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M&A IN INDIA - TAX PERSPECTIVE





FROM OUR CEO

After hitting a three-year low, merger and acquisition (M&A) activity in India witnessed a significant uptrend in late 2015. Reports available in the public domain suggest that during October 2015, 58 M&A transactions took place, worth a combined USD 3,144 million. Notwithstanding this trend, going forward, there continues to be a need for robust initiatives and policy reforms that will improve the business environment and maintain the momentum of growth in the Indian M&A space.

At a macro level, there has been a growing emphasis from the Indian Government on economic growth and development, ease of doing business, and the Make in India and Start-up India initiatives. In the wake of these initiatives on these areas and relatively positive macro-economic indicators, India is likely to remain an attractive destination for inbound as well as domestic M&A transactions.

While these efforts to help investment flows into India are indeed laudable, much more can be done on the tax front to help complement these initiatives and spur M&A activity. The recent Union Budget 2016-17 demonstrates the commitment of the government to providing certainty in tax laws and in reducing tax litigation. Several tax proposals introduced in the Union Budget 2016-17 – such as tax benefits to start-ups, a one-time scheme of dispute resolution for ongoing cases under retrospective amendments, extending concessional tax rates to foreign investors in private companies and a clear roadmap for phasing out tax incentives – will have a far-reaching impact on the investor/taxpayer psyche.

Notwithstanding this, tax litigation in India arising out of M&A activity continues to dominate the headlines. For instance, the almost decade old Vodafone case and the restructuring involving Cairn (both relating to indirect transfers) remain unresolved. Although in both of these cases the tax demands are based on a retrospective amendment to the income-tax law, they serve as a reminder that when structuring a transaction, one has to be mindful of potential tax risks and the possibility for long drawn litigation.

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 analysed key tax developments relating to M&A as well as several tax 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.

Dinesh Kanabar
CEO



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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:

Description	Tax rate (%) ¹	Surcharge (%)	Education cess (%)	Effective rate (%)
A. Where the total income is up to INR 10 million				
Domestic company	30	Nil	3	30.9
Foreign company	40	Nil	3	41.2
B. Where the total income is more than INR 10 million and up to INR 100 million				
Domestic company	30	7	3	33.06
Foreign company	40	2	3	42.02
C. Where the total income is more than INR 100 million				
Domestic company	30	12	3	34.61
Foreign company	40	5	3	43.26

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 10 years and set off against income tax payable under the normal provisions of the Income Tax Act to the extent of the difference between tax according to normal provisions and tax according to MAT.

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

- 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.

Dividend Distribution Tax (DDT)

Domestic companies are required to pay DDT at the rate of 20.36% 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.

1. The Budget 2016 has proposed a corporate tax rate of 29% for domestic companies if their total turnover or gross receipts in the financial year 2014-15 does not exceed INR 50 million. It has also proposed a corporate tax rate of 25% for domestic companies, if set-up and registered after 1 March 2016 and does not claim any tax incentives.

Buyback Tax (BBT)

An Indian unlisted company has to pay 23.07% (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 tax landscape in India

India has been at the forefront of global deal activity over the last few years, particularly since the early 2000s. 2015 saw an uptrend in cross-border deal activity, particularly inbound transactions, aided by the progressive opening up of various sectors to foreign investment by the Indian government as well as the Indian economy establishing itself as the fastest growing economy in the Asia Pacific region. Going forward, several policy initiatives at the government level, such as Make in India, introduction of Goods and Service Tax (GST), focus on start-ups and further liberalisation of the foreign investment policy, are expected to drive M&A activity in the country.

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

Modes of M&A transactions in India

An acquisition can be structured in any of the following formats:

- 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. A share acquisition is one of the most common modes of M&As that have happened 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:** In the case of shares listed on stock exchanges, if the shares have been

held for a period exceeding 12 months and the shares are sold on the floor of the stock exchange after payment of securities transaction tax (STT), any profits on such sale are exempt from payment of any income taxes. In the event such 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% (excluding any surcharge and cess).

- **Unlisted shares:** If the shares are not listed, the minimum period of holding required for availing the benefits of a beneficial rate of tax on long-term capital gains increases to 36 months. This means that if the shares are sold after a period of 36 months from the date they were acquired, the profits from the sale are taxed at the rate of 20%. While computing profits, 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 is 10%. However, for non-residents, no benefit of indexation or exchange rate fluctuations is allowed while computing the taxable profits.

[Note: Subject to the approval of Parliament, 36 months should be read as 24 months as proposed by the Finance Minister in the Union Budget, 2016, presented on 29 February, 2016.]

One controversy that prevails under law is whether the beneficial rate of 10% is available in the event that the shares are of a private limited company. The controversy stems from a very technical interpretation of the definition of the term 'securities' under the governing statute, the Securities Contracts (Regulation) Act, 1956 (SCRA). Given the various judicial pronouncements on the matter, in most deals, buyers insist on a withholding tax at the rate of 20%. Sellers, for their part, can file for a tax refund based on a 10% tax rate, though the grant of a tax refund of this kind is a litigious matter.

[Note: Subject to the approval of Parliament, in the Finance Bill, 2016, the Finance Minister has proposed that beneficial tax rate of 10% will also be available on sale of shares of a private limited company.]

In the event that shares have been held for a period not exceeding 36 months, any profits on such sale are taxed as normal income at the applicable rate of tax.

[Note: Subject to the approval of Parliament, 36 months should be read as 24 months as proposed by the Finance Minister in the Union Budget, 2016, presented on 29 February, 2016.]

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.

Exemptions from capital gains on share sale

India has signed double taxation avoidance agreements, popularly called 'tax treaties', with many countries. With some of these countries, such as Singapore and Mauritius, the tax treaties provide that any capital gains on sale of shares of an Indian company by a seller resident in these countries are not taxable in India, but are taxable in the country of residence of the seller.

In order to be entitled to claim relief under a tax treaty, the Government of India requires a non-resident to provide a tax residency certificate (TRC) with certain information as prescribed. The apex court of India viz the Supreme Court, as well as several other judicial forums, has upheld the validity of the TRC as a sole condition for availing the above capital gains tax exemption.

In spite of this, in a few cases, the Indian tax authorities have been challenging the capital gains tax exemption claimed by the non-resident investors on the basis that they lack substance in their country of incorporation and have been incorporated merely for availing the tax exemption under the relevant tax treaty.

In this regard, it is pertinent to note that India's tax treaty with Singapore has a limitation of benefits (LOB) clause which lays down certain 'substance' related criteria. According to the LOB clause, the benefit of the capital gains tax exemption will be allowed only if:

- The fund based in Singapore is not a shell or conduit entity; and
- The Singapore entity has not been set up for the primary purpose of taking advantage of the capital gains tax exemption opportunity.

In the case that a Singapore entity spends more than S\$ 200,000 in the 24 months preceding the realisation of capital gains, it will be deemed not to be a shell or conduit entity.

The above 'substance' related criteria have not been incorporated in the tax treaty entered into by India with Mauritius and Cyprus. However, several news reports in recent months have suggested that the India-Mauritius tax treaty is in the process of being renegotiated in order to insert an LOB clause similar to the tax treaty entered into between India and Singapore or to withdraw the capital gains tax exemption. However, no formal agreement has been reached to date.

The capital gains tax exemption under the India-Singapore tax treaty is co-terminus with the exemption available under the India-Mauritius tax treaty. Hence, where the said exemption is withdrawn under the India-Mauritius tax treaty, it would also have a significant impact on the Singapore-based investors.

With respect to Cyprus, it is important to note that following Cyprus being named as a notified jurisdictional area, several uncertainties have cropped up over the benefits under the tax treaty entered into between India and Cyprus. These are specifically related to the requirement to withhold taxes at the rate of 30% in respect of streams of income not chargeable to tax in India. While it is clear that income streams like interest will face a 30% tax withholding in India, the position is not clear when it comes to exempt income like dividends and capital gains. Investors based in Cyprus are in a position of suspense until a clarification emerges.

In addition, it is important to note that India is introducing General Anti-Avoidance Rules (with effect from 1 April 2017) which provide for treaty override in case of transaction which lacks commercial substance. Substance parameters will therefore become increasingly relevant once the GAAR provisions become effective.

B. Tax withholding:

While there is no requirement for any 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 favourable treaty country such as Mauritius, unless the seller furnishes a certificate from the income tax department certifying a nil or a lower withholding tax on the transfer. Sometimes buyers agree to withhold lower or nil taxes, subject to contractual indemnities and insurance under the share purchase agreement.

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 laws were 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.

In case an indirect transfer is regarded as a transfer of an Indian asset, Indian tax rules are applicable on the transfer and taxability shall be determined in accordance with the rules for transfer of the share in an Indian company.

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, under the Indian tax laws, if the shares are sold at a value which is lower than the book value of the share (computed using a prescribed formula based on the net worth of the company in question), the deficit between the book value and the consideration is deemed as income and is therefore taxed in the hands of the buyer at the applicable rate of tax.

In case a resident Indian seller sells shares to a non-resident buyer, then under the Indian exchange control laws the sale needs to happen at a minimum of the fair value of the share determined in accordance with internationally accepted methodologies of valuation. In a reverse case, i.e. a non-resident selling shares to a resident, the fair value 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. Sales tax/value added tax (VAT):

There is no sales tax or VAT implication on sale of shares (Refer our article on 'Indirect tax laws impacting M&A deals in India' for detailed understanding).

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. 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 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.

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 recognised 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 shares are not held in dematerialised form.

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. Tax consequences in both cases differ.

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 profits derived on the transfer at 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%. 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 profits on sale. In many cases, 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 profits should be computed taking into account the negative net worth has been a matter of controversy and litigation in Indian courts. While there are judgments both for and against the argument, the seller is advised to budget a tax payout 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. Sales tax/VAT:

There is no sales tax or VAT implication on a sale of business (Refer our article on ‘Indirect tax laws impacting M&A deals in India’ for detailed understanding).

d. No objection certificate from the tax authorities:

Under section 281 of the Indian Income Tax Act, 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 the transfer.

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 individual assets and liabilities based on the fair values of the assets and liabilities in question. Depreciation on the fixed assets is available based on the value allocated to 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 immovable property, many states also have provisions for levy of stamp duty on movable assets. Typically, stamp duty is paid by the buyer.

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 profits are computed as follows:

- The sale consideration shall be 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 will be 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 will be available only on the balance.

For non-depreciable assets other than land, profit is computed simply as the difference between sale consideration and book value of the asset transferred, and the profits 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.¹

b. Tax withholding:

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

c. Sales tax/VAT:

In the case of an itemised sale of assets, VAT is applicable on the movable assets transferred at the applicable rates based on the Indian state in which the sale is carried out (Refer our article on 'Indirect tax laws impacting M&A deals in India' for detailed understanding).

d. No objection certificate from the tax authorities:

The Indian tax laws also provide that any transfer of any asset(s) 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. Thus it is common for a buyer to insist upon the seller to obtain such a no objection certificate from the income tax authorities prior to consummating any transaction.

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.

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.

Merger

In a merger, two or more companies consolidate to form a single entity. The consolidation is undertaken through a High Court-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 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 shareholders of 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.

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

In the case of an amalgamation, shareholders of the transferor entity receive shares of 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 will therefore

1. 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%.

be subject to capital gains tax in the hands of shareholders of the transferor entity.

The Indian tax laws clearly provide that in the case of amalgamation, any transfer of shares in the transferor entity by the shareholders would 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 shares in the transferor company in the hands of the shareholders is preserved as the cost 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'² 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 will be 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.

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

The transferee entity is allowed a deduction of 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.

2. "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
 iiiia) 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;

B. Sales tax/VAT:

There is no sales tax or VAT implication on amalgamation (Refer our article on 'Indirect tax laws impacting M&A deals in India' for detailed understanding).

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 property of the transferor company are located.

There are some states where specific entry exists for charging stamp duty on High Court orders approving the amalgamation scheme (such as Maharashtra, Andhra Pradesh, Gujarat and Karnataka). In some states where there are no specific provisions for stamp duty on amalgamations, there are 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.

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.³ A demerger is an effective tool whereby a running business is put 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 High Court-approved process wherein all the assets and liabilities, along with employees of the identified business undertaking, are transferred to the transferee entity. As part of the demerger consideration, the transferee entity issues 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 High Court scheme, 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;⁴
- The transferee entity issues shares to the shareholders of the transferor entity on a proportionate basis; and
- At least three quarters of the shareholders of the transferor entity (in value) become shareholders of the transferee entity.

Like amalgamation, in a demerger where the transferee entity is 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.

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, so long as 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 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 it is not subject to capital gains tax.

3. "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.

4. 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 utilised 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.

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, in the context of a demerger, whether there is any transfer by the shareholders, since they continue to own the shares of the demerged company, is a matter of debate.

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 remaining 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. Sales tax/VAT:

There is no sales tax or VAT implication on a demerger (Refer our article on 'Indirect tax laws impacting M&A deals in India' for detailed understanding)

C. Stamp duty:

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

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 rationalise/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 are 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.

In recent times, India has also added to this uncertain tax environment through the introduction of a law relating to taxation of gains arising on indirect equity transfers. It started with the well-known Vodafone case the brief facts of which are as below:

How did it start?	What was the dispute about?	Who went to Court?	What was the Court's verdict?	What happened next?	What is the current status?
<ul style="list-style-type: none"> Hutchison's subsidiary in Cayman Islands held a majority stake in an Indian telecom company through a chain of overseas holding companies. Vodafone bought Cayman company, resulting in an indirect acquisition of Indian company. 	<ul style="list-style-type: none"> Indian tax authorities considered gains on transfer of shares of Cayman company (deriving value from India) are liable to Indian tax. Vodafone believed such transaction was outside Indian tax authorities' purview. 	<ul style="list-style-type: none"> Vodafone first went to court in 2007 when tax authorities held that the company should have deducted tax while paying to Hutch. Vodafone argued that the transaction was outside India's tax purview. 	<ul style="list-style-type: none"> In January 2012, the Supreme Court (SC) ruled in Vodafone's favor and held that gains arising from transfer of shares of a foreign holding company, which indirectly held underlying Indian assets were not taxable in India. 	<ul style="list-style-type: none"> The Finance Act 2012, retrospectively amended law to tax transactions of this type, thereby neutralizing the SC's verdict Following global hue and cry from investors, government constituted an expert committee to review the retrospective amendments and recommend changes. 	<ul style="list-style-type: none"> Keeping in perspective the committee's recommendations, Finance Act 2015, provided clarity on certain aspects relating to taxation of indirect transfers (discussed below). Resolution under international investment arbitration initiated by Vodafone against Indian government is pending.

Latest development

The Finance Bill 2016 (yet to be enacted) provides for a Direct Tax Dispute Resolution Scheme, to be introduced with effect from 1 June 2016, to cover disputes arising from retrospective amendments to income tax (including indirect transfer provisions). The tax payers intending to opt for this Scheme will be required to pay only disputed tax at the applicable rate. Interest and penalty will be waived in such cases. In addition, such tax payer will be required to withdraw any appeal filed against such dispute before any appellate authority or withdraw any proceeding for arbitration, conciliation or mediation.

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

The amended provisions governing taxation of indirect transfer,⁵ 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 (iii) 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. However, as is evident, a lot of issues remained unaddressed by the Finance Act, 2012 such as:

- No clarity on the meaning and scope of the term 'substantially'
- No proportional taxation – 100% of gains taxable if 'substantiality' threshold satisfied
- No clarity on valuation methodologies for determining value of assets/shares
- No exclusions for listed company shares, small shareholdings, transfers in group restructurings, etc.
- No clarity on taxability in India of dividends paid by foreign companies deriving value from assets in India
- No clarity on applicability of tax treaties

3. Amendments made to Indirect transfer rules in India by Finance Act, 2015

Some of the aforementioned issues were clarified/addressed by the Finance Act, 2015 which are summarized below:

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 valuation methodology is yet to be prescribed.

The term 'specified date' is defined to mean last day of the accounting period (generally defined to mean twelve-month period ending on 31st 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 per cent, 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. Further, the Rules for determining attribution are yet to be prescribed.

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. A penalty of two per cent of the value of the transaction in respect of which there has been a

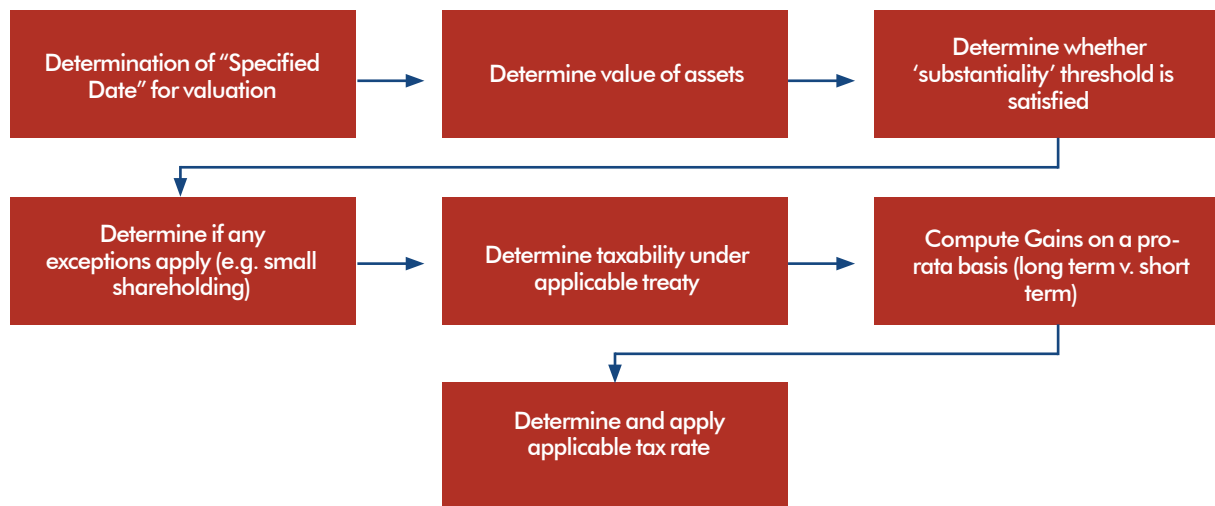
5. Section 9(1)(i) read with Explanation 4 and 5 of the Income Tax Act, 1961

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 Circular⁶ 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.

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



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 taxpayer 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.

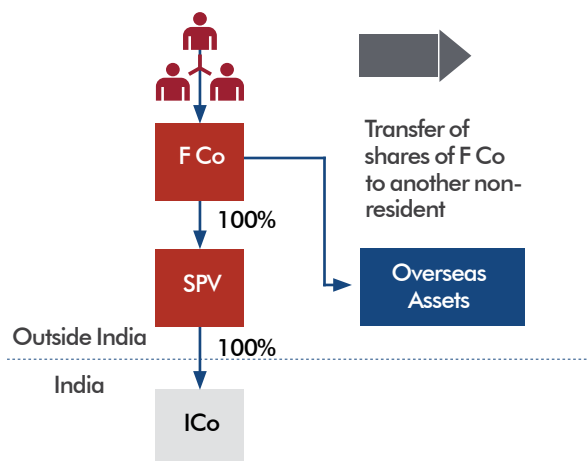
⁶ Circular 4/2015 dated 26 March 2015

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 tax 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.

5. 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 as 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 foreign company (F Co) holds shares of an Indian company (I Co) through a wholly owned special purpose vehicle (SPV). F Co also owns certain other overseas assets. The shareholders of F Co propose to transfer shares of F Co to another non-resident on 1 June 2016. To determine whether any tax liability is triggered

in India pursuant to the aforesaid transfer, it will need to be ascertained whether the shares of F Co derive at least 50 per cent value from India assets as on the 31 March 2016⁷. While making this ascertainment, the following dilemmas could arise:

Assets located in India – value of Indian company shares or its underlying assets?

An interesting question arises while determining the value of assets located in India, i.e. should one consider the value of the underlying assets owned by I Co which are located in India, or, the value of the shares of I Co itself.

The process of identifying and separately valuing the underlying assets owned by I Co could be a complex and time-consuming exercise and could pose practical challenges to the taxpayer and the tax authorities alike. Accordingly, one could consider value of the shares of I Co being representative of value of assets located in India. Similar question could arise while determining the value of assets owned by F Co.

Ignoring the liabilities while ascertaining the value of assets located in India – which one?

Further, the law also provides that while ascertaining the value of assets the value of liabilities should be ignored. In the given case study, while determining the value, one may wonder which liabilities should be ignored. Four propositions maybe put forward in this regard:

- i. The liabilities incurred by the shareholder who transfers shares of F Co need to be ignored, or
- ii. The liabilities which are incurred by I Co alone need to be ignored; no other liabilities may be ignored, or
- iii. The liabilities incurred by F Co alone need to be ignored, or
- iv. The liabilities which are incurred by all the entities in the entire chain i.e. F Co, SPV and I Co need to be ignored.

The position on this is not clear, and one hopes that the detailed valuation guidelines when released will address this ambiguity.

7. The specified date as provided under Indian tax law will be 31 March 2016 if the accounting period of F Co ends on March 31st every year. Where the book value of assets as on 1 June 2016 exceeds the book value as on 31 March 2016 by more than 15 per cent, then 1 June 2016 will be regarded as the 'specified date' and the value ascertainment will need to be as on that date.

Mismatch in commercial valuation versus fair valuation stated in law on account of ignoring liabilities

The impact of ignoring liabilities could result in mismatch against the commercial intent of the parties while determining whether F Co derives substantial value from assets located in India. This can be understood through the example below:

Example 1						<i>(Amount in INR mn)</i>
Liabilities	India	Overseas	Assets	India	Overseas	
Capital	700	300	Fixed and Current Assets	700	1300	
Liabilities	Nil	1000				
Total	700	1300		700	1300	

Value derived	Net worth approach (commercially agreed)	Gross asset approach (as per law)
From assets located in India	70% (i.e. 700/1000)	35% (i.e. 700/2000)
From overseas assets	30% (i.e. 300/1000)	65% (i.e. 1300/2000)
Tax triggered in India	Yes (hypothetically)	No

Under example 1, there would be no tax trigger in India, even though commercially F Co derives substantial value (i.e. more than 50%) from assets located in India.

Example 2						<i>(Amount in INR mn)</i>
Liabilities	India	Overseas	Assets	India	Overseas	
Capital	300	700	Fixed and Current Assets	1300	700	
Liabilities	1000	Nil				
Total	1300	700		1300	700	

Value derived	Net worth approach (commercially agreed)	Gross asset approach (as per law)
From assets located in India	30% (i.e. 300/1000)	65% (i.e. 1300/2000)
From overseas assets	70% (i.e. 700/1000)	35% (i.e. 700/2000)
Tax triggered in India	No (hypothetically)	Yes

Under example 2, there could be a tax trigger in India, even though commercially F Co does not derive substantial value from assets located in India.

Valuation methodology to be adopted

The Rules prescribing valuation methodology to be adopted are yet pending. In absence thereof, the taxpayers remain clueless as to the method to be followed. In this regard, while fair valuing the assets of Indian company the following methods may indicatively be adopted:

- In case of listed Indian company – closing market price of such shares as on the specified date
- In case of unlisted Indian company – any internationally accepted manner of determining fair value such as discounted cash flow method

These valuations could be undertaken/certified by a chartered accountant or a Merchant Banker.

Similarly, while valuing the assets of the foreign company, a literal reading of the law suggests that the fair value of all assets owned by the foreign company would have to be undertaken. However, given that most foreign companies are likely to own a large number of diverse assets, a valuation exercise that requires all assets to be identified and individually valued could prove to be highly impractical. Thus one may arguably adopt the price at which the shares of foreign company are transferred (i.e. the transaction value) as the fair value of assets of the foreign company. Alternatively, in the case of listed foreign companies, the market capitalization could be considered as the value of the foreign company. This approach is likely to provide a non-contentious and objective basis of valuation.

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, considering that currently the laws only provide for a charge of tax on indirect transfer transactions and does not deal with practical aspects such as how to determine whether shares derive 'substantial' value from assets in India, it may be difficult for a buyer to determine the quantum of tax to be withheld. This problem becomes more acute in respect of transactions undertaken on a stock exchange since the identity, cost of acquisition, country of residence etc. of the other party would not normally be known to the buyer.

In such situation, a buyer maybe forced to follow a conservative approach and deduct tax on gross sale consideration at the highest applicable tax rate. The seller 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 alternate, the buyer may insist the seller on providing an indemnity or keeping the tax liability amount in escrow, or insist that the seller 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.

6. Conclusion

Indirect transfers, as a concept, is here to stay, and in fact gaining in popularity around the world. As taxpayers and tax officials alike grapple with the various nuances and complexities surrounding its practical application, a few big picture comments warrant attention.

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 are being 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 transfer of shares of a foreign company which derives its value substantially from assets located in India is deemed to be taxable in India.

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.).

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.⁸ However, 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 or the rationale of corporate actions like buy-back or demerger. The General Anti-Avoidance Rules (GAAR) which is stated to come into effect on 1 April 2017 could also lead to denial of treaty benefits in light of a transaction being treated by the tax authorities as impermissible avoidance arrangements, i.e. those that are established only to claim treaty benefits, without any substance/ commercial rationale.

In the case of restructuring transactions (typically mergers and spin-offs) requiring court approval 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.⁹ While such transactions are usually approved by Courts, notwithstanding these objections, 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 audits.

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 Income Tax Act 1961 (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 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 implications. This can be done in the following ways:

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, appropriate tax will have to be deducted and paid to 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).

8. Form No. 10F

9. M&A transactions in India require the Regional Director under the Ministry of Corporate Affairs to seek inputs/ comments from the ITA in all cases of arrangement/ compromise or reconstruction/ amalgamation requiring court approval. In the case that no response is received from the tax authorities within 15 days of notice, it is to be presumed that there are no objections to the scheme.

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 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,¹⁰ 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), 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 (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) the price 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 Central Board of Direct Taxes (CBDT),¹¹ issued an internal instruction to the tax authorities requiring them to either issue or reject (citing reasons for rejection) a withholding tax certificate within 1 month from the date of application.

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 obtaining a ruling could take more than a year. This makes the AAR route presently unsuited for transaction related rulings, where time will be of the essence.

Obtaining a certificate under section 162 (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. His liability 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 on the sale.

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 certificate¹².

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

11. The highest administrative body for direct taxes in India

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

Such a certificate thus offers considerable certainty to the buyer as to his potential liability in India 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 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.

No objection certificate under Section 281

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

- such a transfer of assets is made for adequate consideration 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 shares, exploring the possibility of obtaining the permission of the tax authorities by way of a No Objection Certificate (NOC) under section 281 becomes critical.

The CBDT has issued a Circular¹³ providing guidelines in respect of application and issuance of an NOC under section 281 of the ITL. 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 ITA 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 10 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.



13. 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 characterised as 'dividends' eligible for a participation exemption in the country of the debenture holder. Similarly, transactions involving disparate characterisation 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 Controlled Foreign Corporation (CFC) rules in India. This could impact the deal pricing. Companies that are highly leveraged could be hit by the tightening of thin capitalisation rules (disallowance of excessive interest expense as a tax deductible item) and earning-stripping rules based on Action 4. Currently, India does not have thin capitalisation rules, though there are some conditions that impact interest deduction.

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 favourable 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.

Last but not the least is the matter of transfer pricing. 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 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.

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 Budget, India has opted to introduce only two provisions based on the BEPS recommendations (i.e. the Country-by-Country Reporting and an Equalisation levy on digital ad spends). However, 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. The multilateral instrument, which will cover important changes to tax treaties including a robust limitation on benefits article as well as a wider definition of permanent establishments is also expected to open for signatures in December 2016. 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.



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. The central government levies taxes/duties such as customs duty, excise duty, service tax and central sales tax, and the state governments levy taxes such as value added tax (VAT), entry tax, octroi, etc.

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. 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 business undertaking. 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 indirect taxes, being a transaction-based tax. The treatment and disclosure requirements could differ under various pieces of legislation. The implications under multiple indirect tax laws of various ways of undertaking the merger/acquisition of a business undertaking are discussed below.

Implications under VAT laws

Sale of business/ business undertaking

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. Such transactions could be regarded as the sale of a running business and not the sale of assets and liabilities, hence, they are not subjected to VAT. Nevertheless, the respective state VAT provisions should be examined so as to meet the procedural compliance/disclosure requirements.

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 the sale of goods and are liable to state VAT at the applicable rate. While the rate of VAT applicable on goods differs from state to state, generally, goods attract a rate of

4-5 percent/12.5 to 15 percent on their identified values.

Based on respective state VAT provisions, the VAT 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 VAT implications given that the definition of 'goods' excludes stocks, shares etc. from its ambit. Hence, a sale of shares transaction is not treated as a sale of goods, which would be subject to VAT.

Merger/demerger/amalgamation of companies

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

Implications under service tax laws

Service tax becomes applicable if any activity is undertaken for a consideration for another person. The fundamental question therefore arises as to whether the sale of a business undertaking could be regarded as the provision of services.

It is worth noting 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 service tax. This seems to suggest that the authorities want to treat such transactions as the provision of services, although they are currently exempted from service tax.

Due to the exemption, no service tax liability arises per se for such transactions, however, if the transaction is considered as an exempt service, this may invite reversal of CENVAT credit under Rule 6 of the CENVAT Credit Rules, 2004 ('CCR').

It is also pertinent to note that the CCR have recently been subject to a proposal for amendment to seek the reversal of CENVAT credit even for transactions that are not considered as the provision of services.

Thus, irrespective of whether the sale of business transaction is considered as the provision of services or not, there could be consequences under the CCR.

Impact on unutilized credits

The CCR provide for the transfer of unutilized credits (excise and service tax) to the transferee in the case of transfer of the whole business on a going-concern basis. In the case of partial transfers, the unutilized credits can be transferred provided the specified conditions are met. Hence, in such cases, due precautions must be taken to ensure the seamless movement of unutilized credits.

The provisions with respect to the transfer of unutilized credits under the state VAT credit system have to be examined on case-by-case basis. In the majority of states, the unutilized credits can be transferred where the complete business is transferred. For a partial transfer, one may have to evaluate the possibility of claiming the transfer of unutilized credits, having due regard to the statutory provisions.

Implications under Foreign Trade Policy

Businesses may hold various licenses under the Advance Authorisation 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 business undertaking 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 business undertaking 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

Mergers and demergers of companies can be done only with the approval of the court. The date of the court order is typically subsequent to the date from which the merger, demerger etc. is effective.

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

The purchase and sale of goods and provision of services during the intervening period may be deleted, as being provided to the business by itself, or may even be added to the turnover, in case of demerger.

For example, if an inter-state sale at a concessional rate is deleted, then the selling company (as existed prior to the merger) would neither be required to obtain nor would the purchasing company be required to issue the statutory forms required for a sale at a concessional rate.

The companies would have to obtain 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 to not only to make such transfers neutral from an indirect tax perspective but also to ensure that the procedural compliance, approvals and transfer requirements under the applicable indirect tax rules are being met.

Implications under Goods and Service Tax

India is on the cusp of introducing Goods and Service Tax (GST), a destination-based consumption tax, replacing several central and state levies. With the consolidation of legislation under the proposed GST regime, it is likely that most of the current statutory provisions, for example the treatment of unutilized credits, intervening period transactions, etc. are likely to continue under the proposed GST laws.

The common framework provided by the GST laws could also help in ironing out the diverse treatments prescribed under the plethora of indirect tax rules and streamlining multiple provisions.

About Dhruva

Dhruva is a boutique tax and regulatory services organisation, 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:

- Strategic approach to complex problems
- In-depth, specialised and robust advice
- Strong track record of designing and implementing pioneering solutions
- Trailblazers in tax controversy management
- Close relationships with the government coupled with a long history of involvement in policy reform
- Technical depth and quality

Our team comprises of nine Partners and over 200 professionals located in Mumbai, Ahmedabad, Bengaluru and Delhi.

Dhruva Advisors is a member of the WTS Alliance, a global network of selected firms represented in more than 100 countries worldwide.

Our recognition

- DHRUVA ADVISORS HAS BEEN RECOGNISED AS A TIER 1 FIRM IN THE INTERNATIONAL TAX REVIEW, WORLD TAX GUIDE 2016 TO THE WORLD'S LEADING TAX FIRMS, IN THE FIRST YEAR OF ITS EXISTENCE
- DHRUVA ADVISORS HAS ALSO BEEN RECOGNISED AS A TIER 2 FIRM IN INTERNATIONAL TAX REVIEW, WORLD TRANSFER PRICING 2016 TO THE WORLD'S LEADING TRANSFER PRICING FIRMS

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