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Legal Sanctity of "Cherry Picking" of Assets in Slump Sale Deals

In M&A transactions, In M&A transactions, "Slum Sales" are considered to be one of the most preferred ways of carrying out a deal due to various tax and stamp duty incentives associated with it. However, the very concept of "slump sale" and the conditions to avail the taxation benefits attached to it restrict any sort of itemization or cherry picking of assets which form part of an undertaking. The legal issues that may arise vary depending on the manner in which the transaction is structured. Nonetheless, since time immemorial, one common and yet ambiguous issue in relation to slum sale structuring has been the legal sanctity of "cherry picking" i.e. selecting and rejecting of certain assets or liabilities while transferring an undertaking on "slump sale basis as a going concern". As a general principal in legal parlance, it is implicit that any sort of cherry picking is in consistent with the concept of "slump sale" as defined under Income Tax Act, 1961 and hence not permissible.

However, recently Delhi High Court in the case of Triune Projects Pvt. Ltd vs. DCIT, upheld the position that a transaction does not cease to be a slump sale merely due the seller retaining certain defunct or unwanted assets of the undertaking. The crux of the judgment is that, for a sale to be termed as 'slump sale' it is not necessary to transfer all assets and liabilities, however, the core elements of the business must be transferred for a lump sum price and the Transferee must be able to continue running the business without the assets which have not been transferred.

Cherry Picking is restricted by statutes?

As mentioned above, typically business transfers are structured as slump sale to minimize tax liability of the Transferor. Slump Sale has been defined under the Income Tax Act, 1961 as follows:

2 (42C): "Slump Sale" means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.

The main elements of a slump sale thus are **(a)** sale of an undertaking; (b) lump sum consideration; and **(c)** no separate values are assigned to individual assets and liabilities.

In this regard, the term **"Undertaking"** as defined under Section 2(19AA) of the Act includes any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

The question of whether exclusion of certain assets of the undertaking from the scope of transfer, would still constitute transfer of an "undertaking" has been at the focal point of considerable debate. The use of the term "any part of an undertaking" in the aforesaid definition grants scope for interpreting the section to permit any transfer of assets that the does not affect the essential "slump sale" nature of the transaction. The argument for this interpretation is buttressed by the fact that the definition does not explicitly require the sale of all assets or defunct assets of the business.

Lack of consistency in Judicial Precedents?

Until now, the question of excluding certain assets or liabilities from the business unit being transferred as a going concern and on a slump sale basis was a gray area. Although, it was a common market practice to exclude certain assets or liabilities as per the commercial understanding and contractual terms between the parties, the legal permissibility of the same was not clear. Various courts has given contrary rulings on this matter and over time two lines of precedent developed. One line of precedent held that a transaction where only specified assets of an undertaking were sold did not qualify as a Slump Sale under Section 50B of the Act, even if the agreement reffered ot the transfer of a "Going Concern".. ***This line of cases implied that the sale of entire undertaking is a pre- requisite of a slump sale as defined in Section2 (42C) of the Act***. On the other hand, the second line of cases held that a sale was a slump sale if it was a sale of a going concern, even if some of the assets were retained by the Transferor. The Delhi High Court seems to have affirmed this second line of judgements.

*In the case of **Triune Projects Pvt. Ltd vs. DCIT**, the Delhi High Court has held that the transaction was not a sham or a colourable device and qualifies for treatment under Section 50(B) of the Act. The sale was for a going concern, which included ongoing service contracts, employment contracts and other tangible assets, and intangible assets such as technical know-how etc. To expect a purchaser to buy and pay value for defunct or superfluous assets flies in the face of commercial sense. Therefore, if certain assets or properties are left out because they would cause inconvenience or lead to some kind of a trouble for the purchasing party, it is well within its right to exclude it from the list of assets and henceforth rejected their contentions.*

Delhi HC validates "cherry picking"?

With the instant ruling, the court has clarified that it is a common commercial understanding of the parties which should be the sole criterion for deciding the inclusions and exclusions under the scope of "undertaking" and it cannot be expected from a purchaser to buy and pay value for superfluous and non-operational debts. Therefore, if certain assets are left out because they would be redundant or cause inconvenience to the purchasing party, such party is well within its rights to exclude it from the list of assets.

The underlying criterion to decide whether the given transaction falls under the scope of "slump sale" would depend upon the fact whether the business in the hands of the Transferee can be run in a similar manner and without affecting the "basic or core" structure of the original transferred business. Even if certain assets are not transferred, it may not affect the business and hence nullifying the validity of such sale of the 'undertaking' as a slump sale is certainly not justified. ***The final test to be applied is whether the Transferee is able to continue running the business without the assets which have not been transferred?***

Way Forward..

The instant ruling of Delhi High Court certainly comes as a major relief to the parties undertaking such transactions, which now can go ahead and decide to exclude certain assets or liabilities which may not be commercially viable for them. However it should be noted that what constitutes the "basis or core structure" of the underlying business will vary from case to case basis and no fixed criteria for the same can be pre determined. Also, whether the ratio of this ruling will be equally applicable in case of exclusion of any non-defunct or commercially sound assets is not very clear. Hence it is advisable for the transacting parties to carefully examine the utility and role of the assets and liabilities in the undertaking before commercially deciding to exclude the same from the scope of transfer.

Further, it should be noted that the given ruling may have effects on other issues related to slump sale transaction also, for instance, the exemption from VAT on slump sale transactions. Delhi High Court herein has specifically examined the issue from the perspective of Section 50 B of the Act and although it may be quite reasonable to extend the same ratio while determining VAT and other tax liabilities, but the same is not completely unambiguous and clarity on such specific aspects by the authorities would be required before concreting any view on the same.

REGULATORY SNAPSHOTS

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