

Business Restructuring

Some Key Points

Significant methods of business restructuring

- (a) **Amalgamation and Merger [Section 2(1B)]:** The exemption from capital gain is contained in sections 47(vi) and 47(vii). In the case of international restructuring, the condition for exemption is contained in section 47(via). Carry forward and set off of accumulated loss and unabsorbed depreciation is governed by section 72A of the Act. Subject to satisfaction of prescribed conditions, the following unabsorbed expenditures of the amalgamating company could be carried forward and set off by the amalgamating company.
 - (i) Capital expenditure on scientific research (section 35)
 - (ii) Expenditure in connection with amalgamation (section 35DD)
 - (iii) Expenditure for obtaining licence to operate telecommunication services (section 35ABB)
 - (iv) Preliminary expenses (section 35D)
 - (v) Deduction for expenditure on prospecting etc for minerals (section 35E)
- (b) **Demerger [Section 2(19AA)]:** It is applicable only in the case of corporate assessee. A demerger transaction is free from capital gains both with respect to transfer of assets as well as issue of shares to the shareholders. The accumulated loss and depreciation to the extent attributable to demerged unit is eligible for carry forward and set off by the resulting company.
- (c) **Conversion of sole proprietary business into company [Section 47(xiv)]:** Subject to certain conditions contained therein conversion of proprietary concern into a corporate entity is not liable for capital gains tax.
- (d) **Conversion of firm into company [Section 47(xiii)]:** Conversion firm into a company subject to certain conditions, is not chargeable to capital gains tax.
- (e) **Conversion of company into LLP [Section 47(xiiiib)]:** Tax exemption in respect of capital gains on conversion of company into a LLP is available subject to fulfilment of certain conditions.
- (f) **Slump sale of business [Section 2(42C)]:** It is applicable on transfer of one or more undertakings for a lump sum consideration without assigning value to individual assets and liabilities. It is applicable to a non-corporate entities is also. If the undertaking was owned and held for more than 36 months the gain thereon is taxable as long term capital gain. Where the holding period is less than 36 months before transfer, it is taxable as short term capital gain.

Question 1

PQR Limited has two units - one engaged in manufacture of computer hardware and the other involved in developing software. As a restructuring drive, the company has decided to sell its software unit as a going concern by way of slump sale for ₹ 385 lacs to a new company called S Limited, in which it holds 74% equity shares.

The balance sheet of PQR limited as on 31st March 2014, being the date on which software unit has been transferred, is given hereunder –

Balance Sheet as on 31.3.2014

Liabilities	₹ (in lacs)	Assets	₹ (in lacs)
Paid up Share Capital	300	<u>Fixed Assets</u>	
General Reserve	150	Hardware unit	170
Share Premium	50	Software unit	200
Revaluation Reserve	120	<u>Debtors</u>	
<u>Current Liabilities</u>		Hardware unit	140
Hardware unit	40	Software unit	110
Software unit	90	<u>Inventories</u>	
		Hardware unit	95
		Software unit	<u>35</u>
	<u>750</u>		<u>750</u>

Following additional information are furnished by the management:

- (i) The Software unit is in existence since May, 2010.
- (ii) Fixed assets of software unit includes land which was purchased at ₹ 40 lacs in the year 2006 and revalued at ₹ 60 lacs as on March 31, 2014.
- (iii) Fixed assets of software unit mirrored at ₹ 140 lacs (₹ 200 lacs minus land value ₹ 60 lacs) is written down value of depreciable assets as per books of account. However, the written down value of these assets under section 43(6) of the Income-tax Act, 1961 is ₹ 90 lacs.
 - (a) Ascertain the tax liability, which would arise from slump sale to PQR Limited.
 - (b) What would be your advice as a tax-consultant to make the restructuring plan of the company more tax-savvy, without changing the amount of sale consideration?

Answer

- (a) As per section 50B, any profits and gains arising from the slump sale effected in the previous year shall be chargeable to income-tax as capital gains arising from the transfer of capital assets and shall be deemed to be the income of the previous year in which the transfer took place.

If the assessee owned and held the undertaking transferred under slump sale for more than 36 months before slump sale, the capital gain shall be deemed to be long-term capital gain. Indexation benefit is not available in case of slump sale as per section 50B(2).

Ascertainment of tax liability of PQR Limited from slump sale of software unit

Particulars	₹ (in lacs)
Sale consideration for slump sale of Software Unit	385
Less: Cost of acquisition being the net worth of Software Unit	<u>185</u>
Long term capital gains arising on slump sale (The capital gains is long-term as the Software Unit is held for more than 36 months)	<u>200</u>
<u>Tax liability on LTCG</u>	
Under section 112 @ 20% on ₹ 200 lacs	40.00
Add: Surcharge@ 5%	<u>2.00</u>
	42.00
Add: Education cess@2% and SHEC@1%	<u>1.26</u>
	<u>43.26</u>

Working Note:

Computation of net worth of Software Unit

	₹ (in lacs)
(1) Book value of non-depreciable assets	
(i) Land (Revaluation not to be considered)	40
(ii) Debtors	110
(iii) Inventories	35
(2) Written down value of depreciable assets under section 43(6) (See Note below)	<u>90</u>
Aggregate value of total assets	275
Less: Current liabilities of software unit	<u>90</u>
Net worth of software unit	<u>185</u>

Note : For computing net worth, the aggregate value of total assets in the case of depreciable assets shall be the written down value of the block of assets as per section 43(6).

(b) Tax-advice

- (i) Transfer of any capital asset by a holding company to its 100% Indian subsidiary company is exempt from capital gains under section 47(iv). Hence, PQR Limited should try to acquire the remaining 26% equity shares in S Limited then make the slump sale in the above said manner, in which case the slump sale shall be exempt

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from tax. For this exemption, PQR Limited will have to keep such 100% holding in S Limited for a period of 8 years from the date of slump sale, otherwise the amount exempt would be deemed to be income chargeable under the head "Capital Gains" of the previous year in which such transfer took place.

- (ii) Alternatively, if acquisition of 26% share is not feasible, PQR Limited may think about demerger plan of Software Unit to get benefit of section 47(vib) of the Income-tax Act, 1961.

Question 2

Axel Ltd. has two industrial undertakings. Unit I is engaged in the production of television sets and Unit II is engaged in the production of refrigerators. The company has, as part of its restructuring program, decided to sell Unit II as a going concern by way of slump sale for ₹ 260 lacs to a new company called Gamma Ltd., in which it holds 85% equity shares. The following is the extract of the balance sheet of Axel Ltd. as on 31st March, 2014:

	₹ (in lacs)	
	Unit – I	Unit – II
Fixed Assets	112	158
Debtors	88	67
Inventories	60	23
Liabilities	33	45

	₹ (in lacs)
Paid-up share capital	231
General Reserve	160
Share Premium	39
Revaluation Reserve	105

The company set up Unit II on 1st April, 2009. The written down value of the block of assets for tax purpose as on 31st March, 2014 is ₹ 150 lacs of which ₹ 60 lacs are attributable to Unit II.

- (i) Determine what would be the tax liability of Axel Ltd. on account of Slump sale;
- (ii) How can the restructuring plan of Axel Ltd. be modified, without changing the amount of consideration, in order to make it more tax efficient?

Answer

- (i) As per section 50B, any profits or gains arising from the slump sale effected in the previous year shall be chargeable to income-tax as capital gains arising from the transfer of capital assets and shall be deemed to be the income of the previous year in which the transfer took place.

If the assessee owned and held the undertaking transferred under slump sale for more than 36 months before slump sale, the capital gain shall be deemed to be long-term capital gain. Indexation benefit is not available in case of slump sale as per section 50B(2).

Ascertainment of tax liability of Axel Ltd. from slump sale of Unit II

Particulars	₹
Slump sale consideration	2,60,00,000
Less : Cost of acquisition (net worth) [See Working Note below]	<u>1,05,00,000</u>
Long-term capital gain (as Unit II is held for more than 36 months)	<u>1,55,00,000</u>
Calculation of tax liability	
Income tax @ 20% (Being long term capital gain under section 112)	31,00,000
Surcharge @ 5%	<u>1,55,000</u>
	32,55,000
Education cess @ 2% and Secondary and higher education cess@1%	<u>97,650</u>
Total tax liability	<u>33,52,650</u>

Working Note: Net worth of Unit II

Particulars	₹
WDV of block of assets	60,00,000
Debtors	67,00,000
Inventories	<u>23,00,000</u>
	1,50,00,000
Less : Liabilities	<u>45,00,000</u>
Net worth	<u>1,05,00,000</u>

(ii) Tax Advice

- Transfer of any capital asset by a holding company to its 100% Indian subsidiary company is exempted from tax under section 47(iv). Therefore, if it is possible for Axel Ltd. should try to acquire the entire shareholding of Gamma Ltd. and thereafter make a slump sale, then the resultant capital gain shall not attract tax liability. However, in such case also, Axel Ltd. should not transfer any shares in Gamma Ltd. for 8 years from the date of slump sale.
- Alternatively, if acquisition of 15% share is not feasible, Axel Ltd. may think about demerger plan of Unit-II to get benefit of section 47(vib) of the Income-tax Act, 1961.

Question 3

Your client, Ashavari Ltd. has two industrial undertakings-one engaged in production of audio music CDs and cassettes and the other engaged in production of video CDs. As a restructuring drive, the company has decided to sell its undertaking producing video CDs as a going concern by way of slump sale for ₹ 450 Lacs to a new company called Tori Ltd., in

which it holds 75% equity shares. The balance sheet of Ashavari Ltd. as on 31st March, 2014 reads as follows:

	₹ in Lacs	
	Audio Unit	Video Unit
Fixed Assets	150	225
Debtors	150	112.5
Inventories	75	37.5
Liabilities	42	75
Paid up share capital	₹ 378 Lacs	
General Reserve	₹ 222 Lacs	
Share premium	₹ 33 Lacs	
Revaluation Reserve	₹ 140 Lacs	

The company set up the video unit on 1st April, 2009. The written down value of the block of assets for tax purpose as on 31st March, 2014 is ₹ 200 lacs of which ₹ 85 lacs are attributable to video unit.

- Determine the tax liability which would arise to Ashavari Ltd. from slump sale;
- Suggest modification of the restructuring plan of Ashavari Ltd. without changing the amount of consideration so as to make it more tax efficient.

Answer

- As per section 50B, any profits or gains arising from the slump sale in the previous year is chargeable to income-tax as capital gains arising from the transfer of capital assets and shall be deemed to be the income of the previous year in which the transfer takes place.

If the assessee owned and held the undertaking transferred under slump sale for more than 36 months before such slump sale, the capital gain shall be deemed to be long-term capital gain.

Particulars	₹
Calculation of capital gains	
Slump sale consideration	4,50,00,000
Less: Cost of acquisition (net worth) [See Working Note below]	1,60,00,000
Long-term capital gain	2,90,00,000
Calculation of tax liability	
Income tax @ 20%	58,00,000
Surcharge @ 5%	2,90,000
	60,90,000
Education cess @ 3%	1,82,700
Total tax liability	62,72,700

Working Note:

Net worth of Video unit	₹
WDV of block of assets	85,00,000
Debtors	1,12,50,000
Inventories	37,50,000
	2,35,00,000
Less: Liabilities	75,00,000
Net worth	1,60,00,000

Note - Indexation benefit is not available in the case of slump sale as per section 50B(2)

- (ii) (a) Transfer of any capital asset from a holding company to its 100% Indian subsidiary company is exempt from tax under section 47(iv). Therefore, if it is possible for Ashavari Ltd to acquire the entire shareholding of Tori Ltd and then make a slump sale, the resultant capital gain shall not attract capital gains tax.

However, Ashavari Ltd should not transfer any shares in Tori Ltd for a period of 8 years from the date of such (slump) sale.

- (b) Alternatively, if acquisition of 25% share is not feasible, Ashavari Ltd. may think about demerger plan of video unit to get benefit of section 47(vib) of the Income-tax Act, 1961.

Question 4

The Balance Sheet of ABC Ltd. as on 30.9.2013, being the date on which Unit C has been transferred by way of slump sale for a consideration of ₹ 920 lacs, is given hereunder -

Balance sheet as on 30.9.2013

Liabilities	₹ in lacs	Assets	₹ in lacs
Paid up capital	1,800	Fixed assets	
Reserves	650	Unit A	150
Liabilities:		Unit B	250
Unit A	40	Unit C	550
Unit B	120	Other assets	
Unit C	80	Unit A	480
		Unit B	870
		Unit C	390
	<u>2,690</u>		<u>2,690</u>

With the help of further information given below, compute the capital gain on slump sale of Unit C –

- (i) Fixed assets of Unit C include land which was purchased at ₹ 50 lacs in the year 2005 and revalued at ₹ 90 lacs as on 31.3.2013.

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- (ii) Fixed assets of Unit C reflected at ₹ 460 lacs (₹ 550 lacs less land value ₹ 90 lacs) is written down value of depreciable assets as per books. However, the written down value of these assets under section 43(6) of the Income-tax Act, 1961 is ₹ 440 lacs.
- (iii) Other assets of Unit C shown at ₹ 390 lacs represents book value of non-depreciable assets.
- (iv) Unit C is in existence since May, 2010.

Answer

Computation of capital gain on slump sale of Unit C

Particulars	₹ in lacs
Sale consideration for the slump sale of Unit C	920
Less: Net worth of Unit C (Refer note 1 below)	<u>800</u>
Long term capital gain arising on slump sale	<u>120</u>
Working note:	
1) Computation of net worth of Unit C	
A) Book value of non-depreciable assets:	
i) Land	₹ 50
ii) Other assets	<u>₹ 390</u>
B) Written down value of depreciable assets under section 43(6)	<u>440</u>
Aggregate value of total assets	880
Less: Value of liabilities of Unit C	<u>80</u>
Net worth of Unit C	<u>800</u>
2) Since Unit C is held for more than 36 months, the long term capital gain of ₹ 120 lacs is taxable under section 112 at 20% plus surcharge @5% plus education cess @2% and secondary and higher education cess @1%. The indexation benefit is not available in the case of a slump sale.	

Question 5

The Balance sheet of JB Opticals Limited as on 31-03-2013 reads as under:

Paid up capital ₹ 2,52,00,000

	Unit A (₹)	Unit B (₹)
Fixed assets	1,00,00,000	1,50,00,000
Debtors	1,00,00,000	75,00,000
Liabilities	28,00,000	50,00,000
Stock in trade	50,00,000	25,00,000
Reserves		1,48,00,000

Share premium		22,00,000
(Revaluation reserve)		(70,00,000)

The company acquired Unit B on 1.04.2011. They made certain capital additions in the form of Generator set and additional building etc., for ₹ 25 lacs during the year 2011-12. The members of the company have authorized the Board in their meeting held on 28.01.2014 to dispose of the unit 'B'. The company decides to sell the Unit 'B' by way of slump sale for ₹ 225 lacs as consideration. The buyer has agreed with the vendor-company to give time for putting through the sale but not later than 30.06.2014 subject to a discount of 1% on agreed sale consideration. However, this discount is not applicable if the sale is completed after 31.03.2014. The company now approaches you to advise them as a measure of tax planning to determine the date of sale keeping in view of the capital gains tax.

Answer

Determination of net worth of Unit B of M/s. J.B. Opticals Ltd.

	₹ (in lacs)
Book value of fixed assets	150
Debtors	75
Stock in trade	<u>25</u>
	250
Less :Liabilities	<u>50</u>
Net worth	<u>200</u>

Comparative calculation of chargeable capital gains

	Sale before 31.3.2014	Sale after 31.03.2014
Sale consideration	2,25,00,000	2,25,00,000
Less: Discount	<u>2,25,000</u>	<u>Nil</u>
Net sale consideration	2,22,75,000	2,25,00,000
Less: Net worth	<u>2,00,00,000</u>	<u>2,00,00,000</u>
Short term capital gain	22,75,000	N.A.
Long term capital gain	N.A.	25,00,000
Tax rate	30.9%	20.6%
Tax thereon	7,02,975	5,15,000

Note: The assessee is advised to effect slump sale after 31.03.2014 as the tax liability arising out of long term capital gains is less than the tax liability arising on short term capital gains, if transferred before 31.03.2014.

Self-examination Questions

1. What is meant by “business restructuring”? What are the various forms of business restructuring?
2. What are the tax benefits available on amalgamation of one company with another? What are the conditions required to be fulfilled by the amalgamating and amalgamated company for availing such tax benefits?
3. Define “demerger”. What are the tax benefits available to the resulting company on account of demerger?
4. Write short notes on -
 - (a) Redemption of preference shares
 - (b) Conversion of debentures into shares.
5. What are the tax effects on conversion of -
 - (a) a sole proprietary business into a company; and
 - (b) a partnership firm into a company.
6. What is meant by “Slump sale”? Discuss the provisions of the Income-tax Act, 1961 relating to slump sales.
7. Write short notes on -
 - (a) Buyback of shares
 - (b) Capital reduction