CROSS BORDER MERGERS AND ACQUISITIONS

Mergers & Acquisitions Division

This paper is the copyright of Nishith Desai Associates. The views expressed in this paper are meant for informational purposes only and do not constitute advice. Consequently, no responsibility is assumed in relation thereto. No reader should act on the basis of any statement contained herein without seeking professional advice. Without prejudice to the generality of the above, since the firm is qualified to practice Indian law only, all references to the laws of any other countries must be validated by professionals licensed to practice such law.

© Nishith Desai Associates, 2002
For Private Circulation Only

Nishith Desai Associates

LEGAL & TAX COUNSELING WORLDWIDE

MUMBAI • SILICON VALLEY

93-B MITTAL COURT, NARIMAN POINT
MUMBAI 400 021. INDIA
TEL: 91 (22) 282-0609
FAX: 91 (22) 287-5792

220 CALIFORNIA AVENUE., SUITE 201
PALO ALTO, CA 94306, USA
TEL: 1 (650) 325-7100
FAX: 1 (650) 325-7300

nda@nishithdesai.com
www.nishithdesai.com

Nishith Desai Associates
June 29, 2002

CROSS BORDER MERGERS AND ACQUISITIONS

Mr. Nishith Desai is the founder of the firm **Nishith Desai Associates** (www.nishithdesai.com), Legal & Tax Counselling Worldwide. He is an international lawyer, researcher, author and a lecturer. He has been on the ex-advisory Board of the New York State Bar Association's International Law Review, chairperson of LawAsia Taxation Committee and a senior country correspondent for "Tax Notes International", US. His practice areas include International Taxation, Corporate Law, Mergers & Acquisition, Venture Capital, Information Technology, International Business Strategy and Structuring of Joint Ventures and Employee Stock Option Plans. Mr. Desai was on the Securities and Exchange Board of India (SEBI) Committee set up to evolve ESOP guidelines in India. He is also a member of the committee appointed by SEBI for synchronization / review of the various venture capital guidelines prevalent in the country. He has lectured extensively including on issues of e-commerce, privacy, ESOPs at various national and international forum.

Nishith Desai Associates (NDA) specializes in globalisation of Indian corporates, information technology, international financial and tax laws, corporate and securities laws and media and telecom law. The firm has structured and acted for the largest number of private equity funds for India. NDA recently acted as underwriter's counsel in **Infosys Technologies and Satyam Infoway's** American Depository Receipt (ADR) offerings in the USA. It also represented **Rediff.com** and **Silverline Technologies** in the ADR listings. NDA was involved in the first cross-border stock swap merger out of India, that is, **BFL's acquisition of MphasiS**. The firm has also worked on the acquisition of **IMP Inc**. by **Teamasia**. The firm is intensely research oriented and has undertaken studies in different areas of law and tax, some of which can be found on its website.

The Mergers & Acquisitions Division of NDA comprises of Siddharth Shah, Vijay Sambamurthi, Shefali Goradia Raj Shroff, Amritha Ahuja and Deanne D'Souza-Monie.

CROSS BORDER MERGERS AND ACQUISITIONS
- Nishith Desai Associates

Synopsis:

I. Introduction

II. Basic terms

III. Indian legal and regulatory considerations
   A. Overseas direct investment under the Foreign Exchange Management Act, 2000
      - Investment in a Joint Venture/Wholly Owned Subsidiary abroad
      - Investment in a foreign company vide an ADR/GDR share swap
   B. Indian corporate and securities law issues
      - Section 81(1A) of the Indian Companies act, 1956
      - SEBI (Disclosure and Investor Protection) Guidelines, 2000
      - Section 372-A of the Indian Companies Act, 1956
      - SEBI (Substantial Acquisitions and Takeovers) Regulations, 1997

IV. Acquiring a company in the US: Corporate, Securities and Anti-trust Law Issues

V. Structuring the transaction from a tax efficient perspective
   A. Indian taxation issues
   B. Cross border tax issues
      - US
      - Europe
   C. Dual Head Structures

VI. Case study of an acquisition of a U.S. company by a listed Indian company

VII. Conclusion

Nishith Desai Associates
June 29, 2002

I. INTRODUCTION

A. *Recent trends in M&A with specific reference to Indian companies acquiring companies in the U.S.*

The past decade has witnessed the phenomenal growth of the Indian software industry and is responsible for putting India back on the world economic map. The nature of the software industry is such that it has a global reach and hence Indian software companies are compelled to have a worldwide presence, not only virtually but physically as well. India's exports of computer software increased from $150 million in 1991 to $2.7 billion in 1998 with most of those exports bound for the United States[1].

Software exports from India have grown steadily. Just five years back software exports accounted for just about 2.5% of India's total exports and in the year 1999-2000, the figure is 10.5% of the total exports[2]. As the Indian software industry is growing there is also a tremendous amount of consolidation and reorganization in the global software industry as companies look for partners and strategic alliances to leverage on their competitive strengths. The Indian software companies are not far behind in this regard. Several leading Indian software companies such as Infosys, Satyam Computers and Silverline Technologies are looking to acquire companies in the U.S. The reason for this development is a sign of the coming of age of the Indian software industry. More and more Indian software companies have realized that the typical Indian software export model will not result in long term profitability. The Indian software export model is based on the low-cost of manpower in India which is why the global software firms sub-contract their software development work to Indian companies and make their profits on the margin. However this does not result in much value addition to the Indian company. Hence Indian companies are looking for acquisition targets in the U.S. which will not only bring them in direct touch with their clients but also helps the Indian company acquire a different skill set without having to stress only on the organic growth process. Mergers and acquisitions are necessary for the survival of the Indian software industry if they wish to become global players and have a worldwide presence. The government of India has also recognized the growing need for Indian software companies to expand their operations abroad and the recently enacted Foreign Exchange Management Act, 2000 ("**FEMA**")[3] further liberalizes the provisions relating to overseas direct investment by Indian companies.

Part I of the paper is a discussion of the recent trends with respect to mergers and acquisitions in India. Part II of the paper deals with the basic terms with respect to mergers and acquisitions. Part III deals with the overview of the overseas direct investment policy which is contained in the FEMA. The overseas direct investment policy which governs investment by Indian companies in foreign companies has been sufficiently liberalized by the FEMA.

Part IV of this paper gives the reader a broad overview of the general corporate law issues, ranging from "minority squeeze out" to antitrust issues, that an Indian company needs to keep in

1. http://www.theglobalist.com/ssw/factsheets/2000/03-20-00.shtml (Accessed on October 12, 2000).

mind while planning a merger or acquisition with a company in the United States. Part V of this paper covers the tax issues that arise when an Indian company acquires a foreign company focusing on the Indian and U.S. tax issues.

Part VI of the paper is a case study of one of the acquisitions that the firm was recently involved in, being an acquisition of a U.S. company by a listed Indian company. This section discusses the complex legal and tax issues that arose in an acquisition spanning three jurisdictions with varied legal systems and tax regimes. And finally, Part VII concludes with a brief discussion on the future trends in M&A with specific reference to the software industry.

---

2. The Foreign Exchange Management Act, 2000

II. BASIC TERMS

Mergers

The Oxford dictionary defines a merger as a " combining of two or more commercial organizations into one in order to increase efficiency and sometimes to avoid competition" [4]. Although there is no specific definition of the term "merger" under the provisions of the Indian Companies Act, 1956, it does have a specific legal connotation. In a merger transaction, two legal entities merge together and there is only one resultant legal entity, which is generally referred to as the "surviving company". All mergers are statutory mergers since all mergers occur as specific formal transactions in accordance with the laws or statutes of the states where the entities are incorporated[5].

Amalgamation

An amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders in the company which is to carry on the blended undertakings.[6] Hence the term "amalgamation" includes a "merger".

Acquisitions

An acquisition is the process by which the stock or assets of a corporation come to be owned by the buyer. The transaction may take the form of a purchase of stock or a purchase of assets[7].

Difference between a merger and an acquisition

An acquisition is the generic term that is used to describe a transfer of ownership whereas merger is a technical term for a particular legal procedure wherein two separate entities merge and only one legal entity survives the merger. There are different forms of mergers, some of which have been dealt with in detail hereinbelow.

Earn-outs

An earn-out is an agreement by the buyer of the assets or a business to make future payments to its target company or its shareholders contingent up on the satisfaction or achievement of specific milestones. Well-structured and carefully drafted earn-out can bridge potential impasse on valuation between the buyer and the seller and result in a deal which otherwise would have been none.

Types of mergers

4 *The Oxford Dictionary For The Business World*, Oxford University Press, New York, 1993.
5 Reed, Stanley Foster and Lajoux, Alexandra Reed, *The Art of M&A*, Third Edition, McGraw-Hill, New York, 1999. P.5.
6 Sharma, L.M. *Amalgamations, Mergers, Takeovers and Acquisitions*, First Edition, Company Law Journal, New Delhi, 1997. P.16.
7 *Ibid.*

- Horizontal merger

A horizontal merger is a merger between business competitors, such as manufacturers of the same type of products or distributors selling competing products in the same market area.

- Vertical merger

A vertical merger is a merger between two companies where one of the two companies is an actual or potential supplier of goods or services to the other so that the two companies are both engaged in the manufacture or provision of the same goods or services but at different stages in the supply route [8].

- Conglomerate merger

A conglomerate merger is one where two companies which are in two different industries, merge together.

- Cash merger

A merger in which some of the shareholders of one of the merging entities receive cash as consideration for them transferring their share in that merging entity.

- Triangular merger

A merger of two companies by which the disappearing company is merged into a subsidiary of the surviving company and the shareholders of the disappearing company receive shares in the surviving company.

- Reverse triangular merger

In a reverse triangular merger the subsidiary of the surviving company is merged into the disappearing company so that it becomes a wholly owned subsidiary of the surviving company.

- Double merger or back-to-back merger

In a double merger, first all of target's outstanding stock is acquired by the acquirer in a reverse triangular merger and then the target, which will be a subsidiary of the acquirer will be merged into the acquirer – "upstream merger" or will be merged into another subsidiary of the acquirer - "sideways merger".

The terms mentioned above are merely illustrative and not exhaustive and there are several new types of transactions that are emerging such as "poof roll-up" acquisitions *etc*.

---

8 *Supra n.5.*

III. INDIAN LEGAL AND REGULATORY CONSIDERATIONS

A. *Overseas direct investment*

The provisions relating to investment by an Indian company in a foreign company were liberalized by the Foreign Exchange Management Act, 1999 ("**FEMA**") (which came into effect from June 1, 2000 and the rules and regulations made thereunder. Subsequently, the Reserve Bank of India issued the Foreign Exchange Management (Transfer or Issue of Foreign Security) Regulations, 2000 (the "**Regulations**") which contain provisions governing any investment made by an Indian company in a foreign company. This chapter discusses the provisions relating to overseas direct investment under the FEMA and the Regulations.

There are only certain special circumstances under which an Indian company is permitted to make an investment in a foreign company [9]. An Indian party is not permitted to make any direct investment in a foreign entity engaged in real estate business or banking business without the prior approval of the Reserve Bank of India ("**RBI**").

There are several routes available to an Indian company which intends to invest in a foreign company. Some of these routes are described hereinbelow:

(1) Direct Investment in a Joint Venture/Wholly Owned Subsidiary

The RBI has been continuously relaxing the provisions relating to investment in a joint venture or a wholly owned subsidiary. Owing to these relaxations the percentage of investment by Indian companies in a joint ventures and wholly owned subsidiaries abroad has been continuously rising. As per the Annual Report of the Department of Commerce for the year 1999-2000, at the end of September 1999 there were 912 active joint ventures abroad with an approved equity of USD 1,150.32 million as compared to 788 joint ventures at the end of September 1998[10.] Further, as of September 1999 there were 831 active wholly owned subsidiaries abroad (with a total equity investment of USD 1,368.39 million) as compared to 644 as of September, 1998[11].

General conditions to be fulfilled for making an investment

An Indian company is permitted to make a direct investment in a joint venture or a wholly owned subsidiary of a sum not exceeding USD 100 million or its equivalent in a financial year[12] without seeking the prior approval of the RBI subject to the following conditions being fulfilled:

1. The direct investment is made in a foreign entity engaged in the same core activity carried

9 Regulation 5 of the Foreign Exchange Management (Transfer or Issue of Foreign Security) Regulations, 2000 provides that no resident Indian (which term would include a company) can make an investment outside India, except in accordance with these regulations or without the prior approval of the Reserve Bank of India.
10 *Annual Report 1999-2000,* Department of Commerce, New Delhi, P.119.
11 *Annual report 1999-2000,*Department of Commerce, New Delhi, P 120.
12 This condition will not apply if the investment is to be made in a joint venture or wholly owned subsidiary in Nepal or Bhutan. If the overseas direct investment is made in Nepal or Bhutan in Indian rupees the total financial commitment shall not exceed Indian Rupees 350 crores in a block of three financial year.

on by the Indian company

2. The Indian company is not on the RBI's caution list or under investigation by the Enforcement Directorate
3. The Indian company routes all the transactions relating to the investment in the joint venture or the wholly owned subsidiary through only one branch of an authorized dealer to be designated by it. However the Indian company is permitted to designate different branches of authorized dealer for onward transmission to the RBI.
4. The Indian company files the prescribed form with the RBI.

Special conditions for investment in a financial company

There are also special additional conditions that apply to an Indian company making a direct investment in a foreign company that is engaged in financial services activities. In case of companies engaged in financial services, an Indian company is permitted to make investment in a foreign company engaged in the financial services sector on an automatic basis if it fulfils the following conditions:

- The Indian company has earned a net profit during the preceding three financial years from the financial services activities
- The Indian company is registered with the appropriate regulatory authority in India for conducting the financial services activities
- The Indian company has a minimum net worth of Rs. 15 crores (Indian Rupees Fifteen Crores) as on the date of the last audited balance sheet; and
- The Indian company has fulfilled the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India[13].

Sources for investment

The Regulations also prescribe that any direct investment (as discussed above) must be made only from the following sources:

- *EEFC account*: The Indian company can make the investment out of the balance held in the Exchange Earners Foreign Currency ("**EEFC**") account of the Indian company.
- *Drawal of foreign exchange*: The Indian company can also make the direct investment by drawal of foreign exchange from an authorized dealer in India provided that the foreign exchange so drawn does not exceed 50% of the networth of the Indian company as on the date of the last audited balance sheet.
- *ADR/GDR proceeds*: An Indian company is also permitted to make a direct investment in a foreign company out of the proceeds of an ADR/GDR issue without the prior approval of the RBI provided it satisfies the following conditions:

    - The ADR/GDR issue has been made in accordance with the provisions of the Scheme for Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt),1993 ("**ADR/GDR Scheme**").

13 The prescribed guidelines are the guidelines issued by the RBI that govern the capitalization of Non-Banking Financial Companies.

- The Indian company files the prescribed form with the RBI

(2) Investment in a foreign company by ADR/GDR share swap

An Indian company can also invest in a foreign company which is engaged in the same core activity in exchange of ADRs/GDRs issued to the foreign company in accordance with the ADR/GDR Scheme for the shares so acquired provided that the following conditions are satisfied:

- The Indian company has already made an ADR/GDR issue and that such ADRs/GDRs are listed on a stock exchange outside India
- The investment by the Indian company does not exceed the higher of an amount equivalent to USD 100 million or an amount equivalent to ten times the export earnings of the Indian company during the preceding financial year[14]
- The ADR/GDR issue is backed by a fresh issue of underlying equity shares by the Indian company
- The total holding in the Indian company by non-resident holders does not exceed the prescribed sectoral cap[15]
- The valuation of the shares of the foreign company is done in the following manner:
    - If the shares of the foreign company are not listed, then as per the recommendation of an investment banker or
    - If the shares of the foreign company are listed then as per the formula prescribed in the Regulations[16]
- The Indian company will also be required to make a filing with the RBI in the prescribed form within thirty days from the date of the issue of ADRs/GDRs to the foreign company[17]

In the event that the Indian company does not satisfy the conditions discussed in points (1) and (2) hereinabove, then the Indian company can make an application to the RBI for special approval. In considering the application the RBI may take into account the following factors:

- *Prima facie* viability of the joint venture/wholly owned subsidiary abroad
- Contribution to external trade and other related benefits
- Financial position and business track record of the Indian company and the foreign company and
- Expertise and experience of the foreign company in the same or related line of activity of the joint venture or the wholly owned subsidiary abroad.

Issue of shares to the employees of the foreign company

In the event that the Indian company wishes to issue stock options to the employees of the

14 The export earnings should be as reflected in the audited balance sheet of the company.
15 The sectoral cap is contained in the Foreign Direct Investment Scheme contained in the Foreign Exchange Management (Transfer or Issue of Foreign Security) regulations, 2000.
16 The valuation in this case would be based on the current market capitalization of the foreign company arrived on the basis of the monthly average price on any stock exchange abroad for the three months preceding the moth in which the acquisition is committed and over and above the premium, if any, as recommended by the investment bank in its due diligence report.
17 Form ODG is the prescribed form.

foreign company (which is a joint venture or a wholly owned subsidiary), the Indian company will be required to comply with the provisions of regulation 8 of the Foreign Exchange Management (Transfer or issue of Security by a person resident outside India) Regulations, 2000 which provides for the issue of shares to persons resident outside India under the Employees Stock Options Scheme.

As per these provisions an Indian Company may issue shares to non-resident:
- employees, or,
- employees of joint venture, or,
- employees of wholly owned subsidiary

Provided that the scheme does not violate the terms of the regulations issued under the Securities and Exchange Board of India Act, 1992 (15 of 1992)[18] and the face value of the shares to be allotted to the non-resident employees does not exceed 5% of the paid up share capital of the company issuing the ESOPs.

In addition to the above, an Indian company can also acquire shares of a foreign company by way of capitalization[19]. RBI has also provided certain additional facilities for Indian companies acquiring listed companies overseas through the bidding or tender procedure[20].

B. *Indian corporate and securities law issues*

An Indian company proposing to make an investment in a foreign company will also be required to comply with certain provisions of the Indian Companies Act, 1956 (the "**Companies Act**") and if the Indian company is also listed on any Indian stock exchange, it will be required to comply with certain regulations issued by the Securities and Exchange Board of India. We have discussed some of these relevant provisions hereunder:

(1) Special resolution under Section 81(1A) of the Companies Act

If the Indian company is incorporated as a public limited company under the provisions of the Companies Act and the Indian company proposes to acquire the shares of the foreign company by issuing its shares as consideration to the shareholders of the foreign company, then the shareholders of the Indian company will be required to pass a special resolution under the provisions of Section 81(1A) of the Companies Act permitting the issue of shares to the shareholders of the foreign company.

(2) SEBI (Disclosure and Investor Protection) Guidelines, 2000

If the Indian company that is issuing its shares to the shareholders of the foreign company as consideration for acquiring shares of the foreign company is listed on any stock exchange in

18 SEBI (Employee Stock Options Scheme and Employee Stock Purchase Scheme) regulations, 1999.
19 Regulation 11. This Regulation provides that an Indian company can also make investments in a foreign company by way of capitalizing the amount due to it from the foreign company by making payment for export of plant, machinery, etc.
20 Regulation 14. This regulation provides that subject to fulfilling certain conditions an Indian company can approach an authorized dealer and request remittance towards earnest money deposit or request the authorized dealer to issue a bid bond guarantee on its behalf for the acquisition of a foreign company.

India, then it will be required to comply with the guidelines for preferential allotment under the SEBI (Disclosure and Investor Protection) Guidelines, 2000 (the "**SEBI DIP Guidelines**") in addition to the provisions of Section 81(1A) of the Companies Act. We have highlighted some of the relevant provisions of the SEBI DIP Guidelines hereinbelow:

- *Pricing*[21] : The shares issued on a preferential basis have to be made at a price that is not less than the higher of either (a) the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date[22] or (b) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

- *Currency of the resolution*: Any allotment pursuant to a resolution permitting the issue of shares on a preferential basis has to be completed within a period of three months from the date on which the resolution is passed by the shareholders[23] failing which a fresh approval will have to be sought from the shareholders. However it is possible to make an application to the SEBI requesting for the extension of the validity of the resolution. The extension is granted on a case by case basis. This means that the entire transaction has to be completed within three months of the shareholders passing the resolution under Section 81(1A) of the Companies Act.

(3) Approval of the shareholders under Section 372-A of the Companies Act

If the investment by the Indian company in the foreign company exceeds sixty percent (60%) of the paid-up share capital and free reserves of the Indian company or one hundred percent (100%) of the free reserves of the Indian company, whichever is more, then the Indian company is required to obtain the prior approval of the shareholders vide a special resolution[24].

The next chapter discusses the corporate and securities law issues that arise when an Indian company acquires/merges with a foreign company.

(4) Compliance with the provisions of the SEBI Takeover Code

- If the issuing company is a listed company and makes a preferential allotment of shares to the acquirer, such an allotment would generally be exempt from the public offer provisions of the SEBI (Substantial Acquisitions and Takeovers) Regulations, 1997 ("**SEBI Takeover Code**") provided that the disclosure requirements as prescribed in Regulation 3(1)(c) of the SEBI Takeover Regulations are fulfilled.
- Further, upon completion of the acquisition and within 21 days from the issuance of shares to the shareholders of the target company, a detailed report in a prescribed format would have to be filed with the SEBI[25].

---

21 Regulation 13.1.1 of the SEBI DIP Guidelines.
22 The term "relevant date" is defined to mean the date thirty days prior to the date on which the general meeting (whether annual or extraordinary) of the shareholders is to held the approve the proposed issue of shares.
23 Regulation 13.4 of the SEBI DIP Guidelines.
24 Section 372(1) of the Companies Act.
25 Regulation 8 of the SEBI Takeover Code.

IV. ACQUIRING A COMPANY IN THE U.S. – CORPORATE, SECURITIES AND ANTI-TRUST LAW ISSUES

There are several issues that an Indian company needs to keep in mind while structuring or planning its acquisition of a foreign company. The Indian company needs to be aware of the corporate and securities law regime in the jurisdiction in which the foreign company is situated in order to determine the takeover code requirements, the provisions relating to the rights of minority shareholders, etc.

Business combinations in the U.S. are governed by the federal laws of the U.S. and the laws of the state(s) where the parties to a business combination are incorporated.

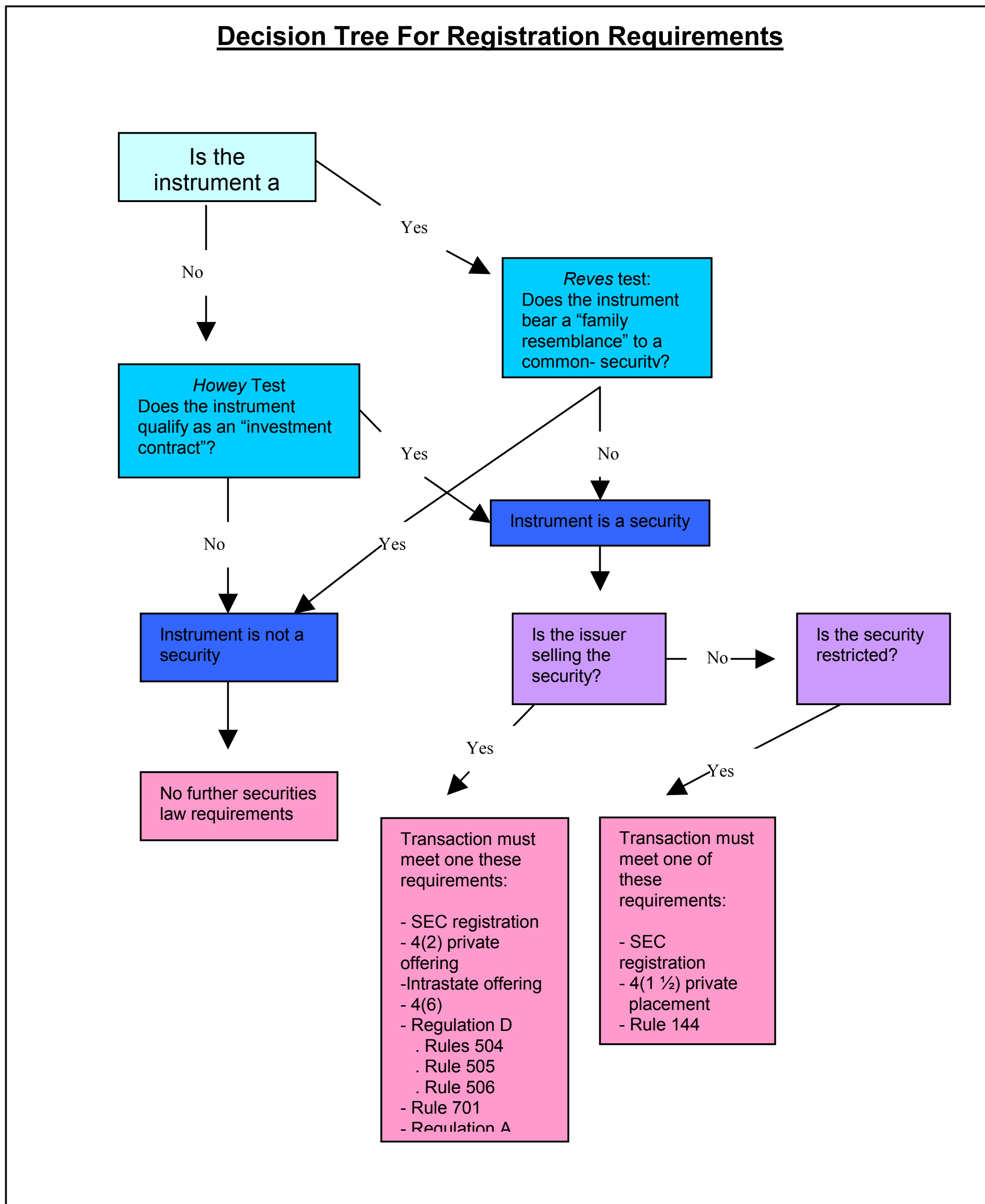
- **Relevant statutes**

The Securities Act and the Exchange Act

The two primary relevant federal laws are the Securities Act of 1933 (the "**Securities Act**") and the Securities Exchange Act of 1934 (the "**Exchange Act**"), including the rules and regulations promulgated by the Securities and Exchange Commissions (the "**SEC**") under both the Securities Act and the Exchange Act. The Securities Act deals primarily with the sale and purchase of securities and applies to all transactions where securities are being offered or sold. The Exchange Act, among other things contains the federal law provisions relating to tender offers, proxy statements, shareholder disclosure obligations and going-private transactions. Recently Regulation M-A was enacted by the SEC under the Exchange Act in an attempt to harmonize and bring together in one regulation the existing Exchange Act rules applicable to business combinations.

While generally any offer of security to US residents would require registration, there are certain exemptions from registration requirement which can be effectively used by overseas acquirers. The following chart lays down the broad registration requirement under the Securities Act:

[This space is left blank intentionally]



Acquisition of a US public company would generally require a full-fledged registration with the SEC. The registration process is time-consuming and also expensive. However, for acquisition of non-public companies there are certain exemptions from registration requirements which can be availed by overseas acquirer. Once of the most commonly used exemption is offering securities by way of private placement in accordance with Regulation D. The following exemptions under Regulation D can be examined by the acquirers:

Rule 504

Rule 504 exempts offerings of up to $1 million within a 12-month period. There may be an unlimited number of purchasers under Rule 504. It is not available to issuers registered under the 1934 Act such as public companies or to investment companies like mutual funds. The issuer is required to file a notice on Form D within 15 days after the first sale of securities.

Rule 505

Rule 505 exempts offerings of up to $ 5 million within a 12 month period. General solicitations and advertising are not permitted in connection with a Rule 505 offering, and the issuer must reasonably believe that there are not more than 35 unaccredited investors. Rule 505 is not available to investment companies. Issuers are required to provide certain specified information to purchasers, unless all of them comprise of accredited investors. This information is compiled in a private placement memorandum or offering circular. Rule 505 requires that purchasers have the opportunity to ask questions and receive answers concerning the terms of the offering. A notice on Form D must be filed with the SEC within 15 days of the first sale of securities.

Rule 506

Rule 506 exempts offerings that are limited to no more than 35 unaccredited investors, provided that the issuer believes immediately prior to making any sale that each unaccredited investor either alone or with his purchaser representative has enough business experience to evaluate the merits and risks of the prospective investment. There can be an unlimited number of accredited investors. However, general solicitations and advertising are not permitted. Certain specified information should be provided to purchasers and the purchasers have the opportunity to ask questions and receive answers concerning the terms of the offering. A notice on Form D must be filed with the SEC within 15 days of the first sale of securities.

It is also important to understand as to who would qualify as accredited investor from the purpose of Regulation D. As per Rule 501 under Regulations D, any of the following would be treated as an accredited investor:

1. Any national bank
2. Any corporation, business trust, or charitable organization with total assets in excess of US $ 5 million
3. Any director, executive officer, or general partner of the issuer
4. Any natural person who had individual income in excess of US$ 200,000 in each of the two most recent years, or joint income with that person's spouse in excess of US$300,000 in each of those years, and who has a reasonable

expectation of reaching the same income level in the current year

5. Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds US$ 1 million

The Exchange Act

The Exchange Act imposes certain duties on companies whose securities are publicly traded and on persons who would buy or sell securities of such companies. During the preliminary phase of an acquisition at least three requirements must be complied with, the violation of which can entail civil and criminal prosecution by the SEC as well as law suits by private parties.

1. A company covered by the Exchange Act may be duty bound to disclose the existence of acquisition negotiations. Disclosures have to be made before entering into the LOI. A non-U.S. acquirer may itself be subject to these requirements if its securities are publicly traded in the U.S. either directly or as American Depository Receipts. A false denial of rumors of such negotiations, even before the signing of a LOI will lead to violation of the Exchange Act.

2. Insider trading is strictly prohibited under the Exchange Act. It is defined to mean the purchase or sale of securities based on material information that is not yet public ("**inside information**"). Passing of such information to another who engages in such a transaction is a serious violation of the Exchange Act punishable by imprisonment, heavy penalties, or with both.

Shareholder disclosure requirements

Persons or groups acting together who own 5% or more of a public company are required, pursuant to the William's Act provisions of the Exchange Act, to make a public disclosure filing pursuant to Regulation 13D-G of the Exchange Act. Whether such a stockholder is required to make such disclosure in Schedule 13G (which requires only basic information about the stock holder and the amount of its holdings) or Schedule 13D (which requires more extensive information), depends on several factors, including whether such a person has acquired the securities with any purpose or intent to change or influence the control of the issuer.

Minority Squeeze-out

State statues provide that if a party owns or acquire more than a certain percentage of another party's stock (typically 90%), the board of directors of the acquiring party may, by resolution, merge the target into the acquiring party. This procedure does not require a vote on the part of either company's stockholders, nor even a resolution of the target's board.

‘Going-private’ transactions

In a transaction structured as a tender offer followed by a merger to eliminate any remaining minority interest, it is possible to offer greater consideration in the front-end tender offer than is to be received in the back-end merger. In this way, if 51% of the shares of a company are tendered, it is possible, subject to certain disclosure requirements, to squeeze out the remaining 49% interest. Certain squeeze-out transactions are referred to as “going-private” transactions and in most cases are subject to Rule 13e-3 of the Exchange Act.

Tender offers in the U.S. must be open for at least 20 days.

Exemptions

The SEC has recently adopted regulations which provide foreign parties acquiring foreign companies having assets in the US with certain limited exemptions from U.S. regulations, some of which are briefly discussed below. An acquisition by a foreign person shall be exempt from the requirements of the act if:

(a) The acquisition is of assets located outside the United States;

(b) The acquisition is of voting securities of a foreign issuer, and will not confer control of:
  (1) An issuer which holds assets located in the United States (other than investment assets, voting or nonvoting securities of another person, and assets included pursuant to Sec. 801.40(c)(2)) having an aggregate book value of $15 million or more, or
  (2) A U.S. issuer with annual net sales or total assets of $25 million or more;

(c) The acquisition is of less than $15 million of assets located in the United States (other than investment assets); or

(d) The acquired person is also a foreign person, the aggregate annual sales of the acquiring and acquired persons in or into the United States are less than $110 million, and the aggregate total assets of the acquiring and acquired persons located in the United States (other than investment assets, voting or nonvoting securities of another person, and assets included pursuant to Sec. 801.40(c)(2)) are less than $110 million.

Antitrust Issues

The Clayton Act is the primary US Statute governing the substantive competition

issues arising out of mergers and acquisitions. The essence of this act is to prohibit acquisitions where the effect of such acquisition is to reduce competition or to create a monopoly. In addition to the Clayton Act, Shearman Act prohibits unreasonable restraint of trade, attempts to monopolise and monopolization. The Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "**HSR Act**") is the statute governing the procedural aspects of the government's right to review of mergers and acquisitions. It is the HSR Act which ensures that any merger or acquisition does not result in restraint of competition or creation of monopoly.

Under the HSR Act, in order to comply with U.S. competition laws, for all types of transactions, a filing of a Notification and Report Form ("**NRF**") with the Antitrust Division of the U.S. Department of Justice ("**DOJ**") and the Federal Trade Commission ("**FTC**") which is a part of the U.S. Department of Commerce. Both the DOJ and FTC have authority to challenge the acquisition as being anti-competitive. Generally, all mergers and acquisitions that meet the following three criteria must be reported under the HSR Act and the related pre-merger notification rules:

1. The transaction is between two persons with minimum sizes of USD 100 million and USD 10 million, respectively, in <u>gross assets</u> or, in <u>annual sales for manufacturing companies</u>.
2. As a result of the transaction, the acquiring person will own either:
   (a) more than USD 15 million of the acquired person's voting securities or assets; or
   (b) 50% or more of the voting securities of a company that has consolidated annual sales or gross assets of USD 25 million or more.
3. One of the persons involved is engaged in U.S. commerce or in an activity affecting U.S. commerce.

The important factor to be borne in mind is the fact that the filing of HSR Act has multiple thresholds. When a person acquires 100% of the stock of a target in one step, the HSR issues are simplified in the sense that only one set of filings are required. However, when an acquirer acquires shares in stages, the HSR Rules multiple filings are required. There are essentially 5 thresholds which require separate filings: USD 50 million, USD 100 million, USD 500 million, 25% of the voting securities if valued at over USD 1 billion and 50% of the voting securities if values at greater than 50%.

Other important factor to be borne in mind is the fact that HSR filings may be triggered even in case of secondary acquisitions if the above thresholds are reached. Also, acquisition of shares with investment intent is exempt upto 10% (and 15% in case of institutional investors) of the voting securities. However, the concept of investment intent is interpreted very narrowly by the agencies. Furthermore, any failure to file the necessary filings under the HSR Rules could attract penalty to the extent of USD 10,000 per day of delay.

Additional considerations

Certain states have nominal stock transfer taxes which need to be paid. This is not comparable to stamp duty paid in India. Furthermore, many regulated industries (e.g. telecom, energy, banking, transportation) must comply with special business combination legislation particular to those industries. Typically, the approval of certain federal or state governing agency is required before the completion of the transaction. Also, transactions having national security implications require special notification to and approval by the US government.

While the above information may be useful for overseas acquirers to evaluate the transaction and registration requirements at an early stage, it would always be advisable to consult US lawyers on the above issues since the securities laws in the US are very intricate and due care should be taken by the acquirer to avoid any regulatory pitfalls since any such lapse could result in a significant economic and reputational injury.

V. TAX ISSUES

This chapter focuses on the tax issues that arise with respect to an acquisition of a company in the U.S./Europe by an Indian company. Effective tax planning for an acquisition is crucial as it can make or break a deal. Pre-acquisition tax planning may also have a significant impact on the target's post-acquisition operations. Careful tax planning from the seller's perspective also may help determine a successful bidder for the target.

Structuring a transaction from a tax efficient perspective involves a study of the tax regime of both jurisdictions where the two entities are located as well as the double taxation avoidance agreement entered into between the two countries, if any.

Indian tax issues

Broadly speaking, the existing provisions of the Indian Income Tax Act, 1961 ("**ITA**") specifically recognizes the following types of restructuring activities :

1. Merger or amalgamation;
2. Slump sale; and
3. Demerger or spin-off.

As per the provisions of the ITA, capital gains tax would be levied on such transactions when capital assets are transferred. Section 2(47) of the ITA defines the term 'transfer' as follows :

"Transfer" in relation to a capital asset includes:

(i) The sale, exchange or relinquishment of the asset; or

(ii) The extinguishment of any rights therein; or

(iii) The compulsory acquisition thereof under any law; or

(iv) In case where the asset is converted by the owner thereof into, or is treated by him as, stock–in–trade of a business carried on by him, such conversion or treatment; or

(v) Any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882; or

(vi) Any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever), which has the effect of transferring, or enabling the enjoyment of, any immovable property.

Thus, if merger, amalgamation, demerger or any sort of restructuring results in

transfer of capital asset, it would lead to a taxable event.

<u>Merger or amalgamation</u> :

Section 2(1B) of the ITA defines amalgamation as under:

"*'Amalgamation' in relation to one or more companies means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that:*

(i) *<u>All the property</u> of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of amalgamation.*
(ii) *<u>All the liabilities</u> of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of amalgamation.*
(iii) *Shareholders holding <u>not less than three-fourths in value of the shares</u> in the amalgamating company or companies (other than shares held therein immediately before the amalgamation or by a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of distribution of such property to the other company after the winding up of the first-mentioned company.*"

Analysis

The above definition highlights that the following conditions need to be satisfied for a merger to qualify as 'amalgamation' under the provisions of the ITA:

- The merger should be pursuant to a <u>scheme of amalgamation</u>
- All the assets and liabilities of the amalgamating company should be included in the scheme of amalgamation.
- No prescribed time limit exists within which the property of the amalgamating company should be transferred to the amalgamated company.
- The requirement that the shareholders holding seventy five per cent (75%) in value of the shares in the amalgamating company to be shareholders in the amalgamated company applies to both preference and equity shareholders. However, it does not prescribe any minimum holding in the amalgamated

company, nor does it stipulate for how long they should continue being shareholders in the amalgamated company.
- The consideration to the shareholders of the amalgamating company can be a combination of cash and the shares in the amalgamated company.

It is possible to issue even redeemable preference shares as consideration to qualify as amalgamation[26].

Capital gains tax implication for the amalgamating (transferor) company: Section 47(vi)

Section 47(vi) specifically exempts the transfer of a capital asset in a scheme of amalgamation by the amalgamating company to the amalgamated company, provided the amalgamated company is an Indian company. It is essential that the merger falls within the definition of amalgamation as given under section 2(1B), if the exemption hereunder is to be availed of.

Exemption from capital gains tax to a foreign amalgamating company for transfer of capital asset, being shares in an Indian company: Section 47(via)

In a cross-border scenario, when a foreign holding company transfers its shareholding in an Indian company to another foreign company as a result of a scheme of amalgamation, such a transfer of the capital asset *i.e.* shares in the Indian company would also be exempt from capital gains tax in India for the foreign amalgamating company if it satisfies the following two conditions:

1. At least 25% of the shareholders of the amalgamating foreign company continue to be the shareholders of the amalgamated foreign company.
2. Such transfer does not attract capital gains tax in the country where the amalgamating company is incorporated.

It is important to note that the definition of “amalgamation” under section 2(1B) necessitates that 75% (in terms of value of shares) of the shareholders of the amalgamating company should be the shareholders in the amalgamated company; however, section 47(via) specifies 25% as the corresponding figure, *albeit* with respect to foreign companies alone. This seems to indicate that the general requirement of shareholding in the definition of amalgamation under section 2(1B) could be overridden by the specific requirement under this section.

There are several types of reorganizations, which are exempt from capital gains tax in the USA, discussed at a later point in this paper. Hence, provided that there are no overriding business / legal considerations, such a transaction should be structured to

26 Delhi HC in Telesound (India) Limited [1983] Comp Cases, 926

satisfy the condition that 25% of the shareholders of the amalgamating company would continue to be shareholders in the amalgamated company. The above provisions also indicate that an Indian company cannot amalgamate into a foreign company without attracting capital gains tax liability in India.

Capital gains tax liability on the shareholders of the amalgamating company: Section 47(vii)

In the case of a merger, the shareholders of amalgamating company would be allotted shares in amalgamated company as a result of the amalgamation. This process presupposes the relinquishment of shares in amalgamating company held by shareholders thereof. It is important to determine whether this constitutes a transfer under section 2(47) of the ITA, which would be liable to capital gains tax. According to judicial precedents in this regard, including decisions of the Supreme Court till recently, this transaction did not result in a "transfer" as envisaged by section 2(47). The reasoning underlying this perspective was as follows:

(i) Sale has been defined under the Sale of Goods Act, 1930 to mean a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price[27.]

(ii) In the case of *Commissioner of Income Tax v. Rasiklal Maneklal (HUF)* [28] the Supreme Court of India (the "**SC**") held that an exchange involves transfer of property by one person to another and reciprocally the transfer of property by the other to the first person.

(iii) Relinquishment takes place when the owner of the asset withdraws himself from the property and abandons his right in the property. It presumes that the property continues to exist after the relinquishment[29]. In case of a merger, the shares of amalgamating company do not continue to exist.

(iv) The destruction of the right in an asset on account of the destruction of the asset itself should not be equated with the extinguishment of right on account of its transfer. Section 45 of the ITA, under which the transfer of capital gains is a taxable event, should relate to capital gains arising out of "transfer" of asset and not on account of "extinguishment of right " by itself. Hence, an extinguishment of right not brought about by transfer was considered to be outside the purview of section 45.[30]

The above position has been reversed by a recent decision of the Supreme Court ("**SC**") in case of *Commissioner of Income Tax v. Mrs. Grace Collis and Another*[31]

---

[27] Section 4(1) of the Sale of Goods Act, 1930
[28] Commissioner of Income Tax v. Rasiklal Maneklal (HUF) [1989] 177 ITR 198X (SC)
[29] *Ibid.*
[30] Vania Silk Mills Private Limited v. Commissioner of Income Tax [1991] 191 ITR 647 (SC)
[31] [2001] 248 ITR 323 (SC)

("**Grace Collis**"). In this case, the SC has held that "extinguishment of any rights in any capital asset" under the definition of "transfer" would include the extinguishment of the right of a holder of shares in an amalgamating company, which would be distinct from and independent of the transfer of the capital asset itself. The SC held that the interpretational stance taken by its previous bench in the case of *Vania Silk Mills Private Limited v. Commissioner of Income Tax*[32] would render the expression "extinguishment of any rights in any capital asset" ineffective and meaningless. Therefore, according to the SC, it follows that the rights of shareholder of the amalgamating company in the capital asset, *i.e.* the shares, stands extinguished upon the amalgamation of the amalgamating company with the amalgamated company and this constitutes a transfer under Section 2(47) of the ITA.

However, under section 47(vii) of the ITA, such a transfer by the shareholders of the amalgamating company is specifically exempt from capital gains tax liability, provided the following conditions are satisfied:

1. The transfer is made in consideration of allotment to the shareholder of shares in the amalgamated company.
2. The amalgamated company is an <u>Indian company</u>

The above conditions, read with the definition of "amalgamation" under section 2(1B) mean that even when a transaction is an "amalgamation", as defined under section 2(1B), it would not result in capital gains tax liability to the shareholders of the amalgamating company only if there is no cash consideration.

The issue addressed by Grace Collis would arise in situations where the amalgamation does not satisfy all the conditions under section 47(vii) and section 2(1B) and is therefore not exempt from the capital gains tax. In view of the decision in Grace Collis, the present position of law seems to be that such a merger would result in capital gains tax to the shareholders of the amalgamating company.

For instance, in case of a cross border merger, where one foreign amalgamating company ("**FA**") having a branch in India merges into another foreign amalgamated company ("**FB**"), all the conditions under section 47(vii) read with section 2(1B) would not be satisfied and the Indian resident shareholders in FA, if any, would be liable to Indian capital gains tax. Depending on the domestic law of the country where the merger takes place, there could be double taxation, though it should be possible to relieve this double taxation under a double tax convention ("**DTC**"), which may exist between India and the foreign country. However, the timing of capital gains incidence and matching of credit may pose some difficulty.

Computation of capital gains tax on disposal of the shares of amalgamated company:

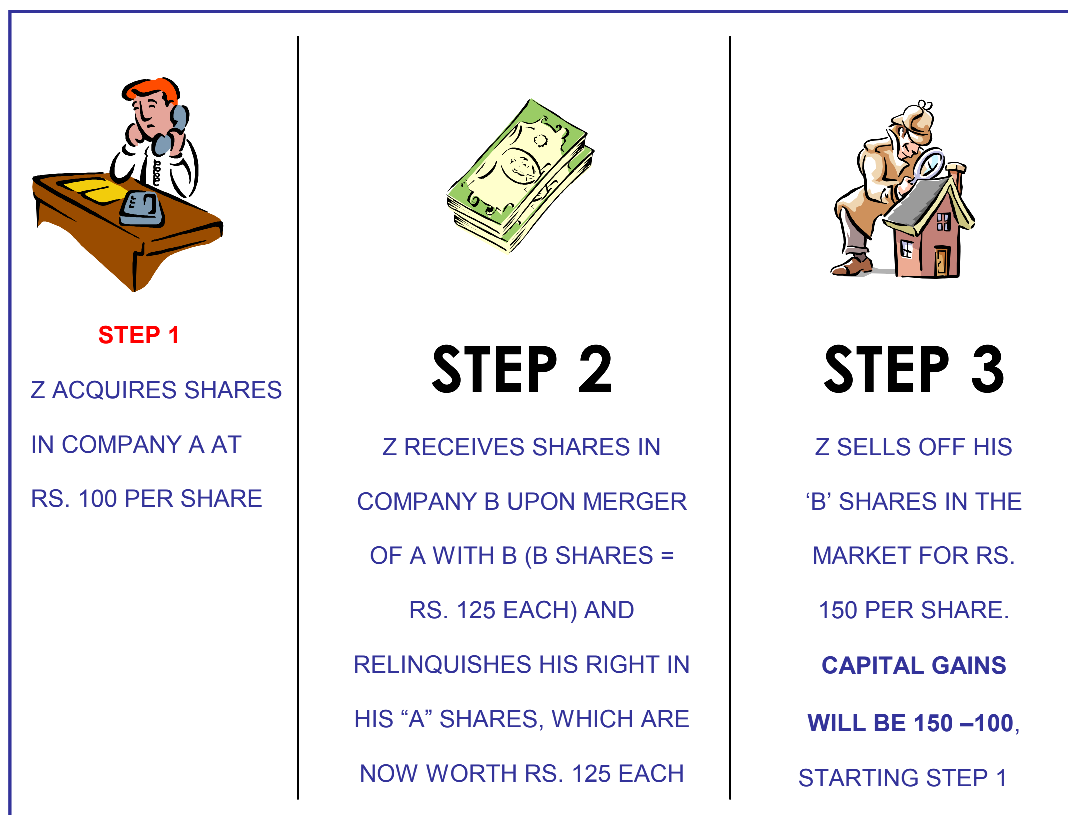
[32] *Ibid*

Section 49(2) of IT Act

> This section contemplates a situation in which shareholders of the amalgamating company, having acquired the shares in the amalgamated company as a result of the amalgamation, now elect to sell off such amalgamated company's shares.

According to the provisions of section 49(2) of the IT Act, where a shareholder of amalgamating company acquires a capital asset, being a share or shares in the amalgamated company, which is an Indian company, by virtue of his shareholding in the amalgamating company A referred to in section 47(vii), the cost of acquisition of the shares in B to the shareholder would be deemed to be the cost of acquisition to him of the shares in the amalgamating company.

Accordingly, when these shareholders sell their shares in the amalgamated company, for computing the capital gains that would accrue to them as a result of the sale, the cost of acquisition would be the cost of their shares in the amalgamating company. Also the period of holding for determining long term or short term gains would begin from the date the shares were acquired by the shareholders in the amalgamating company. To illustrate:



Availability for set off of unabsorbed losses and other tax benefits: Sections 72A,

35AB, 42 and 115AC

With effect from April 1, 2000, the amended section 72A provides that in case of amalgamation of a company owning an industrial undertaking, the amalgamated company would be able to get the benefit of carry forward of losses and depreciation to set off against its future profits, provided the following conditions are satisfied:

1. The amalgamated company holds three-fourth (3/4) of the book value of the fixed assets[33] which it acquired from the amalgamating company continuously for a period of five (5) years;

2. The amalgamated company continues to carry on the business of the amalgamating company for a minimum period of five (5) years from the date of amalgamation. This would imply that if the amalgamating company were engaged in more than one business prior to amalgamation, the amalgamated company would be required to carry on all of those businesses. This may be a commercially unviable proposition;

3. Fulfills such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose. Currently, Rule 9C of the Income Tax Rules, 1962, provides that industrial undertaking of the amalgamated company shall achieve a production level of at least 50% of the installed capacity of the said undertaking before the end of four years from the date of amalgamation and continue to maintain the said minimum level of production till the end of five years from the date of amalgamation.

If any of the above conditions is not satisfied, or if the amalgamation is not of a company owning an industrial undertaking, it would not be possible for the amalgamated company to set off brought forward business loss and unabsorbed depreciation of the amalgamating company. In case of a company owning an industrial undertaking, if there is a default in complying with these conditions at any time within the specified period, the set off would not be permitted in and from the year in which such default occurred.

For the purpose of this section, an industrial undertaking is defined under section 72A(7)(aa). Accordingly, the definition does not cover an undertaking providing services either in the information technology sector or in any other service sector. It includes undertakings engaged in the manufacture or processing of goods, manufacture of computer software, business of generation or distribution of electricity or any other form of power or mining or construction of ships, aircrafts or rail systems and engaged in the business of providing telecommunication services.

33 Prior to the change brought about by Finance Act, 2000, the amalgamated company was required to hold ¾ of the value of assets. The type of assets and the value thereof is now clear.

Availability of carry forward and set off of losses by certain companies: Section 79

Section 79 provides that where there is a change in the shareholding of a company in which public are substantially interested, such a company would not be allowed the carry forward or set off of accumulated losses if shareholders carrying 51% of voting power of the company on the last day of the year in which the loss is sought to be set off are not the same as the shareholders carrying 51% of voting power on the last day of the year in which the loss was incurred. A new proviso was added by the Finance Act 1999 to this section. It provides that this restriction in respect of carry forward and set off of losses would not apply in the following circumstances:

When the change in the shareholding of an Indian company (which is a subsidiary of a foreign company) takes place as a result of amalgamation of the foreign company and if 51% of the shareholders of the amalgamating foreign company continue to be the shareholders of the amalgamated foreign company. This is a welcome relaxation, though the percentage of shareholders to continue in the amalgamated company is fairly high. The proviso does not specify the minimum percentage of shareholding that these 51% shareholders of the amalgamating company should hold in the amalgamated company. It also does not specify for how long they are required to continue holding shares in the amalgamated company. It would be important to evaluate applicability of this section while structuring reorganization of a foreign company, which has an Indian subsidiary.

Demerger

Under a de-merger, all the assets and liabilities of the undertaking of the demerging company are transferred to the resulting company and in consideration for this, the resulting company issues its shares to the shareholders of the demerging company.

Definitions: Sections 2(19AA), 2(19AAA) and 2(41A)

Section 2(19AAA) defines the term “demerged company” to mean a company, whose undertaking is transferred, pursuant to a demerger, to a resulting company.

Section 2(41A) defines a “resulting company” to mean one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company.

Demerger in relation to companies is defined under section 2(19AA) to mean the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the

Companies Act, 1956, by a demerged company of its one or more undertakings to any resulting company in such a manner that-

(i) All the *property* of the undertaking, being transferred by the demerged company, immediately before the demerger becomes the property of the resulting company by virtue of the demerger;
(ii) All the *liabilities* relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;
(iii) The property & the liabilities of the undertaking/undertakings being transferred by the demerged company are transferred *at values* appearing in its *books* of account immediately before the demerger;
(iv) The *resulting company issues*, in consideration of the demerger, its *shares* to the shareholders of the demerged company on a proportionate basis;
(v) The *shareholders holding not less than three fourths in value* of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;
(vi) The transfer of the undertaking is on a *going concern basis*;
(vii) The demerger is in accordance with the conditions, if any, notified under subsection *(5) of section 72A* by the central government in this behalf.

The definition further elaborates certain explanations in respect of the meaning of “undertaking”, “liabilities”, “properties” and “split up” of certain other bodies within the meaning of the term demerger.

The recognition for the need for reorganization and restructuring of businesses for growth and optimization of resource allocation has also resulted in the government reducing the tax cost of such transactions. In furtherance of this purpose, the IT Act provides certain tax beneficial provisions in the case of a demerger. If the demerger fulfills the conditions listed in the definitions under section 2(19AA) and 2(19AAA), the transfer of assets by the demerged company to a resulting company has been exempted from capital gains tax under section 47(vib) of the IT Act. <u>To qualify for the exemption, the resulting company should be an Indian company.</u>

When a demerger of a foreign company occurs, whereby both the demerged and resulting companies are foreign but the assets demerged include or consist of shares in an Indian company, any transfer of these shares is exempt from capital gains tax in the hands of the demerged company under section 47(vic) of the IT Act. The following conditions need to be complied with for availing of this exemption:

(a) The shareholders holding at least three fourths in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; and
(b) Such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated.

Since such a demerger would not be in India and hence the provisions of the Indian Companies Act would not be applicable in respect thereof, the proviso to this clause has waived the application of sections 391 to 394 of he Companies Act, 1956 to such a demerger.

Clause 7 under section 72A permits a resulting company to carry forward and set off the accumulated loss and unabsorbed depreciation of a demerged company, to the extent they are directly relatable to the demerged undertaking or apportioned to the demerged undertaking.

Slump Sale

This is a transaction in which restructuring takes place as a result of which the transferor company transfers one or more of its undertakings on a going concern basis for a lump sum consideration, without assigning values to the individual assets and liabilities of the undertaking[34].

If the undertaking, which is being sold under slump sale was held by the transferor for more than 36 months, the capital gains realized on such sale would be taxed as long term capital gains. If however, the undertaking were to be held for 36 months or less, the capital gains realized would be taxed as short term capital gains[35] at the rate of 36.75 per cent in case of company or partnership and 31.5 per cent in case of individuals. For the purpose of computing capital gains, the cost of acquisition would be the “net worth” of the undertaking on the date of the transfer[36].

This method of restructuring may be used particularly in circumstances when it would not be feasible to go through the process of amalgamation or demerger under sections 391 to 394 of the Companies Act, 1956. It is also a preferred route if there is cash consideration rather than issuance of shares for the transfer of business. This method is not particularly favoured for its tax implications.

Asset Sale

In this form of restructuring, a company only sells the assets of an undertaking for a consideration. The consideration may be in the form of shares of the buyer company

34 Section 2(42C) of the IT Act
35 Section 50B of the IT Act.
36 Section 50B (2) of the IT Act.

or cash or a combination of both. Any gain accruing to the selling company as a result of such a sale would be liable to capital gains tax depending on the period of holding of the asset. All assets forming part of "block of assets" for income tax purposes would give rise to short term capital gain or loss[37]. Such gains would be taxed at 31.5 per cent in case of individuals and 36.75 per cent in case of companies. The assets outside of the "block" would attract capital gains depending on the period of holding of the assets and the nature of the asset.

This form of restructuring may be adopted for a variety of reasons. One main reason may be the special interest that the buyer has in the quality of assets owned by the seller. The buyer may not elect to assume the liabilities of the seller, or he may not even be interested in the business as a going concern.

From the tax perspective of the buyer, it may be better to do asset acquisition, where the seller is expected to realize substantial value from sale of assets. In this case, there will be capital gains tax on the capital gains realized by the seller. Conversely, the buyer would have the advantage of stepping up the cost of acquisition of the assets to the purchase price paid. This contrasts with a situation where it is expected that the seller will make capital loss on the sale of assets. In this situation, it is better for the buyer to do a stock acquisition of the seller (target) and thus retain the high book value of the assets in the books of the acquired company.

Certain other provisions applicable to restructuring:

Sections 10A and 10B of the IT Act provide a deduction from taxable income to a unit set up in software technology park (**"STP Unit"**) or to a unit set up as 100 per cent export oriented unit (**"EOU"**) for its income from export of goods and services or software. This tax benefit is available to these units for a period of ten years from the year in which they were set up. The benefits are phased out and would now cease to be available after the end of the financial year 2008-09.

The Finance Act 2000 inserted Clause 9 to these sections, whereby this tax benefit would not be available to an undertaking, if the undertaking is transferred. In case of companies, if 51 per cent of the shareholders on the last day of the year when the unit was set up do not continue to be the shareholders of the company on the last day of the year in which the tax benefit is claimed, the undertaking would be deemed to have been transferred. In such an event, the undertaking would lose its tax benefit in the year in which such transfer takes place and in all subsequent years. The Finance Act 2001 has softened this position so that the benefit would not be lost if the change in shareholding takes place as a result of the company becoming a company in which public are substantially interested, or as a result of disinvestments of equity by a venture capitalist.

37 Section 50(1) of the IT Act.

The relaxation does not exempt a change in shareholding taking place as a result of restructuring or reorganization, either due to amalgamation or demerger. In such restructuring, if the shareholding of a company changes beyond 49 per cent as compared to the year in which the units were set up, the tax benefit under sections 10A and/or 10B would be lost, unless the transaction due to which the change in shareholding took place converted such company into one in which the "public are substantially interested", *i.e*. a listed company. Further, the change in shareholding would require the "beneficial holding" of the shares to alter. The ITA does not provide a definition of this term. Hence, where there is no change in the shareholding of a second generation subsidiary since its immediate parent still holds all its shares, it is not clear if the tax benefit under these sections would be denied to such second generation subsidiary on account of its immediate parent company's shareholding being altered. Restructuring of holding companies in such a situation could result in loss of tax benefit of this nature. It has been observed that restructuring of foreign parent companies of Indian subsidiaries, which have set up such units and are claiming tax benefits, could well be affected by this provision. One could explore alternative structures to overcome this provision.

Cross-border tax issues in acquisition in the US

In the context of cross-border acquisitions and in particular, U.S., the following issues may be relevant:

1. Structuring the transaction

In order to determine or decide on a structure for the acquisition, one must find out what is the basis of the transaction as to whether the transfer is effected as a stock acquisition or asset acquisition or a merger. Each of these transactions could have different tax implications. The four basic forms that are used for acquisition of a business in the US are:

(a) Asset acquisition
(b) Stock acquisition
(c) Merger or consolidation
(d) Triangular Merger or Subsidiary Merger

A merger could be structured as a forward merger or a reverse merger. In a forward merger, the target company merges into the buyer. For US tax purposes, this transaction is treated as an asset sale by the target to the buyer following which there is a liquidation of the target and subsequently there is a distribution of proceeds to the shareholders of the target company. In a reverse merger, the buyer merges into the target and the shareholders of the buyer get stock in the target. This is treated as a stock acquisition by the buyer.

A triangular or a subsidiary merger is said to occur when the buyer sets up an acquisition subsidiary, which merges into the target. This is also treated as stock acquisition for US tax purposes. In a typical triangular merger, the target merges with a wholly-owned subsidiary of the buyer and the buyer issues its own stock to the shareholders of the target. If the target survives as a result of the merger, it will be regarded as a reverse triangular merger and if the wholly owned subsidiary of the acquirer survives as a result of the merger it will be regarded as a forward triangular merger.

It is perceived that the merger transactions and in particular the reverse merger has the tax advantages of the asset acquisitions and simplicity and convenience of stock acquisitions. In certain cases, a stock deal is combined with the merger where the buyer first acquires majority stock in the target and than merges with it.

2. Tax-free Reorganizations and Spin-offs

Section 351 and 368 of the IRC lists certain tax-free reorganizations. The most commonly used forms are A (forward merger), hybrid A (forward triangular merger), and B (stock swap). Other types of reorganisation (like type C and D) are commonly used when the property of the target is acquired for voting stock of the acquirer. Section 355 provides for tax-free spin-off of shares of a subsidiary by a corporate to its shareholders. In order to qualify the acquisition as a tax free reorganization the parties to the acquisition are required to comply with certain conditions prescribed under section 351 and 368 of the Internal Revenue Code of the US (**IRC**) such as:

- In case of a stock-swap deal, 100% of the shareholders of the target should continue to be the shareholders of the acquirer.
- In case of a triangular merger, atleast 80% of the shareholders of the target should continue to be the shareholders of the acquirer.

3. Tax-free Reorganizations in cross border situation

When a US corporation is being acquired by a non-US corporation, in order to qualify the reorganization as tax free for the US shareholders of the target, one will have to comply with the additional conditions which are laid down under section 367 of the IRC. Section 367 prescribes the following conditions:

(a) The US shareholders of the target should not receive more than 50 percent of total voting power and the total value of the stock of the acquirer.

(b) Total holding (i.e. total of holding before and after reorganization) of the US shareholders and their relatives in the acquirer should not be more than 50 percent of the total voting power and the total value of the stock of the acquirer.

(c) Certain US shareholders (holding more than 5% of the combined entity) would have to enter into a Gain Recognition Agreement (**GRA**) with the IRS. Important terms and conditions of GRA are:

- These US shareholders would keep their assessment for the year in which they transfer the stock of the target company open for eight years.

- The acquirer would not sell the stock in target for 5 years after the date of transfer. If the acquirer sell the stock in the target during that period, the US shareholders who have signed GRA would have to pay capital gains tax on the amount of stock transferred, as if the transfer had taken place on the date of reorganization.

(d) The acquirer should be engaged in active trade or business at least for 36 months before the transfer takes place either directly or through a qualified subsidiary or partnership.

(e) The value of the acquirer should be at least equal to that of the target.

4. Section 338 Election

A section 338 election is a procedure by which a corporate buyer may treat a stock acquisition as an asset acquisition. The election is possible only when the buyer acquires at least 80% of the stock of the target. As per this election, the target is treated as deemed to have sold all the assets in a single taxable transaction at the close date and as a new corporation, having purchased all the assets on the following day. The deemed sales price is the fair market value of the assets less liabilities. Interestingly, it should be noted that it is possible that a transaction is treated as asset acquisition for federal income tax purposes but as a stock acquisition for state tax purposes.

A section 338 election results in taxable capital gains in the hands of the target on the deemed sale of assets and in addition, the selling shareholders are taxed on gain realized on sale of stocks in target.

A section 338 election is advisable when the target has Net Operating Losses (NOL), and gains on deemed sale of assets is likely to be offset by the losses.

5. Carryover Basis v. Cost Basis Transactions

Carryover basis transaction is a transaction in which the assets are carried over at the adjusted pre-acquisition price. Cost basis transaction means a transaction in which the assets are carried over at cost to the acquirer i.e. fair market value. When a

purchaser acquires an asset with a carryover basis with a built-in gain, (being the excess of fair market value over carryover basis), the buyer acquires the asset with a potential tax liability. Conversely, when the assets are acquired on a carryover basis with a built-in loss, the buyer will acquire assets with a potential tax loss.

In a cost basis transaction, the shareholders of the target are generally subject to double taxation. They bear the economic burden of the tax imposed on the asset sale by the target corporation and they are subject to tax at the time distribution or sale of their stock in the target. If the target is an S Corporation or a partnership, the impact of double taxation can be substantially reduced.

6. Entity Classification

It should be considered whether the operating entity is likely to be classified as C corporation, S corporation, General or Limited Partnership or Limited Liability Company etc. It is possible to check the box in the U.S. as to how the shareholders would like the entity to be classified. The tax treatment may vary depending upon how the entity is classified. A C Corp. is a normal company which is a separate tax paying entity whereas an S Corp. and a partnership are only taxed at the shareholder or partner levels. It should be noted that not all the states recognize S Corps. In general, a partnership is the most tax efficient structure for acquisition.

8. Stepped-up Transactions

A stepped-up transaction is an acquisition where in the assets of the target are revalued at the fair market value or the buyer's cost.

9. Hostile Takeovers

It is often the fear of loosing the job, which prompts the management of the target company to block a bid for hostile takeover. When old staff is retrenched, 'Golden Parachute' i.e. a huge severance bonus is often used to ease out the executives. Tax deduction for such excess payments is denied in the hands of the corporates and the recipients have to pay an additional excise tax of 20% on such amounts received. These rules do not apply in the cases where the stock of the target is not publicly traded and the payment is approved by the shareholders. 'Greenmail' payments made to the corporate raider towards inflated price for redeeming his stocks by the target, are also subject to a 50% excise tax in the hands of the raider. Interestingly, in Revenue Ruling 90-11, the IRS has held that the 'Poison Pill' i.e. the right of the existing shareholders to buy additional shares at substantially low price, is a non-taxable event.

*10. Net operating Losses (**NOL**)*

NOL is defined as excess of tax deductions over taxable income. Section 172 of the IRC allows carry forward of losses up to 15 years and carry backwards up to 3 years. A target which has a large amount of carry over NOL is very attractive to the buyer. In general, a buyer may get the benefit of set-off of NOL of the target if it is acquired in a tax-free reorganization. Section 269 of the IRC gives the IRS power to disallow any deduction if it finds that the acquisition took place with the principal objective of evasion or avoidance of tax.

Section 382 of the IRC limits the carry over of loss to the value of the loss of the corporation immediately prior to the ownership change multiplied by the Long-term Tax Exempt Rate prevailing at the time of the ownership change. Section 384 of the IRC restricts a loss corporation to offset its losses against taxable gains recognized by subsidiaries that it acquires and with which it files a consolidated tax return.

11. Anti-abuse Provisions

Section 304 of the IRC applies where a common shareholder holding at least 50% of the voting power or value of a target also holds control (same 50% criteria) in the buyer. In such cases, the transaction of acquisition is re-characterized and the distribution in the hands of the shareholder is treated as dividends instead of capital gains.

12. CFC Provisions

Finally, It is important for any non-U.S. person acquiring a company in the U.S. to be aware of CFC legislation in the U.S. A Controlled Foreign Corporation ("CFC") is a non-U.S. company more than 50% controlled by 10% US shareholders. Under the subpart F rules, U.S. 10-percent shareholders in such CFC are subject to U.S. tax on certain passive income earned by the CFC, whether or not such income is distributed to the shareholders (referred to as "subpart F income"). The CFC shareholder is taxed on investment income earned by the CFC as well as certain sale and service income earned by the CFC from transactions with related persons, if such income exceeds the lesser of 5% or more of the CFC's gross income or $1 Million.

Cross-border tax issues in acquisition in the Europe

In the context of cross-border acquisitions in Europe the following issues may be relevant :

EU Parent Subsidiary Directive :
This Directive deals with the tax treatment of 'distribution of profits'. The two main subjects of the parent subsidiary directive are :

1. The treatment at the level of a qualifying parent company of distributed profits received from a qualifying subsidiary. The member states are required to choose

between the exemption method and the credit method; and

2. The exemptions from withholding tax of profits distributed by a qualifying subsidiary to a qualifying parent company.

For example, Netherlands provides that dividends received by a Dutch parent from a qualifying subsidiary i.e. a company in which the Dutch parent holds 5% interest will not be subject to tax in Netherlands. As opposed to this, UK provides for underlying tax credit for the dividends received from its subsidiary.

EU Merger Directive :

The Merger Directive obliges member states to adopt their domestic legislations in such a way that mergers, divisions, transfer of assets and exchange of shares concerning companies of different member states will be carried out tax neutral. This tax neutrality should allow the enterprises to adopt to the common market. It provides for the following:

1. *Taxation of companies involved*: The essence of the Merger Directive is that capital gains realized, if any, in the course of a merger, a division, transfer of assets or exchange of shares will not be taxed at the time of the transaction. The relief provided by the Merger Directive consists of a deferral of tax, not an absolute exemption from tax, with respect to capital gains.

2. *Taxation of shareholders*: The same principle of tax deferral applies to the shareholders of the transferring (or acquired) company who exchange their shares for shares in the receiving (or acquiring) company upon merger, division, exchange of shares or transfer of assets.

Dual Head Structures

In a dual head structure, the two companies from different countries proposing to merger remain distinct at the top tier level, although the group as a whole operates as a single entity. Here, both the top tier companies maintain their respective listing as well as Such structures come handy when it is necessary to maintain continuity of domicile for the merging companies, continuity of corporate identity, capital gains tax disadvantages, etc.

VI. CASE STUDY

Recently, an Indian listed company acquired an unlisted company in the US. The acquisition was structured as a stock swap deal. The facts of the case were as follows:

Facts

- Company A is a public listed company in India engaged in software business.
- Company B was an unlisted company incorporated under the laws of the State of Delaware, U.S.
- Company A proposed to acquire Company B in an all stock deal.
- Company B already had a stock option plan in place for its employees which needed to be converted into an option plan of the parent i.e. Company A, post acquisition.

Issues

1. U.S. Securities laws issues

(a) *SEC registration requirements:* If Company A issues shares to Company B, such shares would require registration with the SEC under section 5 of the Securities Act, 1933 unless it qualifies as an “exempt offering” as discussed. An exemption from the registration requirement is available under Regulation D of the Securities Act, 1933 in respect of issuance of shares to the shareholders of Company B and under Rule 701 of the Securities Act, 1933 for issuance of shares to the employees of Company B. However the exemption under Regulation D is available provided the total number of un-accredited investors does not exceed thirty five only. In order to avail of the exemption under Rule 701, the employees should be directly employed with issuer.

In this case Company A was acquiring Company B through a reverse triangular merger and hence Company B would continue to exist as a 100% subsidiary of Company A subsequent to the merger. Hence in order to be eligible for the exemptions, the following options were available:

(i) In order to avail of the exemption under Regulation D of the Securities Act, 1933 the outstanding options would have to be accelerated in order to make the employees shareholders and then make the employees exchange the shares held by them in Company B for shares in Company A or
(ii) In order to be eligible to avail of the exemption available under Rule 701, all the employees in Company B would have to be transferred to Company A and subsequently shares of Company A would be issued to them.The

employees could then be leased back to Company B or,

(iii) The third option was to do a full fledged registered ADR offering and exchange the shares of Company B for the ADRs.

Analysis of the available options

Each of the above options had a shortfall which we have set forth hereinbelow:

- In the first option the Regulation D exemption is available only if the number of unaccredited investors do not exceed 35. In this case if the options were accelerated and the employees were made shareholders in Company B, the number of unaccredited investors was likely to exceed 35.
- In the second option transferring the employees to Company A was practically not possible since H1B visas for the employees were taken by Company B and if the employees they were to be transferred to Company A, the entire process would have to be redone.
- With respect to the third option, was a long drawn process and considering the time frame and the costs involved, it was not practical for Company A to do an ADR offering. A solution was needed to be worked which would achieve the ultimate objective of acquiring Company B without having to go through the registration process.

(b) *Disclosure Statements:* Though Rule 506 under Regulation D does not require specific disclosures, the kind of disclosure that need to be made to the shareholders of the target the disclosure requirements are governed by the Securities Exchange Act, 1934 and depends of the size of the offering. If the size of the offering exceeds USD 7.5 million, then the disclosures required to be made to the shareholders of Company B were similar to those needed in an ADR offerings.

(c) US Tax Issues

(i) The direct acquisition of Company B by Company A would have possibly triggered capital gains tax in the U.S. in the hands of the shareholders of Company B even though the consideration is paid in kind i.e. shares of Company A. This would result in a situation whereby the shareholders of Company B would be liable to pay tax without having the liquidity to discharge such liability. Hence the need for a reverse triangular merger.

(ii) Accelerating the stock option plans or issuance of stock option by Company A, would convert 'qualified' stock option plans (“**QSOP**”) of Company B into 'non-qualified' stock option plans (“**NQSOP**”) of A and such NQSOP would not qualify for tax treatment available for QSOP whereby the option holders are not taxed on the exercise of the options and are taxed only on the capital gains realised on the disposition of

shares.

2. Indian legal and tax issues

<u>Indian legal issues</u>

(i) The Founders of Company B were issued stock with reverse vesting whereby the Company B would retain the right to buy-back certain portion of shares every year. This is an alternative to ESOPs to ensure longer-term commitment by the founders. Such restrictions cannot be imposed on the shares of Company A, Company A being a listed company.

(ii) For giving ESOPs to non-residents, RBI does not permit the Indian company to issue shares pursuant to an ESOP whereby the holding of the non-resident employees (i.e. employees of B) exceed 5% of the paid-up capital of the Indian company i.e. Company A.

(iii) For issuance of shares of A to the shareholders of Company B, Company A would have to comply with the Securities and Exchange Board of India guidelines for preferential issue of shares. The shareholders' resolution required under the section 81(1A) of the Companies Act, 1956 is valid for a period of 3 months from the date of passing of such resolution. As this was a cross-border transaction and there was a need for FIPB and RBI approval, the said acquisition could not be consumed within the stipulated time and hence an extension was sought from the SEBI.

(iv) Also, upon consummation of the acquisition, the shareholders of Company B were to hold shares in Company A through a company set-up in a treaty jurisdiction ("**Holdco**"). As the holding of Holdco in Company A was likely to be in excess of 15%, there was a possibility of triggering of the public offer provisions of the takeover code if such issuance did not fall under the exempt category. To ensure this, the disclosure as prescribed under the takeover code had to be made in the notice to the shareholders for passing of a resolution under Section 81(1A) of the Companies Act. Also, proper intimation to the stock exchanges in a timely manner is required and a report in a prescribed format had to be filed within 21 days from the completion of the acquisition.

<u>Indian Tax Issues</u>

The shareholders of B were required to hold the shares of A through a treaty jurisdiction so as to avail tax exemption on the capital gains earned by them on disposition of shares of A.

VII. CONCLUSION

More and more Indian companies are going global and are looking to have a global presence. Although the recent trend of acquiring foreign companies seems to be spearheaded by the IT industry, traditional manufacturing companies such as cement, etc. are not far behind. This is clearly evidenced by the recent acquisition by Indian Hotels of Hotel Carlyle, New York and the acquisition of Tetley, U.K. by Tata Tea Limited. What is emerging as a major problem with respect to cross-border mergers and acquisitions is the conflicting legal regimes of the various jurisdictions in which the two entities are located. The tax efficient structuring of the transaction is also turning out to be the "deal-maker" or the "deal-breaker" as the case may be.

* * * * *