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Tax alert: Issuance of shares by holding company results in non-tax neutral demerger

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The Mumbai Bench of the Income-tax Appellate Tribunal (ITAT) has held that the taxpayer was not entitled to carry forward and set off business losses and unabsorbed depreciation, as the mandatory requirement for the resulting company to issue shares to the shareholders of the demerged company was not met (the holding company could not issue shares on behalf of its subsidiary).

In a nutshell

The term ‘resulting company’ finds significance from the term ‘demerger’ which is defined u/s 2(19AA) of the ITA, wherein one of the conditions for tax neutrality of demerger stipulates that the **resulting company** must issue its **shares** to the shareholders of the **demerged company**, in consideration of the demerger scheme.

It is well settled that in a taxation statute, there is no room for any intendment; that regard must be had to the clear meaning of the words and that the matter should be governed wholly by the language of the notification. Equity has no place in interpretation of a tax statute. Strictly one has to look to the language used and there is no room for searching intendment nor drawing any presumption. Furthermore, nothing has to be read into nor should anything be implied other than essential inferences while considering a taxation statute.

There is substantial difference between a Holding company and a Subsidiary thereof, having their own independent legal existence vested with relevant rules and regulations. The Holding company cannot issue shares on behalf of the Subsidiary, and its obligations are restricted to its own legal liabilities and obligations under the law.

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Background:

- The taxpayer[1] company, say **A Co.,** is engaged in selling vacation homes and leisure hospitality services etc. The taxpayer is one of the 3 entities which signed a court-approved scheme of arrangement, sanctioned by the Bombay High Court (HC) involving listed company **B Co.,** (**demerged** or transferor company) listed company **C Co**. and the taxpayer company, **A Co**., which is a wholly owned subsidiary (WOS) of C Co.
- The scheme of arrangement involved:(i) demerger of the resorts and time-share undertaking of B Co. into the taxpayer company (A Co.) on a going-concern basis and;(ii) amalgamation of the residual business of B Co. into C Co., pursuant to which B Co. ceased to exist.
- During the course of assessment proceedings, the Assessing Officer (AO) held the following:
  - As the shares were allotted by the Holding company of A Co. and not by A Co. or its wholly owned subsidiary, there was violation of the provisions of Section 2(19AA)(iv) read with section 2(41A) of the Income-tax Act, 1961 (ITA) [relating to definition of 'demerger' and 'resulting company', respectively] and due to this violation, the carry forward and set off of accumulated loss and unabsorbed depreciation has to be disallowed.
  - Section 72A of the ITA (relating to carry forward and set-off of accumulated loss and unabsorbed depreciation in amalgamation or demerger, etc.) talks only about loss under the head Profits and Gains of business or profession and not long-term capital loss, and therefore, the carry forward of long-term capital loss needs to be disallowed.
- Aggrieved, the taxpayer filed an appeal and in the course of appellate proceedings the matter reached before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions of Section 2 the ITA

"In this Act, unless the context otherwise requires…

…(19AA) "demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956 (1 of 1956), by a demerged company of its one or more undertakings to any resulting company in such a manner that…

…(iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis except where the resulting company itself is a shareholder of the demerged company;"…

…(41A) "resulting company" means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger;

Relevant provisions of Section 72A the ITA

(1) Where there has been an amalgamation of…
…then, notwithstanding anything contained in any other provision of this Act, the accumulated loss and the unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or, as the case may be, allowance for unabsorbed depreciation of the amalgamated company for the previous year in which the amalgamation was effected, and other provisions of this Act relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly…

[1] ITA No. 843 and 941/Mum/2024 (Mumbai-Tribunal)

...(4) Notwithstanding anything contained in any other provisions of this Act, in the case of a demerger, the accumulated loss and the allowance for unabsorbed depreciation of the demerged company shall—

(a) where such loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting company, be allowed to be carried forward and set off in the hands of the resulting company;
(b) where such loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company, and be allowed to be carried forward and set off in the hands of the demerged company or the resulting company, as the case may be:...

Decision of the ITAT:

The ITAT acknowledged that the issue for consideration was whether the taxpayer company has complied with the requirements of section 2(19AA) and 2(41A) of the ITA, or not, while demerged company merged into it, being a Resultant Company.

The ITAT noted as follows:

Statutory Framework Governing Demerger under Sections 2(19AA) and 2(41A) of the ITA

- Section 2(19AA) of the ITA (relating to the definition of 'demerger') ensures that a transfer of an undertaking from one company to another as part of a genuine restructuring process is not considered a taxable event. The section lays down certain important conditions:
  - Tax Neutrality – The transfer of assets and liabilities during demerger does not attract immediate capital gains tax.
  - Shareholder Continuity – Shareholders of the demerged company must get shares in the resulting company in proportion to their holdings.
  - All Assets & Liabilities Transfer – The entire undertaking, including assets, debts, and obligations, must be transferred to the resulting company.
  - Resulting Company – The company receiving the undertaking must be an Indian company.

  As per clause (iv) section 2(19AA)(iv) in the ITA, the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis except where the resulting company itself is a shareholder of the demerged company.

- The term 'resulting company' finds significance from the term demerger which is defined u/s 2(19AA) of the ITA, wherein one of the conditions for tax neutrality of demerger stipulates that the **resulting company** must issue its **shares** to the shareholders of the **demerged company**, in consideration of the demerger scheme.

  Accordingly, as per Section 2(41A) of the ITA, unless the context otherwise requires, the term 'resulting company' means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger.

- The ITA inter alia provides that a demerger must satisfy all the conditions mentioned in Section 2(19AA) the ITA. It is only when a demerger satisfies all the conditions, that it will be considered a demerger for purposes of the ITA.

Judicial principles governing strict interpretation of taxing statutes

- It is a settled law that the taxation statutes need to be interpreted strictly by its literal meaning. In case of an earlier Supreme Court (SC) ruling[2], the SC reiterated this principle by observing that strict interpretation of a statute certainly involves literal or plain meaning test. The other tools of interpretation, namely contextual or purposive interpretation could not be applied nor any resort be made to look to other supporting material, especially in taxation statutes.

  It is well settled that in a taxation statute, there is no room for any intendment; that regard must be had to the clear meaning of the words and that the matter should be governed wholly by the language of the notification. Equity has no place in interpretation of a tax statute. Strictly one has to look to the language used and there is no room for searching intendment nor drawing any presumption. Furthermore, nothing has to be read into nor should anything be implied other than essential inferences while considering a taxation statute.

- The SC, in another ruling[3], concerning interpretation of Section 44C of the ITA, held that, taxation statutes must be interpreted strictly and that where the statutory language is plain and unambiguous, courts are bound to give effect to its plain meaning. It is impermissible for courts to add or read words into a statute on the assumption that such additions may better advance legislative intent, particularly when the language used by Parliament is clear.
  Reliance on various other rulings[4] in this regard.

- It is a well settled principle of law that the court cannot read anything into a statutory provision or a stipulated condition which is plain and unambiguous. A statute is an edict of the Legislature. The language employed in a statute is the determinative factor of legislative intention. While interpreting a provision the court only interprets the law and cannot legislate it. If a provision of law is misused and subjected to the abuse of process of law, it is for the Legislature to amend, modify or repeal it, if deemed necessary. Legislative casus omissus cannot be supplied by judicial interpretative process.

- In the light of the cited decisions, there was no ambiguity in the provisions and in the absence of any other interpretation by any court of law, there was absolutely no basis for any other interpretation. The fact remains that in the case under consideration, the taxpayer did not issue shares to the demerged company, thus failing to satisfy the conditions laid therein.

- There was no dispute that there is substantial difference between a Holding company and a Subsidiary thereof, having their own independent legal existence vested with relevant rules and regulations. The Holding company cannot issue shares on behalf of the Subsidiary, and its obligations are restricted to its own legal liabilities and obligations under the law. Therefore, the first appellate authority was justified in confirming the action of the AO of disallowing the set-off of brought forward unabsorbed depreciation against income and also in disallowing carry forward of business loss and unabsorbed depreciation under section 72A (4) of the ITA.

Comments:

Corporate reorganizations, including mergers and demergers, have become integral to modern business strategy, facilitating business consolidation and value creation. Recognizing that such restructurings are often undertaken for bona fide commercial reasons, the ITA accords tax neutrality to qualifying demergers, subject to the fulfilment of specific statutory conditions. While the legislative framework seeks to strike a balance

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[2] Commissioner of Customs (Import), Mumbai vs. Dilip Kumar & Company [2018] 95 taxmann.com 327 (SC)

[3] Director of Income-tax (IT)-I, Mumbai vs. American Express Bank Ltd. [2025] 181 taxmann.com 433 (SC)

[4] Britannia Industries Ltd. vs. Commissioner of Income-tax, West Bengal, Kolkata [2005] 148 Taxman 468 (SC); Ajmera Housing Corpn. vs. Commissioner of Income-tax [2010] 193 Taxman 193 (SC); State of Jharkhand vs. Ambay Cement 2005 taxmann.com 1352 (SC)/[2005] 139 STC 74 (SC)

between facilitating genuine business reorganizations and preventing tax avoidance, the application of these provisions sometimes gives rise to interpretational challenges.

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

- The term resulting company finds significance from the term demerger which is defined u/s 2(19AA) of the ITA, wherein one of the conditions for tax neutrality of demerger stipulates that the **resulting company** must issue its **shares** to the shareholders of the **demerged company**, in consideration of the demerger scheme.
- It is well settled that in a taxation statute, there is no room for any intendment; that regard must be had to the clear meaning of the words and that the matter should be governed wholly by the language of the notification. Equity has no place in interpretation of a tax statute. Strictly one has to look to the language used and there is no room for searching intendment nor drawing any presumption. Furthermore, nothing has to be read into nor should anything be implied other than essential inferences while considering a taxation statute.
- It is a well settled principle of law that the court cannot read anything into a statutory provision or a stipulated condition which is plain and unambiguous. A statute is an edict of the Legislature. The language employed in a statute is the determinative factor of legislative intention. While interpreting a provision the court only interprets the law and cannot legislate it. If a provision of law is misused and subjected to the abuse of process of law, it is for the Legislature to amend, modify or repeal it, if deemed necessary. Legislative casus omissus cannot be supplied by judicial interpretative process.
- There is no dispute that there is substantial difference between a Holding company and a subsidiary thereof having their own independent legal existence vested with relevant rules and regulations. The Holding company cannot issue shares on behalf of the subsidiary and its obligations are restricted to its own legal liabilities and obligation under the law.

The ruling insists on strict compliance with every statutory requirement for tax neutrality. Taxpayers may want to consider its impact while evaluating their reorganization mechanics.

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