

Tax Neutral Delisting Through Demerger

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Binoy Parikh

Executive Director, Katalyst Advisors Pvt. Ltd

Background

Consider a case where a listed company is an operating – *cum* – holding company (“TopCo”) is holding majority shares in another listed company (“SubCo”). Commercially, the value of the said SubCo may not truly get captured in the market capitalisation of the TopCo due to the significant holding company discount prevalent in the Indian listed space. In order to unlock the said holding company discount, the cleanest route would be to merge SubCo into TopCo and consolidate the entities.

Problem Statement: However, in practice, a merger may not be feasible due to a variety of reasons such as different businesses being housed in TopCo and SubCo, cultural differences, conflict of interest at the board level, unification of systems, processes, and policies, debt covenants in SubCo, and different regulatory constraints and requirements - for example, ICICI Securities is regulated by SEBI, whereas ICICI Bank is regulated by RBI, and therefore, a merger of ICICI Securities with ICICI Bank could not have been undertaken; instead, shares of ICICI Securities held by public shareholders would be exchanged for shares of ICICI Bank, and ICICI Securities would become a 100% subsidiary and consequently, would become delisted. However, the key drawback for the shareholders, in this case, would be capital gains in their hands on the difference between the fair market value of shares of ICICI Bank received and the cost of acquisition, since such an exchange is a capital gains tax event and is not tax neutral. Further, the fact that this is an in-specie exchange, the shareholders would be out-of-pocket to the extent of capital gains tax required to be discharged on such exchange.

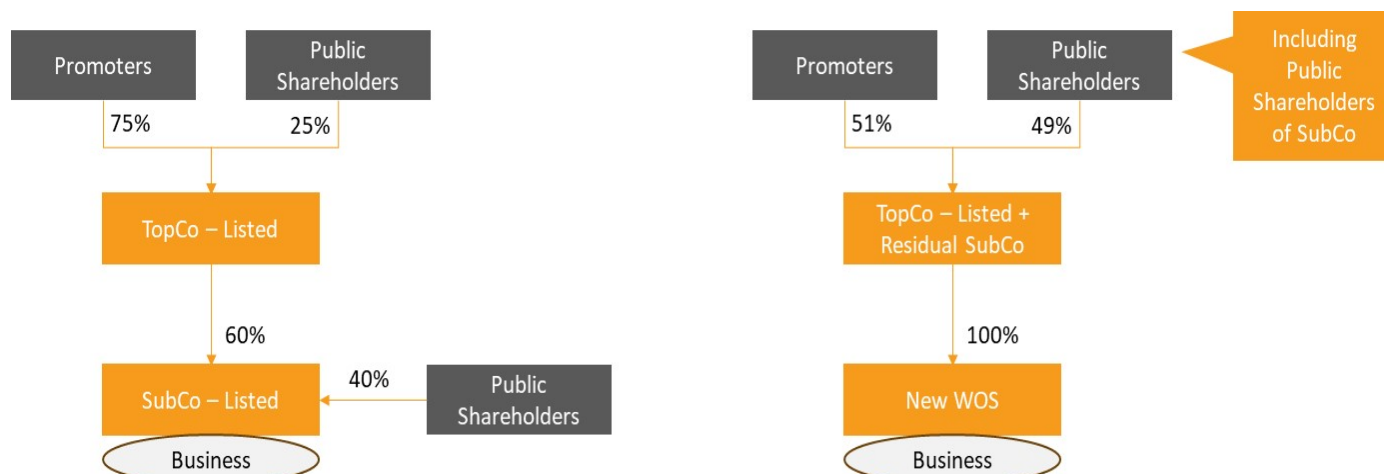
In the context of the above, this article explores alternative structure, where a delisting could potentially be achieved through a demerger, and not a share exchange, in a tax neutral manner.

Demerger Scheme - Contours

In the context of the above **Problem Statement**, a possibility of a **demerger through a Scheme of Arrangement** u/s 230-232 of the Companies Act, 2013 could be explored. In the present case, the TopCo could consider the following structure:

1. Incorporation of a wholly owned subsidiary (“WOS” or “New WOS”) by the Listed Company
2. Demerger of substantial business of the SubCo to the WOS
3. Issuance of shares by the TopCo, and not the WOS as a result of the demerger
 - Shares to be issued by the Listed Company only to the public shareholders of the SubCo
4. Merger of the residual SubCo with ListCo

The Resultant Structure could be diagrammatically represented as follows –



Key Considerations

1. Commercial Considerations: As a result of the above structure, while the promoters and public shareholders of TopCo would get diluted as a result of issuance of shares to the public shareholders of SubCo, potentially, as a result of unlocking holding company discount, now that the business of SubCo is housed in a 100% WOS of TopCo, the market capitalisation of TopCo could potentially increase post the demerger, making up for the dilution with the increase in market capitalisation. Further, given that the business is still housed in a separate company, the independence of the New WOS is retained potentially solving for the key issues highlighted in the Problem Statement. From a regulatory perspective as well, there would only be one listed company, reducing the management bandwidth to manage two listed companies, and attendant compliances. Further, any related party transactions between the TopCo and New WOS could be streamlined going forward, which would have otherwise required approvals from the shareholders of TopCo as well as SubCo. At the same time, growth strategies including fund raising at the New WOS level could be pursued independently. Lastly, the public shareholders of the Listed SubCo could also benefit from the combined business of the TopCo, potentially unlocking value for them as well.

2. Tax Neutral Demerger: Section 2(41A) of the Income-tax Act, 1961 defines “Resulting Company” (i.e., New WOS) to include the New WOS itself and its 100% holding company (i.e., the Listed TopCo). In order for a demerger to be tax neutral, the “Resulting Company” has to issue shares to the shareholders of the Demerged Company (i.e., the Listed SubCo) – given that the definition of the “Resulting Company” includes 100% holding company, a listed company could directly issue shares to the public shareholders of Listed SubCo, and the resultant demerger should be considered as tax neutral demerger in the hands of the TopCo, New WOS, SubCo and the shareholders of both listed companies. However, from the perspective of shareholders, following considerations need to be borne in mind:

1. Grandfathering of Cost of Listed SubCo in the hands of Public Shareholders:

Had the public shareholders of Listed SubCo sold the shares of Listed SubCo, then the public shareholders would have gotten the benefit of market price prevailing on 31 January 2018, and only gains subsequent to 31 January 2018 would be subject to capital gains tax in the hands of the Listed HoldCo. However, since the new shares issued by the TopCo would not have been “acquired” prior to 31 January 2018, would the public shareholders of Listed SubCo get the benefit of grandfathering? Logically, they should - since the cost of acquisition and the period of holding relates back to the cost and date of the original acquisition. An express clarification in this regard is warranted.

2. Grandfathering of Cost of Listed SubCo in the hands of Investors from Mauritius, Cyprus, and Singapore:

From the perspective of investors from Mauritius, Cyprus, or Singapore, the relevant DTAA's only provide for grandfathering of capital gains, if the shares were acquired prior to 1 April 2017. Therefore, even if the original shares in Listed SubCo may have been acquired prior to 1 April 2017, since, technically, the new shares would be issued post 1 April 2017, it may not be considered as having been “acquired” prior

to 1 April 2017. Recently, the Delhi Tribunal, in the case of Sarva Capital LLC [\[TS-467-ITAT-2023\(DEL\)\]](#), held that in case of conversion of CCPS into equity shares, if the CCPS were acquired before 1 April 2017, but were converted into equity shares post 1 April 2017 and subsequently sold post 1 April 2017 as equity shares, then also the said sale should also be eligible for grandfathering under the DTAA. Similar principle can be applied in this case.

Again, an express clarification since the period of holding relates back to the original date of acquisition, the date of acquisition of new shares should also relate back to the date of original acquisition under the relevant DTAAs is warranted.

3. SEBI & Companies Act Considerations: The said demerger would be effected through a Scheme of Arrangement u/s 230-232 of the Companies Act, 2013, which would require a prior approval of the stock exchanges/ SEBI and thereafter the jurisdictional National Company Law Tribunal and other regulatory authorities. Given the elaborate timelines in executing the said transaction (say, 10-12 months), this would warrant an advance planning to effectuate the same by the management of the listed companies.

4. Majority of Minority Approval: One key condition is that the majority approval of public shareholders of the Listed TopCo and the Listed SubCo would be required under the SEBI Master Circular governing Schemes of Arrangement dated 20 June 2023. The said SEBI Circular provides, inter alia, that in case of a merger which results in dilution of more than 5% public shareholding in the listed companies, then approval of the public shareholders of both the listed companies would be required. This, especially, could become tricky in a case where large blocks of shares of the listed company are held by financial institutions, HNI investors, etc. since the promoters would not be able to vote in this case.

5. Valuation Considerations: Given the requirement of majority of minority approval, valuation considerations need to be carefully navigated as a result of different perception of value ascribed to the TopCo and the SubCo for the purposes of share swap as a result of demerger. Therefore, independent valuations for both companies, use of transparent and well-documented methodologies, consideration of multiple valuation approaches, sensitivity analysis to demonstrate how changes in key assumptions affect valuation, and clear communication with stakeholders throughout the process could aid in mitigating valuation concerns.

6. IndAS Implications: Shares issued by the Listed TopCo would be recorded as fresh capital issued with a corresponding debit recorded as investment in the New WOS. Similarly, the New WOS would record the assets/ liabilities vested upon it at carrying amounts (being common control business combination), with a corresponding credit to Other Equity.

7. Stamp Duty Implications: Depending on the state in which the registered office of the Listed TopCo is situated, a certain percentage of the fair market value of shares issued (say, 0.7% in Maharashtra) would be considered for the purposes of stamp duty adjudication.

Key Takeaways

In conclusion, the outlined strategy of delisting through a demerger presents a nuanced alternative to the traditional routes of consolidation or share exchange, specifically within the complex regulatory and tax landscape of India. By leveraging the provisions under the Companies Act, 2013 for a Scheme of Arrangement, the TopCo would have the opportunity to unlock the holding company discount, enhance overall market capitalisation, and streamline operations, all while aiming to maintain tax neutrality and satisfy regulatory prerequisites from shareholders' perspective.

Although the approach necessitates careful navigation of valuation intricacies, especially with the requirement of majority of minority approval, IndAS implications, and stamp duty considerations, the potential benefits to both the TopCo and SubCo shareholders, particularly in terms of value unlocking and simplified corporate structure, could be significant.