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Header: Tax blow for M&A?

Published on Fri, Dec 24, 2010 at 15:27 | Updated at Mon, Dec 27, 2010 at 12:43 | Source : CNBC-TV18

High Court's invalidation of demerger on grounds of Tax Avoidance to impact Indian M&As

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In a decision that is likely to impact conventional M&A structures, the Gujarat High Court has recently rejected a petition filed by Vodafone Essar Gujarat Ltd (Transferor) which sought to demerge its passive infrastructure assets into a group company, Vodafone Essar Infrastructure Ltd. (Transferee).

Background

The transfer of assets from the Transferor to the Transferee was without consideration and did not involve any new allotment of shares to the shareholders of the Transferor. It was noted that, post demerger, the Transferee would merge with Indus Towers Ltd. which would serve as a joint venture company that would develop and operate passive infrastructure assets contributed by India's leading cell phone operators. The broad scheme was explained to be in furtherance of the Government's policy to promote sharing of passive infrastructure assets among telecommunication operators and facilitate development of such infrastructure in rural areas.

The tax department however objected to the scheme on the basis that it was a device for avoiding tax and did not have the necessary ingredients of a valid scheme of arrangement.

Mergers and demergers in India are Court mediated processes requiring the concerned companies to file a scheme of arrangement before a High Court, in accordance with the provisions of the Companies Act, 1956. The scheme would have to relate to the reconstruction or amalgamation of the companies. Sufficient opportunity is provided to the shareholders of the companies as well as their creditors to voice any concerns that should be taken into account by the High Court while sanctioning the terms of the merger or demerger.

The procedure also involves full disclosure of all material facts concerning the company including its latest financial position. The High Court is also entitled to look into the whether the affairs of the company have been conducted in a manner that is not prejudicial to public interest or the interests of its shareholders. On being satisfied with the representations made by the companies, the High Court may sanction the arrangement and specifically provide for the transfer of specific assets or liabilities, or allotment of shares or interests to give effect to the reconstruction or amalgamation.

Gujarat High Court's Decision

The High Court accepted the tax department's objections to the proposed demerger of passive infrastructure assets from the Transferor to the Transferee and refused to sanction the scheme. It was of the view that the proposed demerger did not qualify as a 'scheme of arrangement' under the Companies Act. The proposed demerger could not be viewed as a 'reconstruction' since the parties to the scheme carry on separate businesses- while the Transferor company was engaged in the business of providing mobile services, the Transferee company would provide infrastructure services to various cell phone operators.

Considering that an 'arrangement' essentially involves some sort of a give and take, the Court also held that a demerger of assets for zero consideration would not qualify as an arrangement. Further, in the absence of consideration, the transfer of assets would not even qualify as a valid contract. It was also observed that charter documents of the Transferor did not authorize it to gift the assets to the Transferee and hence the High Court could not legitimize such transfer as a scheme of arrangement.

The High Court also accepted the tax department's objection that the entire scheme was a device to evade taxes. It noted that the scheme resulted in significant tax advantages for both the Transferor and the Transferee. Subsequent to the transfer of assets (excluding liabilities), the Transferor would be able to reduce its taxable profits, while the Transferee would be able to benefit from certain tax exemptions available in relation to the value of the infrastructure assets and also claim depreciation thereupon. Further, since the Transferor had outstanding tax liabilities, the High Court held that it would not be a liberty to transfer the assets.

The High Court also noted that the scheme allowed the Transferor to avoid tax which would otherwise get triggered if it directly sold the assets to the joint venture company for a consideration. The demerger of assets and consequent merger of the Transferee into the joint venture company would also result in savings in terms of reduced stamp duty and value added tax. The High Court therefore refused to sanction the scheme on basis that it was solely designed to evade tax and was against public interests.

Uncertainty pervades

The Gujarat High Court's decision is likely to have a profound impact on M&As in India, especially since one of the primary objectives of structuring a transaction in the form of a merger / amalgamation is to minimize the tax impact on the transaction.

The ultimate object of the scheme was to take advantage of the synergies between the cellular operators and enable efficient and coordinated deployment of passive infrastructure assets. This was also in conformity with the Government's policy objectives. To achieve this business object, the Transferor had a number of options to execute the transfer- some that may result in a significant tax burden and others which would result in tax savings. The mere fact that it adopted a route which minimized tax costs is not an instance of tax evasion and this cannot be said to jeopardize any public interest. Lack of certainty on the other hand results in greater prejudice to public interest.

One may also consider whether the tax implications of the transaction should have been considered at all by the High Court while examining the scheme of arrangement or whether the appropriate forum for this issue is the tax department which would have the jurisdiction to scrutinize the transaction at the time of regular assessment. In the event the transaction does not meet the tests for a tax free merger, the tax authorities would have the power to tax the transaction and hence it may be said the Courts should not go into the question of whether the transaction is motivated by tax avoidance, which by itself is permitted under law. In many other jurisdictions, such types of mergers are common and are part of bigger schemes of re-structuring as in the present instance.

When the Supreme Court of India [in the Azadi Bachao Andolan case 263 ITR 706] accepted the taxpayer's right to legitimately plan his affairs and minimize his tax liability within the four corners of law, the guiding principle was economic certainty. The issue with the High Court's decision is that it does not provide any clearer understanding of the acceptable parameters of tax planning.

Common law has evolved a number of objective standards to identify unacceptable taxpayer conduct. For instance the law cannot look favorably upon acts done by parties which are intended to give the appearance of creating legal rights and obligations different from those that the parties intend to create. Sham transactions or colorable devices of this sort have to be considered illegal. However, bonafide transactions, even if primarily tax driven, but serving a larger business purpose cannot be denied legal recognition.

To conclude in the timeless words of common law, “no man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores.” [Ayrshire Pullman Motor Services and Ritchie v. IRC, (1929) 14 TC 754].

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