



M&A IN INDIA

TAX AND REGULATORY PERSPECTIVE





FROM OUR CEO

The last couple of years have witnessed very strong activity, both on the M&A front as also on internal restructuring. The size of the transactions has increased considerably and the cross-border interest in India is at an all-time high.

Among the notable transactions was the merger of HDFC with HDFC Bank which resulted in HDFC Bank emerging as one of the largest banks in the world. Similarly, the merger of PVR and INOX Leisure created a domestic exhibition giant. The acquisition of ACC and Ambuja Cements by Adani Enterprises was yet another large transaction, marking the entry of the infrastructure group into cement manufacturing. The acquisition of Viatris Inc by Biocon Biologics, and the merger of L&T Infotech and Mindtree were other notable transactions.

As with most countries, the tax and regulatory framework is critical to M&A transactions in India. The regulatory framework for M&A activities has undergone a significant change in the recent past. We have seen changes in the regulations for making overseas investments in India where "Round Tripping" is now permitted. Some of the tax barriers to investing in start-ups have now been eased. A new framework dealing with the International Financial Service Centre (GIFT City) has been introduced.

With India emerging as a credible alternative to China, inbound transactions are expected to increase. Large value M&A transactions invite increasing scrutiny by the tax authorities and the importance of planning to avoid potential tax litigation cannot be over emphasized. The ghosts of the amendments made to overcome the Vodafone litigation continue to haunt us. Similarly, the deeming provisions taxing transactions entered into at less than fair value raise practical challenges.

In the attached publication, we have set out some of the key issues that need to be factored in implementing M&A transactions. These emanate from our practical experience working on some of the most complex transactions. We do hope that you find the insights meaningful and relevant.

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Taxes applicable to corporates in India – At a glance

Corporate tax rates

A quick snapshot of the prevalent corporate tax rates is summarized below:

Applicability	Tax Rate* (%)	Whether Minimum Alternate Tax applicable?
Existing domestic companies with turnover/gross receipts less than INR 400 crores in FY 2020-21	29.12	Yes
Domestic manufacturing companies set up on or after March 1, 2016 and not claiming specified incentives		
Existing domestic companies with turnover exceeding INR 400 crores in FY 2020-21	34.94	Yes
Domestic companies not claiming specified incentives [Note]	25.17	No
New manufacturing companies (set up and registered on or after October 1, 2019) [Note]	17.16	No
Limited Liability Partnerships	34.94	Yes. Alternate Minimum Tax applicable
Foreign company	43.68	NA

*These tax rates have been computed after considering the highest rate of surcharge and cess

Note:

- Existing domestic companies can opt for concessional tax rate of 22%¹. Companies opting for this rate shall not be entitled to claim specified tax deductions or incentives such as additional depreciation, tax holidays and weighted deduction. Companies opting to migrate to this regime are not entitled to carry forward unutilized MAT credit.
- Domestic manufacturing companies set up and registered on or after October 1, 2019 and commencing manufacturing on or before March 31, 2024 can opt for the beneficial tax rate of 15%². As with the concessional tax regime of 22%, such new manufacturing companies would not be able to avail tax deductions or incentives. In addition to this, there are certain anti-abuse conditions prescribed for being eligible to opt for this concessional tax regime of 15%. For instance, the company should not be formed by splitting-up or reconstruction of a business already in

existence. It cannot engage in any business other than manufacturing or distribution of any article or thing and related research. Further, it should not use following assets:

- Any plant or machinery previously used in India, in value exceeding 20% of total value of plant or machinery;
- Any building previously used as a hotel or convention centre.

While availing the concessional tax regime of 15%, domestic transfer-pricing regulations shall apply to such domestic companies.

A company opting to avail the beneficial rate under either of the concessional tax regime, as stated above, is required to exercise the said option on or before the due date of filing its return of income. It is pertinent to note that the option once exercised cannot be subsequently withdrawn.

¹This rate will be increased by 10% surcharge and 4% cess, leading to an effective rate of 25.17%.

²This rate will be increased by 10% surcharge and 4% cess, leading to an effective rate of 17.16%

Minimum Alternate Tax (MAT)

The Indian Income-tax Act, 1961 ('the Income-tax Act') requires that in cases where the tax payable according to regular tax provisions is less than 15% of their book profits, companies (other than companies which have opted the concessional tax regime of 22% and 15%) are required to pay 15%³ of their book profits as MAT. The book profits for this purpose are computed by making prescribed adjustments to the net profit disclosed by the company in its financial statements.

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

Provisions of MAT are not applicable to a foreign company if:

- it is a resident of a country with which India has a treaty and it 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.

³This rate will be increased by 12% surcharge and 4% cess, leading to an effective tax rate of 17.47%

M&A landscape in India

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

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

- I. Share Acquisition
- II. Primary Infusion
- III. Asset acquisition
 - Acquisition of the entire business
 - Acquisition of individual assets
- IV. Merger
- V. Demerger

I. Share acquisition

In a share acquisition, the buyer purchases the equity interest in the target entity from the sellers or owners of the business and becomes the equity owner of the target entity. Share acquisition is one of the most common modes of M&A that takes place in India. The consideration for a share acquisition is typically in the form of cash. However, in more recent times, stock swap deals have also been structured, particularly in transactions where the selling promoters intend to remain part of the business and share the risks and returns of growth.

From a seller's perspective, a share sale deal has the following key implications:

A. Tax on transfer

Listed shares

Any sale of listed equity shares which are held for a period exceeding 12 months shall be subject to capital gains tax of 10%⁴ in respect of any gains exceeding INR 1 lakh. The cost of acquisition of such shares (if acquired before February 1, 2018) is available as a deduction against sale consideration which shall be the higher of (a) Actual Cost or (b) Computed Cost [Computed Cost = lower of (a) highest price of shares on the stock exchange as on January 31, 2018 or (b) consideration received on sale of such shares]. Also, the indexation benefit and the benefit of

computation of capital gains in foreign currency, in case of non-residents, is not available for sale of listed shares.

However, the option to avail the highest price of shares on the stock exchange as on January 31, 2018 is not available for shares acquired on or after October 1, 2004 on which STT has not been paid. However, the Central Board of Direct Taxes ('CBDT')⁵ has provided certain exemptions from the applicability of such condition, which includes acquisition of shares through National Company Law Tribunal (NCLT), gift, etc.

Furthermore, in order to reduce litigation and to maintain consistency in the approach of treatment of income derived from the sale of listed shares and securities, the CBDT⁶ has laid down guidelines for determining whether the gains generated from the sale of listed shares and securities would be treated as capital gains or business income. As per the guidelines, the taxpayer can treat the gains on sale of listed shares and securities held for period exceeding 12 months as capital gains, unless the taxpayer chooses to treat the gains as business income. However, the stand once taken by the taxpayer shall be applicable in subsequent years as well and the taxpayer shall not be allowed to adopt a contrary stand in subsequent years.

In an event where the listed shares have been held for a period not exceeding 12 months and STT has been paid on the sale, gains on such sale will attract capital gains tax at the rate of 15%⁷. The CBDT⁸ has laid down various factors (such as frequency, recording in the books, profit motive etc.) to determine whether the gains generated from the sale of listed shares and securities would be treated as capital gains or business income.

Unlisted shares

Long-term capital gains arising on sale of unlisted shares held for more than 24 months are taxed at the rate of 20%⁹. During the computation of long-term capital gains, indexing the cost of acquisition is allowed to factor in the inflation effect. Additionally, fair market value of shares as on April 1, 2001 is available for shares acquired prior to April 1, 2001. In the event that the seller is a non-resident, the applicable tax rate on long-term capital gains is 10%.¹⁰ However, for non-residents, no benefit of indexation or exchange-rate fluctuations is allowed while computing such long term capital gains tax. The CBDT in a follow up letter¹¹ has clarified that income arising from transfer of unlisted shares would be considered

4. This rate will be increased by applicable surcharge and 4% cess

5. Notification no. 60 of 2018 dated October 1, 2018

6. Circular No. 6/2016 dated May 2, 2016

7. This rate will be increased by applicable surcharge and 4% cess

8. Circular No. 4/2007 dated June 15, 2007

9. This rate will be increased by applicable surcharge and 4% cess

10. This rate will be increased by applicable surcharge and 4% cess

11. F.No.225/12/2016/ITA.II dated May 2, 2016

under the heading of Capital Gain, irrespective of the period of holding. However, the CBDT has carved out certain exceptions to the above principle.

In the event that shares have been held for a period not exceeding 24 months, any gains on the sale are taxed as normal income at the applicable rate of tax. For example, such capital gains in the event of domestic companies will be chargeable at the applicable rates of tax i.e. @ 22%/ 25%/ 30%¹² for residents and 40%¹³ for foreign companies.

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.

Indirect transfers

The concept of indirect transfer seeks to cover transactions involving transfer of shares of a foreign company, if such shares derive substantial value from assets located in India. The share or interest in the foreign company is deemed to derive its substantial value from assets located in India, if both the following conditions are satisfied:

- The value of such assets exceeds the amount of ten crore rupees; and
- Such assets represent at least 50% of the value of all the assets owned by the company

Where both the above conditions are satisfied, the deeming provisions apply only to the income that is reasonably attributable to the assets located in India, in the manner prescribed under the Income-tax Act read with relevant rules. Certain exceptions have been provided under law, primarily to exclude transactions where the shareholder does not have a significant stake or control in the foreign entity.

Treaty benefits may be availed on indirect transfers, wherever applicable.

B. Tax withholding/ collection

The applicability of provisions of tax withholding or collection on the share transfer is primarily dependent on the residential status of the buyer and seller. A quick snapshot of the provisions of tax withholding and collection is summarized below:

Buyer	Seller	Type of shares/ securities	Tax withholding by Buyer (TDS)	Tax collection by Seller (TCS)
Resident or a non-resident (having PE in India)	Resident	Unlisted shares/ listed shares (transaction other than on recognized stock exchange)	Required @0.1% of consideration exceeding INR 50 lakhs where turnover/ gross receipts of Buyer from business exceeds INR 50 lakhs in FY preceeding the transaction	In case TDS is not applicable, TCS required @0.1% of the consideration exceeding INR 50 lakhs where the turnover/ gross receipts of the Seller from business exceeds INR 50 lakhs in the FY preceeding the transaction
		Listed shares (transaction on recognized stock exchange)	Not required	Not required
Non resident (having no PE in India)	Resident	Any security	Not required	In case TDS is not applicable, TCS required @0.1% of the consideration exceeding INR 50 lakhs where the turnover/ gross receipts of the Seller from business exceeds INR 50 lakhs in the FY preceeding the transaction
Resident/ Non-resident	Non-resident	Any security	Required (Refer note 1)	

Note 1 – Where the seller is a non-resident, buyers insist on withholding of tax at the full rate, even if the seller is a resident of a favourable treaty country, such as the Netherlands, unless the seller furnishes a certificate from the income-tax department certifying a nil or a lower rate for withholding tax on the transfer. Sometimes buyers also agree to withhold lower or nil taxes, subject to contractual indemnities and insurance under the share purchase agreement or obtaining a favourable ruling from the Board of Advance Ruling.

12. This rate will be increased by applicable surcharge and 4% cess

13. This rate will be increased by applicable surcharge and 4% cess

C. Pricing

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

However, the Income-tax Act provide that where consideration for the transfer of shares of a company (other than quoted shares) is less than the fair market value ('FMV') of such shares, the FMV shall be deemed to be the full value of consideration in the hands of the transferor for computing tax on capital gains. The FMV for this purpose will be computed as per the formula prescribed under the Income-tax Rules, 1962 ('Income-tax Rules') which essentially seeks to arrive at the FMV based on intrinsic value method, adjusted for stamp duty value or intrinsic value or market value for certain classes of assets, such as immovable properties, jewellery, shares and securities. Similarly, for the transferee, the deficit between the FMV and the actual consideration is deemed as 'income from other sources', and taxed at the applicable tax rates.

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

If one or both of the parties is a non-resident associated enterprise, transfer-pricing rules under the Income-tax Act are also applicable and the arm's length test needs to be satisfied. The Income-tax Act prescribes the rules for determination of an associated enterprise relationship, which triggers the applicability of transfer pricing disclosures and compliances.

D. No objection certificate from the tax authorities

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

E. Goods and Service Tax (GST)

There is no GST implication on the sale of shares

(Refer to our article on 'Indirect tax laws impacting M&A deals in India' for more details).

From a buyer's perspective, a share sale deal has the following key implications:

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 which the public is substantially interested, or not. The Income-tax Act lays down certain conditions for the company to be classified as a company in which the public is substantially interested. In summary, a listed company, any subsidiary of the listed company and any 100% step-down subsidiary of the listed company, all qualify as companies in which the public is substantially interested, subject to compliance with certain conditions. The Income-tax Act provide that in respect of a company in which the public is not substantially interested, 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 this loss shall lapse and no set-off of the loss shall be allowed in the year in which the change in shareholding takes place. There are certain exceptions to this rule, one of them being the change in the shareholding of the Indian company pursuant to an amalgamation or demerger of its foreign holding company, subject to the condition that at least 51% of the shareholders of the amalgamating or demerged foreign company continue to be the shareholders of the amalgamated or the resulting foreign company. Furthermore, where shareholding of companies that are under insolvency proceedings changes beyond 51% pursuant to a resolution plan approved under the Insolvency and Bankruptcy Code, losses will be available for carry forward and set off, after affording a reasonable opportunity of being heard to the jurisdictional Principal Commissioner or Commissioner.

Also, the provisions for lapse of tax losses apply only to business losses and capital losses. These provisions do not affect the continuity of unabsorbed depreciation (UAD).

In respect of companies that are recognized as start-ups, the losses shall be carried forward and set off even where the shareholding changes beyond 51%, provided that all shareholders of the company who held shares carrying voting power on the last day of the year in which the loss was incurred continue to hold those shares on the last day of such previous year, and such loss has been incurred during the period of ten years

beginning from the year in which such company is incorporated.

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. Any premium paid by the buyer for acquisition of the shares is not incorporated into the value of the block of assets or other 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 future transfer of such shares by the buyer.

C. Stamp duty

Share transfer, whether held in physical or dematerialized form, attracts stamp duty cost at the rate of 0.015% of the consideration discharged by the buyer for acquisition of the shares. The responsibility to pay stamp duty, though commercially negotiated, usually lies with the buyer.

II. Primary Infusion

In a primary infusion, the acquirer infuses funds in the target company in lieu of issue of equity shares or other securities and becomes the equity owner or holder of securities of the target entity. Usually, as part of deals, in addition to share acquisition, the acquirer may also be required to infuse fresh funds in the target entity, if funds are required for the target company's growth or to retire certain debts. The infusion of funds can be carried out through the issue of equity, debt or hybrid instruments by the target company. The most common way of infusing funds in the target company is by issue of equity shares / convertible preference shares.

The key implications for issue of equity shares are as follows:

A. Tax on Issue of shares

Unlike share transfer, there is no capital gains tax on issue of shares. However, section 56(2)(viiB) of the Income-tax Act provides for taxation of premium charged on issue of shares by a closely held company, which is in excess of its FMV (Angel Tax), in the hands of such company. The scope of the said provisions was earlier restricted to shares issued to residents; however the Finance Act, 2023, has expanded the scope of these provisions to also cover shares issued to non-residents by closely held companies. The CBDT has issued

notifications providing relief to recognized start-ups¹⁴, as well as to certain non-residents, such as, foreign government and government related organisations, banks, insurance sector entities, foreign portfolio investors, endowment funds, pension funds which are residents of 21 specified countries¹⁵. These countries inter-alia include US, UK, Australia, Germany, Japan, Russia; however, countries like Singapore, Mauritius and the Netherlands are not part of the list.

The Income-tax Rules provide for two methodologies for determining the FMV i.e. the Intrinsic Value Method or Discounted Cash Flow Method. The closely held company can decide to determine its FMV based on any of these methods. For non-residents, CBDT has notified additional valuation methodologies i.e. Comparable Company Multiple method, Probability Weighted Expected Return method, Option Pricing method, Milestone Analysis method or Replacement Cost method¹⁶. Also, valuation at which investment is made by notified entities is deemed as FMV of the shares. If any investor invests at such FMV within a period 90 days and within a safe harbour of 10% variation from FMV, then such investments shall also not be subject to tax under section 56(2)(viiB) of the Income-tax Act.

On the flip side, if the shares of a company (listed or unlisted) are issued at a discount to the FMV, then the difference between the FMV and the consideration may be taxed in the hands of the recipient as 'Income from other sources'. The FMV for this purpose is required to be computed in accordance with the formula prescribed in the Income-tax Rules which is based on intrinsic value method, adjusted for stamp duty value or intrinsic value or market value for certain classes of assets, such as immovable properties, jewellery, shares and securities. Jurisprudence is still evolving on this subject, especially in case of rights issuances.

B. Tax Withholding

There is no requirement for withholding of tax on issue of shares or securities. However, in case a benefit is passed on to the investor, being a resident, pursuant to issue of shares, then, withholding at 10% under section 194R of the Income-tax Act will need to be evaluated.

C. Impact on Tax Losses

In the event there is change in 51% or more voting power on issue of shares, tax losses shall lapse, as discussed above in section on share acquisition.

14. Notification No. 30/2023/F. No. 370142/9/2023-TPL (Part-I) dated May 24, 2023
15. Notification No. 29/2023/F. No. 370142/9/2023-TPL (Part-I) dated May 24, 2023

16. Notification No. 81/2023/F. No. 370142/9/2023-TPL (Part-I) dated September 25, 2023

D. Stamp Duty and other costs

Issue of shares and debentures, whether in physical or dematerialized form, attracts stamp duty cost at the rate of 0.005% of the value of shares issued i.e., face value plus premium. The responsibility to pay stamp duty, though commercially negotiated, usually lies with the subscriber of the shares.

Further, issue of equity shares either on a preferential or rights-issue basis, may require the company to increase its authorized share capital. For increasing the authorized share capital, the company needs to make payment of fees along with stamp duty to Registrar of Companies (RoC). RoC fees is subject to a maximum cap of INR 2.5 Crores.

E. GST

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

III. Asset acquisition

An asset acquisition can broadly be of two kinds:

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

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

Acquisition of the entire business

The Income-tax Act typically recognizes a slump sale as a business acquisition. A slump sale is defined in Income-tax Act as "the transfer of one or more undertaking by any means for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales".

From a seller's perspective, a slump sale has the following key implications:

A. Tax on transfer

In a slump sale, the seller is liable to pay tax on gains derived on the transfer of the undertaking at the rates based on the time for which the business undertaking has been held. If the undertaking has been held for a period of more than 36 months, the applicable rate of tax is 20%¹⁷. 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 a slump sale are computed as the difference between the sale consideration and net-worth computed using a prescribed mechanism.

Sale consideration

The mechanism provides that the sale consideration for a slump sale is the higher of the FMV of the assets transferred pursuant to the slump sale (FMV 1) and FMV of the consideration received for the slump sale (FMV 2). The FMV 1 and FMV 2 are computed on the date of slump sale basis the prescribed formula.

The FMV 1 is essentially computed on the basis of intrinsic value of a company, adjusted for stamp duty value or intrinsic value or market value for certain classes of assets, such as immovable properties, jewellery, artistic work, shares and securities.

The FMV 2 is the amount of consideration discharged in case of monetary consideration. Where the consideration is discharged in kind (shares, immovable property etc.), the FMV of such assets is considered which is essentially the intrinsic value of the shares or securities or stamp duty value for immovable property, or the open market value in case of assets other than shares, securities or immovable property.

Net-worth

The net worth of the business undertaking transferred is based on the tax written down value of depreciable assets and book value of other assets and liabilities, forming part of the undertaking. The amount of self-generated goodwill is taken as nil to compute the net-worth of business undertaking. The net worth computed in this way forms the cost base in the hands of the transferor for computation of gains on sale. In cases where the net worth of the business sold is negative, since the value of the liabilities is higher than the value of the assets, in such cases, the question of whether the gains should be computed taking into account the negative net worth has been a matter of controversy and litigation. While there are judgments both for and against the argument, the seller is advised to budget a tax pay-out based on the negative net worth, i.e., the negative net worth is added to the consideration for computation of capital gains.

¹⁷. This rate will be increased by applicable surcharge and 4% cess

B. Tax withholding

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

C. GST

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

D. No objection certificate from the tax authorities

Similar to a share transfer, any transfer of any asset being land, building, machinery, plant, shares, securities or fixed deposits by a taxpayer during the pendency of any proceedings under the Income-tax Act shall be void as against any claim in respect of any tax or any other sum payable by the taxpayer as a result of the completion of the said proceeding, unless the taxpayer obtains a no objection certificate from the income tax authorities for the transfer.

E. Corporate laws

Under the provisions of the Indian corporate law i.e. Companies Act, 2013, in case the business transfer qualifies as an undertaking, the seller needs to obtain an approval from at least 75% of its shareholders for effecting such business transfer. An undertaking is defined to mean where the investment in the business forms at least 20% of the net worth of the company or generates at least 20% of total income of the company.

From a buyer's perspective, a slump sale has the following key implications:

A. Impact on tax losses

In a slump sale, the tax losses and MAT credit are not transferred to the transferee entity. These continue to be available to the transferor entity.

B. Step-up of cost base

In a slump sale, the transferee is allowed to allocate the lump sum consideration to the individual assets (including intangibles) and liabilities acquired based on their fair value. Depreciation on the fixed assets, tangible and intangible (excluding Goodwill) is available based on the values allocated to them on the slump sale from the year subsequent to the year of slump sale.

C. Stamp duty

Stamp duty is applicable based on the Indian state in which the transferred assets are located. Every state in India has different rules for the applicability of stamp duty. While some states levy stamp duty only on the conveyance of immovable property,

many states also have provisions for the levy of stamp duty on conveyance of movable assets. Typically, stamp duty levy is borne by the buyer.

Acquisition of individual assets

Where individual assets are acquired that do not constitute a business activity, acquisition of those assets is treated differently under the Income-tax Act.

From a seller's perspective, an asset sale has the following key implications:

A. Tax on transfer

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

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

For non-depreciable assets other than land, the gains are computed simply as the difference between sale consideration and book value of the asset transferred, and the gains so derived are taxed as business income at the normal applicable rates of tax. It is pertinent to note that on sale of any goodwill, gains are computed as non-depreciable asset, as per amendment in the Finance Act, 2021.

If land is transferred which 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, which are taxed as capital gains at rates depending on the period of holding¹⁸. Furthermore, where the sale consideration for transfer of land and building is less than its stamp duty reckoner value, then the Income-tax Act provides for deeming the stamp duty reckoner value as the sale consideration for computing the capital gains tax liability. Additionally, fair market value of land as on April 1, 2001 is available for land acquired prior to April 1, 2001.

B. Tax withholding

Sale by residents

If land or building (except agricultural land) is transferred by a resident seller for a consideration exceeding INR 50 lakhs, the buyer is liable to

18. If the capital asset is held for not more than 24 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 24 months, profits are taxed as long-term capital gains at the rate of 20% (this will be increased by applicable surcharge and 4% cess)

withhold taxes @1% on the amount higher of consideration or stamp duty value of such immovable property.

For sale of other assets by the resident seller, the buyer is liable to withhold taxes @0.1% of the consideration exceeding INR 50 lakhs. However, such withholding is not applicable if the turnover or gross receipts from the business of the buyer do not exceed INR 10 crores during the preceding financial year. Also, the provisions of such withholding are not applicable where the buyer is non-resident which does not have a permanent establishment in India.

Sale by non-residents

For itemized sale of Indian assets by a non-resident seller, the buyer is liable to withhold tax at full rate, subject to the provisions of applicable tax treaty.

C. Tax collection

Where the provisions of tax withholding are not applicable, the seller is liable to collect tax @0.1% on the consideration exceeding INR 50 lakhs. However, such tax collection is not applicable if the turnover or gross receipts from business of the seller does not exceed INR 10 crores during the last financial year.

D. No objection certificate from the tax authorities

Similar to share transfer, a transfer of any assets being land, building, machinery, plant, shares, securities or fixed deposits by a taxpayer during the pendency of any proceedings under the Income-tax Act shall be void as against any claim in respect of any tax or any other sum payable by the taxpayer as a result of the completion of the said proceeding, unless the taxpayer obtains a no objection certificate from the income tax authorities for the transfer.

E. GST

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

From a buyer's perspective, an asset sale has the following key implications:

A. Impact on tax losses

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

C. Stamp duty

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

IV. Merger

In a merger, two or more companies consolidate to form a single entity. The consolidation is undertaken through a NCLT¹⁹ approved process wherein all the assets and liabilities of the transferor entity, along with all employees, get transferred to the transferee entity, and the transferor entity is automatically dissolved by virtue of the merger. As a consideration for the merger, the transferee entity issues its shares or gives cash to the shareholders of the transferor entity.

A. Implications under Indian tax laws

Definition under tax laws

Under the Income-tax Act, a merger (referred to as an 'amalgamation') is defined as such if it fulfils the following conditions:

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

In the event 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.

Tax implications in the hands of the transferor entity

The Income-tax Act specifically provides that an 'amalgamation', fulfilling the above-mentioned conditions provided under the Income-tax Act, is not to be regarded as a transfer by the transferor entity if the transferee entity is an Indian company.

In the event of amalgamation of one foreign entity with another foreign entity, wherein capital assets

19. Alternatively, certain qualified companies may also undertake consolidation through Fast Track route pursuant to section 233 of the Companies Act, 2013.

(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 transferee foreign entity; and
- The transfer is not chargeable to capital gains tax in the country in which the transferor foreign company is incorporated.

Tax implications in the hands of shareholders of the transferor entity

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

In this regard, the Income-tax Act provides an exemption that in the case of 'amalgamation', fulfilling the above-mentioned conditions provided under the Income-tax Act, any transfer of shares in the transferor entity by the shareholders will not be liable to capital gains tax on the fulfillment of the following conditions:

- The shareholders of the transferor entity receive only 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 Income-tax Act 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 of foreign entity receive shares in the transferee foreign entity in lieu of shares in the transferor foreign entity.

i. Issue of Bonds, Debentures or payment of cash as a consideration for Amalgamation

As per the Income-tax Act, the requirement for tax neutrality is that the shareholders of the transferor entity shall receive 'shares' in the transferee entity pursuant to amalgamation. Hence, in case consideration is paid as combination of shares and cash or debentures or bonds, etc. of the transferee company to all

shareholders, such receipt of cash, debentures or bonds would be taxable in the hands of the recipient shareholder since exemption is available only on receipt of shares. Additionally, one would need to evaluate the tax neutrality in such cases.

ii. Issue of preference shares as a consideration for Amalgamation

As per the Income-tax Act, the requirement is that shareholders holding at least 75% in value of shares of the transferor entity become the 'shareholders' of the transferee entity. It can be by way of issue of either equity or preference shares by the transferee company. Hence, if the equity shareholders of the transferor company are issued preference shares in the transferee company, then aforesaid conditions should be considered as complied with.

iii. Cost of acquisition and period of holding of shares received on amalgamation

The cost of acquisition of the shares in the transferor company in the hands of the shareholders is preserved as the cost of acquisition of the shares in the transferee company received on merger.

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

However, where the scheme of amalgamation involves a listed company or shares of listed companies, availability of cost as on January 31, 2018 (i.e. grandfathering provisions under section 55(2)(ac) of the Income-tax Act) will need to be analyzed.

Tax implications in the hands of the transferee entity

i. Income from Other Sources

Under the Income-tax Act, where certain properties are received for an inadequate or nil consideration, the difference between the FMV of such property and the consideration paid (if any) would be taxed under the head 'Income from Other Sources'. However, there is specific exemption provided to transferee entity on receipt of property pursuant to amalgamation compliant with the Income-tax Act.

Provisions of Angel Tax will also be required to be kept in mind in case the shares are issued on merger above the face value.

ii. Carry forward of tax losses, unabsorbed depreciation and Capital Losses:

The transferee entity is entitled to carry forward

the accumulated tax losses of the transferor entity for a fresh period of eight years if certain conditions are satisfied by the transferor and transferee entity. Furthermore, UAD can be carried forward indefinitely.

- **Conditions to be satisfied by the transferor entity:**
 - The transferor entity should qualify as owning an industrial undertaking²⁰ or a ship or a hotel or merger between specified banks or public sector companies;
 - 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.

There are no specific provisions under the Income-tax Act (unlike for accumulated business loss and UAD) which enable the transferee entity to carry forward or set-off 'capital losses' of the transferor entity. There are conflicting judicial precedents on this issue. While the Mumbai Bench of the Income-tax Appellate Tribunal²¹ did not permit carry forward of capital losses pursuant to amalgamation, however,

recently, the Pune Bench of the Income-tax Appellate Tribunal²² has held that transferee entity ought to be allowed to carry forward / set-off capital losses post amalgamation.

iii. 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 WDV of the block of assets transferred by the transferor entity is taken as the WDV 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.

iv. 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 (for unexpired period) on amalgamation. However, in some prescribed exceptions, the Income-tax Act provides that the tax holidays will not be continued after an amalgamation.

v. Tax treatment in respect of expenses incurred on amalgamation

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

vi. Accumulated profits of transferor entity on amalgamation:

The accumulated profits of the amalgamating company, whether capitalized or not, will become part of the accumulated profits of the amalgamated company and hence such accumulated profits will be considered for computing dividend income while making any distribution to shareholders by the amalgamated company post-amalgamation.

B. GST

There should not be any adverse GST implication on amalgamation where transfer is on a going-concern basis (Refer to our article on 'Indirect tax laws impacting M&A deals in India' for more details).

20. Industrial undertaking" means any undertaking which is engaged in—
 i. the manufacture or processing of goods; or
 ii. the manufacture of computer software; or
 iii. the business of generation or distribution of electricity or any other form of power; or
 iiia. the business of providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet services; or
 iv. mining; or
 v. the construction of ships, aircrafts or rail systems;

21. Clariant Chemicals (I) Ltd. v ACIT [2015] 152 ITD 191 (Mumbai)

22. Capgemini Technology Services India Limited v DCIT [Income Tax Appeal No. 1857 of 2017 (Pune Tribunal, 30 August 2022)]

C. Stamp duty

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

While there are some states where specific entry exists for charging stamp duty on orders approving the amalgamation scheme (such as Haryana, Maharashtra, Andhra Pradesh, Gujarat, Karnataka, Tamil Nadu and West Bengal) and, there are some states where there are no specific provisions for levying stamp duty on amalgamations. However, there are certain judicial pronouncements treating 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. Some states also provide certain relaxations on fulfillment of certain conditions.

D. Approvals under Indian company law

Under the Indian company law ('Companies Act, 2013'), the merger scheme needs to be approved by the majority of shareholders and creditors, constituting 75% in value, of those present and voting in the NCLT convened meetings of shareholders and creditors (unless dispensed with). Also, a notice with details of the scheme needs to be sent to the Indian income tax authorities. Approval is required from the Ministry of Corporate Affairs and Official Liquidator (OL). Sectoral Regulators approval may also be required, as per applicable regulations.

Furthermore, the Companies Act, 2013 also allows merger between a company and its 100% subsidiary or merger between small companies without the approval of NCLT under the Fast Track Route. In such cases, the scheme needs to be approved by stakeholders and the Central Government.

E. Merger between Limited Liability Partnership ('LLP') and a company

Currently, there are no formal provisions on

permissibility of amalgamation of an LLP into a company or vice versa.

Further, no specific tax exemption is provided under the Income-tax Act for merger of an LLP into a company and vice versa.

F. Cross-Border Mergers

i. Companies Act, 2013

While under the erstwhile Companies Act, merger of a foreign company with an Indian company (i.e. Inbound merger) was permitted, no specific framework was prescribed for merger of an Indian company with a foreign company (i.e. 'Outbound Mergers').

In 2017, the Ministry of Corporate Affairs introduced section 234 in Companies Act, 2013 for undertaking cross border M&A (i.e., Inbound and Outbound Mergers), respectively within the regulatory framework.

Section 234 of the Companies Act, 2013 permits the merger of a foreign company with an Indian company (i.e., Inbound Merger) and the merger of an Indian company with a foreign company incorporated in specified jurisdictions²³ (i.e., outbound merger) after obtaining prior approval of the RBI, and provided it complies with merger provisions as applicable for domestic mergers under Companies Act 2013 i.e., procedural aspects like filing of application with NCLT, conducting meeting of shareholders / creditors, notification to income-tax authorities, other sectoral regulators, etc. needs to be complied.

The proposed merger scheme may, among other terms and conditions, also provide for the payment of a consideration to the shareholders of the transferor company in cash, or in depository receipts, or partly in cash and partly in depository receipts.

Further, the transferee company is required to ensure valuation by a valuer who is a member of a recognized professional body in its jurisdiction and in accordance with internationally accepted principles on accounting and valuation. In this regard, a declaration is required to be submitted by the transferee company along with the application to the RBI for obtaining its approval for the merger.

23. Foreign Companies registered under Jurisdiction fulfilling below parameters are permitted:

i) whose securities market regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding ('MoU') or a signatory to a bilateral MoU with Securities and Exchange Board of India; (or)

ii) whose Central Bank is a member of the Bank of International Settlements (BIS) And

iii) which has not been identified in the public statement of the Financial Action Task Force (FATF) as:

a) A jurisdiction having a strategic anti-money laundering or combating the financing of terrorism deficiencies to which counter measures apply; or

b) A jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.

ii. Indian Exchange Regulations

Previously, no specific framework was prescribed by RBI for regulating cross-border mergers. However, in March 2018, RBI has notified regulations²⁴ wherein 'deemed approval of RBI' is granted in case where cross-border mergers adhere to the certain conditions as prescribed therein. The key conditions are discussed as under:

- In case of Inbound Mergers, the issue of transferee Indian company's securities to a person resident outside India must be in consonance with the conditions in the Foreign Direct Investment (FDI) Regulations viz pricing guidelines, entry routes, sectoral caps, etc.
- In case of Inbound Mergers, the guarantees or borrowings from outside sources inherited by a resultant Indian company must conform to the external commercial borrowing (ECB) norms or trade credit norms, as the case may be, laid down under exchange control regulations within two years of such merger.
- In case of Outbound Mergers, the acquisition / holding of securities in the foreign or / resultant company by an Indian resident must be in consonance with the Foreign Exchange Management (Transfer or issue of Foreign Security) Regulations, 2000 or the provisions of the Liberalized Remittance Scheme, as applicable.
- In case of Outbound Mergers, the guarantees or borrowings of the Indian company which become the liabilities of the resultant foreign company shall be repaid as per the scheme sanctioned by the NCLT in terms of the Companies (Compromises, Arrangements or Amalgamations) Rules, 2016.
- Assets which are not permitted to be held by the resultant company (Indian or foreign) under India's foreign exchange regulations, as a consequence of the merger, must be disposed off within two years of the sanction of the scheme of amalgamation by the NCLT and the proceeds must be repatriated to India or outside India, as applicable, immediately.
- An office in India of the Indian or transferor company, in the case of an Outbound Merger, and an office outside India of the foreign or /transferor company, in case of an Inbound Merger, shall be deemed to be a branch office (i) of a foreign company, inside India, and (ii) of an Indian company, outside India, respectively and must satisfy

applicable exchange control regulations.

- A certificate from the Managing Director / Whole Time Director and Company Secretary (if any) of the concerned company or companies shall also be submitted while filing the application for the scheme of amalgamation with NCLT stating compliance with the aforesaid conditions.

iii. Income-tax Act

Merger of Foreign company into Indian company ('Inbound Merger')

Tax implications in the hands of the transferor entity

The inbound merger would be tax-exempt in hands of transferor (i.e., Foreign Company) since the resultant company is an Indian Company.

Tax implications in the hands of the shareholders of transferor entity

Similarly, it would also be exempt in hands of foreign shareholders on transfer of shares of transferor company since an Indian Company's shares will be issued on merger.

Tax implications in the hands of the transferee entity

- *Income from Other Sources.*
Similar to a domestic merger, an exemption shall be available to a transferee Indian entity on receipt of property from the transferor foreign company pursuant to the inbound merger the fulfilling conditions provided under section 2(1B) of the Income-tax Act.
- *Carry forward of tax losses, unabsorbed depreciation and Capital Losses:*
Currently, there is no mechanism under the Income-tax Act which allows the subsuming of the foreign tax losses of the foreign transferor company post-merger with the resulting Indian transferee company.
- *Cost of Acquisition and Period of Holding of shares issued by Indian Transferee Company:*
Similar to a domestic merger, the cost base and period of holding with respect to the shares of the Indian transferee company would include the cost and period of holding of the shares of the Foreign transferor company.

Merger of Indian company into foreign company ('Outbound Merger')

Though the Companies Act, 2013 and RBI,

24. Notification No. FEMA.389/2018-RB dated March 20, 2018

respectively permit the merger of an Indian company into a foreign company; however, such a merger is not categorized as a tax neutral transaction under the Income-tax Act in the hands of the transferor entity and its shareholders.

Further, in a case where an Indian amalgamating company is engaged in asset intensive business viz a manufacturing plant in India, on outbound merger with foreign amalgamated company, the Indian manufacturing plant shall be regarded as a 'branch office' of a foreign company in India and thereby constitute as permanent establishment in India for tax purposes. As per Indian Laws, the profits attributable on account of Indian operations to the Indian branch of the foreign company, may be taxable at a higher rate of 40% (plus surcharge and cess).

Hence, outbound mergers may be ideal in cases where an Indian amalgamating company is asset light and non-manufacturing. However, while the Indian regulatory framework permits outbound mergers, in the absence of specific exemption, uncertainty around income-tax implications is likely to be a barrier.

V. 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 demerger²⁵. A demerger is an effective tool whereby a business is hived into a separate company, inter-alia to segregate core and non-core businesses, achieve management focus on core business, attract investors or exit a non-core business.

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

A. Implications under Indian tax laws

a. Definition under tax laws

Under Income-tax Act, a demerger is defined as

a transfer pursuant to a scheme of arrangement under the provisions of Companies Act, 2013, by a demerged / transferor company of one or more of its 'undertakings' to a transferee company (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 values²⁶;

The above provision does not apply where the transferee company records the value of the property and the liabilities of the undertaking at a value different from the value appearing in the books of account of the demerged company, immediately before the demerger, in compliance to the Indian Accounting Standards.

- The transferee entity issues shares to the shareholders of the transferor entity on a proportionate basis; and
- At least three-fourth of the shareholders of the transferor entity (in value) become the shareholders of the transferee entity.

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

Undertaking for the purpose of demerger is defined to 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 not constituting a business activity. While analyzing demerger transactions, it becomes important to analyze whether the undertaking definition is satisfied. In the case of Grasim Industries Limited²⁷, the Mumbai Bench of the Income-tax Appellate Tribunal analyzed whether demerger of financial services business met the undertaking definition for tax neutral demerger under the Income-tax Act. The court ruled in favour of the assessee based on the documentation and disclosures regarding the business in various documents, such as, tax audit report, return of income, directors report, etc.

25. 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.

26. liabilities shall include—

(a) the liabilities which arise out of the activities or operations of the undertaking;

(b) the specific loans or borrowings (including debentures) raised, incurred and utilized solely for the activities or operations of the undertaking; and

(c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

27. Grasim Industries Limited v. DCIT (Income Tax Appeal no. 1935 of 2020) (Mumbai Tribunal, April 12, 2021)

b. Tax implications in the hands of the transferor entity

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

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

- At least 75% [in value] of 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 a transfer and hence is not subject to capital gains tax.

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, similar to amalgamation, an exemption has not been specifically extended to the shareholders on receipt of shares of the transferee company.

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 transferee company received on demerger.

d. Tax implications in the hands of the transferee entity

- i. **Income from Other Sources.**

Similar to amalgamation, an exemption is also extended to a transferee entity receiving assets pursuant to scheme of demerger subject to fulfilling conditions prescribed in section 2(19AA) of the Income-tax Act.

Provisions of section 56(2)(vii)(b) of the Income-tax Act will also be required to be kept in mind in case the shares are issued on demerger above the face value.

ii. **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 to the transferee entity in the same proportion in which the assets of the demerged undertaking bears to the total asset of demerged company before demerger. The remaining balance is attributed to the transferor entity.

Unlike amalgamation, in the case of a demerger, the transferee entity will be entitled to carry forward the tax losses for the unexpired period only, and a fresh period of eight years is not available. Transfer of MAT credit to the resulting company pursuant to demerger is not specifically provided under the Income- tax Act, however, there are case laws that permit transfer of MAT credit on demerger.

iii. **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 WDV of the block of assets transferred by the demerged company is taken as the WDV of the block for the transferee 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 transferee company.

iv. **Tax holidays:**

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

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

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

B. GST

There should not be any adverse GST implication on demerger since transfer ought to be on going concern basis (Refer to our article on 'Indirect tax laws impacting M&A deals in India' for more details).

C. Stamp duty

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

D. Approvals under Indian company law

The approval process, as applicable to mergers, applies to demergers also. However, in case of a demerger, unlike a merger, since the demerged company continues to exist after the demerger, the report of the official liquidator may not be called for by the NCLT.

Further, similar to amalgamation, a demerger under the Fast Track Route may also be evaluated.

E. Cross Border Demerger

The existing provisions under Companies Act, 2013 only refer to cross border mergers or amalgamation and do not specifically refer to demergers or any other arrangement per se. Accordingly, permissibility of cross border demerger is a conundrum and doesn't seem to have been resolved yet.

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 when legacy-related liabilities or litigations form an important element of the transaction and the buyer is not comfortable with taking over those legacy matters. Similarly, merger and demergers are used more frequently to rationalize or simplify the group holding structure.

Indirect tax laws impacting M&A deals in India

India follows a dual taxation structure, in which taxes are imposed by the central government as well as the state governments. From July 2017, GST has been introduced in India. It has subsumed a plethora of indirect taxes levied at the federal and state level in India such as, Excise Duty, Service Tax, VAT, Central Sales Tax, Entry Tax etc. Under GST, following are the type of taxes which are levied - Integrated Goods and Services Tax, Central Goods and Services Tax, State / Union Goods and Services Tax, and GST Compensation Cess. Transactions involved in business consolidations can be achieved through sale of shares or amalgamation of companies, or the sale and purchase of a business undertaking through demerger, slump sale or by purchasing individual assets i.e. on an 'itemized sale'.

These transactions require a thorough examination from GST perspective, which is a transaction-based destination tax. The GST implications on various M&A transactions are discussed below:

Implications under GST

Sale of going-concern business

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

Itemized sale of assets

In an itemized sale, individual assets are transferred at a specified price. Such transactions could be regarded as supply of goods and are liable to GST at the applicable rates. Whilst the rate of GST applicable on goods depends on the nature of the goods that are being transferred, generally, goods attract a rate of 5%, 12%, 18% or 28% GST on their identified values.

Based on the nature of the goods transferred and subject to the Input Tax Credit restrictions provided under the GST Acts, the GST paid by the purchaser

may be available as input tax credit, subject to conditions.

Acquisition through purchase of shares

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

Merger, demerger or amalgamation of companies

In the event of amalgamation or demerger of companies, no GST is attracted if the business transfer is on a going-concern basis.

Impact on unutilized credits

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

Implications under Foreign Trade Policy

Businesses may hold various licenses under the Advance Authorization and Export Promotion Capital Goods (EPCG) schemes from the authorities under the Foreign Trade Policy (FTP). It is critical to take into account all such pre-import benefits taken by the business undertaking that is proposed to be 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.

Transactions during the intervening period

Amalgamation or demerger of companies can be undertaken only with the prior approval of NCLT. In several cases, the date of the NCLT order is subsequent to the appointed date of the merger, demerger, etc.

If the companies undertake transactions amongst themselves during the intervening period (i.e. between the appointed date and the date of the NCLT order), then due treatment under the tax laws apply.

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

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

Impact on ongoing or past litigation

For ongoing and past litigation (pending adjudication), the tax authorities should be informed of the proposed transaction, as well as the details of the new company and the new communication address to ensure that

the notices reach 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 the transaction.

Conclusion

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



Repatriation and Exit Strategies

Fund repatriation by a company involves distribution of surplus cash or profits back to the shareholders or investors. When a company generates excess cash or profits, it either reinvests them into the business for growth and expansion; or it distributes them to the shareholders as a return or reward on their investment into the company. Dividends are one of the most popular modes of fund repatriation. A history of consistent payment of dividends is often seen as a positive indicator by potential investors.

Repatriation may or may not include an investor exit. In case of exit, receipt of funds in the hands of the exiting shareholders in an efficient manner is one of the key considerations in determining the mode of exit.

An investor or promoter may choose to exit their investments or companies, either wholly or partially, due to a variety of reasons, such as:

- Achievement of target return/ profitability;
- Change in market dynamics;
- Regulatory and legal issues;
- Conflict of interest with the other shareholders / investors;
- Other commercial factors/understanding.

The manner in which a promoter or investor chooses to exit depends on factors like:

- Type of entity in which investment is made (e.g. Company, LLP, joint venture, etc.);
- Financial instrument involved (equity shares, preference shares, debentures, etc.);
- Residential status of the investor, etc.

In case of a company structure, transfer of shares is one of the most popular modes of exit due to various factors such as, simpler to execute with least timelines, tax certainty, etc. (discussed in detail in the chapter of Modes of M&A). In case the promoter or investor proposes to exit from only one of the businesses, it can be achieved through a hive-off of part of the business (undertaking/part of undertaking) through a slump sale or demerger (discussed in detail in the chapter of Modes of M&A).

Below are some of the other popular modes of exit and/or fund repatriation employed by promoters or investors:

I. Dividend

Dividend refers to the distribution of profits by a company to its shareholders. It enables fund repatriation to equity and/or preference shareholders of a company. It does not provide an exit to investors, and the shareholding remains unchanged.

A. Tax implications

Under the Income-tax Act, the term dividend has a broader meaning to include various types of distributions to the shareholders to the extent the company has accumulated profits. Dividend income is taxable in the hands of shareholders as income from other sources or business income, at respective slab rates, with effect from 1st April 2020. There is also a cap of 15% on maximum surcharge that can be levied on dividend income.

Additionally, where the gross total income of a domestic company includes any income by way of dividends from another domestic company, a foreign company or a business trust, it shall be allowed a deduction equal to the income by way of dividends received by it during the year, to the extent such dividend is onwards distributed by it to its shareholders in same financial year or on or before one month prior to the date of furnishing the return of income of the relevant year. This eliminates the cascading effect on inter-corporate dividends.

Withholding obligations

An Indian company distributing dividend to resident shareholders exceeding INR 5,000, is required to withhold tax at the rate of 10%. Where the dividend is payable to a non-resident or a foreign company, then tax is required to be deducted @20%²⁸. However, if tax treaty benefit is available to the non-resident, then tax can be withheld at the lower rate prescribed in the tax treaty, subject to certain conditions.

B. Stamp duty

There is no stamp duty incidence on payment of dividends by a company to its shareholders.

C. Corporate laws

A dividend can be declared and paid by a company only out of its profits, either for that year or out of previous financial years, arrived at after providing for depreciation. A dividend shall be declared or paid by the company out of its free reserves. Previous years losses and depreciation, if any, are

²⁸. This rate will be increased by applicable surcharge and 4% cess.

required to be set off against profit of the company for the current year prior to dividend declaration.

There is no mandatory requirement to transfer some portion of profits to reserves prior to dividend declaration.

II. Buyback

Buyback involves a company purchasing its own shares or securities from its shareholders, resulting in whole or part exit being provided to such shareholders. It provides exit as well as fund repatriation from the company to its shareholders. Buyback offer is made by a company to all its shareholders, and the shareholders can choose whether they want to tender shares in the buyback offer. Buyback enables a company to return surplus cash to its shareholders and helps boost a company's financial ratios.

A. Tax implications

In the hands of the company

Buyback of shares from a shareholder is taxable in the hands of the company undertaking the buyback at the rate of 20%²⁹ on the 'Distributed Income'. 'Distributed Income' refers to the consideration paid by the company on buy-back of shares, as reduced by the amount which was received by the company for the issue of such shares. The manner for determining the amount received by the company for issue of shares, has been specifically provided in the Income-tax Rules. In case of share subscription, the amount actually received by the company, including premium, is considered as the amount received by the company for issue of such shares. In case of shares issued by an amalgamated company under a scheme of amalgamation, the amount received by the amalgamating company in respect of such shares shall be deemed to be the amount received by the amalgamated company for the issue of such shares. Similarly, the amount received by the resulting company in respect of shares issued under a scheme of demerger, shall be the amount which bears the amount received by the demerged company in respect of the original shares in the proportion of net book value of the assets transferred in demerger to the net-worth of the demerged company immediately before such demerger.

Buyback tax is considered as final payment of tax, and accordingly no credit or set-off of losses is available to the company against the buyback tax liability.

Tax Withholding

As buyback tax on the company is the final tax, there is no obligation on the company for withholding of taxes on the consideration paid by the company to the shareholders.

In the hands of the shareholders

Income received from buyback is consequently exempt from tax in the hands of the shareholders, both resident and non-resident. Accordingly, eligibility of benefit under the relevant tax treaty is not required to be evaluated for non-resident shareholders. The taxability of the buyback proceeds in the respective foreign jurisdiction of the shareholder will need to be evaluated basis its domestic tax law. Hence, non-resident shareholders will also need to analyze the tax provisions of their respective foreign jurisdiction on allowability of credit of buyback tax paid by the company.

B. Pricing

Where a non-resident shareholder is involved in a buyback, pricing guidelines under the exchange control regulations are required to be complied with.

It is also pertinent to note that section 56(2)(x) of the Income-tax Act, commonly known as gift tax, applies where a person receives shares without consideration or for inadequate consideration. However, based on judicial precedent³⁰, a view can be taken that the provisions relating to gift tax may not apply to buyback even if consideration paid on buyback is lower than the tax fair market value of the company, since where a company purchases its own shares, such shares are cancelled and do not become the property of the company.

C. Corporate Laws

From a Companies Act, 2013 perspective, buyback can be undertaken by a company only if it fulfils certain conditions. Some of the key conditions are as follows:

- Buyback can be undertaken only out of free reserves, securities premium account or out of proceeds of any shares or specified securities, except the same kind of shares or securities
- Quantum paid on buyback shall be restricted to:
 - 10% of the total paid-up equity capital and free reserves (including securities premium account) of the company by passing board resolution; or

29. The rate will be increased by applicable surcharge and 4% cess

30. Vora Financial Service (P) Ltd. v. ACIT [2018] 171 ITD 646 (Mumbai)

- 25% of the total paid-up capital and free reserves (including securities premium account) of the company by passing a special resolution at a general meeting of the company
- Post buyback, the debt-to-equity ratio should not exceed 2:1;
- There should be gap of at least one year between two buybacks;
- The company should have no default in repayment of deposits, redemption of debentures or preference shares or such default is remedied and a period of three years has lapsed after such default ceased to subsist;
- Buyback should be authorized by the Articles of Association of a company.

D. Stamp duty

There is no stamp duty incidence on buyback of shares.

III. Capital Reduction

Capital reduction involves reduction of share capital of a company either by reducing the face value of a share or by cancelling the paid up or unpaid portion of shares of a company. It provides an exit as well as fund repatriation from the company to the shareholders. Capital reduction is usually undertaken for the following reasons:

- Restructuring the balance sheet in case of financial stress by offsetting losses against the capital
- Return surplus capital, in excess of the wants of the company, to its shareholders

Unlike buyback, shareholders do not have an option to tender shares in capital reduction, hence, there is a proportionate reduction of shares held by all shareholders. While capital reduction involves a NCLT process and longer timelines, contrary to other modes of repatriation, it does not require a company to have profits to provide exit or fund repatriation to its shareholders.

A. Tax implications

Distribution to the shareholders by a company on the reduction of its capital is taxable as dividend to the extent of accumulated profits, whether capitalized or not. Dividend is taxable in the hands of the shareholders at applicable tax rates, as

discussed above.

Further, the difference between the consideration received, over and above the accumulated profits, and cost of acquisition is taxable as capital gains in the hands of shareholders, in accordance with the provisions of the Income-tax Act.

Since dividend as well as capital gains on capital reduction are taxable in the hands of shareholders, tax treaty benefits can be claimed by non-resident shareholders.

Further, where the consideration received or accruing as a result of the capital reduction of the shares of a company (other than a quoted share) is less than the fair market value of the share; such fair market value shall be deemed to be the full value of the consideration received or accruing as a result of such transfer. This will become applicable for cases where capital reduction is not taxed entirely as dividend.

In cases where capital is reduced without payment of any consideration, loss in the hands of shareholders may not be available in absence of consideration since the computation mechanism fails³¹.

However, where consideration is received on a capital reduction, but it is lower than the cost, then such capital loss may be available based on judicial precedents³².

It is also pertinent to note that there has been a growing trend of the revenue to look at transactions more holistically and recharacterize transactions based on the steps taken during the transaction. In a recent case³³, the Chennai Bench of the Income-tax Appellate Tribunal ruled in favor of the revenue to hold that the purchase of company's own shares undertaken through an NCLT Scheme shall be treated as capital reduction, and would accordingly be taxed as dividend, to the extent of accumulated profits. This has been appealed by the assessee with the Madras High Court. Such decisions warrant the need for careful regard to the steps taken during the execution process, amongst other considerations, in determining the nature of the transaction and the consequent tax impact.

Tax withholding

To the extent capital reduction is taxed as dividend, it shall be subject to withholding of 10% on payment made to resident shareholders. For payment made to non-resident shareholders,

31. Bennett Coleman & Co. Ltd. v ACIT [2011] 12 ITR(T) 97 (Mumbai), Mahindra & Mahindra Ltd. v DCIT (Income Tax Appeal No. 1449 of 2016) (Mumbai Tribunal, June 19, 2020)

32. Jupiter Capital Pvt Ltd. v. ACIT (Income Tax Appeal No. 445 of 2018) (Bangalore Tribunal, 29 November 2018), Carestream Health India Private Limited v. DCIT (Income Tax Appeal No. 826 of 2016) (Mumbai Tribunal, 6 February 2020)

33. Cognizant Technology Solutions India Pvt Ltd v. ACIT (Income Tax Appeal No 269 of 2022) (Chennai Tribunal, 13 September 2023)

withholding will need to be done at applicable tax rates, subject to applicable tax treaties.

B. Pricing

Where a non-resident shareholder is involved in a capital reduction, pricing guidelines under the exchange control regulations are required to be complied with.

Similar to buyback, a view can be taken that the provisions relating to gift tax may not apply to capital reduction even if the consideration is lower than the tax fair market value, since such shares are cancelled and the test of 'becoming property' of the company are not satisfied.

C. Corporate Laws

Capital reduction requires the approval of the jurisdictional NCLT bench. Below are some key requirements:

- A company undertaking capital reduction requires power to reduce its share capital under its Articles of Association;
- Shareholder approval through a special resolution in the general meeting is mandatory;
- Three months' notice must be given to RD, RoC, SEBI and the creditors of the company to make representations to NCLT

D. Stamp duty

There is no stamp duty incidence on reduction of capital.

IV. Redemption of preference shares

Redemption of preference shares refers to the repayment of preference share capital to the shareholders. This provides an exit to the holder and also serves as a mode of repatriation of funds.

It allows shareholders to cash out their investment at a pre-determined price and timeline, and allows the company to control ownership in the event of fundraising.

A. Tax implications

The Supreme Court in the case of *Anarkali Sarabhai*³⁴ held that redemption of preference shares is a transfer and the excess amount received by the shareholder on redemption would have to be treated as 'Capital Gain' and taxed accordingly. Also, applicability of deemed dividend on redemption will need to be analyzed.

Further, considering that redemption also results in purchase of shares, one would need to evaluate if redemption would be taxable in a manner akin to buyback of shares.

B. Corporate laws

Redemption of shares can only be out of profits or out of the proceeds of a fresh issue of shares made for the purposes of redemption.

Premium, if any paid on redemption is to be paid out of the profits of the company or its securities premium account.

A sum equal to the nominal value of shares is required to be transferred to the Capital Redemption Reserve Account.

Conclusion

Shareholders should be mindful of the varied tax and regulatory laws involved while planning a repatriation or exit, along with timing and valuation aspects, in order to derive maximum benefit.

34. *Anarkali Sarabhai v. CIT* [1997] 224 ITR 422 (SC)

Corporate Restructuring – Recent Trends

In India, a corporate restructuring exercise is typically done either through agreements like business transfer agreement or through NCLT approval process, i.e. schemes of arrangement involving mergers, demergers, capital reduction, etc.

Section 230 to 240 of the Companies Act, 2013 contains provisions related to corporate restructuring i.e. compromise, arrangement and amalgamation, which lays down the conditions and processes or compliances involved to implement the transaction and also provide for several progressive concepts such as fast-track mergers and cross border mergers. Under the Companies Act, 2013, the NCLT has been vested with the powers of approving schemes relating to capital reduction, compromise, arrangement and amalgamation ('Scheme'), which were hitherto vested with the jurisdictional High Courts.

Although the process laid down to approve Schemes is fairly detailed under the Companies Act, 2013, at a practical level, given that different jurisdictional benches of NCLT and other regulators are involved in the process of examining and approving the Scheme, several trends and precedents have evolved. Other than Companies Act, 2013, corporate restructuring is also governed by various other laws and regulations including Indian Stamp Act, SEBI regulations (applicable in case of listed corporates), FEMA, RBI regulations, etc. In this chapter, we have summarized some of the key aspects in corporate restructuring one needs to keep in mind while evaluating a corporate restructuring.

I. Concept of Appointed Date in Schemes

The Ministry of Corporate Affairs (MCA)³⁵ has provided the following clarifications in relation to the appointed date (a date from which scheme becomes effective):

- The appointed date may be a specific calendar date or may be tied to the occurrence of an event (such event to be specifically stated in the Scheme);
- The appointed date identified under the Scheme shall be deemed to be the 'acquisition date' for the purpose of conforming to accounting standards;

- The appointed date can be retrospective, however, if it is significantly anti-dated beyond a year, justification for the same should be specifically brought out in the Scheme;
- In case the appointed date is event-based, which is subsequent to the date of filing the order with the registrar of companies, then the company is required to file an intimation of the same with the registrar within 30 days of the Scheme coming into force.

II. Obtaining consent of shareholders / creditors

Different approaches are followed by different benches of NCLT for convening shareholder or creditor meetings. Some benches of the NCLT have been liberal and regularly give dispensation from convening shareholder or creditor meetings based on consents obtained from the shareholders and creditors. However, some benches of the NCLT have been conservative and insist on convening the shareholder and / or creditors meeting.

The Mumbai bench of the NCLT usually gives dispensation from convening shareholder meetings of transferee company in case of merger of a wholly owned subsidiary with its transferee parent company, where the companies involved have a positive net worth³⁶. However, recently the Mumbai bench of NCLT³⁷ in the case of demerger from wholly owned subsidiary to its holding company, directed to hold meeting of shareholders and creditors or to procure consent affidavits for dispensation even of the holding company. On appeal to the National Company Law Appellate Tribunal (NCLAT)³⁸, the impugned order of Mumbai Bench of NCLT was set aside, and dispensation was granted from holding meetings and taking consents from shareholders and creditors of the holding company.

The Chennai Bench of NCLT in the case of Tablets India Limited³⁹, allowed dispensation from conducting the meeting of members based on receipt of consent of 23 shareholders (out of 34 members), constituting 99.81% of the equity shareholders in value. On the other hand, the Ahmedabad Bench of NCLT refused to dispense the shareholders meeting in a scheme of amalgamation involving Mahadev Infrastructure Private Limited⁴⁰, because out of five shareholders, one shareholder had not given its consent, without ascertaining the shareholding value of the single shareholder.

35. Circular dated August 21, 2019

36. Housing Development Finance Corporation – CSA No. 243 of 2017

37. Scheme of Arrangement between Reliance Projects & Property Management Services Limited and Reliance Industries Limited - CA(CAA)/116/MB/2023

38. Company Appeal (AT) No. 109 of 2023

39. CA/43/CAA/2017

40. CA(CAA) No. 48 of 2017

Hence, there is no uniform practice being followed by the different benches of the NCLT for dispensing with meeting of shareholders and creditors. It is advisable that commercial and legal aspects about the consent from shareholders and different classes of creditors are thoroughly considered before implementing any Scheme.

Obtaining No Objection Certificate ('NOC') from creditors of listed entities

The SEBI, vide its circulars⁴¹ has provided the conditions applicable to schemes of arrangement involving listed entities. While seeking no objection to a draft scheme from stock exchanges, listed entities are required to submit an NOC from the lending scheduled commercial banks, financial institutions, debenture trustees, constituting not less than 75% of the total value of the secured creditors. The NOC is to be submitted by the listed entity before the receipt of no objection certificate from stock exchanges.

This requirement is in addition to the requirement under the Companies Act, 2013, for obtaining approval of all classes of creditors of the company to the scheme (majority in number representing 3/4th in value) voting in a meeting, or where such meetings are dispensed by the NCLT upon submission of consents from the creditors.

III. Locus standi of Income-tax authorities in Schemes

The Companies Act, 2013 specifically gives the income-tax authorities an opportunity to raise objections to a Scheme. Section 230(5) of the Companies Act, 2013 mandates that the notice for the shareholders meeting to approve a scheme be sent to the income-tax authorities, who can then represent within 30 days from the date of receipt of such notice before the NCLT. In the recent past, we have observed that the income-tax authorities have been diligent and have started exercising their power of representation actively by raising their objections. Also, for capital-reduction schemes, several NCLT benches are directing to send notice to income-tax authorities, even though there is no such specific requirement in section 66 of the Companies Act, 2013. Below are some schemes where the income-tax authorities have raised objections and how NCLT has viewed these objections:

Invocation of GAAR

The Mumbai Bench of NCLT rejected a scheme involving merger of an investment holding company with the listed company⁴² owing to the adverse observations raised by the income-tax authorities, terming the scheme as an

'Impermissible Avoidance Arrangement' under General Anti-Avoidance Rules ('GAAR'). One of the key contentions of the income-tax authorities was that the objective of the merger was to enable the individual promoters to hold the shares directly in the listed company thereby avoiding tax which would have been applicable in the hands of the holding company. However, interestingly, the Delhi Bench of NCLT in similar facts, involving merger of an investment holding company with the listed company⁴³, set aside the observations of tax avoidance raised by the income-tax authorities and approved the scheme on the basis that the effective ownership of the shares of the listed company continued to be with the existing promoters through family trusts.

Also, recently, the tax department had made a representation to the Chandigarh Bench of NCLT in a scheme of amalgamation⁴⁴ involving merger of two group companies. The tax department claimed that the main objective of the scheme was to avail tax benefit of carry-forward of losses of the transferor company and invoked the provision of GAAR. The NCLT, however, stated that the rationale of the scheme justifies the business consolidation and that the tax arrangements were merely consequential. The treatment of carrying forward and set off of losses was clearly spelt out under the Income-tax Act, which are sufficient to protect the interest of revenue. It is pertinent to note that a scheme approved by NCLT does not override the provisions of the Income-tax Act, and the tax department has the power to deny the tax benefits during assessment proceedings.

In a conflicting decision, the Delhi bench of NCLT⁴⁵ rejected a scheme of amalgamation on the ground that upon merger, the transferee entity would be entitled to claim benefit of the brought forward business losses and depreciation available with the transferor company and would lead to loss of revenue to the tax department. It also held that the scheme was non-compliant with section 72A of the Income-tax Act as there was no mention nor any undertaking in the scheme that the transferee company would comply with the conditions of section 72A of the Income-tax Act.

41. Circular No. SEBI/HO/CFD/DIL2/CIR/0/2021 dated November 16, 2021, Circular No. SEBI/HO/CFD/DIL2/CIR/P/2021/0000000659 dated November 18, 2021 and SEBI/HO/CFD/DIL2/CIR/P/2022/11 dated February 01, 2022

42. Scheme of Amalgamation between Gabs Investments Private Limited and Ajanta Pharma Limited – CSP No.995 of 2017 and CSP No. 996 of 2017 in CSA No, 791 & 792 of 2017

43. Scheme of Amalgamation between PIPL Business Advisors and Investments Private Limited and GSPL Advisory Services and Investment Private Limited and NIIT Technologies Limited – Company Petition CAA – 385/ND/2017 connected with CA (CAA) – 83(ND) of 2017

44. Scheme of Amalgamation between Panasonic India Private Limited and Panasonic Life Solutions India Private Limited CP (CAA) No.8/Chd/Hry/2021

45. Scheme of amalgamation between Minda TG Rubber Private Limited and Toyoda Gosei Minda India Private Limited [CA (CAA) – 111(ND)/2021]

The CBDT in its circular on GAAR⁴⁶ clarified that where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such an arrangement. It needs to be seen whether the tax department will accept the stand that GAAR cannot be invoked if the NCLT has explicitly and adequately considered the tax implications.

Pending tax dues of the transferor companies

Typically, all Schemes carry a specific clause which provides for transfer of all pending tax assessments, dues and proceedings in relation to the transferor company or undertaking to the transferee company. Accordingly, the interest of revenue is adequately protected. Further, almost all NCLT orders specifically provide that sanction of the scheme will not deter the right of the income-tax authorities to raise any objections during assessment proceedings. Despite such protection to the revenue, some schemes have been scrutinized by NCLT based on the objections raised by the income-tax authorities.

For instance, in a merger scheme⁴⁷, the income-tax authorities sent a notice to the NCLT stating that the Scheme should not be approved considering the pending tax dues of the transferor company, thereby seeking to protect its legitimate interests. Consequently, the Bengaluru Bench of NCLT passed an order approving the Scheme subject to the condition that the Scheme can be given effect to only after the transferor company had discharged all the outstanding tax liabilities.

However, on appeal to the NCLAT, this precondition was removed on the grounds that the income-tax demands were under dispute and had not yet crystallized. Also, the transferee company undertook to satisfy such tax demands in accordance with law as and when these crystallized. This decision of NCLAT lays down an important principle that compliance in relation to clearance of all outstanding income-tax liabilities shall not be treated as a condition precedent for approval of a scheme. However, considering that this issue has been a subject matter of dispute, it would be critical to analyse the tax positions of the transferor company while undertaking any corporate restructuring exercise.

IV. Approval of Scheme by statutory authorities

Approval from the Regional Director

The Companies Act, 2013 provides statutory power to the Central Government (delegated to the regional director) to examine a Scheme and provide their comments or views on the same to

NCLT for their consideration, before the NCLT sanctions a Scheme. The regional director can examine a scheme from all aspects, including income-tax, even if no such objections are raised by income-tax authorities⁴⁸.

Approval from sectoral regulators

In a scheme before the Delhi Bench of NCLT⁴⁹, the regional director raised an objection that prior approval of RBI was required considering that all the companies involved in the Scheme were prima facie engaged in investment or lending activities and satisfied the definition of NBFC as per RBI guidelines. Based on this objection, the Delhi Bench of NCLT rejected the Scheme as RBI approval had not been obtained. On appeal, the NCLAT upheld the order of NCLT, since the appellants were unable to demonstrate that the companies involved were not engaged in NBFC activities. In view of this decision, it is advisable that one should examine all sector-specific regulations while evaluating a corporate restructuring exercise.

V. Approval of Scheme by NCLT

A scheme under the Companies Act, 2013 requires the final sanction of the jurisdictional bench of NCLT. The NCLT sanctions a scheme after considering all the observations or objections raised by the various stakeholders. However, the NCLT has the authority to reject a scheme on its own accord even if no stakeholder has raised any objection. The NCLAT has held that NCLT has been constituted consisting of Judicial and Technical Members, who have enough expertise to look into the scheme of amalgamation and arrangements and are also free to decide whether it is just and fair to all stakeholders. It has a duty to act in public interest. In one of the cases, the NCLAT⁵⁰ had upheld the order of NCLT rejecting the scheme on the ground that it was not in public interest, since the financial benefit from the arrangement was flowing only to a few common promoters. The valuation report placed on record was also not relied upon by NCLAT since the valuer had provided disclaimers in the valuation report.

46. Circular no. 7 of 2017 dated January 27, 2017

47. Scheme of Arrangement between Ad2Pro Media Solutions Private Limited and Ad2Pro Global Creative Solutions Private Limited –CP(CAA)No.59/BB/2018 and CP(CAA)No.45/BB/2018

48. Casby Logistics Private Limited [TS152-HC-2015(BOM)]

49. Scheme of amalgamation amongst Bank Street Securities Private Limited and Bhutani Leasing and Finance Limited Cellular Fincap Private Limited and DKT Marketing Private Limited and Jaideepak Textiles Private Limited and A.A Gems Private Limited and AR Agro Industries Private Limited and Win Capital Limited with SRD Trading Private Limited – Company Appeal No. 340 of 2018

50. Scheme of amalgamation of Wiki Kids Limited with Avante! Limited – Company Appeal No. 285 of 2017

Similarly, the Mumbai Bench of NCLT rejected the scheme involving UFO Moviez India Limited⁵¹ on the grounds that the scheme was devised to flout various laws and defeat public interest by playing with the stock market. The NCLT has observed that the scheme involved a series of complicated steps involving demerger, merger, slump sale, sale, reduction of capital and held that it was not possible for an ordinary shareholder who voted in favor of the scheme to understand all the complicated steps involved in the scheme. An appeal had been preferred against the order of NCLT, and NCLAT⁵² has set aside NCLT's order observing that the grounds given for rejection were uncalled for and the NCLT was only required to notice all the requirements of section 230 to 232 of the Companies Act, 2013.

Even in the case of Hotel City Plaza, the Kochi Bench of NCLT⁵³ had rejected the scheme due to non-compliance and violation of the provisions of Companies Act, 2013, by both the transferor and transferee company. The NCLAT⁵⁴ also upheld the order passed by the Kochi Bench of NCLT.

In light of the above, it is important to ensure that a Scheme is easily understood by the regulators and stakeholders and the commercial rationale is clearly spelled out to avoid the Scheme being stalled by NCLT.

It is also vital to understand principles laid down by NCLT in some of the schemes, discussed below, which would provide important inputs while deciding on a corporate restructuring:

Delisting through a scheme of arrangement of listed subsidiary company

Delisting a company from a stock exchange involves a reverse book building process for determining the delisting price. It leads to a cash outflow for the promoter group to buy out the public shareholders and the public shareholders have an option to tender the shares. As per SEBI (Delisting of equity shares) Regulations 2021 ("SEBI Delisting Regulations"), where the acquirer fails to acquire more than 90% stake in the listed entity, the delisting fails.

However, under the special provisions⁵⁵ of the SEBI Delisting Regulations, a listed subsidiary company may get delisted from the stock exchange

through a scheme of arrangement wherein the listed holding company issues equity shares to the public shareholders of the listed subsidiary as a consideration for the cancellation of equity shares of the delisting subsidiary company. Accordingly, public shares in the delisting subsidiary company are mandatorily cancelled without any cash outflow to the promoters, subject to fulfilment of certain conditions.

ICICI Securities has recently announced delisting pursuant to the aforesaid regulations. The public shareholders of ICICI Securities will get equity shares of ICICI Bank, and ICICI Securities will become a wholly owned subsidiary of ICICI Bank.

Selective Capital reduction

A selective capital reduction results in extinguishment of capital of some select shareholders of the same class, while leaving the other shareholders untouched. Under the Companies Act, 1956, there have been precedents wherein High Courts have sanctioned capital reduction schemes to squeeze out the minority shareholders after delisting. However, the courts have closely looked at the value being paid to such minority shareholders and whether the majority of shareholders have approved the scheme.

Under the Companies Act, 2013, the Mumbai bench of NCLT rejected a scheme of capital reduction⁵⁶, even though majority of shareholders had approved the Scheme and no regulator had raised any objection, wherein 75% of shareholding was proposed to be cancelled without any payout. The scheme was rejected on the grounds that in spite of the company having strong fundamentals, it was strange that the majority of the shareholders were not paid any consideration on reduction of share capital.

Capital reduction scheme of a negative net-worth company

The NCLAT⁵⁷ approved capital reduction of a company having negative book net-worth on the grounds that (i) shareholders had approved the scheme through special resolution (ii) no creditors had objected to the scheme (iii) the company had sufficient funds for undertaking the capital reduction and was a going concern.

NCLAT also clarified that reduction of capital is a domestic affair and NCLT cannot sit in the shoes of the shareholders who had approved the scheme based on their commercial wisdom. While this decision paves the way for stressed companies to undertake capital reduction and return capital to their shareholders, it adds to the debate of the degree of intervention that NCLT can have for scheme matters.

51. C.P. (CAA) No./1920/MB/2018

52. Company Appeal (AT) No. 48 of 2019

53. Scheme of amalgamation between Hotel City Plaza Private Ltd and Trivandrum Apollo Towers Pvt. Ltd [TCAA/4/KOB/2019 & TCAA/5/KOB/2019]

54. Company Appeal (AT) (CH) No. 28 of 2021

55. Regulation 37 of the SEBI (Delisting of equity shares) Regulations, 2021

56. Ansa Decoglass Private Limited - C.P. 79/66/MB/2018

57. Precious Energy Services Ltd. v. The Regional Director (NCLAT, Principal Bench, New Delhi – Company Appeal No. 17 of 2021)

Merger of LLP with Company

The Companies Act, 2013 provides that both transferor and transferee entities must be companies. There is no provision in the company law which permits merger of a domestic LLP, firm or any other form of entity into a company. The NCLAT⁵⁸ in the case of scheme of amalgamation between Real Image LLP and Qube Cinema Technologies Private Limited has rejected the merger of LLP with Company.

Conversion of equity shares into preference shares via scheme

The Mumbai Bench of NCLT⁵⁹ approved a scheme of arrangement and amalgamation wherein the scheme was proposed for merger of two transferor companies into transferee company and conversion of equity shares into preference shares. The Regional Director objected to the conversion of equity shares into preference shares.

However, the petitioner companies contended that the conversion is not barred by any provision of law and the term 'arrangement' has a very wide import and includes a reorganization of the company's share capital by the consolidation of shares of different classes or by the division of shares into shares of different classes, or by both of those methods and the term share capital includes both equity and preference shares and there is only change in nomenclature of the share capital.

NCLT accepted the contentions of the Petitioner Companies and sanctioned the scheme, including the conversion of equity shares into preference shares.

VI. NOC from stock exchange for entities having listed Non-Convertible Debt securities ('NCDs') or listed Non-Convertible Redeemable Preference Shares ('NCRPS')

Entities that have listed their NCDs or NCRPS can file a Scheme with the NCLT under sections 230 to 234 of the Companies Act, 2013 only after receiving a no-objection letter from the stock exchange(s). The no-objection letter of the stock exchange(s) shall be valid for only six months from the date of its issuance. The stock exchange(s) shall forward its no-objection letter to SEBI before issuing it to the aforementioned entities.

With the aforesaid amendment brought about in 2022, entities having listed NCDs or NCRPS will

also have to submit all the specified documents to the stock exchange(s) to obtain a no-objection letter and then proceed to file the scheme with the NCLT.

VII. Approval of Scheme by Regional Director (Fast track process)

According to section 233 of the Companies Act, 2013, the following companies may enter into a Scheme by filing an application to the Regional Director instead of filing the application with the NCLT, as prescribed under sections 230 to 232 of the Companies Act, 2013:

- Merger or amalgamation between two small companies
- Merger or amalgamation between a holding company and its wholly owned subsidiary
- Two or more start-up companies
- One or more start-up company with one or more small company

The fast-track process can also be opted in case of demerger.

Notification⁶⁰ of timeline to approve scheme of merger

Recently, the MCA made amendments in the fast track merger rules to reduce the timeline within which the Central Government may confirm the Scheme.

Now, upon receiving the scheme of merger from a company, the RoC and the Official Liquidator ('OL') shall have a period of 30 days to record their objections, if any. If no objection is received by the Central Government and the Central Government is of the opinion that the scheme is in the public interest or in the interest of creditors, the Central Government may issue its order within 15 days of the expiry of 30 days.

Where the objections or suggestions are received by the Central Government, but the Central Government is of the opinion that the objections or suggestions are not sustainable and the Scheme is in public interest or in the interest of creditors, it shall issue a confirmation order within 30 days from the expiry of 30 days. If the Central Government is of the opinion that the scheme is not in public interest or in the interest of creditors, it may file an application with the NCLT within 60 days of the receipt of the Scheme to consider the Scheme under section 232 of the Companies Act, 2013.

If the Central Government does not issue the order within 60 days of receipt of the Scheme, it shall be

58. Company Appeal (AT) No. 352 of 2018

59. C.P. (CAA) 996/MB-II/2020 [order dated September 20, 2021]

60. Notification No. G.S.R. 367(E) dated 15 May 2023

deemed that it has no objection to the Scheme and a confirmation order shall be issued accordingly.

Amendment in the definition of small company

The definition of small company under the Companies Act, 2013 has been amended to increase the limit of paid-up share capital to INR 4 Crores from INR 2 crores and turnover to INR 40 Crores from INR 20 Crores.

This will enable more companies to be covered within the ambit of a small company, making them eligible for the benefits of a small company under the Companies Act, 2013, which includes fast track merger process under section 233 of the Companies Act, 2013 lesser number of board meetings, no auditor rotation, etc.

Conclusion

Over the years, the overall process of implementing a scheme through the NCLT has evolved and has become more certain. The NCLT and other regulators involved in sanctioning a scheme have been increasingly showing greater vigilance, delving into the commercial aspects, valuations, intent as well as substance of the transactions. Considering these recent trends in corporate restructuring, it becomes imperative to analyze any transaction thoroughly before execution, to save on time as well as transaction costs.



Impact of Insolvency Code on M&A Activity

Businesses can encounter failure for a multitude of reasons, including factors like competition, dearth of innovation, economic slowdown, an inefficient business model, excessive debt burden, regulatory changes and more. The repercussions of a business failure could be far-reaching, having extensive economic impact on stakeholders, including, investors, lenders, customers and employees. It is essential that the process of addressing business failure is prompt and effective. In cases where resolution is not attainable, it is crucial to ensure an orderly exit strategy for all stakeholders.

To address these challenges and enhance the chances of successful business resolution, a paradigm shift was brought about in the Indian insolvency and bankruptcy laws in the form of the Insolvency and Bankruptcy Code, 2016 ('IBC' or the Code). Since its introduction in 2016, IBC has played a pivotal role as a landmark legislation providing a single consolidated law in relation to insolvency and facilitating a time-bound and efficient resolution of stressed businesses.

The legislative and regulatory regime has also seen a significant evolution since the enactment of the IBC in 2016. Regulatory authorities and the Central Government have followed a dynamic approach in the implementation of IBC and necessary amendments have been made considering commercial realities and the experience gained on the ground. Further, the judicial authorities have also played a crucial role in the development of the Code. The constitutional validity of the Code has been upheld by the Supreme Court⁶¹. It is also worth noting that since the inception of the IBC in December 2016, a total of 7,058 insolvency proceedings under IBC have commenced. Of these, 5,057 have been closed. Of the proceedings closed, the stressed businesses were rescued in 808 cases, of which 1,053 have been closed on appeal or review or settled; 947 have been withdrawn; and 808 cases have ended in approval of resolution plans; while 2,249 have ended in orders for liquidation⁶².

Interplay of IBC with income- tax law

Upon admission of the application for the resolution process, the NCLT institutes a moratorium. This moratorium signifies a period in which legal proceedings for debt recovery, security interest enforcement, asset sale, or transfer are prohibited. The Supreme Court, in the case of *Monnet Ispat & Energy Ltd.*⁶³, has ruled that once a moratorium has

been enforced under IBC, any existing proceeding, including Income tax proceedings, against the debtor shall stand prohibited. Accordingly, till the completion of the resolution process, all tax litigations against the corporate debtor are suspended. The moratorium remains in effect until the resolution process is concluded.

In addition to the moratorium on tax litigations, the Income-tax Act provides several reliefs for companies under the IBC:

- In case of a closely held company, carry forward and set-off of losses is allowed only if there is a continuity in the beneficial owner of the shares carrying not less than 51% voting power. In case of a company seeking insolvency resolution, it is expected that ownership of shares carrying more than 51% of voting power would change, thus leading to a lapse of the existing brought forward business losses. Towards this end, it has been provided that if a company's resolution plan is approved under the IBC, then such a company would be eligible to set-off losses even if there is a change in shareholding beyond the prescribed limit, after a reasonable opportunity of being heard has been provided to the jurisdictional Principal Commissioner or Commissioner.
- Relief from liability of MAT, has been provided for companies under IBC. Typically, for computation of book profits for the levy of MAT, a company is entitled to set-off brought forward business losses or unabsorbed depreciation, whichever is lower. Consequently, where either the brought forward business losses or unabsorbed depreciation is nil, then no deduction is allowed. With a view to provide relief to companies under IBC, it has been provided that a company whose application is admitted under IBC would be eligible to set-off the aggregate of business losses brought forward and unabsorbed depreciation.
- Where any tax, interest, penalty, fine or any other sum in respect of which a notice of demand has been issued by the tax authority to a company under IBC is reduced as a result of an order of NCLT, the tax authorities shall modify the demand payable in conformity with such order and shall thereafter serve a notice of demand specifying the reduced sum payable.

61. *Swiss Ribbons v. Union of India* [Writ Petition (civil) no. 99 of 2018]

62. Volume 28 of the Quarterly newsletter of the Insolvency and Bankruptcy Board of India – July - September 2023

63. *PCIT Tax v/s. Monnet Ispat & Energy Ltd.*(2018) 18 SCC 786

While these amendments are welcome, several tax issues continue to arise for companies under IBC, for which no relief has been provided yet under the Income-tax Act. **Some of the key issues are as follows:**

- Where any outstanding liability, including accrued interest, of an entity for which the resolution plan is approved (i.e. corporate debtor), is waived in accordance with the approved resolution plan, such waiver or write-back, especially liability in respect of operational creditors, may be subject to tax under both normal and MAT provisions. While the MAT liability could be mitigated by electing into the concessional 25.17% corporate tax regime, no specific exemptions are provided for normal tax in respect of companies under the IBC. For write-backs which were not earlier claimed as deduction, companies were relying on the Supreme Court's decision⁶⁴ to argue that such waivers resulting in benefits in cash should not be taxable under the extant provisions. However, the Finance Act, 2023 has expanded the scope of the definition of business income to include even cash benefits within its purview, necessitating a reevaluation of the tax implications surrounding such waivers. Nevertheless, the corporate debtor undergoing a corporate insolvency resolution plan typically has significant brought forward tax losses that can be set-off against any taxable income resulting from the write back of liabilities. Having said that, timely filing of income-tax returns during the resolution process becomes crucial to ensure that fresh losses incurred can be utilized and carried forward under the Income-tax Act.
- Resolution plans could provide for merger of the company undergoing insolvency. Section 72A of the Income-tax Act permits carry forward of tax losses on merger only on satisfaction of certain conditions. Unlike section 79 of the Income-tax Act, there is no relaxation or exemption provided under section 72A for companies undergoing insolvency.
- The Income-tax Act provides that where consideration for transfer of shares of a company (other than quoted share) is less than the FMV of such shares, the FMV shall be deemed to be the full value of consideration in the hands of the transferor for computing capital gains. The FMV for the aforesaid purposes is computed as per the formula prescribed which essentially seeks to arrive at the FMV based on the intrinsic value approach. Similarly, for the transferee the deficit between the FMV and the actual consideration is deemed as income and taxed at the applicable tax rate. In case of distressed assets and companies, which are generally the subject matter of the approved resolution plan, the share sale or acquisition is likely to be below the FMV. This could lead to a tax implication both for the transferor and the transferee, making the resolution plan expensive and unviable. The Government has an enabling power under the law to exempt certain classes of persons from the applicability of the above provision, however no such exemption has been provided till now for companies under insolvency.
- Various costs are incurred by the acquirer as well as the corporate debtor, in the insolvency process. These costs can include fees for the resolution professional, cost of raising interim funds, costs incurred to facilitate resolution process including costs on restructuring, and more. However, the allowability of these costs under the Income-tax Act remains uncertain. Generally, costs incurred to run the business are deductible from the taxable income, as they are directly related to the business activities. However, it is important to note that these particular costs may not pertain to the day-to-day operations of the business. There is a specific provision in the Income-tax Act that allows for the deduction of costs incurred for amalgamation or demerger over a period of five years. However, there is no specific provision that addresses the deductibility of costs related to insolvency proceedings.
- IBC requires the resolution professional to examine each resolution plan received by him to confirm that each resolution plan does not contravene any of the provisions of the law for the time being in force. Once a resolution plan is approved by the NCLT, it is binding on the corporate debtor and other stakeholders involved. IBC takes precedence over any inconsistent provisions in other laws, as stated in IBC, and confirmed by various judicial precedents. Legal rulings⁶⁵ have established that tax dues are classified as operational creditors, placing them lower in the payment priority hierarchy, below financial creditors and employee dues. Therefore, waiver requests for outstanding tax liabilities can be included in the resolution plan, especially if operational creditors receive no payment in the priority order. However, it remains uncertain whether waivers will be granted for tax related to ongoing matters where dues have not crystallized before the resolution plan approval. In some cases, the NCLT has required obtaining approval from relevant authorities for such waivers⁶⁶.

64. CIT v. Mahindra and Mahindra Limited [2018] 93 taxmann.com 32 (SC)

65. PCIT v. Synergies Dooray Automotive Ltd. [2019] 153 SCL 77 (NCLAT), RMS Employees Welfare Trust v. Anil Goel [2019] 109 taxmann.com 169 (NCL-AT),

66. Parveen Bansal v. Amit Spinning Industries Limited C.A. 360 (PB) 2018 in C.P. No. (IB)-131 (PB)/2017, Tata Capital Financial Services Limited v. M/s Ciscron Projects Private Limited IA No. 763/2019 in C.P. (IB) No. 158/7/HDB/2018

Also, in a recent decision by the Supreme Court in the case of *Rainbow Papers Ltd.*⁶⁷, VAT authorities were declared secured financial creditors due to specific legal provisions in the Gujarat VAT Act, which grant a first charge on the company's assets for outstanding demands. Relying on this judgement, the NCLAT, in the case of *Assam Company India Ltd.*⁶⁸, where the Income-tax authorities had attached the bank account, ruled that government dues should also be considered as secured creditors, and referred the matter back to the NCLT for further consideration. These recent judicial pronouncements have introduced ambiguity in the classification of tax dues as operational creditors.

Conclusion

Addressing the above tax issues would be crucial in encouraging a resolution plan for the insolvent companies and unburdening the banks and the stressed economy from the huge outstanding debts. IBC is still in its early stages in India, and the tax jurisprudence on the subject is an evolving area. Several unresolved tax issues require attention and clarification to ensure IBC's effectiveness in revitalizing India's stressed business landscape.

67. *State Tax Officer v. Rainbow Papers Ltd* [2022] 174 SCL 250 (SC)

68. *PCIT v. M/s Assam Company India Ltd.* (NCL-AT PB, Company Appeal No. 242 of 2022)



Family Business Succession and Estate Planning

One of the biggest challenges faced by Indian promoter families is that of succession. In contrast to a professionally managed enterprise, where succession is more a matter of meritocracy, a wide spectrum of interpersonal issues come into play in the case of family-run businesses. Typically, in the case of businesses that are run by Indian families, it is not uncommon for the businesses to devolve on the succeeding generations, with the result that individuals with different ideologies and varied visions are obligated to manage the business cohesively. Furthermore, these individuals also have to deal with pressures to perform in the backdrop of inter-generational friction, family discord intertwining in business decisions, as well as unclear division of functions, authority and accountabilities.

A well-planned structure, which can ease the issues surrounding such family-run business succession, is therefore the need of the hour. Such planning also facilitates a clear succession plan for the family wealth, thereby ensuring that such wealth is protected, preserved and passed onto future generations in the intended manner.

Wills

Traditionally, wills have been employed as a means of managing succession issues. In common parlance, a will is a legal declaration of a person's (the testator's) wishes regarding the disposal of his or her property after death. A will can be amended as many times as desired and, according to the law, the most recent will of the testator prevails. Furthermore, the transfer of property under a will does not attract stamp duty. However, a will also has certain inherent limitations such as:

- A will can become operational only after the death of the testator;
- A will can provide for the disposition of assets only on a particular date (i.e., the date of demise of the testator);
- Disposition under a will may not be automatic, but takes place through the probate process (especially where the subject matter of succession consists of immovable properties);
- The probate process could be prone to litigation, especially when there is a discord within the family members;
- Potential exposure to estate duty;
- Since the will takes effect post the demise of the testator, it does not provide for ring fencing of assets from third party / creditors liability.

Need for trust structure

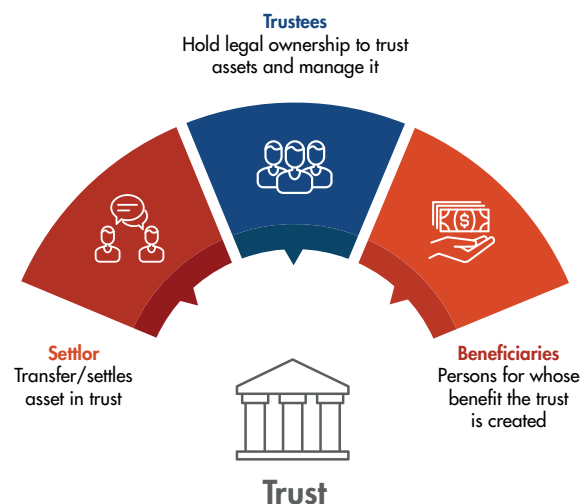
Giving due consideration to the above limitations of wills, more and more high net-worth families are now opting for a trust structure for their succession and wealth planning. A private family trust offers a good deal of flexibility and ease for effective control and management of the wealth. It also facilitates smooth transfer of wealth over generations, provides for contingencies, and facilitates clear directions for income and wealth distribution. Its importance is further amplified given the anticipated re-introduction of inheritance tax, and the possible insulation that a private trust may extend against a will, where the exposure is certain.

Overview of trust structure

Private trusts in India are governed by the Indian Trusts Act, 1882. In a strict legal sense, a trust is not a separate legal entity, unlike a company. It is more akin to a legal arrangement that is made between the author of the trust and the trustee for the benefit of the beneficiary. A private trust does not require registration, unless it is formed through settlement of immovable property.

A trust typically involves three parties:

- **Settlor:** A settlor is the person who settles the trust and is also known as the author of the trust.
- **Trustee:** A trustee is bestowed with the responsibility of managing the assets and liabilities of the trust and has the rights and powers for wealth distribution.
- **Beneficiaries:** Beneficiaries are the persons for the benefit of whom the trust has been settled.



Often the concept of a protector is included in a trust deed. A protector is a person who has veto powers or decision-making powers with respect to specified issues or is appointed to supervise the trustees and would normally step in when the affairs of the trust are not

being run in accordance with the mandate provided by the trust deed. Whether a family advisory council should be appointed under the trust deed to guide inexperienced trustees also needs to be considered.

Benefits of trust structure

A trust structure can help to create an enduring family legacy, by keeping intact the predecessors vision of the family business, although not at the expense of the dynamism and the adaptability that will be necessary for any required changes. A trust structure can also provide a structured format for a family office and enable efficiencies in the management and running of the office. Some of the key benefits of a trust structure are listed below:

- Maintaining family harmony
- Clear segregation of control and ownership
- Forehand planning for contingencies
- Preservation of wealth and the intrinsic value of a business
- Asset protection / ring fencing
- Regulation of third-party entry into a family business
- Restrictions on carrying out competing businesses
- Minimal regulatory compliance
- Can be amended as and when desired
- Not subject to the probate process
- Potential insulation against inheritance tax, if levied

Types of trusts

Revocable and irrevocable trusts

Trusts can take various forms. A revocable trust can be revoked (cancelled) at any time by its settlor, while an irrevocable trust will continue until the term of the trust expires. The tax and regulatory implications of revocable and irrevocable trusts vary.

Specific vs discretionary trust

In case of a specific trust, the share of the beneficiaries in the trust fund and income earned thereon is determinate. A discretionary trust is a trust that involves the beneficiaries being identified, although their beneficial interest in the trust is not ascertained upfront.

A trust may also be formed as a discretionary trust that becomes specific upon the occurrence of a trigger event. Take the case of a family with a father and four children, although the trust is set up as a discretionary trust, with the father as the trustee, the same trust can be made specific, with the shares of the children being fixed, upon the death of the father. Furthermore, a trust can also be created for a specific purpose or for specific assets.

Offshore trusts

There has also been a rise in the creation of offshore trusts by high net-worth individuals to house their overseas assets for better succession as well as the potential mitigation of estate taxes.

Documenting the succession plan

A trust is settled when the settlor hands over any property to the trustee which is to be used and employed for the benefit of the beneficiaries. This legal arrangement is codified by means of a trust deed. Thus, the trust deed becomes a document of prime importance, since it lays out the essential framework for the governance, control and management of family businesses and wealth across generations. It therefore needs to be drafted with the utmost care and caution.

There are no formal rules regarding the format or the contents of a trust deed. Although the contents will vary from family to family, depending upon the family's philosophy, its social and business ideologies and the relations between the members of the family, the following points will need to be considered:

- Defining trustee lineage – this is important so that the structure continues even when the original trustees cease to exist with desired trustees retaining ownership and control
- Delegation of authority and the decision-making matrix – to provide for matters that are to be decided by majority or unanimous consent of the trustees
- Policy for the distribution of the corpus and the income from the trust
- Providing veto powers to identified trustees for specific decisions
- Providing directions with respect to non-compete clauses and exit conditionalities
- Providing distributions and support policies in the event of specific circumstances such as marriage, death, divorce, etc.
- Safeguarding the interests of specific family members, for instance, a spouse (after the demise of the head of the family)
- Specific policies regarding the discipline and behaviour of the next generation
- Allocation of a certain portion of wealth for philanthropic purposes

When setting out the succession policy for a family business, two key factors need to be considered: first, the legal conduct and relationship between the trustees and beneficiaries; second, the softer aspects of human behavior. Many families also develop a separate family charter along with a trust deed, providing guidance on intricate facets of joint family arrangements such as

guidance, directions regarding the routine conduct of family members and behavioral expectations.

Although the trust structure extends significant benefits and is a favored choice for smooth succession planning and potential estate tax protection, due consideration must also be given to tax and regulatory nuances when conceptualizing a private trust structure for its effective and efficient functioning.

Implications under the Income-tax Act

There are specific provisions under the Income-tax Act that deal with the taxability of the income that is earned by a trust.

A private trust is usually formed following a contribution of funds or property from one of the family members (typically the patriarch), which is to be used for the benefit of the larger family. Section 56(2)(x) of the Income-tax Act provides that where a person receives any property without consideration or for a consideration lower than its fair market value, the excess of fair market value over the consideration shall be taxable in the hands of the recipient. However, the proviso to section 56(2)(x) of the Income-tax Act provides that the provisions of section 56(2)(x) of the Income-tax Act shall not apply to a trust where the property is received from an individual by a trust created solely for the benefit of relatives (as defined) of the individual. Where a settlor, being a family member (who qualifies as a relative within the meaning of the Income-tax Act), makes an irrevocable settlement to the trust, no tax implications should arise.

The income that is earned by the trust is taxed and assessed depending on whether the trust is a specific trust or a discretionary trust. Section 161 of the Income-tax Act governs taxation of a specific trust which provides that income (other than business income) of the trust will be taxable in like manner and to the same extent as would have been leviable upon and recoverable from the beneficiaries on an individual basis. Where any income of a specific trust comprises profits and gains from a business or profession, the entire income of the trust shall be taxed at the maximum marginal rate. Such income can be assessed either in the hands of the trustee or in the hands of individual beneficiaries.

Section 164 of the Income-tax Act governs taxability of a discretionary trust and provides that the income of the discretionary trust will be taxable at the maximum marginal rate.

Once the tax liability has been discharged on the income of the trust, subsequent distributions to the beneficiaries ought to be tax-free in India. In case of distribution to non-resident beneficiaries, certain countries consider such income as exempt from taxes where such distribution by the trust is made from the trust corpus or accumulated profits instead of current income of the trust.

It is important that the trust structure is evaluated thoroughly, and trust deeds are drafted with great care, so that tax exemptions are available.

Migration of assets to attain the desired structure may also involve family settlement. A family settlement typically involves arrangement amongst the family members to preserve the family property or to resolve family disputes with an aim to ensure harmony among family members. It involves mutual adjustment of already existing rights and interests of the family members in the property. Courts in India have generally held that family settlement does not result in capital gains tax implications for the member parting away with the property. However, the entire arrangement needs to be evaluated on a fact-to-fact basis to ensure that it is not characterized as an exchange of properties resulting in capital gains tax implications. Also, in the absence of specific exemption, the provisions of section 56(2)(x) of the Income-tax Act need consideration in case of receipt of property by a member (not qualifying as relative under the Income-tax Act) under a family settlement. Family settlements should be documented adequately and appropriately stamped and registered to avoid any challenge in a court of law.

Implications for offshore trusts

The implications on settlement of assets into an offshore trust is similar to that of settlement to an Indian trust. However, aspects on the residency of the trust should be duly evaluated to mitigate its tax residency in India. The Income-tax Act provides that an entity (other than an individual or company) is treated as a non-resident for tax purposes where the control and management is wholly situated outside India. Hence, the residency status of the protector, settlor or trustees will impact the residency status of the offshore trust. The worldwide income of the offshore trust will be taxable in India where the trust is deemed as a resident of India. A non-resident trust is taxable in India only to the extent of income accrued or received in India. Implications in the offshore jurisdiction on settlement of offshore trust and as regards distributions should be analysed.

Implications for non-resident beneficiaries

Where the trust structure involves non-resident beneficiaries, implications in such overseas jurisdiction will need to be factored.

Implications under SEBI Takeover Code

Where the assets that are to be housed under the private trust are shares in a listed company, the provisions of the SEBI Takeover Code become applicable. Migration of shares of a listed company to a trust requires prior approval of SEBI for seeking exemption from the open

offer requirement under Regulations 3 and 4 of SEBI Takeover Code.

In this regard, SEBI has issued a circular⁶⁹ stipulating the conditions to be satisfied while seeking such SEBI approval. The circular restricts layering of trustees and beneficiaries. In other words, trust structures involving sub-trusts as beneficiaries or corporate trustees are not permitted according to the SEBI circular.

Implications under Indian Exchange Control Regulations

In the event one or more family members are non-resident in India, Indian exchange control regulations also need consideration. Where it is proposed that non-residents are to be the beneficiaries in an Indian trust, any distribution to such non-resident beneficiaries should comply with the Indian exchange control regulations.

A separate evaluation may be required to determine whether a non-resident individual could act as trustee of an Indian trust.

Stamp duty implications

Transfer of properties to a trust may also attract stamp duty in accordance with the applicable state laws, and therefore the cost of such transfer will need to be factored.

Conclusion

Formalizing a succession plan requires profound forethought to facilitate smooth and seamless transition of a family's wealth and business over generations, without frustrating the individual desires and wishes of the family members. The plan needs to be structured for tax-efficiency and compliance with the regulatory requirements. Additionally, it must offer sufficient flexibility to adapt to the ever-changing socio-economic and business circumstances. Above all, it needs to be simple to comprehend so that it can be effectively implemented and does not lose its mettle on account of legal verbiage and uncertainties, that can arise with the passage of time and technological advancements.





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