Smart demerger of multiple business divisions in the most tax efficient way

Background

- Deepak Fertilisers and Petrochemicals Corporation Limited (DFPCL or the company) is a listed company with multiple large business verticals engaged in the chemical and fertilisers industry.
- DFPCL has three prominent business divisions:
  - Industrial Chemicals (IC);
  - Technical Ammonium Nitrate (TAN); and
  - Fertilisers (Fertiliser).
- SCM Fertichem Limited (SCM Fertichem) and Smartchem Technologies Limited (Smartchem) are Wholly Owned Subsidiaries (WoS) of DFPCL.
- SCM Fertichem is involved in the business of manufacturing and trading of fertilisers, petroleum and their by-product chemicals.
- Smartchem is engaged in the business of manufacturing and trading of ammonium nitrate and weak nitric acid.

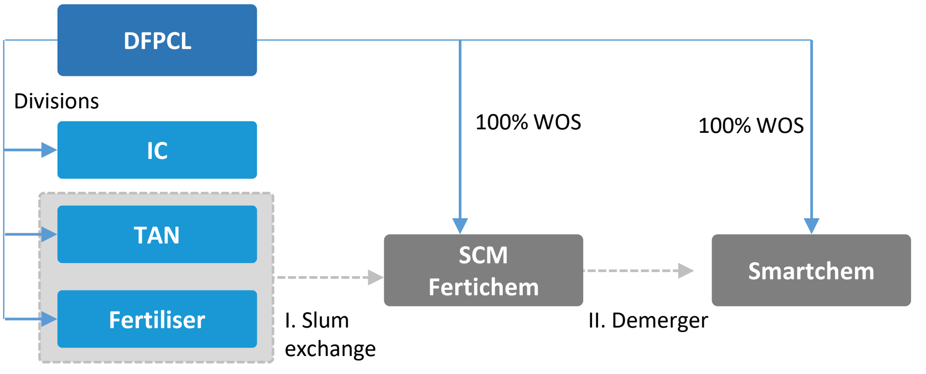
For better realisation of businesses potential of DFPCL and its (WoS) companies, the Board of Directors of the Company approved the Scheme of Arrangement among DFPCL, SCM Fertichem and Smartchem on 29 March 2016.

According to the scheme:

I. TAN and Fertiliser Division of DFPCL would be first transferred to SCM Fertichem by a slump exchange.

II. Subsequently, SCM Fertichem would transfer these two divisions to Smartchem through a demerger.

The structure is represented below:



The objective of the above arrangement is:

- TAN and fertiliser businesses have been interlinked for ages in the form of use of common raw material and similarity of the manufacturing process, while the IC business is relatively independent of such common modalities. Furthermore, the complementary seasonality of the two businesses allows for maintaining a steady level of operations.
- Each business division gets the required management focus and autonomy to pursue the possibilities of expansion and growth.
- DFPCL shall continue to retain control of the TAN and fertiliser business through its WoS.
- The structuring would enable different divisions with different potential for growth to attract a various kinds of investors, strategic partners and know-how providers to scale up their size and operations. Additionally, it enables investors to choose the business of their liking and priorities.

The above structuring should be undertaken in the following two steps:

Step 1: The slump exchange of the TAN and Fertiliser undertaking of DFPCL together with its business and operations (collectively referred to as the Transferred Undertakings) of the Company to SCM Fertichem on a going concern basis (slump exchange). The consideration for it is proposed to be discharged by way of equity shares.

Step 2: Thereafter, the subsequent demerger of the transferred undertakings and vesting it from SCM Fertichem to Smartchem on a going concern basis in accordance with section 2(19AA) of the Income Tax Act 1961 (Demerger).

The rationale behind the above steps and the tax considerations of the proposed arrangement is discussed below:

- **Step 1: Slump exchange:** The consideration for the transfer and vesting of the transferred undertaking of DFPCL to SCM Fertichem is fixed at INR 7.43 billion, which would be discharged through the issue of 16 million equity shares of INR 10 each (face value) at a share premium of total INR 7.27 billion. The capital gains arising on the slump exchange would be exempt from tax under section 47(iv) of the Income Tax Act, 1961 (ITA), which deals with the transfer of capital assets from a holding company to its WoS. SCM Fertichem would continue to remain the WoS of DFPCL.

- **Step 2: Demerger:** For the demerger of the transferred undertaking from SCM Fertichem to Smartchem, Smartchem will issue its equity shares to the shareholders of SCM Fertichem (i.e. DFPCL) with the share exchange ratio of 1:1. DFPCL will receive one fully-paid up equity share of Smartchem for every one share held in SCM Fertichem. There would not be any capital gain tax on the transfer of any capital asset by the demerged company (SCM Fertichem) to the resulting company (Smartchem) as per section 47(vib) of the ITA. Furthermore, according to section 47 (vid), any issue of shares by the resulting company to the shareholders of the demerged company, in the scheme of demerger, is not regarded as a transfer for the purpose of capital gains and hence is not taxable.

Prima facia it appears that the objective of the company is to move the division of TAN and Fertiliser to Smartchem. The key question that arises is the intention behind transferring the division to SCM Fertichem first on a slump exchange basis and then demerging the same divisions to Smartchem.

Our views on the rationale behind the two-step transfer

- The intermediate step of the slump exchange has helped in achieving the separation of a business division of a listed company without listing the resulting Company, which otherwise would have to be listed in the direct demerger arrangement.
- If a direct demerger was considered for transferring the undertaking, it would have resulted in the dilution of control of DFPCL in Smartchem (as shares would have been issued to the shareholders of DFPCL in the course of the demerger) and could have made it unattractive for any strategic investor from any investment perspective.
- Alternatively, if direct slump exchange would have been considered, then the transaction would not have remained tax exempt as per section 47A. According to these provisions, the WoS should continue to remain a WoS for a period of eight years in order to be entitled to tax exemption. Considering the long-term objective of finding a strategic investor for the direct slump sale would have made it difficult for Smartchem to attract investors due to the withdrawal of capital gains exemptions on account of the change in the shareholding of Smartchem before a period of eight years.
- The arrangement has been structured to ensure that there is no dilution of control of the subsidiaries of DFPCL and hence, the liberty to make a decision without public involvement is retained.
- The arrangement is completely tax-free.
- The ultimate objective of separation of divisions met keeping the flexibility to divest stake in the future without going to the shareholders of the Company.
- The structuring does not have any economic impact on the ultimate value of the shareholders of DFPCL and there will not be any change in the economic interest of the shareholders of DFPCL.

SKP View

Through the above structuring, DFPCL was able to transfer two of its business divisions from one WoS to another WoS without any dilution of control of its subsidiaries and in a tax efficient way. Furthermore, throughout this structuring exercise, DFPCL managed to keep the beneficial interest of its shareholders the same since no shares were issued or transferred to any third party.

The arrangement also helped in achieving the dual objective of ensuring that the control is with DFPCL and structure remains attractive of any strategic investment in a tax efficient manner. Furthermore, this structure also enables DFPCL to completely exit the transferred business at any future date in an easy and simplified manner.

Disclaimer: We have not advised DFPCL, or any of its subsidiaries and we are not involved in the transaction directly or indirectly. We have analysed the scheme without any discussion with the management or anyone who is aware about the objective of the arrangement. The views expressed are solely our views and objective/rationale of the scheme can differ from the views expressed by us.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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