



# M&A IN INDIA

## TAX AND REGULATORY PERSPECTIVE





## FROM OUR CEO

*India witnessed an unprecedented set of events in the past couple of years that have played a significant role in the pace of economic as well as political activity in the country. A demonetization drive that took people by surprise was aimed at flushing out the parallel economy of cash from the system. Implementation related challenges aside, the historic move did change the political landscape in India. The move also gave some much needed headroom to the banks which have been reeling under rising bad performing lending calls.*

*The second half of 2017 started with the implementation of the One Nation One Tax concept called Goods and Service Tax (GST). Unification of all indirect taxes under one umbrella with credit availability should help improve the global competitiveness of Indian businesses, and also increase indirect tax collections in the country.*

*The enactment of the Insolvency and Bankruptcy Code, 2016 on May 5, 2016, is a welcome step towards dealing with insolvency of corporates, individuals, partnerships and other entities. The Code creates single law for insolvency and bankruptcy and offers a comprehensive insolvency legislation for all persons.*

*Globally, the year of 2017 was important, particularly, due to the change of Presidency in the US and its fall out on international relations. With Donald Trump taking over as the President of the US, the world has been keenly watching his foreign policy as well as US visa policies. The unprecedented reduction in tax rates from 35% to 21% and introduction of base erosion and anti-abuse tax will have a significant impact on international trade as well as deal activity. Both President Trump and Indian Prime Minister Modi, have repeatedly reaffirmed the strategic importance of Indo-US relations.*

*Within India, the focus on digitization, benefits of GST as well as the Government's continued thrust on foreign investment and Make in India should keep on driving the deal activity. This is perhaps reflected in the deal trends. Indian M&A ended the year 2017 with 1,022 deals with a disclosed value of USD 46.8 billion. In January 2018, there were 47 M&A deals worth USD 15,137 million, while there were 45 such transactions worth USD 2,301 million in the same month of 2017 marking an almost 100% increase in transaction activity. India's market share in the Asia-Pacific region (excluding Japan) also increased to almost 15% which is the highest since 2013.*

*Hence, the importance of tax in M&A simply cannot be understated. Careful attention to tax issues at an early stage in the M&A process can help minimize future tax uncertainty and litigation. Proper attention to tax policies, systems and litigation also remains crucial to the overall success of M&A deals, and can be usefully leveraged to add value, reduce costs and manage risks. In this publication, we have analyzed key tax developments relating to M&A as well as several tax and regulatory issues that often arise in the context of M&A transactions involving India. We hope you will find this useful.*

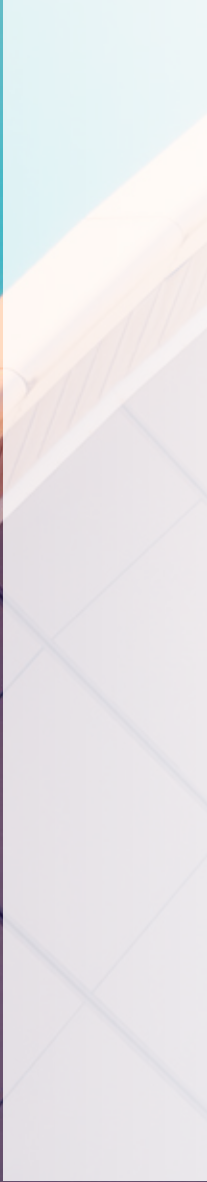
*We look forward to your comments and thoughts.*

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# Taxes applicable to companies in India – at a glance

## Corporate tax rates

The corporate tax rates (including surcharge and education cess) applicable to a domestic and foreign company are summarized below:

Provisions of MAT are not applicable to foreign companies if:

- it is a resident of a country with which India has a treaty and does not have a permanent establishment in India, or

| Description  | Tax rate (%) | Surcharge (%) | Health & Education cess (%) | Effective rate (%) |
|--|--------------|---------------|-----------------------------|--------------------|
| <b>A. Where the total income is up to INR 10 million</b>                               |              |               |                             |                    |
| <b>Domestic company</b>  | 30           | Nil           | 4                           | 31.2               |
| <b>Foreign company</b>   | 40           | Nil           | 4                           | 41.6               |
| <b>B. Where the total income is more than INR 10 million and up to INR 100 million</b> |              |               |                             |                    |
| <b>Domestic company</b>  | 30           | 7             | 4                           | 33.384             |
| <b>Foreign company</b>   | 40           | 2             | 4                           | 42.432             |
| <b>C. Where the total income is more than INR 100 million</b>                          |              |               |                             |                    |
| <b>Domestic company</b>  | 30           | 12            | 4                           | 34.944             |
| <b>Foreign company</b>   | 40           | 5             | 4                           | 43.68              |

The Finance Act 2018 has prescribed a corporate tax rate of 25% for domestic companies if their total turnover or gross receipts in the financial year 2016-17 does not exceed INR 2500 million.

- it is resident of a country with which India does not have a treaty and the foreign company is not required to register under any law applicable to companies.

## Minimum Alternate Tax (MAT)

Indian law requires MAT to be paid by companies on the basis of profits disclosed in their financial statements. In cases where tax payable according to regular tax provisions is less than 18.5% of their book profits, companies are required to pay 18.5% (plus surcharge and education cess as per table above) of their book profits as tax. The book profits for this purpose are computed by making prescribed adjustments to the net profit disclosed by the company in their financial statements.

The tax credit is allowed to be carried forward for 15 years and set off against income tax payable under the normal provisions of the Income-tax Act, 1961 (Act) to the extent of the difference between tax according to normal provisions and tax according to MAT.

## Dividend Distribution Tax (DDT)

Domestic companies are required to pay DDT at the rate of 20.56% on dividends declared, distributed or paid. Such tax is not a deductible expense. The amounts declared, distributed or paid as dividends by domestic companies are generally not taxable in the hands of the shareholders (except for certain categories) as the same are subject to DDT.

Where the recipient domestic corporation declares dividend, credit for dividend received from the domestic subsidiary and foreign subsidiary is available for computation of dividend on which DDT is to be paid by the recipient domestic corporation, subject to prescribed conditions.

## Tax on Certain Dividends received from Domestic Companies

An Individual or Hindu Undivided Family or firm resident in India has to pay 10% tax (excluding surcharge and cess) on income by way of dividend declared, distributed or paid by a domestic company in excess of INR 1 million. This is in addition to DDT which domestic companies are required to pay as mentioned above.

No deduction in respect of any expenditure or allowance or set off of loss is allowed in computing the income by way of dividend.

## Buyback Tax (BBT)

An Indian unlisted company has to pay 23.3% (including surcharge and cess) tax on "distributed income" (differential between consideration paid by the unlisted Indian company for buy-back of the shares and the amount that was received by the unlisted Indian company) on buyback of shares.

The shareholder is exempt from tax on proceeds received from the buyback of shares. No deduction is allowed to the unlisted Indian company in respect of such tax.



# M&A landscape in India

The Indian tax and regulatory framework allows for several modes of carrying out M&A transactions in India. This chapter seeks to cast light on these modes and the key considerations that the buyers and the sellers need to keep in mind to ensure that transactions are implemented efficiently.

## Modes of M&A transactions in India

An acquisition can be structured in any of the following ways subject to commercial considerations:

- Share acquisition
- Asset acquisition
  - Acquisition of the entire business
  - Acquisition of individual assets
- Merger
- Demerger

## Share acquisition

In a share acquisition, the acquirer purchases the equity interest in the target entity from the sellers or owners of the business and becomes the equity owner of the target entity. Share acquisition is one of the most common modes of M&As that takes place in India. The consideration for a share acquisition is typically in the form of cash. However, in more recent times, stock swap deals have also been structured, particularly in transactions where the selling promoters intend to remain part of the business and share the risks and returns of growth. From a seller's perspective, a share sale deal has the following key implications:

### A. Tax on transfer:

- **Listed shares:** Hitherto, in case of shares listed on a stock exchange, if the shares were held for a period of 12 months or more (long term holding) and the shares were sold on the floor of the stock exchange after payment of securities transaction tax (STT), any profits on such sale were exempt from payment of capital gains tax.

The Finance Act 2018 introduced changes in respect of taxability of listed shares which are held for long term. Effective April 1, 2018, any sale of listed shares which are held for long term shall be subject to capital gains tax of 10% [plus applicable surcharge and cess] in respect of any gains exceeding INR 1 lacs in addition to levy of STT. Further, in case any such shares were held on January 31, 2018, and sold after being held for long term after April 1, 2018, the cost of acquisition of such shares

available as a deduction against sales consideration at the time of sale will be higher of (a) Actual Cost or (b) Computed Cost [Computed Cost = lower of (a) highest price of shares on the stock exchange as on January 31, 2018, or (b) consideration received on sale of such shares]. Also, the indexation benefit and the benefit of computation of capital gains in foreign currency [in case of non-resident] will not be allowed in respect of such shares.

However, the benefit of aforesaid 'cost step up' and the reduced rate of tax of 10% shall not be available for the shares acquired on or after October 1, 2004, on which STT was not paid. The Government has clarified that certain exceptions will be provided in this regard which include:

- Acquisition of existing listed equity shares in a company, whose equity shares are not frequently traded in a recognised stock exchange of India, which are made through a preferential issue, excluding the following:
  - Acquisition of shares which has been approved by the Supreme Court, High Court, National Company Law Tribunal, Securities and Exchange Board of India or Reserve Bank of India;
  - Acquisition of shares by any non-resident in accordance with the Foreign Direct Investment (FDI) guidelines or by an Investment fund/ Venture Capital Fund/ Qualified Institutional Buyer;
  - Acquisition of shares through a preferential issue to which the provisions of Chapter VII of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 do not apply.
- Transactions for acquisition of existing listed equity shares in a company which are not entered through a recognised stock exchange, other than the following forms of acquisition: if they were made in accordance with the provisions of Securities Contracts (Regulation) Act, 1956 (if applicable):
  - Acquisition through an issue of share by a company other than preferential issue;
  - Acquisition of shares which has been approved by the Supreme Court, High Court, National Company Law Tribunal, Securities and Exchange Board of India or Reserve Bank of India;
  - Acquisition of shares under employee stock option scheme or employee stock purchase scheme framed under applicable Scheme/ Guidelines or under Takeover Code;

1. However, there was MAT implication on these gains.



- Acquisition of shares by any non-resident in accordance with the FDI guidelines or by an Investment fund or a Venture Capital Fund or a Qualified Institutional Buyer;
- Acquisition by mode of transfer referred to in section 47 (exempt transfers) or 50B (slump sale) of the Income-tax Act, 1961, if the previous owner of such shares has not acquired them by any mode which is not eligible for exemption as per the notification.

In the event the listed shares have been held for a period not exceeding 12 months and STT has been paid on the sale, profits on such sale will attract capital gains tax at the rate of 15%<sup>2</sup>. Further, in order to reduce litigation and to maintain consistency in approach of treatment of income derived from sale of listed shares and securities, the CBDT vide Circular No. 6/2016 has laid down guidelines for determining whether the gains generated from sale of listed shares and securities would be treated as capital gain or business income. As per the said guidelines, the tax payer has liberty to decide whether their gains/losses from sale of listed shares and securities should be treated as business income or as capital gains. However, the stand once taken by the tax payer shall be applicable in subsequent years also and the tax payer is not allowed to adopt a different/contrary stand in this regard in subsequent years.

- **Unlisted shares:** If the shares are not listed, the minimum period of holding required for availing the beneficial rate of tax on long-term capital gains increases to 24 months. This means that if the shares are sold after a period of 24 months from the date they were acquired, the profits from the sale are taxed at the rate of 20%<sup>2</sup>. While computing long term capital gains, indexation of cost of acquisition is allowed, to factor in the inflation effect. In case the seller is a non-resident, the applicable tax rate on long-term capital gains is 10%<sup>2</sup>. However, for non-residents, no benefit of indexation or exchange rate fluctuations is allowed while computing the taxable profits. The CBDT vide a follow up letter no. F.No.225/12/2016/ITA.II has clarified that income arising from transfer of unlisted shares would be considered under the head 'Capital Gain', irrespective of period of holding. However, the CBDT has carved out certain exceptions to the above principle.

In the event that shares have been held for a period not exceeding 24 months, any profits on such sale are taxed as normal income at the applicable rate of tax i.e. 30%<sup>2</sup> for residents and 40%<sup>2</sup> for non-residents.

In a stock swap deal, while the mechanism of taxation remains the same as outlined above, the consideration for the sale is determined with reference to the fair value of the shares received by the seller.

Further, a new provision has been inserted by the Finance Act 2017 which provides that where consideration for transfer of share of a company (other than quoted share) is less than the Fair Market Value (FMV) of such shares, the FMV shall be deemed to be the full value of consideration for computing capital gains. The FMV for the aforesaid purposes will be computed as per the formula prescribed which essentially seeks to arrive at the FMV based on the intrinsic value approach.

### Exemptions from capital gains on share sale

India has signed double taxation avoidance agreements (DTAA), popularly called 'tax treaties', with many countries. India and Mauritius also agreed to an amendment to the India-Mauritius tax treaty, wherein inter alia the capital gains taxation clause has been amended to provide for source-based taxation. Accordingly, the capital gains arising upon transfer of any shares in an Indian company acquired by a Mauritius resident on or after April 1, 2017, shall be taxable in India. The amendment provides for transitional provisions for 2 years, wherein a 50% reduction in tax rate would be available for capital gains arising between April 1, 2017, till March 31, 2019, subject to satisfaction of the conditions now prescribed in the Limitations of benefits (LOB) clause. The LOB clause inter alia prescribes that a Mauritius entity should spend at least Mauritian Rupees 1,500,000 (INR 2,700,000) in the 12 months preceding the date of transfer, to avail the reduced rate of tax on capital gains. However, capital gains on sale of shares in Indian company acquired before April 1, 2017, will continue to be taxable in the country of residence of the seller.

Since, the capital gains tax exemption under the India-Singapore tax treaty is co-terminus with the exemption available under the India-Mauritius tax treaty, India – Singapore tax treaty was also amended along similar lines.

Further, India – Cyprus tax treaty is also modified on similar lines as India – Mauritius and

India – Singapore tax treaty, albeit, without the benefit of reduced tax rate for the transition period of two years.

India has also signed the multilateral convention under Base Erosion Profit Shifting (BEPS) (refer the chapter on "Impact of BEPS on India-focused M&A activity" to understand the impact of the same on India's DTAA with Mauritius and Singapore).

Additionally, India introduced General Anti-Avoidance Rules (GAAR) with effect from April 1, 2017, which

2. The rates are excluding surcharge and cess.

provides for tax treaty override in case of transactions which lack commercial substance. Substance parameters will therefore become increasingly relevant.

## B. Tax withholding:

While there is no requirement for withholding of taxes if the seller is an Indian resident, a withholding requirement arises if the seller is a non-resident. Typically, buyers insist on a withholding of tax at the full rate, even if the seller is a resident of a favorable treaty country such as Mauritius, unless the seller furnishes a certificate from the income tax department certifying a nil or a lower rate for withholding tax on the transfer.

Sometimes buyers also agree to withhold lower or nil taxes, subject to contractual indemnities and insurance under the share purchase agreement or obtaining a favorable ruling from the Authority of Advance Ruling.

### *Indirect transfers*

Many companies in India with international holding companies have multi-layered holding structures in overseas jurisdictions, such as Singapore, Mauritius, Cyprus, the Cayman Islands, etc. Such structures were set up to avoid paying taxes in India by selling the shares of the overseas company and not the Indian company. However, the Indian tax law was retrospectively amended in 2012 to bring indirect transfers within the ambit of Indian taxation. The concept seeks to cover transactions involving transfer of shares of a foreign company if such shares derive substantial value from assets located in India. The threshold for determination of substantial value is 50% of the value of the total assets. Certain exceptions have been provided under law, primarily to exclude transactions where the shareholder does not have a significant stake in the foreign entity. (refer the chapter on 'Taxation of Indirect transfers' for more details)

## C. Pricing:

The impact from a pricing perspective is dependent on whether the transaction involves domestic parties or non-residents. In a deal involving resident buyers and sellers, there are no exchange control requirements for the deal price.

However, the Indian tax laws provide that where consideration for transfer of share of a company (other than quoted share) is less than the Fair Market Value (FMV) of such shares, the FMV shall be deemed to be the full value of consideration in the hands of the Transferor for computing capital gains. The FMV for the aforesaid purposes will be computed as per the formula prescribed which essentially seeks to arrive at the FMV based on the intrinsic value approach. Similarly, for the Transferee the deficit between the FMV and the actual consideration is deemed as income and taxed at the applicable tax rate.

In case a resident Indian seller transfers shares to a non-resident buyer, then under the Indian exchange control laws, the transfer needs to take place at a minimum of the fair value of the share determined in accordance with internationally accepted methodologies of valuation. However, in a reverse case, i.e. a non-resident transferring shares to a resident, the fair value of the shares becomes the price ceiling instead of a price floor.

In the case that one or both of the parties is a non-resident related party, transfer pricing rules under the Indian tax laws are also applicable and the arm's length test needs to be satisfied. The Indian tax laws prescribe rules for determination of an 'associated enterprise' relationship which triggers the applicability of transfer pricing disclosures and compliances.

## D. Goods and Service Tax (GST):

There is no GST implication on sale of shares (Refer our article on 'Indirect tax laws impacting M&A deals in India' for more details).

### *Impact from the buyer's perspective*

#### a. Impact on tax losses:

The impact on continuity of any accumulated tax losses is determined by whether the company whose shares are transferred is 'a company in whom the public is substantially interested' or not. The tax law lays down certain conditions for the company to be classified as a 'company in which the public is substantially interested'. In summary, a listed company, any subsidiary of the listed company and any 100% step down subsidiary of the listed company, all qualify as companies in which the public is substantially interested, subject to compliance with certain conditions. The Indian tax laws provide that in the case of a company in which the public is not substantially interested, if there is a change in 51% or more of the voting power at the end of the year in comparison with the voting power as at the end of the year in which a loss is incurred, then such loss shall lapse and no set-off of the loss shall be allowed in the year in which the change in shareholding takes place. There are certain exceptions to this rule, one of them being the change in the shareholding of the Indian company pursuant to an amalgamation or demerger of its foreign holding company, subject to the condition that at least fifty-one per cent shareholders of the amalgamating or demerged foreign company continue to be the shareholders of the amalgamated or the resulting foreign company.

Also, the provisions for lapse of tax losses apply only on business losses and capital losses. These provisions do not impact the continuity of unabsorbed depreciation.

In respect of companies which are under insolvency proceedings, the Finance Act 2018 provides that where shareholding of such companies changes beyond 51% pursuant to a resolution plan approved under the insolvency code, losses will be available for carry forward and set off.

#### b. Step-up of cost base:

In a share acquisition, the cost base of assets of the company for tax deductibility does not change, since there is no change in the status of the company. However, any premium paid by the buyer for acquisition of the shares is not incorporated into the value of the block of assets of the company whose shares are acquired. The premium is available to the buyer as a cost of acquisition of the shares and is deductible for the purpose of income tax only at the time of transfer of the shares by the buyer.

#### c. Recognition and amortisation of intangibles:

In a share acquisition, no intangible assets are recognized in the books of the target company.

#### d. Stamp duty:

Share transfer attracts a stamp duty cost at the rate of 0.25% of the deal value. The responsibility to pay stamp duty, though commercially negotiated, usually lies with the buyer. However, stamp duty applies only if the transferred shares are not held in dematerialised form.

#### e. Securities laws:

In the event the shares acquired by the buyer are listed on any recognised stock exchanges in India, the buyer needs to comply with the provisions of the securities laws applicable to listed companies, prescribed by the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Regulations). Under the Takeover Regulations, SEBI has prescribed that in the event of acquisition of shares or voting rights of a listed company, entitling the acquirer to exercise 25% or more of the voting rights in the target company or acquisition of control, the acquirer is obliged to make an offer to the remaining shareholders of the target company for acquiring at least 26% more voting rights.

The price to be paid in the open offer is determined in accordance with the prescribed guidelines, which inter alia takes into account the negotiated price for the primary acquisition triggering the open offer. The Takeover Regulations are an evolved set of regulations which govern various modes of acquisition, including direct and indirect acquisition of

shares, voting rights or control in a listed Indian company and seek to protect the interests of the public shareholders by giving them exit rights on similar terms at which the controlling shareholders have divested their stake in the company. These Regulations also provide for certain exemptions for instance inter-se transfer between relatives and group companies, acquisition of shares pursuant to a Scheme of arrangement, etc.

#### f. Competition/ anti-trust laws:

The Indian anti-trust laws provide for various financial thresholds in a business combination. If such financial thresholds are met, which are based on value of assets and turnover, the transaction needs to be approved by the Competition Commission of India. The regulatory provisions provide for an exemption from the need for an approval in the event the target company's assets in India do not exceed INR 350 crores or the target company's turnover does not exceed INR 1000 crores.

## Asset acquisition

An asset acquisition can broadly be of two kinds:

- I. Acquisition of the entire business,
- II. Acquisition of individual assets.

A business acquisition entails acquisition of a business undertaking as a whole, meaning that assets and liabilities which together constitute a business activity are acquired for a lump sum consideration. On the other hand, the acquisition of individual assets involves purchase of assets separately, not necessarily constituting an entire business undertaking. The tax consequences differ in both cases.

#### I. Acquisition of the entire business:

The Indian tax laws recognise a business acquisition separately, in the form of a slump sale. Slump sale is defined in law as *"the transfer of one or more undertaking as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales"*.

#### Implications from a seller's perspective

##### a. Tax on transfer:

In a slump sale, the seller is liable to pay tax on gains derived on the transfer of the undertaking at the rates based on the time for which the business undertaking has been held. If the undertaking has been held for a period of more than 36 months, the applicable rate of tax is 20% (excluding surcharge and cess). If the undertaking has not been held for more than 36 months, then the profits are treated as short-term capital gains and charged to tax at the normal applicable rates of tax.

### *Mode of computation of profits on slump sale*

The profits on slump sale are computed using a prescribed mechanism which takes into account the net worth of the business undertaking transferred, based on the tax basis of depreciable assets and book basis of other assets and liabilities, forming part of the undertaking. The net worth so computed forms the cost base in the hands of the transferor for computation of gains on sale. In cases where the net worth of the business sold is negative, since the value of the liabilities is higher than the value of the assets, in such cases, the question of whether the gains should be computed taking into account the negative net worth has been a matter of controversy and litigation. While there are judgments both for and against the argument, the seller is advised to budget a tax pay-out based on the negative net worth, i.e. the negative net worth is added to consideration for computation of net worth.

#### **b. Tax withholding:**

There is no withholding tax requirement if the seller is an Indian company.

#### **c. GST:**

There is no GST implication on a sale of business (Refer our article on 'Indirect tax laws impacting M&A deals in India' for more details).

#### **d. No objection certificate from the tax authorities:**

Under section 281 of the Income-tax Act, 1961, any transfer of any asset by a taxpayer during the pendency of any proceedings under the tax law shall be void as against any claim in respect of any tax or any other sum payable by the taxpayer as a result of the completion of the said proceeding, unless the taxpayer obtains a no objection certificate from the income tax authorities for the transfer.

#### **e. Corporate laws:**

Under the provisions of the Indian corporate law, for a business to qualify as an undertaking, the investment in the business should form at least 20% of the net worth of the company or should generate 20% of total income of the company. Further, the seller needs to obtain an approval from at least 75% of its shareholders for effecting a slump sale transaction.

### **Impact from the buyer's perspective**

#### **a. Impact on tax losses:**

In a slump sale, the tax losses are not transferred to the transferee entity. Also, the credit in respect of minimum alternate taxes is retained with the transferor company.

#### **b. Step-up of cost base:**

In a slump sale, the transferee is allowed to allocate the lump sum consideration to the individual assets and liabilities acquired based on their fair value. Depreciation on the fixed assets is available based on the value allocated to them on the slump sale.

#### **c. Recognition and amortisation of intangibles:**

The buyer is allowed to allocate a portion of the consideration to intangible assets which may be acquired as part of the business undertaking.

#### **d. Stamp duty:**

Stamp duty is applicable based on the Indian state in which the assets transferred are located. Every state in India has different rules for applicability of stamp duty. While some states levy stamp duty only on conveyance of immovable property, many states also have provisions for levy of stamp duty on conveyance of movable assets. Typically, stamp duty levy is borne by the buyer.

#### **e. Competition/ anti-trust laws:**

Similar to a share acquisition, in the event a business acquisition meets the prescribed financial thresholds, an approval from the Competition Commission of India is required to be obtained.

### **II. Acquisition of individual assets:**

In the event that individual assets are acquired which do not constitute a business activity, acquisition of those assets is treated differently under the Indian tax laws.

### **Implications from a seller's perspective**

#### **a. Tax on transfer:**

In an itemised sale of assets, the tax treatment differs for depreciable and non-depreciable assets. In respect of depreciable assets, the gains are computed as follows:

- The sale consideration is deducted from the written down value (WDV) of the block of assets in which the asset transferred falls.
- If the sale consideration exceeds the entire WDV of the block, the excess is charged to tax at the normal applicable rates of tax.
- If the sale consideration is less than the WDV of the block, depreciation for the year is available only on the balance block.

For non-depreciable assets other than land, the gains are computed simply as the difference between sale consideration and book value of the asset transferred, and the gains so derived are taxed as business income at the normal applicable rates of tax.

If land is transferred, that does not form part of the stock in trade of the business, a benefit of indexation to factor in the impact of inflation is available on the cost of acquisition while computing profits and the profits are taxed as capital gains at rates depending on the period of holding.<sup>3</sup> Further, where the sale consideration for transfer of land and building is less than its stamp duty reckoner value, then the income-tax law provides for deeming the stamp duty reckoner value as the actual sale consideration.

#### b. Tax withholding:

There is no withholding tax requirement if the seller is an Indian company.

#### c. GST:

In case of an itemised sale of assets, GST is applicable on the movable assets transferred at the applicable rates. (Refer our article on 'Indirect tax laws impacting M&A deals in India' for more details).

#### d. No objection certificate from the tax authorities:

Under section 281 of the Income Tax Act, 1961 any transfer of any assets by a taxpayer during the pendency of any proceedings under the tax law shall be void as against any claim in respect of any tax or any other sum payable by the taxpayer as a result of the completion of the said proceeding, unless the taxpayer obtains a no objection certificate from the income tax authorities for such transfer.

### Impact from the buyer's perspective

#### a. Impact on tax losses:

In an itemised sale, the tax losses are not transferred to the transferee entity. Also, the credit in respect of minimum alternate taxes is retained with the transferor company.

#### b. Step-up of cost base:

In an itemised sale, the actual consideration paid is available to the transferee as the cost of acquisition, for the purposes of depreciation as well as capital gains on future transfer.

#### c. Stamp duty:

Stamp duty is applicable based on the Indian state in which the assets transferred are located. Every state in India has different rules for applicability of stamp duty. While some states levy stamp duty only on immovable property, many states also have provisions for levy of stamp duty on movable assets. Typically, stamp duty is paid by the buyer.

#### d. Competition/ anti-trust laws:

An asset acquisition which meets the prescribed financial thresholds, is also subject to approval from the Competition Commission of India.

## Merger

In a merger, two or more companies consolidate to form a single entity. The consolidation is undertaken through a National Company Law Tribunal (NCLT)<sup>4</sup> - approved process wherein all the assets and liabilities of the transferor entity, along with all employees, get transferred to the transferee entity and the transferor entity is automatically dissolved by virtue of the merger. As a consideration for the merger, the transferee entity issues its shares to the shareholders of the transferor entity.

### A. Implications under Indian tax laws

#### a. Definition under tax laws

Under the Indian income tax laws, a merger (referred to as an amalgamation) is defined as such if it fulfils the following conditions:

- All assets and liabilities of the transferor entity are transferred to the transferee entity; and
- At least three fourths of the shareholders of the transferor entity [in value] become the shareholders of the transferee entity

In case the transferee company is a shareholder in the transferor company, no shares are required to be issued by the transferee company in lieu of such shares, on amalgamation.

#### b. Tax implications in the hands of the transferor entity

The law specifically provides that an amalgamation is not regarded as a transfer by the transferor entity if the transferee entity is an Indian company.

In case of amalgamation of one foreign entity with another foreign entity, wherein capital assets (being shares of an Indian company or shares of a foreign company which derives its value substantially from shares of an Indian company) are transferred, no capital gains tax implication will arise in India if the following conditions are satisfied:

- At least 25% of the shareholders of the transferor foreign entity remain shareholders of the foreign transferee entity; and
- The transfer is not chargeable to capital gains tax in the country in which the transferor foreign company is incorporated.

3. If the capital asset is held for not more than 36 months, the profits are treated as short term capital gains and taxed at the normal applicable rates of tax. If the capital asset is held for more than 36 months, profits are taxed as long-term capital gains at the rate of 20%.

4. Provisions relating to merger/ restructuring scheme(s) under Companies Act, 2013 i.e. section 230 to section 232 are effective from 15 December 2016 and accordingly the power to approve such scheme(s) has been vested in the NCLT.

### c. Tax implications in the hands of shareholders of the transferor entity

In the case of an amalgamation, the shareholders of the transferor entity receive shares in the transferee entity in lieu of their shareholding in the transferor entity. This then raises the question as to whether this process will be considered as a 'transfer' and therefore be subject to capital gains tax in the hands of the shareholders of the transferor entity.

In this regard, the Indian tax law provides an exemption that in the case of amalgamation, any transfer of shares in the transferor entity by the shareholders will not be liable to capital gains tax on the fulfilment of the following conditions:

- The shareholders of the transferor entity receive shares in the transferee company in consideration of the transfer; and
- The transferee entity is an Indian company.

However, it is interesting to note that no specific capital gains tax exemption is provided to the shareholders under the Indian tax laws in the case of amalgamation between foreign companies involving transfer of shares of an Indian company or a foreign company which derives its value substantially from shares of an Indian company, wherein the shareholders receive shares in the transferee foreign entity in lieu of shares in the transferor foreign entity.

**Cost of acquisition and period of holding of shares received on amalgamation** – the cost of acquisition of the shares in the transferor company in the hands of the shareholders is preserved as the cost of acquisition of the shares in the transferee company received on merger.

Similarly, the period of holding of the shares of the transferor company is also available in respect of the shares of the transferee company received on the merger.

### d. Tax implications in the hands of the transferee entity

#### i. Carry forward of tax losses and unabsorbed depreciation:

The transferee entity is entitled to carry forward the accumulated tax losses and unabsorbed depreciation of the transferor entity for a fresh period of eight years if certain conditions are satisfied by the transferor and transferee entity.

#### • Conditions to be satisfied by the transferor entity

- The transferor entity should qualify as owning an 'industrial undertaking'<sup>45</sup> or a ship or a hotel;

- The transferor entity should have been engaged in the identified business for at least three years;

- The transferor entity should have continuously held (as on the date of amalgamation) at least 75% of the book value of its fixed assets held by it two years prior to the date of amalgamation.

#### • Conditions to be satisfied by the transferee entity

- The transferee entity must hold at least 75% of the book value of the fixed assets acquired on amalgamation for at least five years;

- The transferee entity must carry on the business of the transferor entity for at least five years from the date of the amalgamation;

- The transferee entity must achieve the level of production of at least 50% of the installed capacity before the end of four years from the date of amalgamation and continue to maintain this level of production till the end of five years from the date of amalgamation.

#### ii. Cost of assets and depreciation in the books of the transferee entity for the assets transferred on amalgamation:

Where any block of assets is transferred pursuant to the amalgamation, the opening written down value of the block of assets transferred by the transferor entity is taken as the written down value of the block for the transferee entity. For any non-depreciable asset, the cost in the books of the transferor company is available as the cost in the books of the transferee company.

#### iii. Tax holidays:

Where the transferor entity is eligible for any tax holidays, the continuity of those tax holidays in the hands of the transferee entity is usually maintained on an amalgamation. However, in some prescribed exceptions, the tax law provides that the tax holidays will not be continued on an amalgamation.

5. "Industrial undertaking" means any undertaking which is engaged in—

- i) the manufacture or processing of goods; or
- ii) the manufacture of computer software; or
- iii) the business of generation or distribution of electricity or any other form of power; or
- iiia) the business of providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet services; or
- iv) mining; or
- v) the construction of ships, aircrafts or rail systems;

**iv. Tax treatment in respect of expenses incurred on amalgamation:**

The transferee entity is allowed a deduction for the expenditure incurred wholly and exclusively for the purpose of amalgamation equally over a period of five years starting from the year in which the amalgamation takes place.

**v. Accumulated profits of transferor entity on amalgamation:**

The Finance Act 2018 provides that on amalgamation, the accumulated profits of the amalgamating company, whether capitalized or not, will become part of accumulated profits of the amalgamated company and hence such accumulated profits will be considered for the purposes of Dividend Distribution Tax while making any distribution to shareholders by the amalgamated company post amalgamation.

**d. Merger of Indian company into foreign company:**

Though Companies Act, 2013 permits merger of an Indian company into a foreign company, however, the same is not categorised as a tax neutral transaction under the Indian income tax laws in the hands of the transferor entity and its shareholders.

**B. GST:**

There is no GST implication on amalgamation (Refer our article on 'Indirect tax laws impacting M&A deals in India' for more details).

**C. Stamp duty:**

Stamp duty on amalgamation is a state levy and stamp duty implication will arise in the state(s) where the registered office of the transferor and transferee companies and the immovable properties of the transferor company are located.

While, there are some states where specific entry exists for charging stamp duty on High Court (though the Stamp Duty Law has not yet been amended to provide for NCLT instead of High Court) orders approving the amalgamation scheme (such as Maharashtra, Andhra Pradesh, Gujarat and Karnataka), there are some states where there are no specific provisions for levying stamp duty on amalgamations. However, there are certain judicial pronouncements treating High Court orders that sanction amalgamation schemes as instruments of conveyance and subject them to stamp duty.

Usually, stamp duty on amalgamation schemes is charged as a proportion of the value of shares issued on the amalgamation, which in return is referenced to the value of the property transferred on merger. However, different states have different

rules for levy of stamp duty on these kinds of transactions. Stamp duty mitigation options are also available in some states where the merger happens between group entities with at least 90% common or inter se shareholding.

**D. SEBI/stock exchanges approval:**

**a. In-principal approval to the merger scheme**

In case shares of the transferor and/or the transferee entity is listed on the stock exchange(s), approval of concerned stock exchange(s) and SEBI will be required. As a process, the listed entity is required to submit the merger scheme [before moving the jurisdictional NCLT] along with key documents like valuation report, pre and post-merger shareholding pattern, fairness opinion, Auditor's certificate certifying the accounting treatment, etc. Once SEBI provides its comments on the merger scheme to the stock exchange(s), the concerned stock exchange issues its observation letter [or in-principal approval letter] to the listed entity.

Further, any shares issued by the listed entity/unlisted entity pursuant to the merger scheme need to be listed on the stock exchanges, subject to compliance guidelines laid down by the concerned stock exchanges.

**b. Exemption from open offer requirements**

As mentioned earlier, the Takeover Regulations require any acquirer which acquires shares or voting rights in excess of the prescribed limits, such acquirer is mandatorily required to make minimum open offer of 26% to the public shareholders at a price as computed under the said regulations.

Any acquisition of shares pursuant to merger scheme is exempted from the open offer requirements, if the following conditions are satisfied:

1. **Where the listed entity is directly involved in merger transaction** – if the same is achieved pursuant to an order of a court or a competent authority under any Indian or foreign law/regulation; or
2. **Where the listed entity is not directly involved in merger transaction** – if the same is achieved pursuant to an order of a court or a competent authority under any Indian or foreign law/regulation, subject to
  - the component of cash and cash equivalents in the consideration paid being less than 25% of the consideration paid under the scheme; and
  - where after implementation of the scheme, persons directly or indirectly holding at least 33% of the voting rights in the combined entity are the same as

the persons who held the entire voting rights before the implementation of the scheme.

### E. Indian foreign exchange regulations:

The impact of Indian foreign exchange regulations needs to be seen where the transferor entity has foreign shareholders who will receive shares of transferee entity post-merger. As per the said regulations, issue of shares by the transferee Indian company to the foreign shareholders of transferor Indian company shall fall under automatic route if the following conditions are satisfied:

- Foreign shareholding in the transferee entity does not exceed the sectoral cap; and
- Transferor/Transferee entity is not engaged in the business which falls under prohibited sector under the exchange control regulations.

Further, the Reserve Bank of India vide notification dated March 20, 2018, has laid down the conditions for inbound and outbound mergers [like treatment of assets/ liabilities which can't be held by foreign companies/ Indian companies, treatment of loans taken by foreign company on merger with Indian company post-merger etc] and specific approval of RBI will not be required if such conditions are duly complied with.

### F. Competition/ anti-trust laws:

The Indian anti-trust laws provide for various financial thresholds in a business combination. If such financial thresholds are met, which are based on value of assets and turnover, the transaction needs to be approved by the Competition Commission of India.

### G. Approvals under Indian company law:

Under the Indian company law, the merger scheme needs to be approved by majority shareholders and creditors, constituting 75% in value, of those present and voting in the NCLT convened meetings of shareholders and creditors. Also, a notice with details of the scheme needs to be sent to the Indian income tax authorities, Sectoral Regulators and approval from the Ministry of Corporate Affairs, Official Liquidator is also required as a process for final sanction to the scheme by the NCLT.

Further, the Indian company law also allows merger between a company and its 100% subsidiary or merger between small companies without the approval of NCLT. In such cases, the scheme needs to be approved by stakeholders and the Central Government. (Refer our article on 'A New Regime on Corporate Restructuring in India' for more details).

## Demerger

Unlike amalgamation, in a demerger, only the identified business undertaking gets transferred to the transferee entity and the transferor entity remains in existence post demerger.<sup>6</sup> A demerger is an effective tool whereby a running business is hived into a separate company, so as to segregate core and non-core businesses, achieve management focus on core business, attract investors or exit a non-core business.

However, like amalgamation, a demerger is also undertaken through a NCLT approved process wherein all the assets and liabilities, along with employees of the identified business undertaking, are transferred to the transferee entity on a going concern basis. As part of the demerger consideration, the transferee entity issues its shares to the shareholders of the transferor entity.

### A. Implications under Indian tax laws

#### a. Definition under tax laws

Under the Indian income-tax laws, a demerger is defined as a transfer pursuant to a scheme of arrangement under the provisions of Indian company law, by a demerged company of one or more of its undertakings to a resulting company and which satisfies the following conditions:

- All assets and liabilities of the identified business undertaking of the transferor entity are transferred to the transferee entity on a going concern basis at book values;<sup>7</sup>
- The transferee entity issues shares to the shareholders of the transferor entity on a proportionate basis; and
- At least three-fourth of the shareholders of the transferor entity (in value) become the shareholders of the transferee entity.

Like amalgamation, in a demerger where the transferee entity is already a shareholder of the transferor entity, the aforesaid condition of issuance of shares (by the transferee entity to itself, being a shareholder of the transferor entity) does not apply.

6. "Undertaking" shall include 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.

7. liabilities shall include—  
 (a) the liabilities which arise out of the activities or operations of the undertaking;  
 (b) the specific loans or borrowings (including debentures) raised, incurred and utilized solely for the activities or operations of the undertaking; and  
 (c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.



### **b. Tax implications in the hands of the transferor entity**

The income tax laws specifically provide that in case of a tax neutral demerger, no capital gains tax implication will arise on the transferor entity on transfer of capital assets to the transferee entity, if the resulting company is an Indian company.

In case of demerger of a foreign entity into another foreign entity, wherein capital assets being shares of an Indian company or shares of a foreign company which derives substantial value from shares of an Indian company are transferred, no capital gains tax implication will arise in India if the following conditions are satisfied:

- At least 75% of the shareholders of the transferor foreign entity remain shareholders of the foreign transferee entity; and
- The transfer is not chargeable to capital gains tax in the country in which the transferor foreign company is incorporated.

### **c. Tax implications in the hands of shareholders of the transferor entity**

In the case of a demerger, the issue of shares by the transferee entity to the shareholders of the transferor entity (in lieu of shareholding in transferor entity) is not regarded as 'transfer' and hence not subject to capital gains tax.

Also, similar to amalgamation, such exemption has not been specifically extended to the shareholders on receipt of shares of the resulting company, in the event of a demerger between foreign companies involving transfer of shares in an Indian company or a foreign company which derives its value substantially from shares in an Indian company. However, unlike in case of a merger where the shareholders of the transferor company transfer their shares in the transferor company for shares in the transferee company, in the context of a demerger, the shareholders of the transferor company continue to own the shares of the transferor company. Thus, there arises a debate as to whether there is indeed a transfer by the shareholder of the transferor company as envisaged under the Indian income-tax laws in the case of a demerger.

**Cost of acquisition and period of holding of shares in the hands of shareholders** – Upon a demerger, the cost of acquisition of shares in the transferor entity and transferee entity will be split in the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the transferor entity immediately before the demerger.

The holding period of the shares of the demerged company is also available in respect

of the shares of the resulting company received on demerger.

### **d. Tax implications in the hands of the transferee entity**

#### **i. Carry forward of tax losses and unabsorbed depreciation:**

The transferee entity is entitled to carry forward the accumulated tax losses and unabsorbed depreciation of the identified business undertaking in the following cases:

- Where such loss or unabsorbed depreciation is directly relatable to the undertaking being transferred; and
- Where such loss or unabsorbed depreciation is not directly relatable, then it has to be apportioned between the transferor entity and transferee entity in the same proportion in which the assets of the undertakings have been retained by the transferor entity and transferred to the transferee entity.

Unlike amalgamation, in the case of a demerger, the transferee entity will be entitled to carry forward the tax losses for the unexpired period only and a fresh period of eight years is not available.

#### **ii. Cost of assets and depreciation in the books of the transferee entity for the assets transferred on demerger:**

Where any block of assets is transferred pursuant to the demerger, the opening written down value of the block of assets transferred by the demerged company is taken as the written down value of the block for the resulting company. For any non-depreciable asset, the cost in the books of the demerged company is available as the cost in the books of the resulting company

#### **iii. Tax holidays:**

Where the demerged entity is eligible for any tax holidays, the continuity of those tax holidays in the hands of the resulting entity is usually maintained on demerger. However, in some prescribed exceptions, the tax law provides that the tax holidays will not be continued on demerger.

#### **iv. Tax treatment in respect of expenses incurred on demerger:**

Similar to amalgamation, the transferee entity is allowed deduction of the expenditure incurred wholly and exclusively for the purpose of demerger equally over a period of five years starting from the year in which the demerger takes place.

**B. GST:**

There is no GST implication on a demerger (Refer our article on 'Indirect tax laws impacting M&A deals in India' for more details)

**C. Stamp duty:**

Stamp duty provisions on a demerger are similar to those on amalgamation.

**D. SEBI/stock exchanges approval:**

The approval requirements for the demerger transaction from SEBI/ stock exchanges are similar to those on merger. Similarly, no open offer requirements arise on demerger if it satisfies the conditions as discussed in case of merger.

**E. Indian foreign exchange regulations:**

Issue of shares by the resulting company to the shareholders of demerged company should also fall under the automatic route under the said regulations, subject to compliance with conditions as provided earlier in the merger section.

**F. Competition/ anti-trust laws:**

The said laws on demerger are similar to those on merger.

**G. Approvals under Indian company law:**

The approval process as applicable to merger, applies to demerger also. However, in case of demerger, unlike merger, since the demerged company continues to exist post the demerger, the report of OL may not be called for by the NCLT.

**Conclusion**

In view of the above provisions, it is evident that numerous options are available for structuring a transaction. Depending on the facts of the specific case, the optimal mode of implementing the transaction could be shortlisted. For instance, asset sales are usually preferred over stock sales or merger/demergers when legacy related liabilities/litigations form an important element of the transaction and the buyer is not comfortable with taking over those legacy matters. Similarly, merger/demergers are used more frequently to rationalize/simplify the group holding structure.



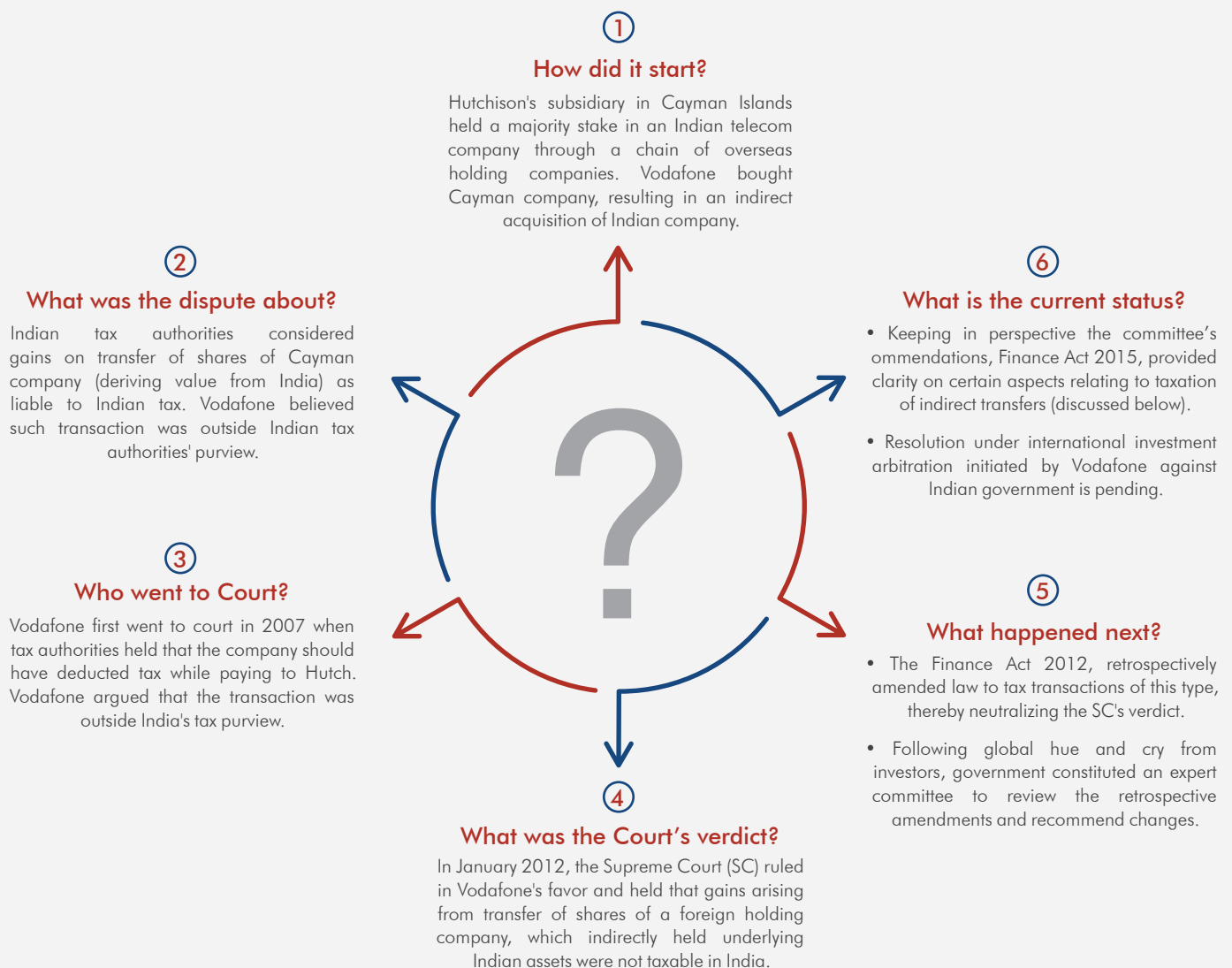
# Taxation of indirect transfers in India

## 1. Background

As governments and businesses reflect on lessons learned from the global economic crisis, one can see unprecedented changes in terms of tax and regulatory policies being redrafted, businesses being reinvented and new markets being created. Keeping in pace, the tax authorities worldwide continue to adapt their tax administration models to deal with these changes so as to make sure they collect the amount of taxes they consider due. The result: complexity, uncertainty and increased controversy.

This is the reality companies are dealing with every day which is evidenced by frequent reports of billion-dollar tax controversies hitting the headlines.

The law has also been retrospectively amended to provide for tax on gains arising on indirect transfers. It started with the well-known Vodafone case the brief facts of which are as below:



## 2. Indirect transfer rules in India (as introduced by Finance Act, 2012 with retrospective effect)

The Act was amended in 2012 to retrospectively tax capital gains arising from transfer of shares or interest in a foreign company/ entity, if such shares or interest derived (directly or indirectly) value substantially from assets located in India (commonly referred to as the indirect transfer provision). This retrospective amendment was brought about to overturn the Supreme Court's decision in the case of Vodafone International Holdings B.V. The amended provisions governing taxation of indirect transfer<sup>8</sup>, when dissected, provide as under:

- i. Income arising through the **transfer of a "capital asset" situated in India is deemed to be income accruing or arising in India;**
- ii. An asset or a capital asset can be in the form of **"share or interest" in a company/entity registered or incorporated outside India;**
- iii. The share/interest referred to at (ii) above is deemed to be situated in India if (but, only if) the **share or interest derives, directly or indirectly, its value "substantially" from the assets located in India.**

The deeming fiction, once operative, virtually means that the share/interest of an overseas entity is an Indian asset and accordingly tax implications of transfer of such asset need to be evaluated as if it is transfer of an Indian asset

### Threshold for applicability of provisions

The Finance Act, 2015 provided that shares of a foreign company will be deemed to derive their value **substantially** from assets located in India if the value of assets in India exceeds INR 100 million and the **value of assets in India represents at least 50% of the value of all assets owned by the foreign company i.e.**

$$\frac{\text{Fair Value of Assets located in India}}{\text{Fair Value of all Assets owned by foreign company}} = \text{at least 50 per cent}$$

### Methodology for valuation

The value of assets, both tangible and intangible, is to be taken to be the fair market value on the 'specified date' without reduction of liabilities (if any) in respect of the asset. The CBDT issued rules<sup>9</sup> prescribing valuation methodology for computation of the fair market value of the various classes of assets.

Manner of computing fair market value (FMV) of Indian assets

| Nature of Asset  | Manner of computing FMV  |
|--|--|
| Shares of a listed Indian company (where such shareholding does not confer management or control rights in the Indian company) | <p>The FMV of the shares will be the observable price of the share on the stock exchange.</p> <p>The term "Observable price" is defined to mean higher of (a) average of weekly high and low of closing prices of the shares quoted on the stock exchange during 6-month period preceding the specified date; (b) average of weekly high and low of closing prices of the shares quoted on the stock exchange during two weeks preceding the specified date.</p> |
| Shares of a listed Indian company (where such shareholding confers management or control rights in the Indian company)         | <p><b>FMV = (A+B)/C, where</b></p> <p><b>A</b> = market capitalisation of the Indian company based on the observable price;</p> <p><b>B</b> = book value of liabilities of the company on the specified date;</p> <p><b>C</b> = the total number of outstanding shares</p>   |
| Unlisted shares of an Indian company   | FMV as determined by a valuation report as increased by the value of the liability, if any, considered in such determination   |

8. Section 9(1)(i) read with Explanation 4 and 5 of the Income Tax Act, 1961

9. The Income-tax (19th Amendment) Rules, 2016 dated 28 June, 2016

| Nature of Asset  | Manner of computing FMV   |
|--|---|
| Interest in partnership firm or Association of Persons (AOP) | <p><b>Step 1</b> - compute value of partnership firm on the basis of a valuation report as determined by a merchant banker/accountant in accordance with internationally accepted methodology, as increased by value of liability, if any, considered in such determination</p> <p><b>Step 2</b> - value determined in Step 1 to be apportioned to the extent of capital of partnership firm or AOP in the ratio of partner's capital contribution</p> <p><b>Step 3</b> - balance value to be apportioned on the basis of asset distribution ratio on dissolution of partnership firm/AOP or in absence thereof, in the profit sharing ratio</p> <p><b>Step 4</b> - FMV on interest in partnership firm/AOP = Value as per Step 2 + Value as per Step 3</p> |
| Any other asset  | Value as determined on the basis of valuation report as increased by the value of the liability, if any, considered in such determination   |

To determine the fair value of shares/interest of Indian company/entity, all assets and business operations of such company/entity located in India as well as abroad shall be considered.

The value of Indian assets as determined above shall be required to be converted into foreign currency based on the telegraphic transfer buying rates of such currency on the specified date.

Manner of computing FMV of all the assets of the foreign company

| Nature of Asset   | Manner of computing FMV  |
|---|--|
| In case of transfer between persons who are not connected persons   | <p><b>FMV = A+B, where</b></p> <p><b>A</b> = market capitalisation of the foreign company computed on the basis of the full value of consideration for transfer of share/interest</p> <p><b>B</b> = book value of liabilities as certified by a merchant banker/accountant</p> |
| In case of transfer of shares of a foreign company listed on the stock exchange between connected persons     | <p><b>FMV = A+B, where</b></p> <p><b>A</b> = market capitalisation of the foreign company based on observable price</p> <p><b>B</b> = book value of liabilities of the company/entity on the specified date</p>  |
| In case of transfer of shares of a foreign company not listed on any stock exchange between connected persons | <p><b>FMV = A+B, where</b></p> <p><b>A</b> = FMV of the foreign company/entity as on the specified date based on valuation report</p> <p><b>B</b> = value of liabilities of the company/entity considered for determination of FMV in A above</p>                              |

The term 'liability' has been defined to mean value of liabilities as shown in the balance-sheet excluding the paid-up equity capital or member's interest and the general reserves and surplus and security premium related to the equity shares)

The term 'specified date' is defined to mean the last day of the accounting period (generally defined to mean twelve-month period ending on 31 March) of the foreign company preceding the date of transfer. However, where the book value of assets on the date of transfer exceeds the book value as on the last day of the accounting period preceding the date of transfer by more than 15%, then the date of transfer will be regarded as the 'specified date'.

### Pro-rata taxation of gains

The tax liability arising on indirect transfers will be restricted to that part of the gains as is reasonably attributed to assets located in India. Income attributable to indirect transfer of assets shall be determined on the basis of the following formula prescribed by the Rules:

**A X B/C where:**

**A** = Income from indirect transfer of assets

**B** = FMV of the India assets on the specified date

**C** = FMV of all the assets of the company or entity as on the specified date

Where the transferor fails to provide necessary information to the Revenue authorities to apply the aforesaid formulae, the whole income (and not proportional) from transfer of shares/interest will be deemed to be attributable to assets located in India.

### Exemptions

Exemption has been provided from indirect transfer provisions for shareholders who do not have rights of management or control and do not hold voting power/share capital in excess of five per cent. Further, exemption has also been provided in cases of intra-group restructurings pursuant to overseas amalgamations and demergers subject to certain conditions (i.e. continuity of shareholding and non-taxability in overseas jurisdiction).

### Reporting obligations

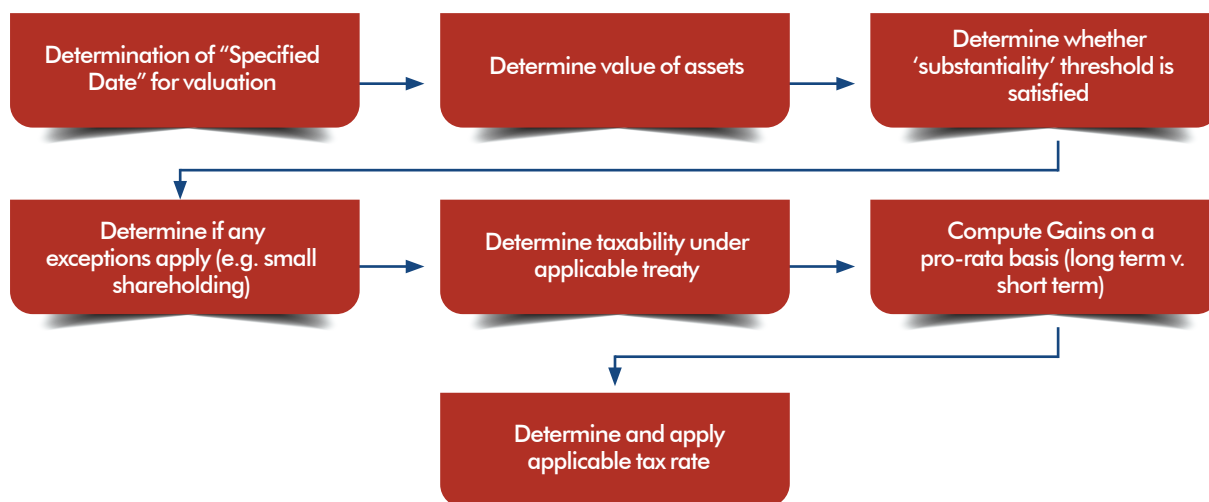
Reporting obligations have been cast on Indian concerns (through or in which assets in India are held by foreign companies/entities deriving value substantially from assets located in India) to furnish prescribed information and documents relating to the determination of income arising from indirect transfers. The Rules broadly require the Indian concerns to report details of immediate holdings company/intermediate holding company/ultimate holding company, holding structure, agreement for transfer of asset, financial statements of the foreign company/entity, information of business operations, personnel, finance/properties, audit reports, etc. of the foreign entity, details of payment of tax outside India, etc within a specified timeframe.

A penalty of 2% of the value of the transaction in respect of which there has been a failure to report has been prescribed, if such transaction has the effect of directly or indirectly transferring the right of management or control in relation to the Indian concern. In any other case of failure to report, a penalty of INR 500,000 has been prescribed.

### Applicability of indirect transfer provisions to dividends

It has also been clarified through a Circular<sup>10</sup> issued subsequent to Finance Act, 2015 that dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets located in India will not be deemed to be income accruing or arising in India.

## 3. Computation of capital gains arising in the hands of the seller pursuant to trigger of indirect transfer rules and withholding obligation on the buyer



10. Circular 4/2015 dated 26 March 2015

Once substantial value test is met, the transaction will be considered as one of transfer of an asset situated in India and capital gains chargeable on such income in the hands of the seller will need to be ascertained. In this context, it may also be worthwhile to check if any relief is available to the seller from taxation of capital gains arising pursuant to indirect transfer under the applicable tax treaty. For instance, India's treaty with Mauritius, Singapore, Cyprus, Netherlands, etc. may offer such relief.

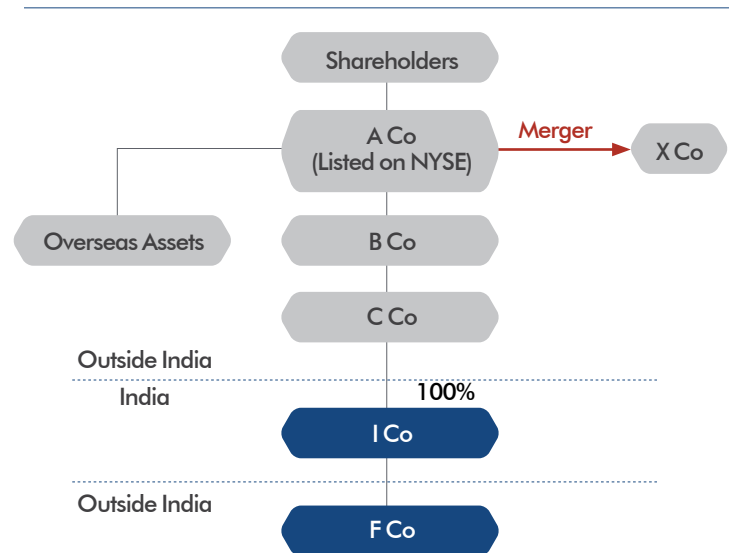
Where no relief is available under the applicable treaty, a quantification of the capital gains liability and tax thereon will need to be done. Typically, capital gain is computed as excess of sale consideration received over cost of acquisition of the asset transferred. In certain situations, the law provides for enhancement of such cost of acquisition for adjusting the inflation. These gains will need to be pro-rated with respect to Indian asset(s) chargeable to tax in India.

The tax rate applicable on such capital gains could range from 10% to 40% and would depend on the period for which the seller held the shares in the foreign company (refer section on tax on transfer under share transfer in our article on 'M&A landscape in India' for further details).

The Indian tax laws extend an obligation on the buyer to withhold applicable tax amount before remitting the sale consideration to a non-resident seller. Failure to do so, may result in the buyer being treated as an 'assessee in default' and inter alia have interest and penalty consequences. Typically, in a third party sale situation, the buyer insists upon the sellers on providing an indemnity or keeping the tax liability amount in escrow, or insist that the sellers obtain a Nil withholding tax certificate from the Indian tax authorities. In certain cases, the buyer and seller may also collectively file an application with the Authority for Advance Ruling to get upfront clarity on the taxability issues.

#### 4. Is the dust settled?

While the law makers tried their best to lay down clear guidance on rules impacting taxation of gains arising on indirect transfer, a lot of issues still remain unaddressed adding to the uncertainty. Some of the aspects that have not been addressed yet relate to determination of cost of acquisition, availability of indexation, specific exemption at the shareholder level in case of transactions that are otherwise exempt, measures to prevent potential double taxation in multi-layer structures, withholding obligation on the buyer, etc. These are explained via a case study below:



A Co, a foreign company listed on NYSE, indirectly holds shares of an Indian company (I Co) through a series of overseas holding companies. X Co, another group company proposes to consolidate operations of A Co within its fold. The transaction is structured by way of merger of A Co with X Co. Pursuant to merger, the assets and liabilities held by A Co including its investment in B Co and other overseas assets would vest with X Co. X Co will issue its shares as consideration for merger to the shareholders of A Co.

#### **Determining the Indian tax liability in the hands of the Transferor(s)**

Pursuant to the aforesaid merger, tax liability can arise at two stages:

- I. Transfer of shares of B Co by A Co to X Co
- II. Transfer of shares of A Co by shareholders of A Co

To determine whether any tax liability is triggered in India pursuant to the aforesaid merger, it will need to be ascertained whether the shares of A Co and B Co derive at least 50% value from India assets as on the specified date. Towards this end, two different methods of valuation would be applicable since the Notified Rules prescribe different methods for valuing listed and unlisted foreign company shares when the transaction is between connected persons. This could be a cumbersome exercise.

Now assuming that both A Co and B Co derive more than 50% value from assets located in India (determination made as per the guidelines issued in this regard), the following implications could arise.

An exemption may be available from Indian taxation on transfer of shares of B Co by A Co if the following two conditions are fulfilled:

- a. At least 25% shareholders of A Co continue to remain shareholders of X Co
- b. Such transfer does not attract any tax on capital gains in the overseas country where A Co is incorporated.

Even where any of the aforesaid conditions are not fulfilled, it may be possible to take an argument that no tax liability ought to arise in India, since the amalgamating company being A Co would not receive any consideration for the said transfer.

As regards the taxability of capital gains arising on transfer of shares of A Co by the shareholders, no exemption is provided in the Act for non-taxability of such gains (except where the shareholder holds less than 5% stake in A Co). The shareholder could explore relief from Indian taxation if:

- a. The tax treaty of the country where the shareholder is a resident does not allocate the taxing right to India, and/or
- b. By invoking non-discrimination clause under the applicable tax treaty (in a similar situation involving domestic merger under the Act, the shareholder would have been eligible for tax exemption).

#### **Determining the withholding obligation for the Buyer**

As mentioned above, the buyer is required to withhold applicable tax before remitting the sale consideration to the seller. However, in the given case, it would be difficult for the buyer (X Co) to determine the quantum of taxes to be withheld since the identity, cost of acquisition, country of residence, etc. of the shareholders would not normally be known to the buyer.

In such situation, a buyer may be forced to follow a conservative approach and deduct tax on gross sale consideration at the highest applicable tax rate. The selling shareholders in such situation may have no option other than to file a tax return in India and claim a refund for the excess taxes deducted (if any). In certain cases, there may be a double whammy for the selling shareholders where neither they are able to get a relief from Indian taxation nor are they able to claim a credit in the resident country for the taxes paid in India.

### **Ruling issued by the Authority for Advance Ruling in the case of Banca Sella Holding SPA**

Briefly, the transaction involved the merger of Sella Servizi Bancari S.C.P.A (SSBS) into Banca Sella Holding SPA, (BSS), both Italian companies. This resulted in:

- The shareholders of SSBS receiving shares of BSS;
- The 15% shareholding of BSS in SSBS getting cancelled; and
- The Indian branch of SSBS getting transferred to BSS.

The AAR held that in the absence of consideration flowing to SSBS, the transfer of Indian branch could not be taxed as capital gains in India. Further, it also held that tax exemption given in the Act to capital gains arising from transfer of capital asset pursuant to an amalgamation in India, should also be extended to amalgamation of Italian companies by applying the non-discrimination clause of the India-Italy tax treaty (as a similar transaction involving residents would not be taxable under domestic law).

The AAR also held that, there would be no tax liability in the hands of BSS on extinguishment of its shares in SSBS in the absence of any consideration paid to it. As regards the other Italian shareholders of SSBS who received consideration (in the form of shares of BSS), the capital gains arising to them would be taxable only in Italy under the India-Italy tax treaty. Furthermore, the AAR also stated that the indirect transfer provisions under the Act would not be triggered on transfer of shares of SSBS, as it derived a small value from assets located in India.

In this context, the AAR also stated that the foreign company can be regarded as deriving substantial value from India only if the value derived from the Indian assets is at least 50%. While coming to this conclusion, the AAR placed its reliance on the Delhi High Court decision in the case of Copal Research.



**Other ambiguities:**

- Under the Act, while ascertaining the value of assets located in India, no relief has been provided for excluding the value of assets held by the Indian entity in overseas jurisdictions. Technically speaking these should have excluded from the valuation scope since the foreign entity whose shares are being transferred would not be deriving that value from Indian assets.
- Inclusion of liabilities while determining the FMV of the company for the purposes of the Indirect transfer rules may create inconsistency with the commercial valuation.
- There is no mechanism in the Act to provide a cost step-up for the tax liability once incurred due to indirect transfer. For instance, in the given case study, assuming the shareholders of A Co end up paying tax in India on the mentioned transfer, on a subsequent transfer of shares of C Co by B Co, the entire capital gains would again be taxable in India.
- Further, for calculating the book value of liabilities, although the Notified Rules provide exclusion for general reserves and surplus and security premium in addition to the equity capital it is pertinent to observe quasi-equity instruments such as convertible preference shares and convertible debentures—which economically may be on a par with equity—may be treated as a liability for this purpose and may thus artificially inflate the FMV of equity shares being transferred.
- It may be practically difficult for the Indian entity (I Co) to know or keep track of the transfers at its parent's level and the foreign entity may get to know about such a transaction post the transfer. Therefore, the information which the Indian entity needs to procure and submit with the revenue authorities may not be feasible in every situation.

## 5. Impact on transactions prior to amendments made by Finance Act 2015

As highlighted earlier, the threshold for the term 'substantial' was inserted by Finance Act, 2015. Considering the retrospective application of indirect transfer provisions, in absence of a definition of the term 'substantial', there has been controversy and ambiguity in respect of transactions undertaken prior to 2015 resulting in indirect transfer. While limited guidance is available on this subject, the Delhi High Court's decision in the case of Copal Research<sup>11</sup> throws some light on this aspect. Herein the Delhi High

Court posited that the expression 'substantial' necessarily has to be read as synonymous to 'principally', 'mainly' or at least 'majority'. The Court proceeded to pronounce that the gains arising from the sale of shares of a company incorporated overseas which derives less than 50% of its value from assets in India would certainly not be taxable under section 9(1)(i) of the Act<sup>12</sup>.

Further, the Rules laying down the valuation mechanism, have also come into effect only from June 28, 2016. With no guidance available, there now exists an ambiguity if the criteria under these Rules will be applied as advisory for the period prior to them being notified.

## 6. Clarifications issued by CBDT/ amendments to indirect transfer provisions for FII/ FPIs

On December 21, 2016, the CBDT released a Circular<sup>13</sup> containing responses to questions raised by various stakeholders (including foreign portfolio investors (FPIs), private equity/venture capital investors, etc.) in the context of the applicability of indirect transfer provisions under the Act. However, after the issue of the circular, in view of the representations received from FPIs and other stakeholders, the operation of the circular was kept in abeyance until the representations were considered and examined.

When the foreign investors requested the tax authorities to ring-fence FPIs/ FIIs from the applicability of indirect transfer provisions, the Budget 2017 granted relief from the provisions of indirect transfer to Category I and Category II FPIs as well as FIIs registered under erstwhile FII regulations. The Act retrospectively exempted transfer of direct or indirect investment made by a non-resident in an FII registered as Category I or Category II FPI under the SEBI (FPI) Regulations, 2014 and FIIs registered under erstwhile FII Regulations, from applicability of indirect transfer provisions with effect from Financial Year (FY) 2014-15 and FY 2011-12 respectively.

While the proviso granting exemption to FIIs is applicable from FY 2011-12 onwards, it appears that the Government has put to question the investments held by FIIs which are disposed of prior to April 1, 2011.

11. DIT (IT) vs Copal Research Ltd [371 ITR 114 (Delhi)]

12. In a recent update, the Supreme Court has granted SLP against High Court's ruling

13. Circular 41/2016 dated 21 December 2016

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## Conclusion

The early days of indirect transfer provisions, characterized by wide ranging charging provisions coupled with a near absence of exemptions, machinery and computational provisions appears to be at an end. Suitable exemptions to mitigate the rigor of these provisions are being introduced and computational aspects such as valuation have been clarified. This is undoubtedly a very welcome step, and will go a long way in providing certainty to taxpayers.

Needless to mention, the practical application of these provisions will continue to throw up more challenges, which will undoubtedly lead to uncertainty and litigation. One however, hopes that these are resolved proactively by legislative and administrative action, rather than being left to the judiciary. This will go a long way in making the indirect transfer regime more progressive and robust.



## Managing tax risks in M&A transactions – engagement with the Indian tax authorities

Cross-border Private Equity (PE)/M&A deals involving direct or indirect transfer of assets in India have constantly been under the scanner of the Indian tax authorities. The Vodafone controversy involving asserting tax liability in India on the gains on transfer of shares of a foreign company having underlying assets in India has been one of the most high-profile and talked about cases in recent years. This dispute also led to the introduction of the indirect transfer provisions in India's income tax law with retrospective effect whereby the gains derived on transfer of shares of a foreign company which derives its value substantially from assets located in India is deemed to be taxable in India.

Earlier, several of India's tax treaties provide for an exemption from Indian tax, of capital gains arising from the sale of shares, both of Indian companies (e.g. Mauritius, Singapore, etc.) as well as of foreign companies that derive value substantially from assets located in India (e.g. France, Mauritius, Singapore, Finland, Luxembourg, Cyprus, Switzerland, etc.).

However, in light of the recent amendments in India-Mauritius and India-Singapore tax treaty, the tax treatment on capital gains arising on sale of shares of an Indian company has undergone a change. Per the amended India-Mauritius treaty, the capital gains arising on transfer of Indian company shares (which are acquired on or after April 1, 2017) would be taxable in India. The treaty also provides a relaxation whereby the capital gains arising from April 1, 2017, to March 31, 2019, will be chargeable to 50% tax in India, subject to fulfillment of Limitation on Benefits (LOB) Article. Further, the gains on transfer of Indian company's shares acquired before 1 April 2017 shall continue to avail an exemption from India tax. Following this, the India – Singapore tax treaty has also witnessed similar amendments with respect to taxation on capital gains on transfer of shares of an Indian company.

Under the law, the only requirement for a non-resident to claim tax treaty benefits is to furnish a valid Tax Residency Certificate (TRC) and other specified information in a prescribed Form<sup>14</sup>. However, the tax authorities have often challenged the eligibility of non-resident transferors to claim tax treaty benefits by various means for e.g. by questioning the substance in investment structures based out of tax efficient jurisdictions like Mauritius or Singapore, the rationale of corporate actions like buy-back or demerger etc. Furthermore, with the General Anti-Avoidance Rule (GAAR) provisions now effective, claiming a tax treaty benefit/ exemption will have to also pass through the test of such GAAR provisions. Under GAAR regime, if any transaction/arrangement or a part of any transaction/arrangement is structured with a main purpose of obtaining a tax benefit, then the tax

authorities can treat the same as an impermissible avoidance arrangement. As regards the interplay of GAAR provisions vis-à-vis the tax treaty benefits, the Central Board of Direct Taxes (CBDT) recently by way of a circular<sup>15</sup> clarified that whilst claiming a treaty benefit, the GAAR provisions will prevail over the Limitation of Benefits (LOB) clause in the tax treaty, except in the cases where tax avoidance is sufficiently addressed by the conditions of LOB clause.

In the case of restructuring transactions (typically mergers and spin-offs) requiring the approval of the NCLT under Indian company law, authorities under Company law, as well as the tax authorities have sought to challenge such transactions on the grounds of alleged tax avoidance<sup>16</sup>. While such transactions are usually approved by the NCLT, notwithstanding these challenges, the NCLT/courts tend to observe that their approval does not preclude the tax authorities from determining the tax implications independently during the course of regular tax assessments.

Although the current Government has taken several proactive measures in order to create a tax friendly environment for investors, in the case of big ticket PE/M&A deals, tax risks continue to remain very relevant. These risks as well as potential measures to alleviate them are discussed below.

In a cross border transaction involving transfer of assets situated in India (say shares of an Indian company), the following typical tax risks exist:

- Withholding tax obligation on the buyer while paying the sales consideration to a non-resident seller, if the gains are held to be taxable in India;
- The buyer can be treated as an agent of non-resident seller under section 163 of the Act, which would lead to an assessment on the buyer in a representative capacity for the income arising to the non-resident seller;
- Assets transferred by a seller on whom there are outstanding tax demands / pending proceedings can be held void under section 281 of the Income-tax Act (Act) in certain circumstances.

In order to mitigate these risks, especially the risk relating to potential liability arising on account of withholding tax obligations, buyers generally insist upon indemnities, escrow arrangements or a tax insurance cover to safeguard their interests.

Alternatively, parties to PE/M&A transactions may also consider it prudent to approach the tax authorities to obtain certainty on the withholding and other tax implications. This can be done in the following ways:

14. Section 90A read with rule 21AB and Form No. 10F

15. Circular 7 of 2017

16. Per the provision of section 230 – 232 of the Companies Act, 2013, the notice of the merger/ restructuring scheme(s), inter-alia, needs to be also sent to the income-tax authorities. In the case no representation is received by the NCLT from the income-tax authorities within 30 days of the receipt of the notice, it is to be presumed that they have no objections to the merger/ restructuring scheme

## 1. Obtaining a withholding tax certificate from the tax authorities

Section 195 of the Act requires taxes to be deducted at source on amounts paid to non-residents, which are chargeable to tax in India. Thus, in transactions where the seller is a non-resident, the buyer (irrespective of whether it is a resident in India or not) is required to (a) quantify the gains arising to the seller on such transaction and (b) determine its taxability. If such gains are taxable in India, then the buyer will have to deduct appropriate tax and deposit the same with the government. Non-compliance with such provisions results could leave the buyer liable to pay the taxes along with interest and potential penalties.

To minimize uncertainties in this regard, the parties can approach the income-tax authorities to determine the appropriate taxes to be withheld in respect of the transaction. Either the buyer or the seller can make an application to the tax office in this regard (under sections 195 or section 197 of the Act respectively).

A withholding certificate issued by the tax authorities under Section 197/195 of the Act entitles the seller to receive the sale proceeds without deduction of any tax or after deduction of tax at a reduced rate. Such a certificate could also provide a crucial safeguard to the buyer against any potential tax liability on account of withholding. Accordingly, if such a certificate is obtained, the requirement of escrow, indemnity etc. may not be necessary.

In practice, however, tax authorities usually prefer to adopt a conservative approach while issuing such certificates, and often (though not always) require at least some tax to be deducted on payments to non-resident sellers. This is motivated by concerns over their ability to recover taxes from non-resident sellers post the final assessment proceedings.

Having said this, the issuance of such certificates is only a tentative determination (and not the final assessment, which will be undertaken by the tax authorities post filing of tax return by the seller). Conclusions and findings arrived at in the course of issuance of a withholding tax certificate are not binding, and it is open to the tax authorities to come to a different conclusion in these proceedings. For instance, in the case of Aditya Birla Nuvo Limited<sup>17</sup>, the tax authorities had issued a certificate under section 195 of the Act allowing the buyer to make payments without deduction of tax at source. However, in the course of subsequent assessment proceedings (which were initiated on the buyer as an agent

of the seller under section 163 of the Act), the benefits of the India-Mauritius treaty were sought to be denied and taxes sought to be recovered.

Notwithstanding a potential exposure under section 163 of the Act (mitigation strategies discussed below), obtaining a withholding certificate from the tax authorities goes a long way in mitigating exposures on the buyer. Such certificates also have a significant impact on the transaction economics as they could potentially enable the seller to receive the entire (or at least a substantial part of) consideration at the time of the transaction itself, rather than it lying in escrow or with the Government, pending the completion of normal assessment proceedings, which could take several years.

There is no time limit under the Act for the tax authorities to issue withholding tax certificates. However, in January 2014, the CBDT, issued an internal instruction to the tax authorities requiring them to either issue or reject (citing reasons for rejection) a withholding tax certificate within one month from the date of application.

## 2. Obtaining a ruling from Authority for Advance Rulings (AAR)

As an alternative to approaching the tax authorities for obtaining a withholding certificate, parties to a transaction may also approach the AAR to get clarity on the tax implications arising out of the transaction. The AAR is a quasi-judicial body primarily set-up to make it possible to ascertain the income-tax / withholding liability of transactions in advance, and thus providing certainty and avoiding expensive and protracted litigation. Rulings of the AAR are binding on the taxpayer (i.e. the Applicant) and the tax authorities in respect of the transaction for which the Ruling was sought. However, it may potentially be challenged before the High Court, and eventually the Supreme Court at the instance of either party.

Statutorily, the AAR is expected to pronounce its decision within six months from the date of making the application. However, there is currently a sizeable back-log of cases with the AAR, and, as a result there is an uncertainty as regards the timelines involved for obtaining a ruling. This makes the AAR route presently unsuited for transaction related rulings, where time will be of the essence.

17. (Mum) [2011] 12 taxmann.com 141

### 3. Obtaining a certificate under section 162 of the Act (in respect of potential liability as a representative assessee)

As mentioned above, under section 163 of the Act, a person (whether a resident or a non-resident) who acquires a capital asset in India from a non-resident can be treated as an 'agent' of the non-resident for tax purposes. Where a person is held to be an agent of a non-resident, he is liable to be taxed as a representative assessee of the non-resident in respect of the income for which he is considered an agent. The liability of the agent in such a case would be co-terminus with that of the principal non-resident. Thus, in addition to the withholding tax liability referred to above, a buyer could potentially also be treated as an agent of a non-resident seller, and held liable to pay taxes arising to the non-resident seller.

The law, however, provides that a buyer who apprehends that he may be assessed to tax in a representative capacity may retain an amount equal to the estimated tax liability from sums payable by him to the non-resident principal. It is further provided that where there is a disagreement between the non-resident seller and the buyer on the quantum of amount to be so retained, the buyer may approach the tax authorities and obtain a certificate from them determining the amount to be retained by him pending the final assessment. Importantly, it is provided that the final liability of the agent (at the time of assessment) cannot exceed the amount set out in such a certificate<sup>18</sup>.

Such a certificate thus offers considerable certainty to the buyer as to his potential liability in India in his capacity as an agent of the non-resident seller. If a certificate is obtained under section 162 determining that no amount needs to be retained by the buyer, then no recourse to the buyer is subsequently possible for recovery of taxes on gains arising to the non-resident seller.

It is also interesting to note that unlike a withholding tax certificate referred to above, which is provisional, a certificate under section 162 conclusively determines the potential liability of the buyer in respect of taxes arising to the non-resident seller/ income recipient.

### 4. No objection Certificate under Section 281 of the Act

The discussion above focused on obtaining certainty in respect of taxes arising from the transaction in question. In addition to the above, the impact of pre-existing tax liabilities and pending tax proceedings against the Seller could also have a significant impact on the transaction.

Under section 281 of the Act, where there are pending proceedings or taxes payable by a person, any transfer of specified assets by such person could be considered as void unless:

- such a transfer of assets is made for adequate consideration and without notice of pendency of such proceedings or taxes payable by such person; or
- if it is made with the previous permission of the tax authorities.

Since the applicability of this section directly affects the buyers title to the acquired assets, exploring the possibility of obtaining the permission of the tax authorities (by way of a No Objection Certificate) under section 281 becomes critical.

The CBDT has issued a Circular<sup>19</sup> providing guidelines in respect of application and issuance of an NOC under section 281 of the Act. The guidelines provide that the application must be made at least 30 days prior to the expected date of transfer. Further, it also provides timelines and the manner of issuance of NOC by the tax authorities under various circumstances depending upon the status of pending demand or likelihood of demand arising in next six months.

The guidelines provide that where there is no existing demand and no demand expected to arise in the next six months, the permission should be granted within ten working days from the date of making the application. Similarly, the guidelines also provide the approach to be followed for issuance of NOC where tax demand disputed or undisputed exists.

## Key Takeaways

Dealing with potential tax risks arising from transactions involving assets (directly or indirectly) located in India are often a key part of negotiations. While some level of uncertainty is indeed unavoidable, as the above discussion shows, there are multiple options available for parties to obtain certainty on some or more aspects. With the new Government taking proactive steps to improve the overall taxpayer experience in the country, these options are increasingly being resorted to in the course of transactions.

While the process of obtaining such certificates is often complex and time consuming, a properly developed strategy in this regard involving the provision of detailed factual information and supporting documents, as well as intensive engagement with tax officials could help significantly in this regard.

18. Except where, at the time of final settlement, the agent holds additional assets of the principal, the liability may extend to such additional assets.

19. Circular no 4/2011 dated 19 July 2011.

## Impact of BEPS on India-focused M&A activity

The Base Erosion Profit Shifting (BEPS) project initiated by the Organisation for Economic Co-operation and Development (OECD), and endorsed by G8 and G20 governments, is the single most important multilateral initiative in the field of international tax in recent decades. The objective of this project is to revise prevailing international tax rules so as to eliminate gaps and mismatches that enabled the shifting of profits to no tax or low-tax jurisdictions. It was widely felt that in addition to loss of revenue for governments, BEPS also undermined the integrity of the overall tax system. It has been noted that the problems associated with BEPS are exacerbated in an Indian context due to India's heavy reliance on revenues from corporations (including multinationals), which are in turn dependent upon international tax rules.

**“India has supported BEPS since inception. It has played a leading and intensive role in the formulation of its proposals. India is committed to implement the minimum standards of the Action Plan, including country-by-country reporting”.**

**- Finance Ministry official who represented India at the BEPS deliberations**

The Action Plan on BEPS released by the OECD in 2013 identified 15 Actions based on three fundamental pillars:

1. Introducing **coherence** in domestic tax rules that affect cross-border activities,
2. Reinforcing **substance** requirements in the existing international standards,
3. Improving **transparency** as well as certainty for businesses and governments.

Given the above, changes to the international tax framework as a result of BEPS are, by now, seen as inevitable. With India's increased participation in global trade, both as a consumer and a supplier of goods and services, these changes are likely to have a far-reaching impact on the way companies conduct their businesses and M&A world is no exception.

The impact of BEPS on M&A activity involving India can be felt in more ways than one. For instance, target companies that have hybrid arrangements or instruments in their structure could suffer an increased effective tax rate (ETR) if proposals contained in Action 2 of BEPS are enacted (as outcomes such as multiple deductions for a single expense, or deductions without corresponding taxation, would be put to an end). To take another example, interest payments on compulsorily convertible debentures (CCDs) could be disallowed in India if those payments are characterized as 'dividends'

eligible for a participation exemption in the country of the debenture holder. Similarly, transactions involving disparate characterization of Indian entities (e.g. Limited Liability Partnerships) under Indian law and foreign law could also trigger the applicability of these kinds of provisions.

An additional outcome of BEPS is that target companies with significant overseas operations and that earn substantial passive incomes (such as dividend, interest or royalty), which are typically subject to a reduced level of tax, may suffer an increased ETR upon enactment of stricter CFC rules in India. This could impact the deal pricing. Companies that are highly leveraged could be hit by the tightening of thin capitalization rules (disallowance of excessive interest expense as a tax-deductible item) and earning-stripping rules based on Action 4. Towards this end, provisions pertaining to thin capitalization were enacted in Indian law vide Finance Act, 2017.

Given the rampant use of tax havens without having any commercial substance built in, addressing treaty abuse and treaty shopping is seen as one of the most important areas dealt with as part of the BEPS project. This issue assumes particular relevance in the Indian context, considering the Indian government's long-stated concerns on the subject. Thus, structures where investors come in through jurisdictions with favorable tax treaties could potentially come under scrutiny, thanks to BEPS. If treaty benefits are denied, gains on exit could become taxable in India, which might affect projections made in a pre-BEPS world. The revision of India's tax treaties with Mauritius, Singapore and Cyprus are steps towards this direction. The approach adopted by the Government in re-negotiating these treaties appears to be mature and pragmatic. Specifically, the provision regarding grandfathering of existing investments and the reasonable transition period which is provided, are steps in the right direction and point to an increased recognition within the Government of the need to avoid abrupt policy shifts. This will go a long way in providing significant re-assurance to investors and provide a clear roadmap for taxation of future investments.

In the transfer pricing arena, the work on Actions 8 to 10 of the BEPS list is targeted to ensure that transfer pricing outcomes are aligned with value creation. The transfer pricing rules have to be aligned with the economic activity that generated the profits. Thus, companies with significant intangible assets or risks and capital that are located in or transferred to countries with a low tax rate could suffer an increased ETR if tax laws are modified in the head-quarter country or in territories where the company holds intangible assets or risk and capital. Increased reporting, disclosures and compliances under the country-by-country reporting rules would also need to be factored in. All these aspects will now assume more significance than before in any due diligence exercise.

Findings in relation to the aforesaid areas could lead to a material change in the tax profile of a target company and might result in significant tax exposures and reputational risks. When performing a tax due diligence in the BEPS era, the following aspects would need a thorough investigation:

- Existing intercompany holding and financing structure,
- Commercial rationale and beneficial ownership of investment and Intellectual Property holding companies,
- Permanent Establishment (PE) risks,
- Tax planning arrangements, and
- Transfer pricing policies of the target group.

All of these could significantly impact various key areas such as the valuation of the deal, the mode and the subject matter of acquisition.

## Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Last but not the least, the signing of the Multilateral Convention on June 7, 2017, by India and over 65 other countries, marks the beginning of a new era, not only in the evolution of global tax policy, but also at a practical level for taxpayers and advisors alike. The measures adopted by Multilateral Convention attempt to inter alia prevent Treaty abuse, improve dispute resolution and prevent artificial avoidance of PE. Applying a treaty will no longer be a simple exercise involving a quick reference to a rate chart. It will become a complex exercise that could significantly alter existing treaty positions. The Multilateral Convention shall apply to specific tax treaties only once the same has 'entered into force'. Multilateral Convention shall enter into force as follows:

- For the first five countries that ratify the Multilateral Convention – 1<sup>st</sup> day of the month following the expiry of 3 calendar months after the deposit of the 5<sup>th</sup> instrument of ratification, acceptance or approval
- For countries that ratify subsequently – 1<sup>st</sup> day of the month following the expiry of 3 calendar months after the deposit by the country of its instrument of ratification, acceptance or approval

Once the Multilateral Convention has entered into force, the Multilateral Convention will have effect (i.e. will apply to specific tax treaties) at different points of time with respect to (a) taxes withheld at source and (b) all other taxes:

- **For withholding taxes**  
To credits/payments that occur in the taxable year beginning after the Trigger date
- **For other taxes**  
To the taxable year beginning after the expiry of 6 months from the Trigger date

**Trigger date** = 30 days after the completion of internal procedures is notified by both contracting states.

With the process of signing complete, the Multilateral Convention is one step closer to implementation.

The time-consuming process of notification and reservations, is almost complete, albeit on a provisional basis. The sheer number of countries involved, and the interplay between the various reservations made and options exercised by various countries makes the practical application of the Multilateral Convention a complex and highly involved task.

## Impact of Multilateral Convention on India's tax treaty with Singapore and Mauritius

Singapore has signed the Multilateral Convention on June 7, 2017. Singapore has covered its existing tax treaties with 68 countries (including India) under the Multilateral Convention. Accordingly, the India-Singapore tax treaty will be deemed to be modified using the Multilateral Convention.

As per Article 7(1) of the Multilateral Convention accepted by Singapore and India, the benefits under the India-Singapore tax treaty may be denied if it is reasonable to conclude (having regard to all facts and circumstances), that obtaining tax benefit was 'one of the principal purposes' of any arrangement or transaction that resulted directly or indirectly in that benefit.

The treaty benefit may not be denied if it can be established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the India-Singapore Tax Treaty.

Mauritius has signed the Multilateral Convention on July 6, 2017. Mauritius has covered its existing tax treaties with 23 countries under the Multilateral Convention. However, Mauritius has chosen not to include/cover the tax treaty with India under the Multilateral Convention. Accordingly, the Multilateral Convention does not modify the India-Mauritius tax treaty and the existing India-Mauritius tax treaty continues as it is. However, Mauritius has committed to modify its tax treaty (in line with BEPS project) with India and other countries by 2018 end by entering into bilateral negotiation.

## Conclusion

Considering these are early days of BEPS proposals, and that the extent to which each jurisdiction will embrace the proposed Action plans is not fully known, it may be difficult to ascertain at this point the exact impact of BEPS on a structure or arrangement. In the recent past, India has opted to introduce various provisions based on the BEPS recommendations (i.e. the Country-by-Country Reporting, an Equalisation levy on digital ad spends, thin capitalization rules, etc.). Also, it is expected that other areas covered in BEPS will be considered in detail over the coming days and months and could eventually become part of the law. While some uncertainty will be inevitable until the full slate of BEPS measures are implemented, focus on the guiding principles of 'Coherence', 'Transparency' and 'Substance' should help taxpayers identify, assess and address potential tax risks.

## Impact of Insolvency Code on M&A Activity

Businesses do fail due to a variety of reasons such as competition, lack of innovation, economic slowdown, inefficient business model, excessive debt, etc. Business failure has extensive economic impact affecting several stakeholders including investors, lenders, government, customers and employees. Therefore, it is imperative that a business failure is resolved in a time-bound and efficient manner and where resolution is not possible an exit is provided.

The Insolvency and Bankruptcy Code, 2016 (IBC) is a landmark legislation providing a single consolidated code in relation to insolvency and facilitating a time-bound resolution of stressed business. The enactment of IBC in 2016 and implementation of provisions relating to corporate insolvency resolution process from December 1, 2016, was very timely.

As of September 2017, the stressed advance ratio of public sector banks was as high as 16.2%<sup>20</sup>. These stressed assets are now being actively resolved under the IBC ecosystem with more than 500<sup>21</sup> insolvency resolution petitions already admitted across a variety of sectors including 12 large defaulters as notified by the Reserve Bank of India in 2017. Resolution of these stressed assets under the IBC is leading to a spurt in the M&A activity and is expected to be a key theme driving M&A activity in the near to medium term. IBC has also contributed to the improvement in ease of doing business rankings where inter alia on account of resolving insolvency, India ranked 103 in 2018 as compared to 136 in the year earlier<sup>22</sup>.

### Corporate Insolvency Resolution Process (CIRP) under IBC.

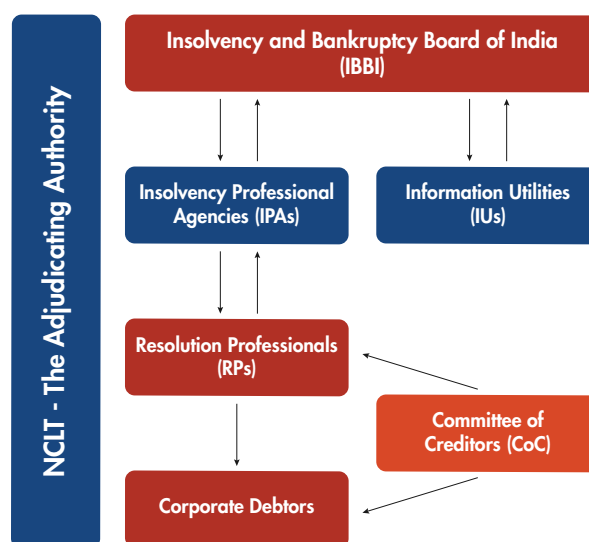
IBC has brought a paradigm shift in the way in which insolvency proceedings are conducted in India. This is because of its emphasis on 'cash flow approach' i.e. resolution proceedings can be initiated as soon as there is a default in payment and the resolution process is implemented through a 'Creditor in Control' regime in a time-bound manner.

CIRP under the IBC involves the participation of various constituents. Some of the key constituents include –

- Insolvency and Bankruptcy Board of India (IBBI) – IBBI is the apex body established under the IBC to oversee administration and implementation of the IBC
- Insolvency Professional Agency (IPA) – IPA is a professional body registered with IBBI. It develops a code of conduct for IRPs and is a 1st level regulator of IRPs
- Resolution Professional (RP) – RP is a licensed

professional enrolled with an IPA and registered with IBBI. RP is responsible for conducting the resolution process under the IBC

- Information Utilities (IUs) – IU is a person registered with IBBI to collect, collate, authenticate and disseminate financial information to be used in IBC proceedings
- Corporate Debtor – a corporate/LLP who owes the debt to any person.
- Committee of Creditors (CoC) – CoC is a body comprising financial creditors who appoint RP for resolution process and approve a resolution plan
- Adjudicating Authority – National Company Law Tribunal (NCLT) is the adjudicating authority for adjudicating matters of insolvency and liquidation of corporate persons.



If a person i.e. a financial creditor and/or operational creditor has a right to payment (including a right arising from a breach of contract) then such a person is said to have a claim against the corporate debtor. If the corporate debtor fails to pay any debt (> Rs 1 Lakh) in respect of a claim (whether to the financial or operational creditor) when such a debt has become due and payable, then a default is said to have occurred and an application can be made to NCLT to initiate CIRP. A Corporate Debtor who has committed a default can on its own accord also make an application to NCLT to initiate CIRP. The CIRP process begins only when NCLT admits the application.

If the application is admitted then NCLT declares a moratorium i.e. a prohibition on the institution of suits/ continuation of pending suits/ transfer of assets of corporate debtor/ recovery of any property till the completion of CIRP.

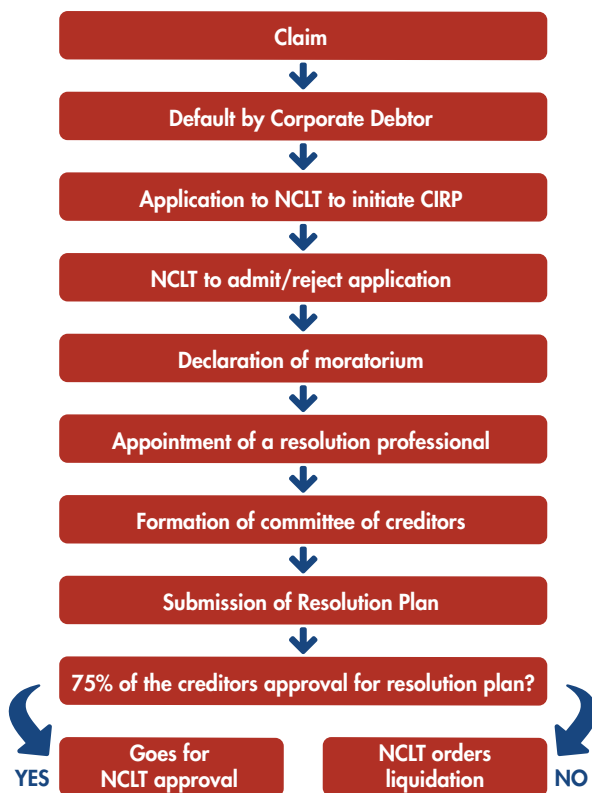
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21 IBBI

22 <http://pib.nic.in/newsite/PrintRelease.aspx?relid=173116>



An Interim RP is then appointed by NCLT and the management of the corporate debtor vests in Interim RP. Interim RP constitutes a CoC. CoC then appoints an RP. RP then invites a resolution plan from the eligible bidders<sup>23</sup> which is then approved by CoC by a majority vote of 75%<sup>24</sup> in value. The Resolution plan thereafter goes for the approval of NCLT. If approved by NCLT, then the same is binding on the corporate debtors, employees, members, creditors, guarantors and other stakeholders involved in the CIRP process. If the resolution plan is not approved or no resolution plan is received, then NCLT has the power to order the liquidation of the corporate debtor.



As mentioned earlier, CIRP process is required to be completed in a time-bound manner within a period of 180 days. NCLT could extend this time-limit by a further 90 days, however, no further extension is permitted under the IBC.

## The interplay of IBC with income-tax law

As with M&A transaction, resolution under IBC is also has income-tax implications. The Finance Act, 2018 provides for following reliefs in respect of companies under IBC:

- In case of a closely held company carry forward and set-off of losses is allowed only if there is a continuity in the beneficial owner of the shares carrying not less than 51% voting power. In case of a company seeking insolvency resolution, it is expected that ownership of shares carrying more

than 51% of voting power would change thus leading to a lapse of the existing brought forward business losses. Towards this end, the Finance Act, 2018 provides that if a company's resolution plan is approved under the IBC, then such a company would be eligible to set-off losses even if there is a change in shareholding beyond the prescribed limit subject to certain conditions.

- Typically, for computation of book profits for the levy of MAT, a company is entitled to set-off brought forward business losses or unabsorbed depreciation, whichever is lower. With a view to provide relief to companies under IBC, the Finance Act 2018, provides that a company whose application is admitted under IBC would be eligible to set-off aggregate of brought forward losses and unabsorbed losses.

While these amendments are welcome, there are several tax issues in relation to companies under IBC which have not yet been addressed. Key issues amongst these are –

- Where any outstanding liability, inclusive of any accrued interest, in respect of the Corporate Debtor for which the Resolution Plan is approved, is waived in accordance with the approved Resolution Plan, such waiver / write-back may be subject to tax under both normal tax and MAT provisions. This waiver may not be commensurate with the available losses, leading to additional tax liability
- The Indian tax laws provide that where consideration for transfer of share of a company (other than quoted share) is less than the Fair Market Value (FMV) of such shares, the FMV shall be deemed to be the full value of consideration in the hands of the Transferor for computing capital gains. The FMV for the aforesaid purposes is computed as per the formula prescribed which essentially seeks to arrive at the FMV based on the intrinsic value approach. Similarly, for the Transferee the deficit between the FMV and the actual consideration is deemed as income and taxed at the applicable tax rate. In case of distressed assets and companies, which are generally the subject matter of the approved Resolution Plan, the share sale/ acquisition is likely to be below the FMV. This could lead to tax implications both for the Transferor and the Transferee making the resolution plan expensive and unviable.

Addressing the above tax issues would be crucial to encourage a resolution plan for the insolvent companies and unburdening the banks and the stressed economy from the huge outstanding debts.

<sup>23</sup> Section 29A of IBC provides certain criteria for persons not eligible to be resolution applicant (bidders)

<sup>24</sup> A panel led by corporate affairs ministry has laid a proposal to reduce this to 66% in value

## Indirect tax laws impacting M&A deals in India

India follows a dual taxation structure, in which taxes are imposed by the central government as well as the state governments. From July 2017, GST has been introduced in India. GST has subsumed a plethora of indirect taxes presently levied at the federal and state level in India such as Excise Duty, Service Tax, Value Added Tax (VAT), Central Sales Tax, Entry Tax etc. Under GST, the type of taxes to be levied are Integrated Goods and Services Tax, Central Goods and Services Tax, State / Union Goods and Services Tax, and GST Compensation Cess. Transactions involved in business consolidations can be achieved through the sale and purchase of either a business as a whole or of a business undertaking (BU). These transactions are executed in the form of a merger or demerger or an amalgamation of companies. Alternatively, these transactions can also be executed through a transfer or sale of shares.

A business can be acquired either on a going-concern basis as a whole or on a 'slump-sale' basis, or by purchasing individual assets i.e. on an 'itemized sale' basis. In a slump sale scenario, the entire business undertaking is sold as a going concern for a lump-sum consideration i.e. the transfer of all assets along with the liabilities of the BU. In an itemized sale, the identified assets and liabilities of the business are transferred at an agreed price (i.e. the cherry-picking of assets by the buyer).

These transactions must be examined closely under the lens of GST, being a transaction-based destination tax. The GST implications on various ways of undertaking the merger/acquisition of a business undertaking are discussed below.

### Implications under GST Regime

#### *Sale of business/BU*

The sale of a business as a whole, on a going-concern basis, entails the transfer of all assets and liabilities of the business comprising moveable and immovable property, stock-in-trade, receivables, payables, etc, for a lump-sum consideration. It is pertinent to note that the transfer of a business on a going-concern basis, whether of the whole business or an independent part thereof, has been exempted from GST. The transfer of business, should be in such manner that it should enable the transferee to carry on the business further as a going concern. Such transfer should not be done only with respect of certain individual assets, but entire business including its employees, open contracts, credits, liabilities, etc. should also be transferred as a part of business.

#### *Itemized sale of assets*

On the other hand, in an itemized sale, individual assets are transferred at a specified price. Such transactions could be regarded as supply of goods and are liable to GST at the applicable rates. Whilst the rate of GST applicable on goods depends on the nature of the goods that are being transferred, generally the goods attract a rate of 45%, 12%, 18% or 28% GST on their identified values.

Based on the nature of the goods transferred and subject to the Input Tax Credit restrictions provided under the GST Acts, the GST paid by the purchaser may be available as input tax credit, subject to conditions.

#### *Acquisition through transfer/sale of shares*

Alternatively, if the business is acquired through the transfer or sale of shares, then there will not be any GST implications given that the definition of 'goods' and 'service' excludes stocks, shares, etc from its ambit. Hence, a sale of shares transaction can not be treated as a supply of goods or service and hence should not be subject to GST.

#### *Merger/demerger/amalgamation of companies*

In the event of a merger or demerger or the amalgamation of companies, again no GST is attracted as this is the transfer of an entire business on a going-concern basis.

### Impact on unutilized credits

The Input Tax Credit provisions under GST provide for the transfer of unutilized credits lying in the electronic credit ledger of the transferor to the resulting undertaking or the transferred business, pursuant to a change in the constitution on account of sale, merger, demerger, amalgamation, transfer of business etc., subject to conditions. In such cases, due precautions must be taken to ensure the seamless transfer of unutilized credits.

### Implications under Foreign Trade Policy

Businesses may hold various licenses under the Advance Authorization and Export Promotion Capital Goods (EPCG) schemes from the authorities under the Foreign Trade Policy (FTP). It is critical to take an account of all such pre-import benefits taken by the BU that is being transferred, which might have unfulfilled post-export obligations. This is because various benefits claimed under FTP schemes are actual user based. Any change in user would necessitate obtaining prior approvals or permission from the authorities to pre-empt any dispute in future.

Apart from the various implications of the transfer of a BU per se discussed above, a few other areas that have a bearing on the day-to-day operation, both during the intervening period and subsequent to the transfer, would merit consideration.

## Transactions during the intervening period

The merger, demerger or amalgamation of companies can be done only with the approval of the NCLT. The date of the NCLT order is typically subsequent to the date from which the merger, demerger, etc is effective.

If the companies undertake transactions amongst themselves during the intervening period (i.e. between the effective date and the date of the court order) then due treatments under the tax laws apply.

The supply of goods and services amongst the companies being amalgamated or merged during the intervening period, the transactions of such supplies and receipt would be included in the turnover of supply or receipt of the respective companies and taxed accordingly. The companies undergoing a change in the constitution would be treated as distinct entities till the date of order of the Court or Tribunal.

The companies would have to obtain, cancel and/or amend their registrations with the tax authorities and meet the procedural compliance requirements.

## Impact on ongoing or past litigation

For ongoing and past litigation (pending adjudication), the tax authorities should be informed of the proposed slump sale or merger or demerger or amalgamation of companies, as well as the details of the new undertaking and the new communication address to ensure that the notices reaches the new company.

## Approval or permission from regulatory authorities/bodies

Businesses that are specifically covered by licenses or permissions granted by regulatory authorities are required to seek clearance from such authorities on a proposed merger or demerger or amalgamation scheme.

A comprehensive and holistic approach is required on such business consolidation transactions, with a view not only to making such transfers neutral from an indirect tax perspective but also ensuring that the procedural compliance, approvals and transfer requirements under the applicable indirect tax rules are being met.



## A new regime for corporate restructuring in India

Corporate restructuring exercises in India have been typically done through mergers and demergers which are largely governed by the provisions of the Companies Act.

Section 230 to 240 of the Companies Act, 2013 (2013 Act) contains provisions related to corporate restructuring i.e. compromise, arrangement and amalgamation, which aim to simplify and streamline the process involved. It provides for several progressive concepts such as fast track mergers and cross border mergers, and sets out several concepts which were followed in practice, but not contained in the erstwhile Companies Act, 1956 (CA 1956). Under the 2013 Act, the National Company Law Tribunal (NCLT) has been vested with the powers of approving all such schemes relating to compromise, arrangement and amalgamation (Schemes), which were hitherto vested with the jurisdictional High Courts.

**Hitherto company-related issues were handled by four different bodies — Company Law Board (CLB), High Court (HC), Board for Industrial & Financial Reconstruction (BIFR), and the Appellate Authority for Industrial and Financial Reconstruction (AAIFR). NCLT will subsume all these bodies. Further, NCLT will also adjudicate insolvency resolution for companies.**

The concept of NCLT and National Company Law Appellate Tribunal (NCLAT) (hereinafter NCLT and NCLAT referred to as 'Tribunal') was first introduced in CA 1956 by the Companies (Second Amendment) Act, 2002. However, this Tribunal was never constituted under the CA 1956. Hence, all Schemes continued to be approved by the jurisdictional High Court. It was only on June 1, 2016, that Ministry of Corporate Affairs (MCA) finally notified the constitution of NCLT and NCLAT. The NCLT has started functioning with eleven Benches – two at New Delhi and one each at Ahmedabad, Allahabad, Bengaluru, Chandigarh, Chennai, Guwahati, Hyderabad, Kolkata and Mumbai. The Principal Bench of the NCLT will be at New Delhi. All the powers of the High Court relating to Schemes are vested with the Tribunal, which now act as a single window approving authority for all the Schemes.

### 1. Key differentiating points in the new regime

- **Mandatory obtaining of auditor's certificate on the accounting treatment prescribed in the Scheme**

2013 Act makes it mandatory for listed and unlisted companies to obtain an auditor's certificate on the accounting treatment

prescribed in the Scheme, where the auditor is required to certify that the accounting treatment mentioned in the Scheme is in compliance with the accounting standards.

There was no such specific requirement under the CA 1956.

- **Prohibition on creation of treasury stocks**

2013 Act provides that the transferee company cannot hold any shares in its own name or in name of any trust whether on its behalf or on behalf of any of its subsidiary or associate companies. Accordingly, any such shares need to be mandatorily cancelled/extinguished pursuant to the Scheme.

The idea behind introduction of this provision is to curb the practice of holding shares by the transferee company in its own name or in the name of a trust, either directly or indirectly. This will result in greater transparency, and curb increase in promoter control through the trust structure.

- **Extensive disclosures to members/creditors**

With a view to encourage transparency and empower stakeholders to take informed decisions, several additional disclosures are required to be made in the notice for convening of members/creditors meeting. These disclosures include providing information/documents such as

- valuation report, effect of the scheme on various stakeholders including creditors, Key Managerial Personnel, promoters, non-promoter members, debenture holders, directors and debenture-trustees, status of regulators approvals.

- **Notice of members/creditors meeting to be sent to regulatory authorities**

Post admission of Application for approval of the Scheme by NCLT, notice for convening of members/creditors meeting is also required to be sent to regulatory authorities, such as – Regional Director (RD), Registrar of Companies (RoC), Official Liquidator, Income-tax authorities and other applicable Sectoral Regulators, who are required to submit their objections (if any) within 30 days from the date of receipt of the notice.

The purpose behind this provision seems to be to invite participation of various regulators so as to assist the NCLT to take an informed decision. Interestingly now the onus of providing suggestions/objections to the Scheme within the confined time has been shifted on to the regulators. However, the same is yet to see any impact at the practical level in terms of timelines.

### • Objections to the Scheme

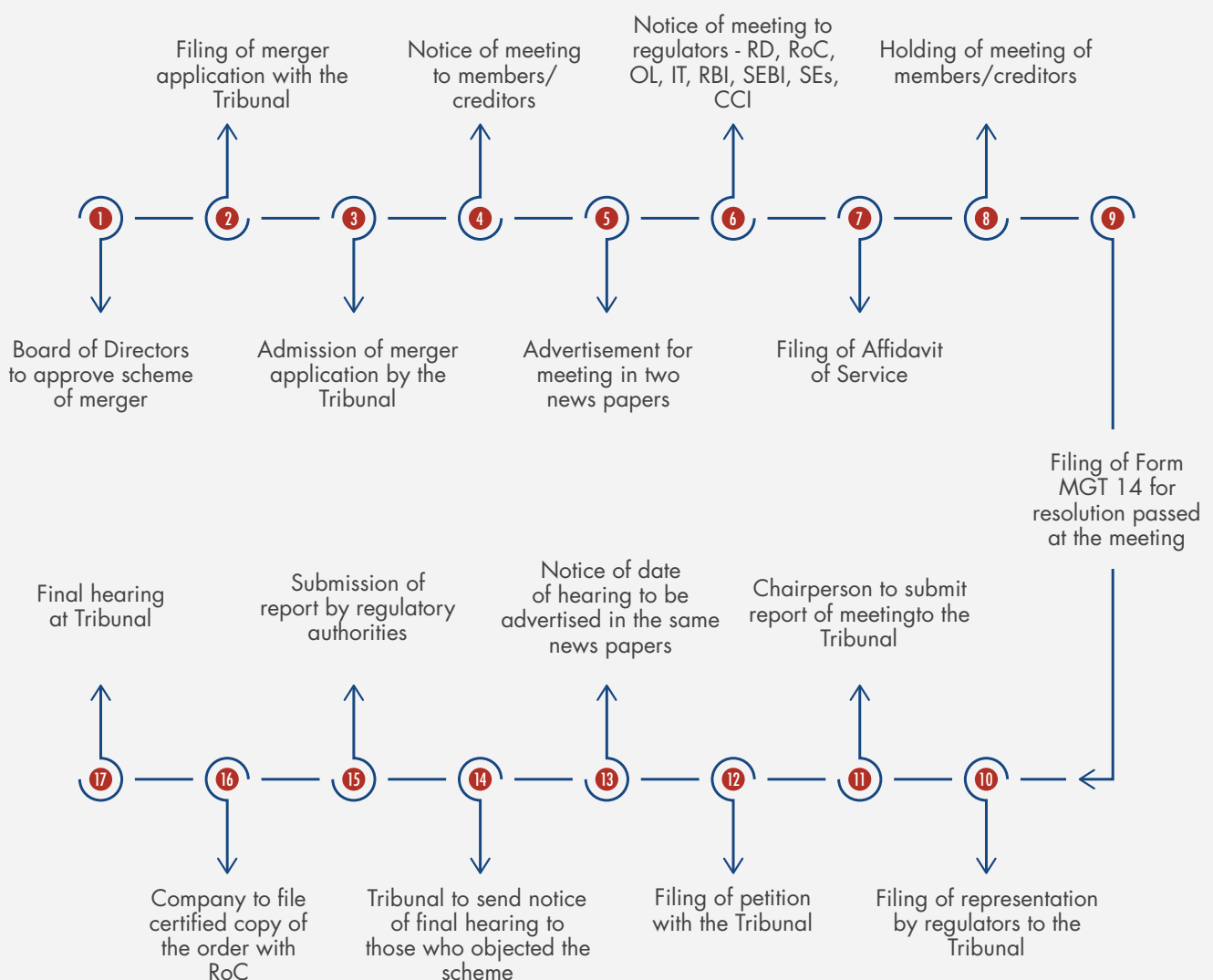
With a view to eliminate objections of persons who try to oppose the Scheme on frivolous grounds, the 2013 Act has introduced a threshold for raising objections to the Schemes. The minimum threshold to object the Scheme are as below -

- **Shareholders** holding **at least 10%** of the shareholding

- **Creditors** having outstanding debt of **at least 5%** of the total debt

### • Indicative merger/demerger process under section 230-232 of the 2013 Act

The indicative process for implementing a Scheme of Amalgamation under section 230-232 of the Companies Act, 2013 (2013 Act) read with Merger Rules is given below –



## 2. Fast Track Mergers

This is a new concept which has been introduced under the 2013 Act which provides for a simplified and fast track merger/demerger process. It can be used for merger/demerger between small companies<sup>25</sup> or between holding company and

its wholly owned subsidiary or such other classes of companies as may be prescribed.

25. Small company means a company, other than a public company having (i) paid-up share capital not exceeding fifty lakh rupees or such higher amount, as may be prescribed, which shall not be more than five crore rupees; or (ii) turnover, which as per its last profit and loss account, does not exceed two crore rupees or such higher amount, as may be prescribed, which shall not be more than twenty crore rupees.

Under this process, the merger/demerger will have to be approved by the Central Government and there will be no requirement to approach the Tribunal for its approval. Further the Scheme would also need to be approved by members holding at least 90% of the total number of share and by creditors representing nine-tenth in value. It is pertinent to note that following this process is optional and not mandatory.

### 3. Cross-border mergers

Section 234 of the 2013 Act which deals with cross-border mergers is notified by MCA and section is operative with effect from April 13, 2017. Further, in consultation with RBI, MCA also notified corresponding amendments in the Merger Rules by inserting new Rule 25A.

With notification of cross-border merger provisions, Indian companies is now permitted to merge with foreign companies in notified foreign jurisdictions. Further, the Reserve Bank of India vide notification dated March 20, 2018 has laid down the conditions for inbound and outbound mergers [like treatment of assets/ liabilities which can't be held by foreign companies/ Indian companies, treatment of loans taken by foreign company on merger with Indian company post-merger etc] and specific approval of RBI will not be required if such conditions are duly complied with. This will enable an Indian company to restructure its shareholding and migrate its ownership to an international holding structure resulting in providing access to foreign markets. However, such outbound mergers are not tax neutral, unlike domestic and inbound mergers.

However, this notification has lead to several practical challenges. For example, in case of Inbound Merger, existing debt of foreign companies from overseas sources is required to be in compliance with the Indian ECB guidelines. Also, in case of Outbound mergers, the Foreign Company can hold only those assets in India which a Foreign Company is permitted to hold under the existing RBI regulations. Hence, a Foreign Company may not be able to hold immovable property in India pursuant to a merger.

Further, Section 234 of the 2013 Act explicitly states that the scheme of merger may provide for payment of consideration to the shareholders of the merging company in the form of cash or depository receipts or partly in cash and partly in depository receipts. This may have ramifications under the Indian tax laws since issuance of shares is one of the primary requirements for a tax neutral merger / demerger.

In order to make cross border mergers a viable option for corporate restructuring, several laws, including income-tax laws and exchange control regulations, will have to be suitably amended.

### 4. Capital Reduction

2013 Act has made the capital reduction process more time consuming and stringent. Some of the key changes are as under:

- Extension of mandatory requirement of obtaining auditors certificate on the accounting treatment, as required under the merger/demerger schemes, to the capital reduction schemes.
- Company will not be permitted to undertake capital reduction if it is in arrears in repayment of deposits or the interest payable thereon. This will forbid all defaulting companies to proceed with any kind of capital reduction process, till the arrears are made good.
- The NCLT is required to take into consideration the representations of creditors, Central Government, RoC and SEBI (in case of listed companies) by giving them a 3 months' notice, before sanctioning such a scheme. This may radically increase the timelines involved in a capital reduction process.

### 5. Scheme of Arrangement by Listed Entities – SEBI guidelines

Procedure to be followed by Listed Entities for undertaking Schemes of Arrangement has been provided by SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 through a circular dated March 10, 2017, to align the SEBI requirements with the recently notified sections of the 2013 Act.

Some of the important amendments introduced are as under:

- Provisions of the Circular will not be applicable to the schemes which solely provide for merger of a wholly owned subsidiary with the parent company. However, such draft schemes are required to be filed with the Stock Exchanges for disclosures purposes.
- The issuance of shares pursuant to schemes only to 'select group of shareholders' or 'shareholders of unlisted companies' shall follow the pricing provisions laid down for Preferential Issue of shares by listed Companies.
- Unlisted entities can be merged with a listed entity only if the listed entity is listed on a Stock Exchange having nationwide trading terminals.

### Conclusion

The new provisions under the 2013 Act are a move towards greater transparency and accountability. The mergers and acquisition process is likely to be streamlined and litigation by shareholders is expected to be reduced.

## About Dhruva

Dhruva Advisors LLP is a boutique tax and regulatory services organization, working with some of the largest multinational and Indian corporate groups. We bring a unique blend of experience, having worked for the largest investors in India, advising on the largest transactions and on several of the largest litigation cases in the tax space. We work closely with regulators on policy issues and our clients on tax advocacy matters. We believe in thinking out of the box, handholding our clients in implementation and working to provide results.

Key differentiators:

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- In-depth, specialised and robust advice
- Strong track record of designing and implementing pioneering solutions
- Trailblazers in tax controversy management
- Long history of involvement in policy reform
- Technical depth and quality

Dhruva has presence in Mumbai, Ahmedabad, Bengaluru, Delhi, Singapore, Dubai and USA. The key industries that the team advises on include financial services, IT and IT-enabled services (ITES), real estate and infrastructure, telecommunications, oil and gas, pharmaceuticals, chemicals, consumer goods, power, as well as media and entertainment.

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- Dhruva Advisors has been consecutively recognized as a Tier 1 Firm in the International Tax Review, World Tax Guide 2016 and 2017 to the world's leading tax firms.
- Dhruva Advisors has also been awarded the Best Newcomer of the Year 2016 - ASIA by the International Tax Review.



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