Tax alert: Exemption allowed for share transfer to WOS, followed by merger

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The Chennai Bench of the Income-tax Appellate Tribunal (ITAT) has held that transfer of shares by non-resident taxpayer, of its wholly owned Indian subsidiary (WOS), to another WOS, was a bona fide transaction exempt under the Income-tax Act, 1961. Further, the ITAT held that the decision to subsequently merge the WOS, according to the taxpayer, was based on commercial expediency and the Revenue cannot question the authenticity of the transaction.

In a nutshell

In absence of any material to establish sham or lack of commercial substance, the transaction cannot be disregarded merely because it results in tax benefit. The settled position of law is that tax planning within the framework of law is permissible.

Revenue cannot take armchair decision and dictate the manner in which business decisions are to be taken.

Accounting treatment and disclosures as per accounting standards cannot be the basis for treating the transaction as non-genuine.

Without any finding that the arrangement resulted in misuse or abuse of the provisions of the ITA, or that it lacked economic or commercial substance, the transaction cannot be disregarded merely on perceived tax advantage.

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Background:

- The taxpayer[1] is a tax resident of France and does not carry out any business operation in India. It had made several investments in operating group entities around the world, including investments in Indian entities [say wholly owned subsidiaries (WOS) A Co and B Co].
- The taxpayer held 60% of the shares in A Co since 2012 and the remaining 40% was held by taxpayer's joint venture (JV) partner. Since the JV did not materialize, the taxpayer bought the 40% shares of A Co, from its JV partner in 2018, whereby A Co became its WOS.
- The taxpayer, during the year under consideration, sold WOS A Co shares to WOS B Co.

  As per the taxpayer, the transaction of sale of shares by taxpayer was not a 'transfer' under the provisions of section 47(iv) of the Income-tax Act 1961 (ITA) i.e. section 70(1)(c) of Income-tax Act 2025 [relating to certain transactions not regarded as transfer for the purposes of capital gains] and hence not taxable in India.

  Subsequently, A Co got merged with B Co through fast-track merger route.
- The Assessing Officer (AO), during audit proceedings, did not accept the taxpayer's submissions and proceeded to treat the entire consideration received on sale of shares of A Co as Income from Other Sources, *inter-alia*, on the following basis:
  - No proper justification was provided as to why B Co would purchase the shares of A Co from the taxpayer with it having to pay a consideration incurring the huge fall in its cash flow, where the same could have been avoided with the normal merger process.
  - The value per share of A Co as per the Net Asset Value (NAV) method was say INR 40 per share, and as per the Discounted Cash Flow (DCF) method, say INR 70. The taxpayer considered the valuation as per the DCF method which was based on projections.

    Therefore, A Co, which was already planned to be merged / amalgamated with B Co (thereby extinguishing the shares of A Co after merger / amalgamation), was valued at the beneficial rate per share only to transfer the consideration received (against the sale of A Co shares) to the taxpayer.

    The merger/amalgamation could have happened without sale of shares of A Co.
  - The acquisition of balance 40% shareholding of A Co in 2018 pursuant to exit of JV partner and the subsequent transfer in 2019 was a transaction in the nature of trade. As per taxpayer, the motive was not to accrue any profit or yield but only to enable fast track merger of A Co with B Co. Thus, the nature of remittances received were revenue in nature and not capital.
- Aggrieved with the AO's decision, the taxpayer filed objections before the Disputes Resolution Panel (DRP), which confirmed the addition made by the AO.
- Aggrieved, the taxpayer filed an appeal before the Chennai Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions of Section 47 the ITA

"Nothing contained in section 45 shall apply to the following transfers :—

….

(iv) any transfer of a capital asset by a company to its subsidiary company, if—

(a) the parent company or its nominees hold the whole of the share capital of the subsidiary

[1] Valeo Bayen vs. Deputy Commissioner of Income-tax, International Taxation [2026] 186 taxmann.com 471 (Chennai - Trib.)

company, and

(b) the subsidiary company is an Indian company;"

Decision of the ITAT:

The ITAT acknowledged that the issue for consideration was whether the transfer of shares by the taxpayer to its wholly owned subsidiary constituted a colourable device to avoid tax.

Sale of shares of A Co and subsequent merger – a commercial decision

- The taxpayer had acquired major portion of shares (60%) in A Co since 2012 and the same was held as an investment and not as stock-in-trade.

  The Revenue did not consider the transaction as a whole i.e. the earlier holding of the taxpayer, and decided merely based on the subsequent acquisition. In absence of any material to establish sham or lack of commercial substance, the transaction could not be disregarded merely because it results in tax benefit. The settled position of law is that tax planning within the framework of law is permissible.
- The AO questioned the necessity of share transfer vis-à-vis merger i.e. why the taxpayer had chosen the fast-track merger instead of a normal merger; the AO treated the transaction as non-genuine as the taxpayer could not substantiate the action with proper evidence. It is well settled that Revenue cannot sit in the armchair of a businessman and dictate the manner in which business decisions are to be taken.
- The decision to sell the shares and subsequently merge the wholly owned subsidiaries, according to the taxpayer, was based on commercial expediency and the Revenue cannot question the authenticity of the transaction based on the only reason that the taxpayer had received consideration without paying taxes as per the provisions of the ITA. Accordingly, the observations of the AO on alternate modes of merger not explored by the taxpayer as a reason for making the addition, could not be agreed with.

Financial disclosure not a basis for holding it as non-genuine transaction

- The financial disclosure by B Co post-merger was accounting disclosure where the net assets of A Co being more than the consideration paid was adjusted against capital reserve. The words "cancelled and extinguished" are used in the financials since the shares of A Co post-merger would become shares of B Co and since B Co could not hold its own shares, the shares of A Co would automatically get cancelled and extinguished.
- Further, the accounting treatment and disclosures as per accounting standards could not be the basis for treating the transaction as non-genuine, and that too for disclosures made in the Indian subsidiary of the taxpayer. The Revenue otherwise had not recorded anything with regard to the transaction, as to how the same was in violation of the provisions of the ITA and how the exemption claimed was not allowable under the ITA.

Conditions under section 47(vi) of the ITA satisfied

- The Revenue's grounds for denial of exemption under section 47(iv) of the ITA was that the shares of A Co transferred by the taxpayer was not capital asset. The taxpayer was holding the major portion of shares of A Co as investments since 2012 and the deciding the nature of asset as trading asset solely based on subsequent acquisition of 40% shares, without holistic examination of intention and conduct of the taxpayer, was not tenable.
- Once the asset is a capital asset there is no reason to question the applicability of section 47(iv) and the real test would then be whether the taxpayer has rightly claimed the exemption.
- The taxpayer held 100% shares in A Co and B Co and both these companies were Indian companies.

Accordingly, the exemption as claimed by the taxpayer could not be denied.

Valuation method adopted by taxpayer – valid

- The valuation report was rejected by AO on mere comparison with net asset value (NAV) and the AO did not record any defects in DCF methodology adopted by the taxpayer. The taxpayer had the statutory right to select either the DCF or NAV method and the AO had the power to examine the valuation report and question the assumptions.
- The AO could not reject the valuation report without pointing out specific defects or inaccuracies in the report. The AO didn't require the taxpayer to furnish any details pertaining to the valuation and did not record any defects about projections etc. Therefore, the allegation regarding undervaluation or beneficial pricing lacked merit.

Tax benefit alone does not make a transaction impermissible

- The existence of a tax benefit, by itself, could not lead to the conclusion that the transaction was impermissible, unless it was demonstrated that the arrangement lacked commercial substance or was carried out in a non-genuine manner.
- In present case, the transaction resulted in a reorganization of shareholding without any change in the ultimate beneficial ownership, thereby indicating continuity of economic interest where the capital asset continued to exist in India. Further, there was no material to suggest that the transaction was circular, self-cancelling, or devoid of real economic effect.

In view of the above, the ITAT held that in absence of any finding that the arrangement resulted in misuse or abuse of the provisions of the ITA, or that it lacked economic or commercial substance, the transaction could not be disregarded merely on perceived tax advantage. Hence, the transaction was a bona fide transfer covered by section 47(iv) of the ITA.

Comments:

Certain transactions may lead to tax benefit. Transactions which lead to tax benefit are often challenged by the tax authorities and the tax benefit may be denied. Various court rulings[2] have held that tax planning within the framework of law is permissible and the same has been reiterated in this ruling.

The domestic tax law framework introduced the General Anti-Avoidance Rules under the ITA to deal with cases which may be treated as impermissible avoidance arrangements. It contains detailed criteria as to when can an arrangement be treated as an impermissible avoidance arrangement.

The ITAT in this ruling has, *inter-alia*, held the following:

- In absence of any material to establish sham or lack of commercial substance, the transaction cannot be disregarded merely because it results in tax benefit. The settled position of law is that tax planning within the framework of law is permissible.
- Accounting treatment and disclosures as per accounting standards cannot be the basis for treating the transaction as non-genuine.

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[2] Vodafone International Holdings B.V. vs. Union of India [2012] 17 taxmann.com 202 (SC)/[2012], Mc Dowell & Co. Ltd. vs. Commercial tax Officer [1985] 22 Taxman 11 (SC)/[1985] 154 ITR 148, Union of India vs. Azadi Bachao Andolan [2003] 132 Taxman 373 (SC)/[2003] 263 ITR 706

carried out in a non-genuine manner.

- Without any finding that the arrangement resulted in misuse or abuse of the provisions of the ITA, or that it lacked economic or commercial substance, the transaction cannot be disregarded merely on perceived tax advantage.

It may be pertinent to note that the Indian corporate law now provides for fast-track merger schemes as opposed to traditional merger scheme which may take comparatively more time. Hence, may taxpayers opt for fast-track mergers. In the current case, one of the contentions of the Revenue was that the taxpayer could have opted for normal merger instead of fast-track merger. The said contention of the Revenue was rejected by the ITAT on the basis that the Revenue cannot sit in the armchair of a businessman and dictate the manner in which business decisions are to be taken.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.