]
[11] [2021] 436 ITR 546 (Del.)

monetary. Slump sales cover exchange, relinquishment, and everything else stated in section 2(47). When the selling consideration is in the form of capital assets, the fair market value of the capital assets must be used to compute the capital gain on the slump sale.

There is a hiving-off or flip of an undertaking in both a slump sale and a demerger. The allegation of depreciation is one of the ambiguous areas following a slump sale. According to Section 43(6)(c), the real cost of an asset in the case of a slump sale is determined by the amount of depreciation that would have been allowed to the assessee if the asset was the sole asset in the relevant block of assets. However, the amount of such a reduction cannot be greater than the figure put down. Since the block asset idea has been popular since 1st April 1988, no consideration is given to determining the WDV of assets owned before that date[12].

In the case of a corporate demerger, the relevant parts of the Companies Act, 2013 must be consulted, and the ultimate conclusion is that no income tax is due by the demerged firm. The new business is also exempt from paying taxes on the issuing of shares in exchange for the demerger of the undertaking.

Explanation 2A states that any asset constituting part of a block of assets transferred by the demerged business to the resultant company will have its WDV decreased by the WDV of the assets transferred to the resulting company as a result of the demerger for the immediately prior previous year. Similarly, Explanation 2B states that each asset that is part of a block of assets transferred by a demerged business to the resultant company has its WDV equal to the WDV of the demerged company's transferred assets immediately before demerger.

The claim for depreciation in the year of demerger is divided between the demerged firm and the new company in proportion to the number of days the assets were utilised. The sixth proviso to section 32(1)(ii) allows for depreciation apportionment in the event of a demerger, although it does not apply to slump sales. The buyer, who appears to have inherited the predecessor's WDV, appears to be qualified to claim depreciation for the year in which the slump sale occurs. As a result, the vendor's depreciation claim for the depreciable assets transferred must be denied in the year of the slump sale. An explanation in this respect may be necessary to offer further clarification for the seller and vendee's depreciation claims in the year of the slump sale.

In a demerger, the resultant firm might claim the demerged company's unabsorbed business loss. This advantage is not accessible to a transferee who purchases a company in a slump sale.

[12] V.K.Subramani, Slump Sale V. Demerger,133 taxmann.com 126 [2021]

VI. CONCLUSION

An examination of slump sale and demerger laws reveals that their application overlaps in certain instances and is mutually incompatible in others. Demerger is tax-free, whereas slump sales are taxed as short- or long-term capital gains, with reinvestment exemptions under section 54EC.

More attention should be paid to demergers, such as the conversion of firms into companies or companies into limited liability partnerships (LLPs), as well as simplifying the legal requirements by delineating demergers from the provisions of the Companies Act, 2013, where no public money or stake is involved, in order to make business reorganisations more friendly and achieve the goal of ease of doing business in India.

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