

DEMERGER AND ITS TAX IMPLICATIONS

"Demerger" in relation to companies means

- the transfer by a demerged company
- of its one or more undertakings
- to any resulting company
- pursuant to a scheme of arrangement
- and all the following conditions are fulfilled :-
 - (i) **All the property of the undertaking**, being transferred by the demerged company, immediately before the demerger, **becomes the property of the resulting company by virtue of the demerger.**
 - (ii) **All the liabilities relating to the undertaking**, being transferred by the demerged company, immediately before the demerger, **becomes the liabilities of the resulting company** by virtue of the demerger.
 - (iii) The property and the liabilities of the undertaking or undertakings being transferred by the demerged company are **transferred at the values appearing in its books of account immediately before demerger.** [Revaluation is to be ignored]
"Provided that the provisions of this sub-clause shall not apply where the resulting company records the value of the property and the liabilities of the undertaking at a value different from the value appearing in the books of account of the demerged company, immediately before the demerger, in compliance to the Indian Accounting Standards specified in Annexure to the Companies (Indian Accounting Standards) Rules, 2015;".
(Proviso added by Finance Act. 2019)
 - (iv) The resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis. **This condition is not applicable where resulting company itself is holding the shares in demerged company.**
 - (v) The shareholders **holding not less than 75% in value of the shares** in the demerged company **becomes the shareholders of resulting company** or companies by virtue of demerger.
 - (vi) The transfer of undertaking is on a going concern basis.

Following explanation has been added to the definition of the term "demerger":

Explanation 6.—The reconstruction or splitting up of a public sector company into separate companies shall be deemed to be a demerger, if such reconstruction or splitting up has been made to transfer any asset of the demerged company to the resulting company and the resulting company—

- (i) **is a public sector company, and**
- (ii) **fulfils such other conditions as may be notified by the Central Government.**

TAXATION OF SHAREHOLDERS OF DEMERGED COMPANY AND THE RESULTING COMPANY

1. By virtue of Section 47, there will be **no capital gains in the hands of shareholders of demerged company** when they receive in exchange of shares of the demerged company the reduced shares of demerged company and the new shares of resulting company.
2. By virtue of Section 2(22), there will be **no dividend in the hands of shareholders on distribution of shares pursuant to a demerger by the resulting company** to the shareholders of the demerged company (whether or not there is a reduction of capital of the demerged company).
3. By virtue of amendment in Section 2(42A), **for calculating the period for which the shares received upon demerger are held, the period for which shares were held in the demerged company shall also be considered.**
4. By virtue of Section 49(2C), the cost of acquisition of shares of resulting company shall be:

$$\frac{\text{Cost of Acquisition of shares held by the assessee in the demerged company}}{\text{Net Book Value of assets transferred in demerger}} \times \frac{\text{Net Worth of the demerged company immediately before such demerger}}{\text{Net Worth = Paid up Share Capital + General Reserves}}$$

Where Net Worth = Paid up Share Capital + General Reserves

5. By virtue of Section 49(2D), the cost of acquisition of shares in the demerged company shall be:

Cost of Acquisition of Original Shares in the demerged company
Less: Cost of Acquisition of Shares in the resulting company as calculated in Section 49(2C).

TAXATION OF RESULTING COMPANY

1. The actual cost of asset transferred by demerged company to resulting company in hands of resulting company shall be:

- (i) **Actual Cost to the demerged company (Non-depreciable asset)**
- (ii) **WDV in hands of demerged company. (Depreciable asset)**

Section 49(1) provides that where a capital asset is transferred by demerged company to resulting company, then the actual cost of capital asset to the resulting company shall be the actual cost of capital asset in hands of demerged company.

2. **The following expenditures which are unamortised in hands of demerged company in respect of undertaking transferred to resulting company shall be allowed to the resulting company for the balance number of years. The said expenditure shall not be allowed to demerged company in the year of demerger:**

- (i) Preliminary expenses under section 35D
- (ii) Expenditure for obtaining license to operate telecommunication services under section 35ABB.
- (iii) Expenditure under voluntary retirement scheme under section 35DDA.

3. **Apportionment of Depreciation** – As per amendment in Section 32, where there has been a demerger, the aggregate of depreciation available to the demerged company and the resulting company shall not exceed in the previous year, the depreciation calculated at the prescribed rates as if the demerger had not taken place and such **depreciation shall be apportioned between the demerged company and the resulting company in the ratio of number of days for which assets were used by them.**

4. **Carry forward of losses and depreciation** – As per Section 72A, if the loss and unabsorbed depreciation of the demerged company directly relates to the undertakings transferred in the demerger, then such loss and depreciation shall be carried forward by the resulting company and not the demerged company. However, **if such loss and unabsorbed depreciation is not directly relatable to the undertaking transferred to the resulting company**, then the loss and depreciation shall be apportioned between the demerged company and the resulting company in the following proportion:-

Assets retained by the demerged company	:	Assets transferred to the resulting company
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The loss and depreciation shall be allowed to be carried forward for the balance number of years for which the demerged company would have carried forward.

5. **Expenses on demerger shall be allowed in five successive Assessment Years beginning with the previous year in which demerger takes place. The deduction shall be 1/5th of such expenditure on demerger.**

6. Where the demerged company was allowed a deduction in respect of any loss/expenditure /trading liability and subsequently the resulting company obtains some benefits, such benefit shall be taxable as Profits and Gains of Business or Profession in the hands of the resulting company.

7. **Bad debts Recovery** – If the bad debts of the demerged company are recovered by the resulting company, then there will be no income under Section 41(4) as per the judgement of **P.K. Kaimal**.
8. **Debts of Demerged Company Written off as bad debts by the Resulting Company**–Deduction shall be allowed to the Resulting Company as per Supreme Court in **Veerabhadra Rao**.
9. **Amendment of Section 10AA/ 80-IAB/ 80-IE** – Where an undertaking which is entitled to deduction under Section 10AA/ 80-IAB/ 80-IE is transferred before the expiry of the period specified in Section 10AA/ 80-IAB/ 80-IE in the scheme of demerger by the demerged company to the resulting company, then:
 - a) No deduction under Section 10AA/ 80-IAB/ 80-IE shall be available to the demerged company for the previous year in which demerger takes place; and
 - b) The provisions of Section 10AA/ 80-IAB/ 80-IE shall apply to the resulting company in the same manner in which they would have applied to the demerged company.

Deduction under section 80-IA shall not be available to resulting company if demerged company transfers the 80-IA undertaking to resulting company.

10. **Section 32AD:** Where the new asset is sold or otherwise transferred in connection with the scheme of demerger within a period of five years from the date of its installation, the provisions of section 32AC and section 32AD shall apply to the resulting company as they would have applied to the demerged company.

TAXATION OF DEMERGED COMPANY

1. **By virtue of Section 47,** there will be no capital gains, when a capital asset is transferred, in a demerger, by the demerged company to the resulting company, provided that the resulting company is an Indian company.
2. Where any asset forming part of block of assets is transferred by the demerged company to the resulting company, then the Written Down Value of block of assets shall be reduced by the written down value of assets transferred to the resulting company pursuant to demerger.
3. **By virtue of Section 47(vic),** there will be no capital gains on transfer of shares held in an **Indian company, by the demerged foreign company to the resulting foreign company if the following conditions are satisfied:**
 - a) **The shareholders holding not less than 75% in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company and**
 - b) **Such transfer does not attract tax on the capital gains in the country, in which the demerged foreign company is incorporated.**

Note: The cost of acquisition of shares of Indian company in hands of resulting foreign company shall be the cost of such shares in hands of demerged foreign company.