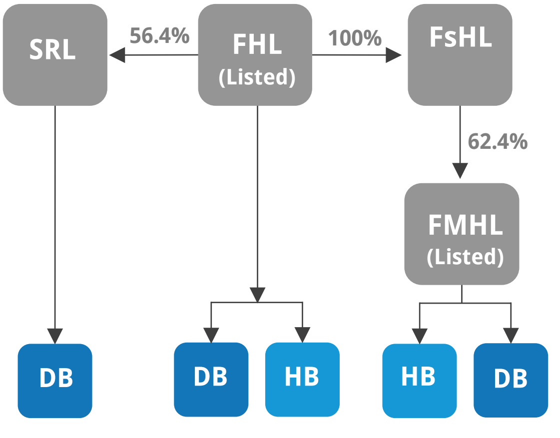
Reducing compliance cost and creating independence through mergers, demergers and slump sales

Background

- Fortis Healthcare Limited (FHL) is a public limited company listed on Indian stock exchanges. FHL is primarily engaged in providing integrated healthcare delivery services such as healthcare and diagnostics services and its businesses include managing and operating a network of hospitals, preventive healthcare and diagnostic services.
- Fortis Malar Hospitals Limited (FMHL) is a subsidiary of Fortis Hospitals Limited (FHsL). FHsL is a wholly-owned subsidiary of FHL. FMHL operates hospitals and provides diagnostic services (i.e. pathology services). FHsL holds 62.4% stake in FMHL.
- SRL Limited (SRL) is a subsidiary of FHL and is primarily involved in establishing, maintaining and managing clinical reference laboratories and other laboratories for providing testing and diagnostics services. FHL holds 56.4% stake in SRL.

Based on the group structure of the Fortis group, the healthcare delivery service businesses i.e. 'Hospitals Businesses' (HB) and 'Diagnostics Businesses' (DB) were housed in FHL and FMHL whereas SRL was engaged only in the diagnostics business.

The structure of Fortis group at that time is given below.



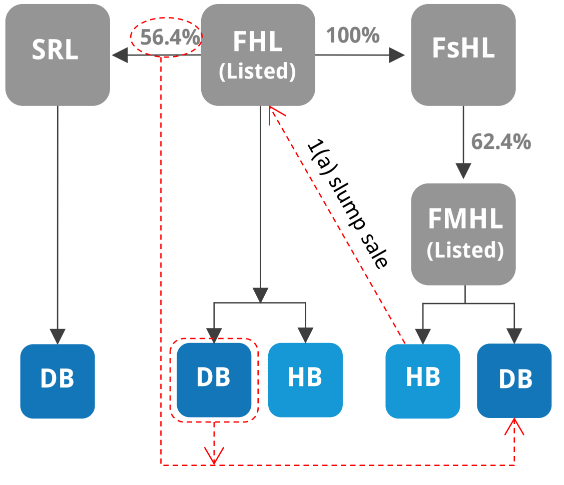
In order to benefit from potential synergies and incremental operational efficiencies from combining similar and related businesses under a single entity, the Board of Directors of FHL approved a composite scheme of arrangement[1] and amalgamation (the scheme) to strategically separate the different businesses into two separate entities. The scheme provides for the **consolidation of the DB under FMHL and the HB (business of operating and managing of hospitals) under FHL.**

The appointed date as per the scheme was 1 January 2017. The scheme was filed with the National Company Law Tribunal, Chandigarh for approval in February 2017. The scheme provided for the following:

Step 1

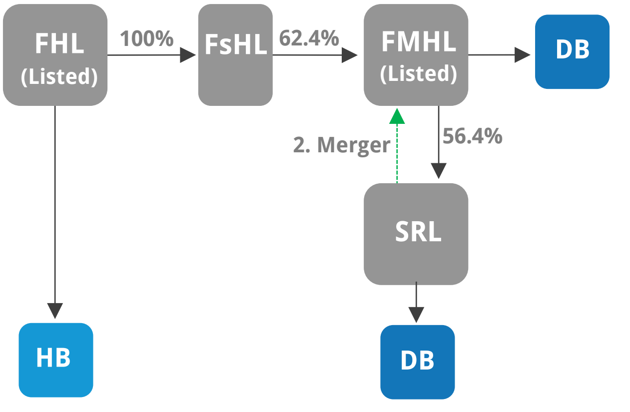
Step 1(a): Transfer of the HB of FMHL to FHL by way of **Slump Sale**[2]. FMHL would retain its existing DB.

Step 1(b): Demerger of business undertaking comprising of the DB in FHL and investments held by FHL in SRL (56.4% stake) to FMHL.



Step 2

Merger of SRL into FMHL to consolidate the DB under FMHL. Subsequent to the merger, the name of FMHL would be changed to SRL Limited.



The likely rationale behind each of these steps and their accounting treatment is explained below:

Step 1(a) - Slump sale: The rationale for this step is to consolidate the HB under one entity - FHL. As per the scheme, FHL shall pay an amount of INR 430 million as a lump sum consideration to FMHL towards acquisition of the HB of FMHL by way of slump sale. Slump sale was considered for the transfer of this undertaking over the process of demerger as a demerger would have resulted in cross-holdings by subsidiary company (FHsL) into the holding company (FHL), which is not permitted under Indian company law. The slump sale also enabled them to fund FMHL.

[1] A composite scheme of arrangement and amalgamation refers to an arrangement between the company and its shareholders and/or creditors. It may involve merger, demerger, slump sale or any other arrangement as approved by the Tribunal.

[2] Slump sale means the transfer of one or more undertakings as a result of sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales

Accounting treatment for Step 1(a):

i. **In the books of FHL**: As per the scheme, FHL will account for HB in its books of account in accordance with Appendix C – 'Business Combinations of entities under Common control' of Indian Accounting Standard 103 (Ind AS 103). Accordingly, FHL will record the assets and liabilities of the HB at the carrying amounts as appearing in the books of FMHL as on the appointed date. Furthermore, FHL will record the difference between the consideration paid by FHL and the carrying of amounts of net assets of the HB as capital reserves. Under the previous Accounting Standards (AS) regime, there was no accounting treatment prescribed for the accounting of slump sale transactions. The acquirer would record the assets in its books by allocating the consideration on the basis of purchase price allocation report (asset valuation report) from an independent valuer. The difference between the consideration paid and the value of assets as per the valuation report would be recorded either as goodwill or capital reserves depending on facts of each case. Under the Ind AS regime, creation of goodwill in the books of the transferee company in transactions involving common/associated entities is not allowed.

ii. **In the books of FMHL**: The accounts of FMHL shall reduce the carrying amount of the assets and liabilities of the HB as on the appointed date and any difference between the consideration received and the carrying amount of the assets and liabilities of the HB would be recorded as capital reserves.

Tax treatment on slump sale

From a tax perspective, Section 50B of the Income Tax Act, 1961 provides the manner for computation of capital gains tax arising on slump sales. Some of key points related to taxation on slump sales are:

i. Capital gains arising from the transfer of an undertaking are deemed to be long-term capital gains. However, if the undertaking is 'owned and held' for not more than 36 months immediately before the date of transfer, the gains shall be treated as short-term capital gains.

ii. Capital gains arising from slump sales are calculated as the difference between the sale consideration and the net worth of the undertaking. The net worth is deemed to be the cost of acquisition and the cost of improvement. The net worth is the difference between the aggregate value of total assets of the undertaking and the value of its liabilities as appearing in its book of accounts. The aggregate value of total assets is computed as under:

- Tax Written Down Value (WDV) as determined in case of depreciable assets; and
- The book value in case of other assets

iii. No indexation benefit is available on the cost of acquisition (i.e. net worth).

iv. Long-term capital gains on slump sales are charged at the rate of 20% (plus applicable surcharge and cess), while short-term capital gains are charged at the normal rate of tax - 30% (plus applicable surcharge and cess).

On the commercial side, in case of a slump sale, it is necessary to have a mechanism in place to deal with the movement in the net worth of the undertaking during the period between approval/finalisation of the slump sale and the actual date of agreement of the slump sale. Any material movement in the net worth during this period can have an impact on the value actually received by the buyer.

Furthermore, where the takeover includes debtors, TDS receivable, etc. the agreement must also include adequate covenants to cover interest of both the parties to safeguard them from any loss arising on account of the same. It is important to note that the brought forward tax losses don't get transferred in case of a slump sale.

Step 1(b) - Demerger: Through this process, the DB would be consolidated under one entity - FMHL. As a consideration for this demerger, FMHL would allot its equity shares to the shareholders of FHL in proportion to their existing shareholding based on the exchange ratio agreed by shareholders. The possible objectives behind choosing the demerger route for the transfer of DB are given below.

- To make the transaction cash-free (A slump sale would have involved a transfer of funds from FMHL to FHL).
- A demerger also entitles the transferee company (FMHL in this case) to carry forward and set-off the tax losses of the acquired undertaking, if any.
- Since the objective is to consolidate entire business of DB under FMHL, the investment in SRL was also considered as a part of DB business and demerged.
- Furthermore, the transfer of investment in SRL in any other manner would not only have involved the payment of cash consideration but also tax outflow. The demerger route enabled transferring the shareholding of SRL from FHL to FMHL in a completely tax-free manner while meeting the intent of consolidation of the DB.

Accounting treatment for the Step 1(b):

i. **In the books of FHL:** FHL will reduce the carrying amount of the assets and liabilities of the DB as on the appointed date. Furthermore, the share premium account of FHL shall be reduced by an amount equal to the carrying amount of the DB and the scheme provides that this reduction in share premium account would be in accordance with the provisions of the Companies Act, 2013 and Companies Act, 1956. Through this, FHL has utilised the balance in the securities premium account which otherwise could only be utilised for limited purposes.

ii. **In the books of FMHL:** As per the scheme, FMHL will account for the DB in its books in accordance with Appendix C – 'Business Combinations of entities under Common control' of Ind AS 103 - Business Combination. Accordingly, FMHL will record the assets and liabilities of the HB at the carrying amounts as appearing in the books of FHL as on the appointed date. FMHL will credit its share capital with the aggregate nominal value of the new equity shares issued by it to the shareholders of FHL and the difference between the carrying amount of the net asset of DB and the equity shares issued shall be recorded as capital reserves.

Earlier, the accounting standards did not provide for any accounting treatment for demergers.

Step 2 - Merger: Through this step, the entire DB was consolidated under FMHL. FMHL allotted its equity shares to the shareholders of SRL (excluding FMHL's own holding of 56.4% stake in SRL, pursuant to the demerger).

<u>Accounting method for Step 2:</u>

i. **In the books of FMHL:** As per the scheme, FMHL will account for the amalgamation of SRL in its books in accordance with Appendix C – 'Business Combinations of entities under Common control' of Ind AS 103 - Business Combination. Accordingly FMHL will credit its investment in SRL and correspondingly record the assets and liabilities of SRL at the carrying amounts as appearing in the books of SRL as on the appointed date. FMHL will also credit the equity share capital issued to the shareholders of SRL (excluding itself) and the difference between the carrying amounts of net assets of SRL and the equity shares issued by FMHL shall be recorded as capital reserves. Under Accounting Standard 14 – Accounting for amalgamations, the transferee company had an option to create goodwill in its books by following the purchase method for the merger. However, under the new Ind AS, no goodwill can be created in the case of mergers of companies under common control.

Demerger entitles the resulting entity to carry forward the losses of demerged entity. However, one must verify the correctness of the tax losses brought forward related to the demerged undertaking to avoid any denial of benefits due to litigations/disputes at a later stage.

ii. **In the books of SRL:** Once the scheme comes into effect, SRL will be dissolved without winding up.

Rationale for the restructuring as per the scheme:

- The scheme would enable the shareholders of SRL to realise the value of their shares as they get shares in a listed entity (FMHL) after the merger.
- As the shareholders of SRL would receive the listed shares of FMHL, the non-promoter shareholders of SRL, which includes private equity investors, would get an exit route for their investments.
- A simplified organisational structure would help shareholders and investors better understand and evaluate both businesses independently as investment options.
- It would be strategically apt for both businesses to be restructured under separate entities to enable them to pursue future growth opportunities in their respective segments
- It would facilitate both businesses moving forward independently with greater focus and specialisation; leveraging their respective capabilities and strong brand presence.

SKP's view

Through this arrangement, FHL group has separated and merged the hospital business and diagnostic business into two separate entities in order to gains benefits from greater clarity, a stronger focus and an independent growth trajectory.

Furthermore, as a part of the structuring scheme, one of the group entities – SRL Limited was also eliminated, which further benefited the FHL group by reducing compliance costs.

From a tax perspective, the scheme is tax efficient with the slump sale being the only taxable transaction while the demerger and merger were completely tax free. From a shareholders' perspective, FHL Group has kept the beneficial interest of its shareholders and promoters unaffected throughout this restructuring exercise.

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