

# **Legal, Accounting and Taxation Aspect of Amalgamation, Demerger and Takeover**

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## **A) LEGAL ASPECT**

The beginning to amalgamation may be made through common agreements between the transferor and the transferee but mere agreement does not provide a legal cover to the transaction unless it carries the sanction of company court for which the procedure laid down under section 391 of the Companies Act should be followed for giving effect to amalgamation or demerger through the statutory instrument of the Court's sanction. Though Chapter V of the Companies Act, 1956 comprising of sections 389 to 396A deals with the issue and related aspects covering arbitration, compromises, arrangements and reconstructions but at different times and under different circumstances in each case of amalgamation, demerger or takeover, it becomes essential to refer to other Acts, such as Court Rules, Income Tax Act, SEBI laws, NBFC Regulations, Sales Tax Act, Excise Laws, Indian Stamp Act, Tenancy Rights, Urban Land Ceiling Act, Accounting Standards and Guidance Notes issued by ICAI etc. The procedure is complex as a number of acts, regulations comes into picture simultaneously. In this Article, I have tried to summarize various applicable laws to properly plan out an amalgamation or demerger.

### **What is Amalgamation**

- Merger of one or more companies into another company
- One company survives and the others lose their existence
- The survivor is called the 'Amalgamated' company and others are called 'Amalgamating' companies
- Amalgamated company takes over assets & liabilities of amalgamating companies
- Consideration is paid in form of equity shares, debentures, cash or a mix of all
- Two types of amalgamations,
  - ◆ merger of one with another, sometimes also referred to as absorption; and
  - ◆ merger of two or more companies to form a new company

From the above definition, it is clear that amalgamation and merger are different terms but as far as India is concerned, same are considered as synonymous and used interchangeably.

### **What is Demerger**

- In 'demerger', a division of a company is transferred to a newly-formed company or an existing company
- The transferor is called a 'Demerged' company and the transferee is called a 'Resulting' company

- Both the demerged company and resulting company retain their existence after demerger
- Consideration is paid by allotment of shares of resulting company to the shareholders of the demerged company
- The remainder of the demerged company's undertaking are vested therein.

### **What is Takeover**

- Takeover is the purchase by one company of the controlling interest of another company
- Takeovers may take form of
  - ◆ Agreement with the majority of shareholders of the company's management
  - ◆ Purchase of shares carrying voting powers in the open market
- Both the companies (i.e., purchaser of shares as well as the company of which the shares were being purchased) remain as such as they were before the takeover

### **Basic difference between the three**

- Amalgamation/merger and demerger, as the name suggests, are totally opposite from each other
- Major differences between Amalgamation and Takeover
  - ◆ The amalgamating company loses its existence, but the taken-over company stays as it is
  - ◆ Amalgamation is governed by Companies Act, whereas takeover is governed by SEBI guidelines
  - ◆ Accounting procedure of amalgamation & takeover is totally different
- Merger & Takeover have a number of technical similarities to each other – e.g., valuation techniques, academic orientation, etc.

The Companies Act does not specifically define the terms mergers or amalgamations. However, it contains the provisions which would qualify the procedure for effecting mergers and amalgamations. Section 390 provides that the term arrangement includes reorganization of the share capital of the Company. Section 391 gives a Company power to compromise or make arrangement with creditors and members. Section 394 contemplates provisions for facilitating reconstruction and amalgamation of companies. Besides, Companies(Court) Rules, 1959 lay down the procedure for carrying out amalgamations.

In the Companies (Second Amendment) Act, 2002 the power of the Court has been transferred to the Company Law Tribunal. The same shall take effect from the date of enforcement and till then the Courts will continue to enjoy the power to approve the Scheme of amalgamations, mergers etc.

## **Procedure to be followed for sanction of Scheme by Court**

### Procedure for application

The procedure for application under section 391(1) is given in Rules 67 & 68 of the Company Court Rules. Rule 67 deals with Summons for directions to convene a meeting. Rule 68 deals with Service on Company.

### Who can make the application u/s 391(1)

For proposing a Scheme, it is not required that a meeting of the Company be called and the directors are empowered to propose a scheme, provided they are authorized by the articles to do so. However, only a Company, a member, a creditor or the liquidator can move an application u/s 391 and not any other person.

### Jurisdiction of Court

The Court to which the application and petition under these provisions has to be made depends upon the jurisdiction of which court the Company lies in. This is determined pursuant to Section 10, which defines such jurisdiction with reference to the registered office of the Company.

### Provisions to be contained in the Scheme

A scheme of amalgamation should, contain provisions, inter alia, for the following:

- ♦ Appointed date;
- ♦ Effective date;
- ♦ Capital structure of the transferor and transferee companies;
- ♦ Share exchanges ratio;
- ♦ Transfer of undertaking and liabilities of transferor company to transferee company from the appointed date;
- ♦ Continuance of legal proceedings of transferor company by transferee company after the effective date;
- ♦ Transferor company to carry on business on behalf of transferee company between appointed date and effective date;
- ♦ Effect of amalgamation on contracts of transferor company after the effective date
- ♦ Services of transferor company's employees, their service conditions, effect of amalgamation thereon, retirement benefits, etc;
- ♦ Allotment of transferee company's shares to the transferor company's shareholders in exchange of their shares in transferor company as per the share exchange ratio, treatment as to fractional coupons, rights of the shareholders;
- ♦ Dissolution on transferor company (without winding-up) on the effective date;
- ♦ Conditions subject to which the scheme is to take effect.

### Procedure on receipt of the Application

Upon receipt of the application, a hearing takes place in the Judge's Chambers, and after the hearing the Judge may either dismiss the application (in which case the amalgamation proceedings are terminated) or order a meeting of the members and

give directions as he may think necessary. The order made on the summons should be in Form No. 35 with such variations as may be necessary (Rule 69)

Although the initial application moved by the company is *ex-parte*, all the parties interested in the action are entitled to place their viewpoint before the Judge as to whether the proposed order convening the meeting should or should not be made.

#### Functions of the Court at the stage of application u/s 391(1)

The court is not mere conduit pipe or stamping authority to whatever scheme that may be laid before it. Not unoften, motivations in the moving of such schemes are oblique. It is in fact for the court to first look at the scheme whether it has any strength or merits of its own and is financially viable or a mere attempt to take back affairs and the assets of the company which had been earlier perforce taken over at the time of winding up.

The word may used in sub-section 391 clearly implies that the court has the discretion to make the order or not to make.

#### Order of meetings of Members and Creditors by Court

The court need not order holding of the meetings of both the creditors and members and meeting of only those members/creditors or class thereof whose interests are affected may be ordered. This is also clear by the use of the words, "as the case may be" in Section 391(1) and (2). Further, where it is clear that the persons who are to approve the scheme are bound to oppose them, there is no point in calling for a meeting of them.

Creditors' meeting may be dispensed with in the following cases:

- ♦ If the major creditors, say the banks and financial institutions, agree in writing for the scheme of arrangement/amalgamation, the said consents can be produced before the court to prove that the interests of the creditors are not adversely affected and that there is no need to call a meeting of creditors.
- ♦ Where the interest of the creditors are not affected, then at the outset, it can dispense with calling the meeting of creditors.

Similarly, in the case of two private limited companies in amalgamation which have a few common shareholders, by taking affidavits from each shareholder, even the meeting of the shareholders can be dispensed with if the court agrees to the dispensation.

#### Conduct of Meetings of Members

Under Rule 69 of the Companies (Court) Rules, the judge at the hearing of summons usually gives directions with respect to various matters, including the person to be appointed as chairman of the meeting. Normally, an advocate name is suggested for the post of chairman. The manner of holding and conducting of the meetings is solely at the discretion of the Court which shall give directions therefore. In the absence of any specific directions in regard to quorum in terms of Rule 67 of the Companies

(Court) Rules, 1959, the provisions of Section 174 of the Companies Act shall apply. In terms of Rule 77, the decision of the meeting held in pursuance of an order made in Rule 69 shall be ascertained only by taking a poll.

*Procedure subsequent to filing of Chairman's Report – Filing of petition*

In terms of Rule 79, where the proposed compromise or arrangement is agreed to with or without modification, as provided by sub-section (2) of section 391, the Company shall within 7 days of the filing of the report by the chairman present a petition to the Court for confirmation of the compromise or arrangement. The petition shall be in Form No. 40. The Court can reject the petition if it is not filed within seven days of filing of report of the chairman relating to the results of the meetings.

*Approval of the Scheme by the Court*

Where the majority of the members have duly approved the Scheme, where the scheme considering the background is fair and reasonable and is beneficial to the members of both the companies, it is not for the court to launch any investigation into commercial merits or demerits of the Scheme and should not interfere with the collective wisdom of the shareholders.

*Limitations on the Court's power on the Scheme*

Only those assets, etc. that are capable of lawful transfer can be transferred by the sanction order of the Court. The Scheme cannot provide for transfer of statutory tenancy rights, which require the permission of the landlord.

*Appointed date and Effective date*

Every scheme of amalgamation/demerger shall have an 'appointed date' and effective date'. 'Appointed date' is the date on which the assets and liabilities are transferred and vested in the transferee company. Appointed date is usually retrospective, usually the beginning of a financial year and the accounts on the said date form the basis of valuation and exchange ratio. 'Effective date' is the date on which the scheme is complete and effective, usually the date on which a certified copy of the order of the High Court is filed with the ROC, or the last of the various approvals required is obtained.

**Amalgamation involving NBFC Companies**

An NBFC has to comply with some guidelines during Pre and Post amalgamation period. NBFC has to comply with Circular No. DNBS (PD) CC No. 12/02/99-2000 dated 13.01.2000 connected with Circular No. 12/02.01/99-2000 wherein it is provided that if change in management takes place due to Amalgamation/Merger, the NBFC has to give a Public Notice of three months before effecting said change in Management/Control. The Control is having same meaning as defined in Regulation 2(1)(C) of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulation 1997. The Public Notice should indicate the following points

- ♦ How transfer of Management will take place

- ♦ Particular of Management
- ♦ Planning/Reason of such Amalgamation

The Notice should be published in one leading National and another in leading Local Vernacular Language News Papers. If change in Management will happen due to Amalgamation of an NBFC having Public Deposits with another Company it is obligatory on the part of such NBFC to give an options to the every depositor to decide whether they want to remain with New Management or not. Negative answer will provide exit option to the depositors.

Following steps are generally taken for Amalgamation of NBFCs

- a) Intimation to RBI whether there is any change in Management or not due to amalgamation with a copy of scheme
- b) If there is change in Management, 90 days prior Notice be given as mentioned above. Said notice along with brief particulars of New Management with Annexure (III) be submitted with RBI within 7 days of such notice
- c) Providing details to the RBI as asked for. Following documents/papers are generally asked by the RBI
  - ♦ Certified copy of order issued by the High Court
  - ♦ News papers cuttings issued during Amalgamation
  - ♦ Form 21 filed with concerned ROC with Receipt issued by the ROC
  - ♦ Resolution for Non-Acceptance of Public Deposit and a Certificate from Auditor for Non-Acceptance of Public Deposit.
  - ♦ Balance Sheet of Transferor Company(ies) and Transferee Company just before appointed date and consolidated Balance Sheet of Transferee Company thereafter.
  - ♦ If any of Transferor Company(ies) or Transferee Company is having public deposit – details of deposits and steps taken for making payments to those depositor who had chosen option of getting repayment.

### **Amalgamation involving Listed Companies**

Whenever a listed company is involved into a scheme of amalgamation/arrangement, one has to comply with the provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 and the norms of concerned Stock exchange/s where the shares of the company are listed.

As per *Clause 24(f)* of the Listing agreement, one has to necessarily file the scheme of amalgamation/arrangement duly approved by the Board of Directors of the Company at least a month before it is presented to the Court or Tribunal.

Along with the Scheme of amalgamation/arrangement one has to file the following supporting documents to get approval under clause 24(f) of listing agreement from the concerned Stock exchange/s.

- Balance Sheet of Applicant Companies

- Extract of Board Meeting in which Scheme was approved
- Declaration under clause 24(g) as to Scheme does not violate or override provisions of SEBI & Stock Exchange
- Declaration under clause 40A of Listing Agreement as that the Company will continue its shares listed in the Stock Exchange, and will also lists its new shares issued in connection with the Scheme.
- Declaration under clause 40B of Listing Agreement that the Company will continue to comply with the relevant provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997
- Submission of 3 copies of Notice convening shareholder's meeting under clause 31 of the Listing Agreement.
- Valuation Report
- Pre & Post-Merger Shareholding pattern of all the applicant companies

Once the certified copy of order received from the High Court (where the scheme was filed), the Company has to issue shares to the shareholders of transferor company in terms of the scheme of amalgamation/arrangement.

As per Clause 24(a) of the Listing agreement, every company is required to obtain 'in-principal' approval for listing from the stock exchanges where its shares are listed before issuing any further shares or securities. For the purpose of obtaining 'in-principal' approval the listed company has to file the following documents:

- Certified copy of High Court Order and intimating the effective date of amalgamation.
- Extract of Board Meeting for the purpose of calling EGM (to increase the Authorised Share Capital of the Company, if required) and the Record Date.
- Notice of Extra-Ordinary General Meeting
- Explanatory Statement
- Extract of Extra-Ordinary General Meeting
- Extract of Board meeting in which the shares are allotted.

The company is required to make a listing application to the stock exchange/s for the new shares issued. Once the shares are listed, the company is required to get its shares dematerialized with the CDSL and NSDL and get the trading permission from the stock exchange/s.

### **Stamp Duty aspect of Mergers and Demergers**

Section 394(2) states that the undertaking of the transferor companies shall vest in the transferee company by virtue of the order of the Court. The term 'instrument' as defined in section 2(14) includes every document by which right or liability is transferred. Therefore, is the order of any Court an instrument liable to stamp duty Under section 2(10) of the Indian Stamp Act, the term 'Conveyance' includes:

- ♦ A conveyance on sale; and

- ♦ Every instrument by which property whether movable or immovable is transferred .

Thus, neither the term ‘instrument’ nor ‘conveyance’ specifically includes ‘order’ of the Court in their fold.

However, the term ‘Conveyance’ defined in Section 2(g) of the Bombay Stamp Act specifically includes in its ambit “every order made by the High Court under section 394 of the Companies Act, 1956 in respect of amalgamation of companies”. Similar definition of the term ‘Conveyance’ is also included in the Gujarat law.

Therefore, it is explicit that by specific inclusion in their respective statutes, the term ‘Conveyance’ shall include an amalgamation order and hence, stamp duty would get attracted on such order in the state of Maharashtra and Gujarat.

However, some days back, the stamp duty on mergers or demergers in West Bengal became a highly debatable issue in view of judgment passed in the matter of *Gemini Silk Ltd's case [C.P. 74 of 2002]*. In this case, the Hon’ble justice Girish Chandra Gupta held that the order sanctioning the scheme under section 394 is covered by the definitions of ‘conveyance’ and ‘instrument’ under the Act and therefore is liable to stamp duty. However, the said order was set aside by the Divisional Bench and thus as of now, stamp duty is not applicable on undertakings transferred through amalgamation or demerger scheme sanctioned by the Court. Thus, we find in practical field a lot of immovable properties are being transferred through such schemes in West Bengal, which saves a substantial amount of stamp duty.

## B) ACCOUNTING ASPECT OF AMALGAMATION OR DEMERGER

The accounting treatment for amalgamations is governed by AS-14 issued by ICAI. The following accounting entries are to be passed in the books of the transferee company.

### Accounting entries

	<u>Amount (Rs.)</u>
1) Respective Assets A/c Dr.	XXXX
To, Transferor Company (Merger A/c)	XXXX
(Being respective assets of transferor company transferred on account of merger sanctioned by ----- )	
2) Transferor Company (Merger A/c) Dr.	XXXX
To, Respective liabilities A/c	XXXX
(Being respective liabilities transferred on account of merger sanctioned by ----- )	
3) Respective Expenses A/c Dr.	XXXX
To, Transferor Company (Merger A/c)	XXXX



(Being respective expenses transferred on account of merger sanctioned by ----- )

\*For Expenses incurred subsequent to the appointed date till effective date.

- |    |   |      |
|----|---|------|
| 4) | Transferor Company (Merger A/c) Dr.   | XXXX |
|    | To, Respective Income A/c   | XXXX |
|    | (Being respective income transferred on account of merger sanctioned by ----- )   |      |
|    | *For Income incurred subsequent to the appointed date till effective date.  |      |
|    |   |      |
| 5  | Transferor Company (Merger A/c) Dr.   | XXXX |
|    | To, Share Capital Suspense A/c  | XX   |
|    | To, General Reserve A/c   | XX   |
|    | (Being entry passed for equity shares to be allotted to the shareholders of the transferor company as per the scheme of amalgamation sanctioned by the ----- )                                  |      |
|    | * Where the scheme of amalgamation sanctioned under the statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed. |      |

For all amalgamations the following disclosures should be made in the first financial statements following the amalgamations :-

Disclosures:

Issued subscribed & paid up capital  
(--- Equity shares of Rs. -- each to be allotted to the shareholders of erstwhile Transferor Company in terms of scheme of Amalgamation sanctioned by ----- )

Notes on accounts

- i) Pursuant to the Scheme of Amalgamation of erstwhile Transferor Company with the Transferee Company as sanction by the ---- , the assets and liabilities of the erstwhile Transferor Company was transferred to and vested in the company with retrospective effective from ----- . The Scheme has accordingly been given effect to in these accounts.

- ii) The Amalgamation has been accounted for under the pooling of interest method as prescribed by the Accounting Standard (AS-14), issued by the Institute of Chartered Accountants of India. Accordingly, the assets and liabilities of the erstwhile transferor company as at 31<sup>st</sup> March..... have been taken at their book values subject to adjustments made for the difference in the accounting policies between the companies and/or as specified in the Scheme of Amalgamation. Accordingly, Rs..... has been credited to General Reserve during the year.
- iii) In terms of the Scheme of Amalgamation, pending allotment, an amount of Rs. .... has been shown under the Share Capital Suspense a/c as at 31<sup>st</sup> March,.....

## C) TAXATION ASPECT OF AMALGAMATION OR DEMERGER

### Definitions as per Income Tax Act, 1961

#### Amalgamation – Section 2(1B)

Basic features of Amalgamation:

- ♦ All property as well as liabilities of amalgamating company becomes property of amalgamated company immediately after amalgamation
- ♦ Shareholders holding not less than 3/4<sup>th</sup> of the share capital of the amalgamating company become shareholder of amalgamated company

The above purchase should not be pursuant to a purchase agreement or winding-up.

#### Demerger – Section 2(19AA)

Basic Features of Demerger:

- ♦ All properties & liabilities of the undertaking relating to the demerged company are transferred to resulting company
- ♦ Assets & liabilities to be transferred at book value – any valuations to be ignored
- ♦ Resulting company issues shares to shareholder of demerged company on proportionate basis
- ♦ Not less than 3/4<sup>th</sup> of the shareholder of demerged company become shareholder of resulting company
- ♦ Demerged undertaking is transferred as a going concern

### Amortization of amalgamation and demerger expenditure

#### Section 35DD

- ♦ Expenditure should be incurred by an Indian company, being the assessee
- ♦ Expenditure shall be allowed over a period 5 successive previous years, commencing from the year in which demerger or amalgamation takes place
- ♦ No other deduction shall be allowed in respect of the said expenditure.

Resident Company →→ amalgamates with →→ Resident Company

- ♦ Amalgamating company incurs expenditure – deduction shall be allowed only for the 1<sup>st</sup> year, since from the 2<sup>nd</sup>, the amalgamating company ceases to exist
- ♦ Amalgamated company incurs expenditure – normal deduction is allowed

Resident Company →→ demerges unit to →→ Resident Company

- ♦ Demerged company incurs expenditure – normal deduction is allowed
- ♦ Resulting company incurs expenditure – normal deduction is allowed

### **Computation of actual cost in case of amalgamation & demerger**

Section 43(1) defines ‘actual cost’ of an asset.

Explanation 7 & 7A to Sec. 43(1) –

- ♦ Capital asset transferred by amalgamating/demerged company to amalgamated/resulting company
- ♦ Amalgamated/resulting company is an Indian company
- ♦ Actual cost of asset transferred to amalgamated/resulting company shall be that as were in the books of amalgamating/demerged company before amalgamation/demerger.
- ♦ If amalgamated/resulting company is not Indian company, cost shall be consideration paid for the asset

### **Benefits under the head Capital Gains in case of amalgamation**

- Transfer of capital asset by amalgamating company to amalgamated Indian company is exempt – section 47(vi)
- Transfer of Indian company’s shares by amalgamating foreign company to amalgamated foreign company is exempt if following conditions are satisfied – Section 47(via)
  - ♦ At least 25% of the shareholder of amalgamating foreign company remain shareholders of amalgamated foreign company
  - ♦ Such transfer does not attract any capital gain in the country of amalgamating company
- Transfer by a shareholder of shares of an amalgamating company in exchange of allotment of shares of the amalgamated Indian company is exempt from capital gain tax – Section 47(vii)

### **Benefits under the head Capital Gains in case of Demerger**

- Transfer of capital asset by demerged company to resulting Indian company is exempt – Section 47(vib)
- Transfer to Indian company’s shares by demerged foreign company to resulting foreign company is exempt if following conditions are satisfied – Section 47(vic)
  - ♦ Shareholders holding not less than 3/4<sup>th</sup> in value of the shares of demerged foreign company remain shareholder of resulting foreign company

- ♦ Such transfer does not attract any capital gain in the country of demerged company
- ♦ Proviso – this exemption is not applicable in case of demerger as mentioned in Section 391 to 394 of the Companies Act, 1956 (i.e., demerger of an Indian company to a foreign company)
- Transfer or issue of shares by the resulting company in a scheme of demerger to the shareholders of the demerged company is exempt – Section 47(vii)

### **Carry forward & set off of accumulated losses & unabsorbed depreciation in case of amalgamation**

#### Section 72A

- Amalgamation between a company owning
  - ♦ Industrial undertaking;
  - ♦ Ship; or
  - ♦ Hotel
 with another company
- Amalgamation of a banking company u/s 5(c) of the Banking Regulation Act, 1949
- Accumulated losses as well as unabsorbed depreciation of amalgamating/demerged company shall be considered as losses & unabsorbed depreciation of the amalgamated/resulting company, as the case may be
- In case of amalgamation or demerger, capital loss of the amalgamating company is not allowed to be carried forward or set off as per Section 72A

#### Conditions to be fulfilled by amalgamating company

- Has to be engaged in business for 3 years or more prior to date of amalgamation
- Has, as on date of amalgamation, continuously held at least 3/4<sup>th</sup> of the book value of fixed assets for a period of 2 years

#### Conditions to be fulfilled by amalgamated company

- Holds continuously for a minimum of 5 years from date of amalgamation at least 3/4<sup>th</sup> of the book value of fixed assets of the

### **Carry forward & set off of accumulated losses & unabsorbed depreciation in case of demerger**

- Accumulated loss or unabsorbed depreciation, if directly relatable to an undertaking, which is transferred to a resulting company shall be allowed to be carried forward and set off in the hands of resulting company – Section 72A(4)(a)
- If loss or unabsorbed depreciation is not directly relatable, the loss carried forward shall be apportioned between the demerged company and the resulting company in proportion to the assets of the undertaking retained by the demerged company and that transferred to the resulting company – Section 72A(4)(b)

**Continuation of benefits after amalgamation or demerger in the hands of transferee**

- Scientific research expenditure u/s 35(5)
- Patent right/copyright expenditure u/s 35A(6)
- Expenditure on know-how u/s 35AB(3)
- Expenditure for licence to operate telecommunication services u/s 35ABB(6 & 7)
- Amortization of preliminary expenses u/s 35D(5)
- Expenditure on prospecting etc. u/s. 35E(7)
- Chapter VI-A deductions u/s 80-IA(12) & 80-IB(12)
- Tax holiday u/s 10A(7A) & 10B(7A)