

Tax Issues in M&A Transactions

August 2016

About NDA

Nishith Desai Associates (NDA) is a research based international law firm with offices in Mumbai, Bangalore, Palo Alto (Silicon Valley), Singapore, New Delhi, Munich and New York. We provide strategic legal, regulatory, and tax advice coupled with industry expertise in an integrated manner.

As a firm of specialists, we work with select clients in select verticals. We focus on niche areas in which we provide high expertise, strategic value and are invariably involved in select, very complex, innovative transactions.

We specialize in Globalization, International Tax, Fund Formation, Corporate & M&A, Private Equity & Venture Capital, Intellectual Property, International Litigation and Dispute Resolution; Employment and HR, Intellectual Property, International Commercial Law and Private Client. Our industry expertise spans Automotive, Funds, Financial Services, IT and Telecom, Pharma and Healthcare, Media and Entertainment, Real Estate, Infrastructure and Education. Our key clientele comprise marquee Fortune 500 corporations.

Equally passionate about philanthropy, social sector and start ups, our role includes innovation and strategic advice in futuristic areas of law such as those relating to Bitcoins (block chain), Internet of Things (IOT), Privatization of Outer Space, Drones, Robotics, Virtual Reality, Med-Tech and Medical Devices and Nanotechnology.

Nishith Desai Associates is ranked the 'Most Innovative Asia Pacific Law Firm in 2016' by the *Financial Times - RSG Consulting Group* in its prestigious **FT Innovative Lawyers Asia-Pacific 2016** Awards. With a highest-ever total score in these awards, the firm also won Asia Pacific's best 'Innovation in Finance Law', and topped the rankings for the 'Business of Law'. While this recognition marks NDA's ingress as an innovator among the globe's best law firms, NDA has previously won the award for 'Most Innovative Indian Law Firm' for two consecutive years in 2014 and 2015, in these elite *Financial Times* Innovation rankings.

Our firm has received much acclaim for its achievements and prowess, through the years. Some include:

IDEX Legal Awards: In 2015, Nishith Desai Associates won the "M&A Deal of the year", "Best Dispute Management lawyer", "Best Use of Innovation and Technology in a law firm" and "Best Dispute Management Firm". IDEX Legal recognized Nishith Desai as the Managing Partner of the Year in 2014.

Merger Market has recognized Nishith Desai Associates as the fastest growing M&A law firm in India for the year 2015.

World Tax 2015 (International Tax Review's Directory) recognized NDA as a Recommended Tax Firm in India

Legal 500 has ranked us in tier 1 for Investment Funds, Tax and Technology-Media-Telecom (TMT) practices (2011, 2012, 2013, 2014).

International Financial Law Review (a Euromoney publication) in its **IFLR1000** has placed Nishith Desai Associates in Tier 1 for Private Equity (2014). For three consecutive years, IFLR recognized us as the Indian "Firm of the Year" (2010-2013) for our Technology - Media - Telecom (TMT) practice

Chambers and Partners has ranked us # 1 for Tax and Technology-Media-Telecom (2015 & 2014); #1 in Employment Law (2015); # 1 in Tax, TMT and Private Equity (2013); and # 1 for Tax, TMT and Real Estate – FDI (2011).

India Business Law Journal (IBLJ) has awarded Nishith Desai Associates for Private Equity, Structured Finance & Securitization, TMT, and Taxation in 2015 & 2014; for Employment Law in 2015

Legal Era recognized Nishith Desai Associates as the Best Tax Law Firm of the Year (2013).

ASIAN-MENA COUNSEL named us In-house Community 'Firm of the Year' in India for Life Sciences Practice (2012); for International Arbitration (2011); for Private Equity and Taxation in India (2009). We have received honorable mentions in **ASIAN-MENA COUNSEL** Magazine for Alternative Investment Funds, Antitrust/Competition, Corporate and M&A, TMT, International Arbitration, Real Estate and Taxation and being Most Responsive Domestic Firm.

We have won the prestigious 'Asian-Counsel's Socially Responsible Deals of the Year 2009' by **Pacific Business Press**.

We believe strongly in constant knowledge expansion and have developed dynamic Knowledge Management ('KM') and Continuing Education ('CE') programs, conducted both in-house and for select invitees. KM and CE programs cover key events, global and national trends as they unfold and examine case studies, debate and analyze emerging legal, regulatory and tax issues, serving as an effective forum for cross pollination of ideas. Our trust-based, non-hierarchical, democratically managed organization that leverages research and knowledge to deliver premium services, high value, and a unique employer proposition has been developed into a global case study and published by John Wiley & Sons, USA in a feature titled 'Management by Trust in a Democratic Enterprise: A Law Firm Shapes Organizational Behavior to Create Competitive Advantage' in the September 2009 issue of Global Business and Organizational Excellence (GBOE).

Please see the last page of this paper for the most recent research papers by our experts.

Disclaimer

This report is a copyright of Nishith Desai Associates. No reader should act on the basis of any statement contained herein without seeking professional advice. The authors and the firm expressly disclaim all and any liability to any person who has read this report, or otherwise, in respect of anything, and of consequences of anything done, or omitted to be done by any such person in reliance upon the contents of this report.

Contact

For any help or assistance please email us on ndaconnect@nishithdesai.com or visit us at www.nishithdesai.com

Contents

1. TAX CONSIDERATIONS ON M&A TRANSACTIONS	01
I. Introduction	01
II. Merger	01
III. Demerger	02
IV. Share Sale	04
V. Slump Sale	05
VI. Asset Sale	07
2. CROSS BORDER TAX ISSUES	10
I. Introduction	10
II. Claiming Treaty Benefit: Requirements and Procedure	10
III. Withholding Tax Obligations	11
IV. Structuring Investments into India – Suitable Holding Company Jurisdictions	12
V. Tax as a Representative Taxpayer/Assessee	14
VI. Provisions for Cross-border Mergers	14
VII. Tax Indemnities on Transfer	15
3. PREVAILING AMBIGUITIES IN INDIRECT TRANSFER PROVISIONS	16
I. Introduction	16
II. Uncertainty and Subsequent Changes after the 2012 Amendment	16
III. Prevailing Issues	17
IV. Current Situation with Respect to Taxation of Indirect Transfers	18
4. CAPITAL GAINS TAXATION: TIMING AND VALUATION	20
I. Event of Taxation	20
II. Computation of Capital Gains	20
5. TAXATION OF EARN-OUT ARRANGEMENTS	22
I. Introduction	22
II. Issues in the Tax Treatment of Earn-outs	22
III. Earn-outs in Employment Agreements	22
IV. Earn-outs as Purchase Consideration	23
V. When will an Earn-out be Taxed?	23
VI. Conclusion	24
6. CARRY FORWARD OF LOSSES IN CASE OF M&A TRANSACTIONS	25
I. Introduction	25
II. Mergers	25
III. De-mergers	26
IV. Section 79 of the ITA	27
7. MERGERS AND ACQUISITIONS - ESOP / EMPLOYEE TAXATION	29
I. Introduction	29
II. Taxation of Employees	29
III. M&A Involving Transfer of Employees from One Corporate Entity to Another	30

IV.	Extinguishment of ESOPs in Transferor Entity	30
V.	Grant of ESOP in Transferee Entity	30
VI.	Transition Payments	30
VII.	M&A not Involving Transfer of Employees from One Corporate Entity to Another	31
VIII.	Conclusion	31
8.	DRAFTING TAX REPRESENTATIONS AND TAXATION OF INDEMNITY PAYMENTS	32
I.	Introduction	32
II.	Tax & Business Representations	32
III.	Tax Indemnity	33
9.	MERGERS AND ACQUISITIONS – NON-COMPETE AND DEPRECIATION – TAX ISSUES	35
I.	Introduction	35
I.	Taxation of Non-compete Receipts	35
III.	Taxation of Non-compete Expenditure	36
IV.	Conclusion	38
10.	ANTI-ABUSE RULES TO BE CONSIDERED IN AN M&A TRANSACTION	39
I.	Introduction	39
II.	Successor Liability Concerns	39
III.	Domestic Transfer Pricing Rules	39
IV.	Anti-Abuse Rules under DTAA's	40
V.	The General Anti-Avoidance Rule	40

1. Tax Considerations on M&A Transactions

I. Introduction

The Indian Income Tax Act, 1961 (“**ITA**”) contains several provisions that deal with the taxation of different categories of mergers and acquisitions. In the Indian context, M&As can be structured in different ways and the tax implications vary based on the structure that has been adopted for a particular acquisition. The methods in which an acquisition can be undertaken are:

1. **Merger:** This entails a court approved process whereby one or more companies merge with another company or two or more companies merge together to form one company;
2. **Demerger:** This entails a court approved process whereby the business / undertaking of one company is demerged into a resulting company;
3. **Share Purchase:** This envisages the purchase of the shares of the target company by an acquirer;
4. **Slump Sale:** A slump sale is a sale of a business / undertaking by a seller as a going concern to an acquirer, without specific values being assigned to individual assets;
5. **Asset Sale:** An asset sale is another method of transfer of business, whereby individual assets / liabilities are cherry picked by an acquirer.

In the sections that follow, we have provided further insights into each of the specific methods of acquisitions.

II. Merger

A merger of companies is typically conducted through a scheme of arrangement under Sections 391-394¹ of the Indian Companies Act, 1956,

and requires the approval of the High Court.

In order for a merger to be tax neutral, it must satisfy specific criteria and qualify as an Amalgamation under the ITA. These criteria are in addition to the requirements under the Companies Act. Hence, an Amalgamation must necessarily be conducted under a scheme of arrangement approved by the High Court.

The ITA defines an Amalgamation as the merger of one or more companies with another company or the merger of two or more companies to form a new company. For the purpose of the ITA, the merging company is referred to as the “amalgamating company” and the company into which it merges or which is formed as the result of merger is referred to as the “amalgamated company”. An Amalgamation must satisfy the following criteria:

1. All the properties and liabilities of the amalgamating company must become the properties and liabilities of the amalgamated company by virtue of the Amalgamation; and
2. Shareholders holding at least 3/4th in value of the shares in the amalgamating company (not including shares held by a nominee or a subsidiary of the amalgamated company) become shareholders of the amalgamated company by virtue of the Amalgamation.

It is only when a merger satisfies all the above conditions, that the merger will be considered as an Amalgamation for the purposes of the ITA. Where a merger qualifies as an Amalgamation, subject to fulfilling certain additional criteria, the Amalgamation may be regarded as tax neutral and exempt from capital gains tax in the hands of the amalgamating company and also in the hands of the shareholders of the amalgamating company (discussed below). In certain circumstances,

1. Corresponding to Sections 230 to 232 of the Companies Act, 2013. However, these sections are yet to be notified.

the amalgamated company may also be permitted to carry forward and set off the losses of the amalgamating company against its own profits.²

In the context of a merger/Amalgamation, Section 47 of the ITA specifically exempts the following transfers from liability to capital gains tax.

1. Transfer of capital assets by an amalgamating company to the amalgamated company if the amalgamated company is an Indian company.
2. Transfer of shares in an Indian company by an amalgamating foreign company to the amalgamated foreign company if both the criteria below are satisfied:
 - *At least 25% of the shareholders of the amalgamating company continue to remain shareholders of the amalgamated company.* Hence, shareholders of amalgamating company holding 3/4th in value of shares who become shareholders of the amalgamated company must constitute at least 25% of the total number of shareholders of the amalgamated company.
 - *Such transfer does not attract capital gains tax in the amalgamating company's country of incorporation.*
3. Transfer of shares in a foreign company in an amalgamation between two foreign companies, where such transfer results in an indirect transfer of Indian shares.³ The criteria to be satisfied to avail this exemption are the same as above.
4. Transfer of shares by the shareholders of the amalgamating company in consideration for allotment of shares in amalgamated company is not regarded as transfer for capital gains purpose. This exemption is available if the amalgamated company is an Indian company.⁴

2. Please refer to Section VI for further details on carry forward of losses in a M&A context.

3. Please refer to Section III of this paper for more details on the provisions relating to indirect transfers.

4. The Supreme Court has held in *CIT v. Grace Collis and Ors.* [2001] 248 ITR 323 (SC) that such transfer of shares constitutes "extinguishment of rights" in a capital asset and hence falls within

For such shareholders, the cost of acquisition of shares of the amalgamated company will be deemed as the cost at which the shares of the amalgamating company were acquired by the shareholder.

III. Demerger

A demerger is a form of restructuring whereby one or more business undertakings⁵ of a company are transferred either to a newly formed company or to an existing company and the remainder of the company's undertaking continues to be vested in the first company. The consideration for such transfer will flow into the hands of the shareholders of the demerged undertaking either through issue of shares or other instruments (for it to qualify as a tax neutral demerger) or by way of cash.

A demerger must also be conducted through a scheme of arrangement under the Companies Act with the approval of the High Court. The ITA defines a demerger under Section 2(19AA) as a transfer pursuant to a scheme of arrangement under Sections 391-394 of the Companies Act, 1956, by a "demerged company", of one or more of its undertakings to a "resulting company" and it should satisfy the following criteria:

1. All the properties and liabilities of the undertaking immediately before the demerger must become the property or liability of the resulting company by virtue of the demerger.
2. The properties and liabilities must be transferred at book value.
3. In consideration of the demerger, the resulting company must issue its shares to the shareholder-

the definition of "transfer" under Section 2(47) of the ITA, but has been specifically exempted from capital gains by virtue of Section 47(vii) of the ITA. As an inference from this judgment, it may be said that if a merger does not qualify for such exemption, then shareholders of the amalgamating company who receive shares in the amalgamated company may be liable for capital gains tax as their shares in the amalgamating company may be deemed to have been 'transferred'.

5. The ITA defines an 'undertaking' to include an undertaking, or a unit or a division an undertaking or business activity taken as a whole.

ers of the demerged company on a proportionate basis (except where the resulting company itself is a shareholder of the demerged company).

4. Shareholders holding at least 3/4th in value of shares in the demerged company become shareholders of the resulting company by virtue of the demerger. Shares in demerged company already held by the resulting company or its nominee or subsidiary are not considered in calculating 3/4th in value.
5. The transfer of the undertaking must be on a going concern basis.
6. The demerger must be subject to any additional conditions as notified by the Central Government under Section 72A(5) of the ITA.

If all the above criteria are satisfied, the demerger will be considered as tax neutral and exempt from capital gains tax.

Under Section 47 of the ITA, the following transfers relating to demerger do not attract capital gains tax liability:

1. Transfer of assets in a scheme of demerger from the demerged company to the resulting company, if the resulting company is an Indian company.
2. Transfer of shares in an Indian company by a demerged foreign company to a resulting foreign company if both the conditions below are satisfied:
 - Shareholders holding at least 3/4th in value of the shares of the demerged company continue to remain shareholders of the resulting company; and
 - Such transfer does not attract capital gains tax in the country of incorporation of the demerged company.
3. Transfer of a capital asset being shares in a foreign company by the demerged foreign company to the resulting foreign company, where such transfer results in an indirect transfer

of Indian shares.⁶ The conditions to be satisfied to avail this exemption are the same as above.

4. Transfer or issue of shares by resulting company to shareholders of the demerged company in consideration of demerger of the undertaking.

Indirect Taxes: There is no VAT incidence upon transfer of properties and liabilities under an amalgamation or a demerger.

Stamp Duty: Stamp duty on transfer of assets is governed by the relevant state Stamp Act. In terms of stamp duty, though the state laws provide for rates of stamp duty to be paid on various instruments, it is observed that generally there is no specific entry for a High Court order sanctioning the scheme of amalgamation or demerger, in the absence of which High Courts have taken the view that the High Court order involving the transfer between two juristic persons of certain movable and immovable property, is a 'conveyance' and should therefore be chargeable to stamp duty under that head, and the scheme of arrangement itself is an 'instrument' under which the going concern is transferred. This position has been consolidated by the Supreme Court in *Hindustan Lever and Anr. v. State of Maharashtra and Anr.*⁷

The Bombay High Court⁸ has held that a scheme of arrangement entails transfer of a going concern, and not of assets and liabilities separately. As a going concern, the value of the property transferred under a scheme of arrangement is reflected from the shares allotted to the shareholders of the transferor company under the scheme. Accordingly, under the Bombay Stamp Act, 1958 (applicable in the state of Maharashtra), stamp duty payable on conveyance relating to amalgamation of companies is 10% of the aggregate of the market value of the shares issued or allotted in exchange or otherwise and the amount for consideration paid for such demerger, provided that it shall not exceed (i) 5% of the total true market value of the immovable property located within the state of Maha-

6. Please refer to Section III of this paper for more details on indirect transfer provisions.

7. (2004) 9 SCC 438

8. *Li Taka Pharmaceuticals Ltd. And Anr. v. State of Maharashtra and Ors.*, AIR 1997 Bom 7

rashtra and as transferred by the transferor company to the resulting company; or (ii) 0.7% of the aggregate of the market value of the shares issued or allotted and the amount of consideration paid for the demerger, whichever is higher.

IV. Share Sale

One of the most commonly resorted to methods of acquisition is share acquisition, which involves the acquisition of the shares of the company in which the target business is vested. The entire company is sold lock, stock and barrel. The major tax implications of share acquisition are (i) liability to a tax on the capital gains, if any, and (ii) liability under Section 56(2)(vii-a) of the ITA.

- i. **Capital Gains:** if the shares qualify as capital assets under Section 2(14) of the ITA, gains arising upon the transfer of shares would attract a capital gains tax liability. The taxable rate in India would depend on (i) whether the capital gains are long term capital gains or short term capital gains, (ii) whether the target company is a public listed company, public unlisted company or a private company, (iii) whether the

transaction has taken place on the floor of the stock exchange or by way of a private arrangement, and (iv) whether the seller is a resident or a non-resident. Further, in respect of a cross-border share sale, the relevant Double Taxation Avoidance Agreement (“DTAA”) would determine whether capital gains are taxable in India or in the other country.⁹

The general rule is that short term gains arise from the transfer of a capital asset which is held for less than 3 year, while long term gains arise if the capital asset is held for more than 3 years. However, for all listed securities to qualify as long term capital gains, a holding period of only 12 months is applicable. As per the Finance Act, 2016, unlisted securities of both private and public companies will also qualify as long term capital assets if held for 24 months. The table below sets out the capital gains tax rates for different forms of share sales:¹⁰

9. Please refer to Section IV of this paper for more details on capital gains tax implications, including the applicable rates of capital gains tax.

10. These rates are exclusive of surcharge and cess. Cess at the rate of 3% is applicable on tax and surcharge amount. Surcharge on the tax amount is applicable at the following rates:

Individuals having income more than INR 10 million	12%
Domestic companies with income between INR 10 million and INR 100 million	7%
Domestic companies with income more than INR 100 million	12%
Foreign companies with income between INR 10 million and INR 100 million	2%
Foreign companies with income more than INR 100 million	5%

	Short Term Capital Gains			Long Term Capital Gains		
	Resident	Non-resident		Resident	Non-resident	
	Individual / Companies	Individuals	Companies	Individual / Companies	Individuals	Companies
Listed equity shares sold on the floor of the stock exchange*	15%	15%	15%	Nil	Nil	Nil
Listed equity shares sold off the floor of the stock exchange	Individual – slab rate Company -30%	30%	40%	20%	10%**	10%**
Unlisted securities or shares of a private company ¹¹	Individual – slab rate Company -30%	30%	40%	20%	10%**	10%**

*Provided Securities Transaction Tax has been paid.

**This beneficial rate is applicable if the inflation indexation is not claimed.¹²

- ii. **Section 56:** Where a firm or a company acquires shares of a company at a price which is less than the fair market value of the shares by an amount exceeding Rs.50,000, the acquirer is taxable on the amount of such undervaluation, and the rate of tax is the normal corporate tax rate of 30% ¹³ (excluding surcharge and cess) in the case of an Indian company and 40% (excluding surcharge and cess) in the case of a foreign company. If the acquirer is a firm, it would be taxable at 30%. This tax implication does not arise where either the acquirer or the target is a listed company.

Securities Transaction Tax (“STT”): If the sale of shares takes place on the floor of a recognized stock exchange in India, STT is levied on the turnover from share sale. In the case of intraday sales, STT at the rate of 0.025% is payable by the seller, while in the case of delivery based sales, STT at the rate of 0.10% is payable by the buyer and the seller.

11. The Finance Act, 2016 has extended the beneficial rate of 10% on
12. Indexation of gains is provided for under the second proviso to Section 48 of the ITA. Such indexation is permitted with regard to long term capital gains in order to account for inflation.
13. In 2015, the Government had proposed a gradual reduction in the domestic corporate tax rate from 30% to 25% over a period of four years. The Finance Act, 2016 has taken the first steps in this direction by providing that new manufacturing entities set up in India are entitled to a lower rate of 25% (excluding surcharge and cess) if they meet certain criteria. Furthermore, the domestic corporate tax rate has also been lowered to 29% for domestic companies whose turnover in FY 2014-15 did not exceed INR 5 crores (approx. USD 800K)

Indirect Taxes: VAT is not applicable on sale of shares.

Stamp Duty: Stamp duty levied on transfer of shares is 0.25% of the consideration paid for the transfer of shares under the provisions of the Indian Stamp Act, 1899.¹⁴

V. Slump Sale

A ‘slump sale’ is defined under the ITA as the sale of any undertaking(s) for a lump sum consideration, without assigning values to individual assets or liabilities.¹⁵ ‘Undertaking’ has been defined to include an undertaking, or a unit or a division of an undertaking or business activity taken as a whole. However, undertaking does not mean a combination of individual assets which would not constitute a business activity in itself.¹⁶

The ITA expounds on the taxation of a slump sale. The ITA states that the gains arising from a slump sale shall be subject to capital gains tax in the hands of the transferor in the year of the transfer.¹⁷ In case the transferor held the undertaking for a period of 36 (thirty six) months or more, it would be taxable as long term capital gains, otherwise it would be short term capital gains. The amount subject to capital gains shall be the consideration for the slump sale less the ‘net worth’ of the undertaking, which has been defined to mean the aggregate value of assets

14. Article 62 of Schedule 1
15. Section 2(42C) of the ITA
16. Explanation 1 to Section 2 (19AA)
17. Section 50B of the ITA

of the undertaking / division less the value of liabilities of the undertaking / division.¹⁸ The value of the assets and liabilities to be considered for the computation is the depreciated book value of such assets or liabilities, with certain exceptions.

What constitutes 'slump sale'?

Indian courts have evolved certain principles underlying 'slump sale' under the ITA.

A. Continuity of Business

The Bombay High Court while dealing with the concept of 'slump sale' generally clarified that one of the principle tests for determination of whether a transaction would be a 'slump sale' is whether there is continuity of business.¹⁹ Thus, the concept of 'going concern' is one of the most important conditions to be satisfied when analyzing whether a transaction can be regarded as a slump sale. The same view has also been upheld by the Punjab and Haryana High Court.²⁰

B. Transfer of Liabilities

The continuity of business also assumes that all assets and liabilities of the concerned undertaking are transferred under the sale. This view has been upheld by the Supreme Court, whereby it held that an 'undertaking' was a part of an undertaking/ unit/ business when taken as a whole.²¹ Additionally, the 'net worth' of the undertaking being transferred considers the book value of the liabilities to be reduced from the aggregate amount of assets of the undertaking, emphasizing the requirement of transferring liabilities.

C. Transfer of all Assets

While an essential element of a 'slump sale' is that the assets and liabilities of the undertaking are transferred to ensure continuity of business, for a transaction to be characterized as a 'slump sale', it is not essential that all

assets are transferred. The Punjab and Haryana High Court has held that it is not essential that all assets are transferred for a transaction to qualify as a slump sale. Even if some assets of the transferor are retained by it, and not transferred to the transferee, the transaction may still retain the characteristic of a slump sale. However, for it to be considered a slump sale, it is essential that the assets (along with the liabilities) being transferred are an undertaking in itself, and can function 'without any interruption'.²² This understanding of the term 'undertaking' is equally applicable to demergers.

D. Exchange not a Slump Sale

The Bombay High Court has held that for any transaction to be considered as 'slump sale', an essential element is that the transfer of the undertaking must be for cash consideration. In the case in hand, the High Court, while referring to an earlier judgment of the Supreme Court held that a transfer of an undertaking in exchange for shares/ bonds of the transferee entity would not constitute a 'sale' and accordingly, it would not be taxed as a slump sale under section 50B of the ITA.²³

E. Long Term Capital Gains

Another important aspect of a slump sale is that the gains arising from the sale of an undertaking (if any) shall be computed as long term capital gains, if the undertaking as a whole has been held for a period of 36 months, irrespective of the fact that some of the assets may have been held for a period of less than 36 months.

The substance, not the form of a slump sale transaction is to be examined. In cases where the entire undertaking has been transferred under different agreements, the Income Tax Appellate Tribunal ("ITAT"), Mumbai has held that the same would constitute a slump sale.²⁴

Indirect Tax: There should be no VAT on sale of the business as a slump sale. This is because what is being sold is the undertaking or the business on a slump sale

18. Explanation 1 to Section 50B of the ITA

19. *Premier Automobiles Ltd. vs. Income Tax Officer and Anr.* [2003] 264 ITR 193 (Bom)

20. *Commissioner of Income Tax vs. Max India Ltd.* [2009] 319 ITR 68 (P&H)

21. *R.C. Cooper vs. Union of India* AIR 1970 SC 564

22. *Premier Automobiles Ltd. vs. Income Tax Officer and Anr.* [2003] 264 ITR 193 (Bom) as approved in *Commissioner of Income Tax vs. Max India Ltd.* [2009] 319 ITR 68 (P&H)

23. *Bharat Bijlee Limited v. The Addl. CIT* (ITA No. 2153 of 2011)

24. *Mahindra Engineering & Chemical Products Ltd. vs. ITO* (TS-253-ITAI-2012 (Mum))

basis, and 'business' per se does not qualify under the definition of 'good'. Since a business cannot qualify as a 'good', there should be no incidence of VAT on the transfer of business on a slump sale basis.

Stamp Duty: Please refer to the below section on "Asset Sale"

VI. Asset Sale

As compared to slump sale discussed above, an asset sale is an itemized sale of the assets of company or a piece meal sale of the assets of the company. In an itemized sale of assets, for determining taxability of capital gains, a distinction is drawn between depreciable and non-depreciable assets.

A. Non-depreciable Assets

On sale of all assets not being depreciable assets, capital gains are calculated as per Sections 45 and 48 of the ITA, i.e., the amount by which the sale consideration of the asset exceeds its cost of acquisition. Each asset is assigned a value, and the consideration for such asset is also determined. The gains from the sale of each asset is determined and the transferor is liable to capital gains tax on the gains (if any) from the sale of each asset. Further, whether the sale would result in short term or long term capital gains would need to be analyzed individually depending on the holding period for each asset by the transferor. Accordingly, it may be possible that certain assets result in short term capital gains, while some result in a long term capital gain, despite being sold as part of the same transaction.

B. Depreciable Assets

When an asset forms a part of a block of assets²⁵ on which depreciation is allowed as deduction under the ITA at the rate applicable on the block, the capital

gains arising from such transfer are taxed only as short-term capital gains irrespective of the period of holding of the asset. The capital gains from transfer of depreciable assets are determined as the difference, if any, between the sale consideration from the transfer of the concerned assets, together with the transfer of any other asset within that block in the same financial year, and the aggregate of (i) expenditure incurred in connection with such transfer, (ii) depreciated value of the concerned block of assets at the beginning of the financial year, and (iii) actual cost of any asset acquired during that year and forming part of that block.

If the sale consideration does not exceed the aggregate of the above values, then there is no capital gains which are said to arise from the sale of the asset even if the sale consideration exceeds its cost of acquisition. In such a situation the sale consideration is adjusted within the block and the value of the block is reduced by the amount of sale consideration of the asset.

The main features of an asset sale would be best understood in contrast to the sale of an undertaking under a slump sale.

1. While in case of a slump sale, each asset is assigned a value for the purposes of only stamp duty, etc., in case of an asset sale, each asset is considered as a separate sale and hence values are assigned to each asset. The ITAT, Hyderabad, quoting multiple judgments from the Supreme Court, has held that what is important for a transaction to be an itemized sale is that each asset be assigned a value for the purpose of the transaction.²⁶ The ITAT went on to state that the mere fact that values had been assigned to individual assets would not necessarily mean that the transaction is an itemized asset sale, but that it could still be regarded as a slump sale. What is essential is that the values have been assigned for the purpose of the sale of the assets.

25. "block of assets" is defined in Section 2(11) of the ITA as a group of assets falling within a class of assets in respect of which the same percentage of depreciation is prescribed. Such block of assets may comprise of (a) tangible assets such as buildings, machinery, plant or furniture; (b) intangible assets such as know-how, patents copyrights etc.

26. *Coromandel Fertilisers Limited vs. Dy. Commissioner Of Income-Tax* 2004 90 ITD 344 Hyd

2. As the name suggests, an asset sale does not include the transfer of liabilities of the transferor company. In some cases, all the assets of a business may be transferred, which may be required to operate the business going forward, without transferring any liabilities. In such cases while the transferred assets operate as a going concern, the transaction is an asset sale, since the liabilities are not transferred.

Indirect Tax: VAT could be applicable depending on the nature of asset sold, and could be as high as 13.5%.

Stamp Duty: Stamp duty payable on transfer of assets, whether in case of an itemized sale or slump sale, is governed by the provisions of the relevant stamp act where the document of instrument of transfer is executed / produced. For instance, in Maharashtra, the stamp duty payable on conveyance of immovable property and movable property is 5% and 3%, respectively, of the consideration paid therefor.

However, since the stamp duty is payable on the instrument for transfer, no stamp duty is payable if there is no instrument effecting the transfer. For instance, if the movable tangible assets are delivered by way of physical delivery and the buyer merely acknowledges receipt of such assets by way of a 'delivery note', then no stamp duty is payable on such acknowledgment or receipt of assets. As regards movable assets that are intangible in nature, such as goodwill, stamp duty at the rate of 3% will need to be paid on the instrument conveying such intangible assets. If the intangible asset like goodwill is transferred by way of an instrument, such as the business transfer agreement or the asset purchase agreement, then the business transfer agreement or the asset purchase agreement will need to be stamped to the extent of at least 3% of the value of the goodwill. If there are other assets that are being conveyed by way of the business transfer agreement or the asset purchase agreement, then such instruments should be stamped to such appropriate value as may be required under the relevant stamp act. The applicable rates of stamp duty will vary on a state wise basis.

Below is a comparison between the various methods of acquisition as discussed above

	Slump Sale	Share Sale	Asset Sale	Amalgamation	Demerger
Definition	Transfer of an undertaking / business for a lump sum consideration on a going concern basis without values being assigned to the individual assets and liabilities in such sale.	Acquisition in whole or part of the shareholding of a company from the existing shareholders. Unless specifically agreed to, the seller has no continuing interest in, or obligation with respect to, the assets, liabilities or operations of the business	The sale of the whole or part of the assets of the target to the acquirer with individual values assigned for each asset.	Merging of one company into another company or merging of two or more companies to form a new company under a court approved process in compliance with Section 391 to 394 of the Companies Act, 1956.	Transfer of undertaking of company to another company under a court approved process in compliance with Section 391 to 394 of the Companies Act, 1956.
Court Approval	Not required	Not required	Not required	Required	Required
Transfer	All Assets + Liabilities pertaining to the undertaking	All Assets + Liabilities pertaining to the company	Such assets/liabilities that the parties may determine	All Assets + Liabilities of the Amalgamating Company	All Assets + Liabilities relating to the undertaking being transferred

Capital Gains	<p>Capital gains realized on the transfer of the undertaking, if held for:</p> <ul style="list-style-type: none"> ■ more than 36 months, are taxed as long term capital gains. ■ if held for less than 36 months are taxed as short term capital gains. <p>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 (<i>Section 50B of the ITA</i>)</p>	<p>Capital gains realized on the transfer of listed shares, if held for more than 12 months is taxed as long term capital gains. Capital gains realized on the transfer of the shares, if held for 12 months or less is taxed as short term capital gains.</p> <p>As per the Finance Act, 2016, the holding period for unlisted shares has been reduced from 36 months to 24 months.</p>	<p>In case of depreciable assets, capital gains computed on a block of asset basis and the value over and above the aggregate of the written down value of the block of assets and expenditure incurred in relation to the transfer will be treated as the capital gains and subject to tax as short term capital gains.</p> <p>In other cases, capital gains tax payable by the seller will depend on the period that the seller has held each of the assets that are transferred.</p>	<p>No capital gains tax liability if it is a tax neutral amalgamation, and if the transaction is covered under Section 47 of ITA.</p>	<p>No capital gains tax liability if it is a tax neutral demerger, and if the transaction is covered under Section 47 of ITA.</p>
Carry forward of losses	No carry forward of losses	Carry forward of losses if change in shareholding does not exceed 49%	No Carry forward of losses	Carry forward of losses if conditions under Section 72A of ITA are satisfied.	Carry forward of losses if conditions under Section 72A of ITA are satisfied.
Value Added Tax	Value Added Tax not applicable	Value Added Tax not applicable	Value Added Tax applicable which usually ranges between 0% - 13.5% depending on the nature of goods.	Value Added Tax not applicable	Value Added Tax not applicable
Stamp Duty	Rate of stamp duty payable on the slump sale is state specific	0.25% of the sale consideration	Rate of stamp duty payable on the asset purchase agreement is state specific	Rate of stamp duty payable on amalgamation is state specific	Rate of stamp duty payable on demerger is state specific

2. Cross Border Tax Issues

I. Introduction

Tax issues arise in cross border deals when two different jurisdictions seek to tax the same sum of money or income or the same legal person thereby resulting in double-taxation. Many countries are aware that double taxation acts as a disincentive for engaging in any cross border trade or activity. Therefore with the primary view to encourage mutual cooperation, trade and investment, the countries enter into bilateral Double Taxation Avoidance Agreements (“DTAA”) to limit their taxing jurisdictions voluntarily through self-restraint.

The availability of such benefits and the ultimate tax liability often drives or breaks cross border transactions. Particularly in the Indian context, where the tax administration is perceived to be aggressive and the laws uncertain, any protection offered by a treaty jurisdiction is important. It is important for the buyer in the context of whether there is any withholding obligation while making a remittance to the seller.

India is currently going through an overhaul of the existing investment climate as it has recently amended the India-Mauritius DTAA and has promised to bring the DTAA's with Singapore, Cyprus and Netherlands in line with the amended India-Mauritius DTAA. Together, these jurisdictions represent almost all the investment that has been made into India. This is in addition to the fact that the General Anti-Avoidance Rules (“GAAR”) is also set to be effective from 1st April 2017, the same date when the India – Mauritius DTAA shall stand amended.

It is expected that the current status quo will remain till 1st April 2017. It is also expected that if the DTAA's are amended, then they will be suitably protected from the implementation of the uncertain and widely discretionary GAAR provisions. The positions explained below must be re-verified when there is a substantial change in the laws or the DTAA's.

II. Claiming Treaty Benefit: Requirements and Procedure

Under Section 90(2) of the ITA, if the non-resident is resident in a country with which India has a DTAA, he would be taxable according to the provisions of the DTAA or the ITA, whichever is more beneficial to him.

Relief under the DTAA should normally be available as long as the non-resident is resident and a separate legal person liable to tax under the laws of the relevant country and liable to tax under its laws. Sections 90(4) and 90(5) require a non-resident claiming treaty relief to:

- i. Furnish a valid Tax Residency Certificate (“TRC”) issued by the government of its home country;
- ii. Provide certain additional information, as may be prescribed from time to time, in Form 10F.

At present, the following details are required to be provided by a non-resident claiming relief under a DTAA:

- i. *Status of the claimant i.e., individual, company, firm etc.;*
- ii. *Nationality*
- iii. *Claimant's tax identification number in the country of residence and in case there is no such number, a unique number on the basis of which the claimant is identified by the Government of the country of which he claims to be a resident;*
- iv. *Period for which the residential status, as mentioned in the TRC, is applicable; and*
- v. *Claimant's address outside India, during the period for which the TRC is applicable.*

Typically, a non-resident claiming relief under a DTAA is required to furnish an income tax return to the tax authorities, where he would be required

to quote his Permanent Account Number (“PAN”), which is a tax identification number issued by the Indian tax authorities.

III. Withholding Tax Obligations

Under Section 195 of the ITA, any person making a payment of a sum to a non-resident that is chargeable to tax under the ITA (read with relevant provisions of the applicable DTAA) would be required to withhold tax on such sum at the appropriate rate. Such withholding is required to be made either at the time of payment or at the time of credit of income to the account of the non-resident. However, if the amount paid is not taxable in India, there is no requirement to withhold tax on such payments.²⁷ However, if the amount paid has an element of income that is taxable in India, then even a non-resident who making such remittance is obligated to withhold as per the ITA.

India levies withholding tax on certain types of passive income (e.g. interest, royalties etc.). India does not levy a withholding tax on dividends, since a Dividend Distribution Tax (“DDT”) is paid by the distributing company.²⁸

The normal withholding tax rate on royalties and fees for technical services is 10%, and lower rates may apply if provided for in a tax treaty.

The normal withholding tax rate on interest is 40%. However, more beneficial rates (ranging from 5% – 20%) of withholding are available to non-resident creditors depending on the nature of the security involved, the status of the non-resident creditor etc.

India levies a tax on capital gains arising from the transfer of an asset located in India.²⁹ In the case of capital gains arising from the transfer of shares of an Indian company, the tax on such gains is typically eliminated through the use of structures involving a Mauritian or Singaporean holding company, since under the DTAA in place between India and the aforementioned countries, subject to certain criteria being fulfilled (e.g., absence of a permanent establishment in India) only the country of residence of the transferor is entitled to levy a tax on capital gains arising from the transfer of shares of an Indian company, and importantly, these countries do not tax capital gains.³⁰

In the context of the India-Mauritius DTAA, the Central Board of Direct Taxes (“CBDT”) has issued Circular 682 of 1994 which states that “*any resident of Mauritius deriving income from alienation of shares of Indian companies will be liable to capital gains tax only in Mauritius as per Mauritius tax law and will not have and capital gains liability in India*”. The CBDT also issued Circular 789 of 2000 which states that: “*Wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAA accordingly*”.

27. *GE India Technology Centre Ltd. v. CIT*, [2010] 327 ITR 456; *Vodafone International Holdings BV v. Union of India*, [2012] 341 ITR 1 (SC)

28. The Finance Act, 2016 has proposed the introduction of a tax at the rate of 10% on dividends in excess of INR 1 million (approx. USD 15,000) declared by a domestic company and received by a resident individual, LLP or partnership firm. This is in addition to the DDT paid by the distributing company. It is expected that the introduction of this tax, will affect the ability of non-residents to claim foreign tax credit in their home jurisdictions on DDT paid by the distributing company.

29. India also levies a tax on the gains arising on the transfer of shares or an interest in a foreign company, if the share or interest derives its value substantially from assets (tangible or intangible) located in India. This tax on indirect transfers of Indian assets is dealt with in more detail in the section on Indirect Transfer Tax.

30. In certain scenarios, eligibility to claim relief under a DTAA may be conditional upon the satisfactions of certain “substance” requirements. For example, the India-Singapore DTAA incorporates a “Limitation on Benefits” clause, which requires a Singapore resident company to demonstrate the following, before it can claim benefits under the DTAA:

- i. The primary purpose of its incorporation in Singapore should not be to take advantage of the treaty benefits.
- ii. It should not be a shell / conduit company and it must have bona fide business activities.
- iii. It will be deemed not to be a conduit company if:
 - a) Its total annual expenditure on operations in Singapore is at least S\$200,000 during 2 years prior to share transfer, or
 - b) It is listed on a stock exchange in Singapore.

The India-Mauritius DTAA contains no such clause at present, but the Indian and Mauritian Governments are in negotiations to introduce a “Limitation on Benefits”.

Despite this, the Mauritius route has been the subject of much litigation. However, the Supreme Court has held³¹ that relief under the DTAA cannot be denied as long as the Mauritius investor is a valid company in existence having a TRC issued by the Mauritius Revenue Authority. The above proposition has been followed in number of other cases,³² most recently in *Serco BPO (P) Ltd. v. AAR*.³³

In the event relief under the relevant DTAA is not available, a non-resident would be taxed on capital gains at the rate of 15% for short term capital gains on sale of listed shares on the stock exchange (subject to STT) or 40% for other short term gains. Long term capital gains arising from sale of listed shares on the stock exchange are exempt (but subject to STT) or taxed at 10% if sold outside the stock exchange.

The capital gains tax for non-residents on transfer of unlisted securities is 10% for non-residents without indexation benefit. However, this benefit was typically only applicable effectively for unlisted shares of a public company, and not a private company. The Finance Act, 2016 has recently extended the reduced tax rate of 10% (without indexation benefit) w.e.f. April 1, 2017 to transfer of shares of 'a company not being a company in which the public is substantially interested', thereby extending it to shares of private companies. Capital gains arising from the transfer of any other asset are taxed at the rate of 20%.

A. Tax Identification Number for Non-Residents

Section 206AA of the ITA, provides that where any person fails to provide his Permanent Account Number ("PAN") to the person responsible for deducting tax at source, the latter shall be required to deduct tax at the rate of 20%, or the maximum applicable rate chargeable under the ITA, whichever is higher. Whether this provision would be applicable to a non-resident claiming treaty benefit has been the subject of much litigation, with the courts holding both for and against the proposition.³⁴ In the Finance Act, 2016, the Government has proposed permitting non-residents to furnish alternative documents such as a tax identification number issued by their country of residence. This measure, if implemented, effective from June 1, 2016, will ensure that the needless incremental burden borne by non-residents who are doing business with India is avoided.

IV. Structuring Investments into India – Suitable Holding Company Jurisdictions

In light of a non-resident's ability to claim benefits under an applicable DTAA, we have highlighted some of the more beneficial jurisdictions through which investments into India are often structured. Of course, the requirement to demonstrate commercial substance is ever present.

31. *GE India Technology Centre Ltd. v. CIT*, [2010] 327 ITR 456; *Vodafone International Holdings BV v. Union of India*, [2012] 341 ITR 1 (SC)

32. *In re, E*Trade Mauritius Limited*, [2010] 324 ITR 1 (AAR); *Dynamic India Fund I*, AAR 1016/2010 dated July 19, 2012; *DDIT v. Saraswati Holdings Corporation*, [2009] 111 TTJ 334; *DB Swirn Mauritius Trading*, [2011] 333 ITR 32 (AAR); *In re, Ardex Investments Mauritius Ltd.*, [2012] 340 ITR 272 (AAR); *In re, SmithKline Beecham Port Louis Ltd.*, [2012] 340 ITR 56; *In re, Castleton Investment Ltd.*, [2012] 348 ITR 537; *Moody's Analytics Inc.*, [2012] 348 ITR 205; *In re, DLJMB Mauritius Co.*, [1997] 228 ITR 268; *Zaheer Mauritius v. DIT*, [2014] 270 CTR (Del) 244

33. C Writ Petition No. 11307 of 2014 (O&M)

34. *DDIT v. Serum Institute of India Ltd*, MANU/IP/0145/2015, decided on 30.03.2015 by the Income Tax Appellate Tribunal, Pune and reiterated in *DDIT v. Infosys BPO*, MANU/IL/0278/2015, dated 29.06.2015 and further affirmed in *Wipro v. ITO*, MANU/IL/0042/2016, dated 12.02.2016, by the Income Tax Appellate Tribunal, Bangalore.

	MAURITIUS	CYPRUS	SINGAPORE	NETHERLANDS
Capital gains tax on sale of Indian securities	<p>Mauritius residents not taxed. No local tax in Mauritius on capital gains till 1st April, 2017.</p> <p>After 1st, April 2017:</p> <p>i. No tax on capital gains on investments made before 1st April, 2017.</p> <p>ii. 50% of applicable Indian tax rate on investments made from 1st April 2017 to 1st April 2019, subject to anti-abuse or limitation of benefits provisions.</p> <p>iii. Full rate of Indian tax for investments made after 1st April 2019.</p>	<p>Cypriot residents not taxed.** No local tax in Cyprus on capital gains. The Indian / Cyprus government have recently been in discussions and have announced that the Cyprus treaty will be amended on the lines of the Mauritius treaty.</p>	<p>Singapore residents not taxed till 1st April, 2017. Exemption subject to satisfaction of certain 'substance' criteria and expenditure test by the resident in Singapore. No local tax in Singapore on capital gains (unless characterized as business income).</p> <p>After 1st April, 2017, expected to be in line with Mauritius DTAA (without the benefit of grandfathering)</p>	<p>Dutch residents not taxed if sale made to non-resident. Exemption for sale made to resident only if Dutch shareholder holds lesser than 10% shareholding in Indian company. Local Dutch participation exemption available in certain circumstances.</p>
Tax on dividends	<p>Indian company subject to DDT at the rate of 15% (exclusive of surcharge and cess) on a gross basis.</p>	<p>Indian company subject to DDT at the rate of 15% (exclusive of surcharge and cess) on a gross basis.</p>	<p>Indian company subject to DDT at the rate of 15% (exclusive of surcharge and cess) on a gross basis.</p>	<p>Indian company subject to DDT at the rate of 15% (exclusive of surcharge and cess) on a gross basis.</p>
Withholding tax on outbound interest	<p>No relief. Taxed as per Indian domestic law till 1st April, 2017.</p> <p>After 1st April, 2017, tax on interest payments from India capped at a flat rate of 7.5%</p>	<p>10%**</p>	<p>15% till 1st April, 2015.</p> <p>After 1st April, 2017, tax on interest payments from India expected to be capped at a flat rate of 7.5%</p>	<p>10%</p>
Withholding tax on outbound royalties³⁵ and fees for technical services	<p>15% (for royalties). FTS³⁶ may be potentially exempt in India till 1st April, 2017.</p> <p>After 1st April, 2017, FTS is capped at 10% of the gross amount.</p>	<p>15%**</p>	<p>10%</p>	<p>10%</p>
Other comments	<p>The treaty has been amended and the amended protocol will take effect from 1st April, 2017</p>	<p>Cyprus economic crisis and financial situation to be taken into consideration.</p> <p>DTAA has been re-negotiated and it is amended in line with the Mauritius treaty.</p>	<p>Treaty has to be re-negotiated due to changes in Mauritius DTAA. Uncertainty remains as to final terms of the DTAA, although it is expected to be in line with Mauritius DTAA.</p>	<p>To consider anti-abuse rules introduced in connection with certain passive holding structures.</p> <p>DTAA may be re-negotiated in the near future to do away with exemption on capital gains tax.</p>

35. Finance Act, 2015 proposes to reduce the withholding tax rate applicable in case of royalty and FTS to offshore entities to 10% (on a gross basis).

36. Fees for Technical Services

***Following the blacklisting of Cyprus by the Indian tax authorities in 2013, payments made to entities incorporated in Cyprus are subject to a withholding tax at the rate of 30% or such higher rate as may be applicable. Please note that the Indian government is currently re-assessing the blacklisting.*

V. Tax as a Representative Taxpayer/Assessee

In a cross-border transaction where due to a merger or an acquisition capital gains arises, even though the person ultimately liable for tax on such capital gains is the seller, the person responsible for making the payment may also be treated as a representative assessee of the seller. This requirement is independent of the requirement of the buyer to deduct tax at source ("TDS"), or the withholding tax obligations of the buyer.

Where any final tax liability falls on a non-resident, particularly a foreign company, and the tax authorities are of the opinion that it may be difficult to recover tax liable from such non-resident during the final assessment proceedings may, even at the stage of deduction of TDS, proceed to recover such amounts from an agent of the non-resident by treating the agent as a representative taxpayer/assessee.

The power to treat an agent of the non-resident as a representative taxpayer and recover amounts due from the non-resident from the representative taxpayer is not limited only to TDS proceedings alone and recoveries can be made even for liabilities due after the final assessment is completed. It is also legal for the tax authorities to proceed against both the non-resident and their agent simultaneously so long as the recovery is made only from either one of them. The representative assessee has in turn the right to recover such amounts paid by it on behalf of the non-resident from the non-resident.

The following persons may be held to be a representative assessee of a non-resident:

- a. A person employed by or on behalf of the non-resident; or
- b. A person has any business connection with the non-resident; or
- c. A person from or through whom the non-resident receives income directly or indirectly; or
- d. A trustee of the non-resident;

In this context, the term 'business connection' means a continuing business relationship carried on by non-resident with a person that yields profits or gains through some activity in India.

In the landmark ruling by the Supreme Court of India in the *Vodafone International Holdings BV v. Union of India*³⁷, the Court noted that the representative assessee provisions cannot be invoked to tax the buyer entity when there is not transfer of a capital asset. Therefore, the representative assessee provisions may only be used if there is income chargeable to tax in India.

VI. Provisions for Cross-border Mergers

The merger of two foreign companies involving the transfer of shares of an Indian company, is normally tax exempt provided that the merger satisfies the criteria for an Amalgamation set out in Section I and, (i) at least 25% of the shareholders of the merging company remain shareholders in the merged company, and (ii) such transfer does not attract capital gains tax in the country in which the merging company is incorporated.

The demerger involving the transfer of shares of an Indian company by a demerged foreign company to the resulting foreign company are also tax exempt provided that (i) the shareholders holding not less than $\frac{3}{4}$ of the shares in the demerged foreign company remain shareholders in the resulting company and (ii) such transfer does not attract capital gains in the country in which the demerged foreign company is located. As mentioned in Section I, the merger of an Indian

37. *Vodafone International Holdings BV v. Union of India* (2012)6SCC613

company with a foreign company is also tax exempt, provided the resulting company is an Indian company.

VII. Tax Indemnities on Transfer

Tax indemnities are a critical aspect of negotiating M&A deals. It has been discussed in greater detail in the Section VIII of this paper.

Given the adversarial nature of India's tax regime, from a commercial stand point it becomes essential to negotiate suitable tax indemnity agreements to cover not only the actual tax that may become payable but provide for the costs associated with prolonged litigation such as interest, penalties, advisory

and litigation costs. The tax indemnity is normally negotiated for a period of 7 years, since the tax authorities are empowered to reopen past assessments if not more than 6 years have elapsed from the end of the relevant assessment year.

It is also possible for investors to resort to tax insurance to reduce the risk involved if ultimately any tax is liable to be paid. It is advisable to pre-empt any litigation or adverse orders by the tax authorities and approach the Authority for Advance Rulings instead at the earliest possible stage. The rulings of the Authority for Advance Rulings are binding on both the taxpayer and tax authorities, which may provide a well needed measure of certainty in respect of the transaction.

3. Prevailing Ambiguities in Indirect Transfer Provisions

I. Introduction

Through the Finance Act, 2012, the Indian legislature had introduced “indirect transfer provisions”.

These provisions require that gains arising from the transfer of shares of a company incorporated outside India would be taxable in India if such shares substantially derive their value from assets located in India.

The introduction of these provisions in the ITA has been widely debated by various participants of the Indian economy. The provisions were introduced as a knee-jerk reaction to the Supreme Court’s decision in the *Vodafone International Holdings B.V. v. Union of India & Ors.*³⁸ As is well recorded, the *Vodafone* case involved a contention by the Indian revenue authorities that the acquisition of an entity located in the Cayman Islands by Vodafone’s Dutch subsidiary involved an *indirect* transfer of underlying assets situated in India. Consequently, the revenue authorities claimed that the gains arising on the transfer were liable to capital gains tax in India. The Supreme Court ruled in favour of *Vodafone* stating that the impugned provision³⁹ did not cover such transactions within its scope.

Consequently in 2012, the Indian legislature amended Section 9(1)(i) of ITA by adding an additional explanation⁴⁰ clarifying that an offshore capital asset would be considered to have a situs in India if it substantially derives its value (directly or indirectly) from assets situated in India (“**2012 Amendment**”).

Further, the provision was made applicable with retrospective effect as the explanation stated that such assets “*shall always be deemed to have been situated in India*”.

II. Uncertainty and Subsequent Changes after the 2012 Amendment

The introduction of the provisions with retrospective effect caused wide spread concern. Further, the situation was exacerbated due to the fact that there was no clarity around the term “substantially” that was the basis of determining the scope of the 2012 Amendment.

The situation had already led to litigation with the Delhi High Court weighing in on the issue in the case of *DIT v. Copal Research Mauritius Limited, Moody’s Analytics, USA & Ors.*⁴¹ In its decision, the High Court had stated that the term “substantially” as used in explanation 5 to Section 9(1)(i) should be interpreted to mean “principally”, “mainly” or at least “majority”. Consequently, it concluded that the indirect transfer tax provisions shall apply when the overseas company derives at least 50% of its value from Indian assets.

As a response to the prevailing uncertainty, through the Finance Act, 2015 (“**2015 Act**”), the Indian Government introduced the following additional provisions to clarify the position on indirect transfers:-

A. Threshold Test for Substantiality and Valuation

The 2015 Act provided that the share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds the amount of INR

38. [2012] 34 ITR 1 (SC)

39. Section 9(1)(i), the ITA. The provision deals with “**Income deemed to accrue or arise in India**”

40. Explanation 5 to Section 9(1)(i) states as follows:

“Explanation 5.-For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.”

41. [2015] 371 ITR 114(Delhi)

10 crores (INR 100 million); and (ii) represents at least 50% (fifty percent) of the value of all the assets owned by the company or entity. The value of the assets shall be the Fair Market Value (“FMV”) of such asset, without reduction of liabilities, if any, in respect of the asset. However, the manner of determination of the FMV of the assets was not prescribed in the 2015 Act and was to be subsequently provided for in the rules. Very recently, the draft rules released earlier this year have been finalized.

B. Date for Determining Valuation

Further the 2015 Act stated that typically, the end of the accounting period preceding the date of transfer shall be the specified date of valuation. However, in a situation when the book value of the assets on the date of transfer exceeds by at least 15%, the book value of the assets as on the last balance sheet date preceding the date of transfer, then the specified date shall be the date of transfer. However, this results in ambiguity especially in cases where intangibles are being transferred.

C. Apportionment of Gains

The 2015 Act introduced explanation 7 to Section 9(1)(i) which stated that the gains arising on transfer of a share or interest deriving, directly or indirectly, its value substantially from assets located in India will be taxed on a proportional basis based on the assets located in India vis-à-vis global assets. However, it did not provide for determination of proportionality and the same are proposed to be provided subsequently by a separate set of rules.

D. Exemptions

The 2015 Act also stated that the provisions shall not be applicable in the following circumstances:-

- i. Where the transferor of shares or interest in a foreign entity, along with its related parties does not hold (i) the right of control or management; and (ii) the voting power or share capital or interest exceeding 5% of the total voting power or total

share capital in the foreign company or entity directly holding the Indian assets (“**Holding Co**”).

- ii. In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly, then the exemption shall be available to the transferor if it along with related parties does not hold (i) the right of management or control in relation to such company or the entity; and (ii) any rights in such company which would entitle it to either exercise control or management of the Holding Co or entitle it to voting power exceeding 5% in the Holding Co.
- iii. In case of business reorganization in the form of demergers and amalgamation, exemptions have been provided. The conditions for availing these exemptions are similar to the exemptions that are provided under the ITA to transactions of a similar nature.

III. Prevailing Issues

A. Concerns for Multi-layered Structures

The presence of indirect transfer tax provisions raises critical concerns for an organization which seeks to take exposure to an Indian entity through an intermediary holding vehicle. Not only at the time of exit, but there is also a risk of taxation when cash is up-streamed by way of redemption of shares of the holding company that are held by the parent company.

While the Central Board of Direct Taxes (“**CBDT**”) has released a circular⁴² that has clarified that a distribution of dividends by an offshore company with underlying Indian assets would not result in a tax liability under Section 9(1)(i) read with Explanation 5. The operative portion of the 2015 Circular states as follows:-

■
“Declaration of dividend by such a foreign company outside India does not have the effect of transfer of any under-

42. Circular no.4 of 2015

lying assets located in India. It is therefore, clarified that the dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets in India would not be deemed to be income accruing or arising in India by virtue of provisions of Explanation 5 to Section 9(1)(i) of the Act.”

However, there is lack of certainty over distributions that arise out of redemption of shares made out of accumulated profits of the holding vehicle to the parent company. While a view may be taken that redemptions should not be scrutinized under explanation 5 of section 9(1)(i) of the ITA due to that fact that Section 2(22) of the ITA (which defines the term “dividend”) includes distributions by way of any “capital reduction” and provides that “dividend” includes any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits, whether the such accumulated profits have been capitalized or not. However, this position suffers from ambiguity due to the fact Section 46A of the ITA treats purchase of its own shares by an Indian company to be a transaction that is subject to capital gains and does not consider such purchases to be a form of dividend distribution.

Further, Indian revenue authorities have also raised issues around commercial substance in interpreting issues of indirect transfers. For instance, the authority of advanced rulings while dealing with an application filed by *Sanofi Pasteur Holdings SA*⁴³, held that a French special purpose vehicle (“SPV”) to be a colorable device which was set up to avoid Indian tax and capital gains arising from a transaction in India. However, in the instance of *Sanofi* the Andhra Pradesh High Court held that it would be incorrect to label the SPV as a colorable device as the eventual demand raised by Indian authorities was lower than the demand from the French revenue authorities.

Further, the Court also took the following points into consideration:-

- i. The minority shareholders of SPV had no evident extraordinary control of the SPV
- ii. The SPV continued exist post sale of shares by its shareholders.
- iii. The SPV was conceptualized in accordance with the group’s established business practices and organization structure.

Lastly, another issue, that arises in such a scenario is that the existence of indirect provisions may lead to multiple incidences of taxation i.e. every instance of indirect transfer shall create a taxable transaction in India. Therefore, in a situation where there are multiple levels of transactions, the indirect transfer provisions may lead to an absurd consequence of the liability being imposed each time by the Indian revenue authorities.

B. Availability of Tax Credits

In respect of taxes paid due to the indirect transfer provisions, credit for such payment may not be available if the jurisdiction of the assessee does not recognize such payment for credit against a capital gains liability that arises out of a direct transfer of assets.

IV. Current Situation with Respect to Taxation of Indirect Transfers

In 2014, the finance minister had announced in his budget speech that a high level committee would be constituted which would oversee any fresh case where the assessing officer proposes to assess or reassess income in respect of indirect transfers by applying the 2012 Amendment.

43. *Sanofi Pasteur SA v. Department of Revenue* [2013] 30 taxmann 222

In his recent budget speech on February 29, 2016, the finance minister has further stated that this committee will now be chaired by the revenue secretary and consist of chairman of CBDT and an external expert.

Further, in order to give an opportunity to the past cases which were ongoing under Section 9(1)(i) of the ITA, the finance minister has proposed a one-time scheme of dispute resolution in the form of Direct Tax Dispute Resolution Scheme (“DTDRS”), under which, subject to the taxpayer agreeing to withdraw any pending case in any court, tribunal, arbitration, mediation under any Bilateral Investment Protection Agreement (“BIPA”), the dispute can be settled by paying the tax arrears alone in which case the liability concerning the interest and penalty shall be waived.

While it remains to be seen whether the DTDRS will find traction amongst the affected entities, the lack of rules concerning apportionment of income attributable to Indian assets and determination of fair market value continue to affect operations for structures which fall within the scope of these provisions.

Recently, the Indian revenue authorities have issued rules that prescribe fair market value computation methods and reporting requirements for indirect transfer provisions. The objective behind the rules is to provide clarity on these teething issues and shed light on the circumstances where such provisions would be applicable. The rules are unclear on various issues such as what constitutes “control” over an entity and provide for overzealous reporting requirements and to that extent it may take time for a final determination of how the rules will actually be applied in practice.

4. Capital Gains Taxation: Timing and Valuation

I. Event of Taxation

The ITA defines ‘income’ to include ‘capital gains’ and prescribes a set of rules for taxing such capital gains. Pursuant to Section 45 of the ITA capital gains tax is levied on the gains or profits arising from the transfer of a ‘capital asset’. A ‘capital asset’ has been broadly defined under the ITA as including property of *any kind* (including the shares or good will of a company) held by a tax payer other than those assets held as stock in trade, certain personal effects, agricultural land, and certain bonds.

As per Section 45, capital gains tax must be assessed at the time of transfer of the capital asset, and not necessarily at the time when consideration is received by the transferor or the date of the agreement to transfer. In other words, a tax payer is required to pay capital gains tax with respect to the year his right to receive payment accrues, even if such payment is deferred in whole or in part.

Further, Section 195 of the ITA requires tax to be withheld on any sum paid to a non-resident for which tax is chargeable under the ITA.⁴⁴ India levies capital gains tax on gains arising from the transfer of shares located in India or deriving their value substantially from assets (tangible or intangible) located in India.⁴⁵ Tax is required to be withheld at the applicable rates for such transfers to non-residents at the time of payment or credit of such income into the account of the non-resident seller. It is also important to note that such withholding is required to be made on the whole consideration amount and not just the gains arising from the transfer. Further, certain capital receipts that do not involve any element of profit or gain are also taxed. For example notional gains from the purchase of shares by a company (other than a company held by the government or a listed company) for a value less than the fair market value of the shares,

are subject to capital gains tax to the extent of the difference. However, in all instances the right to capital gains must accrue or arise before the gains can be taxed.

II. Computation of Capital Gains

Section 48 of the ITA provides that capital gains are computed by deducting the following from the full value of consideration:

- i. cost of acquisition of the capital asset;
- ii. any cost of improvement of the capital asset; and
- iii. expenditure incurred wholly and exclusively for such transfer.

It is now settled law that the term “full value of consideration” means the entire consideration received by the tax payer, whether or not such amount is the market value of the capital asset transferred. For example, where Company A offers its own shares as consideration for the shares of Company B, using the relevant market value as the basis for calculating the exchange ratio, the full value of consideration in the hands of Company B will be the market value of Company A’s shares (and not par value) as the market value was the consideration actually received.

Further, the cost of acquisition includes the entire amount paid for the asset regardless of whether such payment is made in installments over a period of time. However, the Supreme Court in its landmark decision in the case of *CIT, Bangalore v B C Srinivasa Shetty*⁴⁶ laid down the principle that cost of acquisition should be capable of being ascertained in order for the machinery provided in Section 48 of the ITA to apply. If such cost is not ascertainable, no capital gains tax would arise.

44. Withholding requirements under Section 195 of the ITA are discussed in more detail in section II.

45. Tax on indirect transfers of Indian assets is discussed in more detail in the section III.

46. 1981 AIR 972

While the judgment was geared at providing clarity to tax payers, it resulted in a significant loss of revenue for the Income Tax Department on transfers of certain capital assets like goodwill, intellectual property rights, and securities issued to shareholders without consideration. In order to address this situation, the Government inserted Section 55(2)(a) and 55(2)(aa) w.e.f. April 1, 1995 which provides that the deemed acquisition cost of various financial and self-generated assets (ie. bonus shares, rights issues, good will, etc.) for which acquisition cost cannot be determined is to be nil. Section 55(3) further states that where the cost for which the previous owner acquired the asset cannot be ascertained, the fair market value of the asset at the time of the previous owner's acquisition should be considered.

The ITA also provides additional deeming provisions whereby the cost of acquisition may be deemed to be an amount other than the actual cost. For example, Section 50C provides that in the event that the actual consideration received for the sale of land or building is less than the amount determined by government authorities for stamp duty valuation (ready reckoner value), then the amount determined by the government authorities is deemed to be the cost of acquisition. Further, Section 50D provides that in the event that the consideration received for a capital asset, other than land or building, is not ascertainable or cannot be determined, then the cost of acquisition for the transfer is deemed to be the fair market value of the asset on the date of transfer.

5. Taxation of Earn-out Arrangements

I. Introduction

It is increasingly common for M&A transactions to include a deferred contingent payment to the sellers as part of the consideration when the buyer and seller cannot agree on the value of a target company.

This type of payment, or “earn-out” is contingent upon the happening of certain events or the achieving of pre-set targets such as meeting a post-transaction earnings goal. Earn-out arrangements are particularly helpful when the target company is an early-stage or high-growth company where value would be better represented by future performance as against historic performance. With the Government’s encouragement of start-ups in India, and the steady rise in M&A activity in the country, it is important to understand the tax treatment of such earn-out arrangements.

Business and valuation models containing an earn-out arrangement are prevalent in international M&A practice with investors seeking recourse to the same in cases where promoter involvement is sought to be retained throughout the transition period or even to motivate the seller to keep customers and increase productivity even after the acquisition. However, in India, such arrangements are largely used in domestic deals since an acquisition of shares by a foreign acquirer from a resident seller for a deferred consideration requires prior approval from the RBI which in practice is not granted very often. Although there are various methods of structuring such arrangements, this restriction has made deferred consideration and earn-out covenants difficult to negotiate and implement in cross-border M&A.

II. Issues in the Tax Treatment of Earn-outs

The tax treatment of earn-outs requires in-depth analysis using basic principles of income tax law. Various fundamental questions need to be answered such as-

- Is the earn-out contingent upon the Promoter’s continued employment by the buyer or only the achievement of business targets?
- In case of the former, is an earn-out only an incentive compensation making it Salary Income for the purposes of Section 17 of the ITA?
- In case of the latter, is an earn-out an additional purchase price, i.e. a part of the full consideration making it a Capital Gain taxable in accordance with Section 45 of the ITA?
- Considering that in case of an earn-out arrangement the amount payable is unascertainable at the time of transfer, when should it be taxed?

III. Earn-outs in Employment Agreements

Earn-out arrangements are often contained in employment agreements between the company and the Promoter. The Authority for Advance Rulings (“AAR”) in *Anurag Jain, In re*⁴⁷, subsequently affirmed by the Madras High Court⁴⁸, was examining one such arrangement and found that the contingent payments contemplated in a business transfer agreement had a real nexus with the employment agreement and were in the nature of incentive remuneration for achieving a prescribed target. The AAR found that such

47. In re Anurag Jain, 277 ITR 1 (Authority for Advance Rulings).

48. In re Anurag Jain, 308 ITR 302 (Madras High Court).

contingent payments fell squarely under Section 17(3) (ii) and could therefore be categorized as Salary Income.

IV. Earn-outs as Purchase Consideration

On the other hand, when an earn-out arrangement is not disguised as remuneration, it is to be considered as part of the full value of consideration receivable. The AAR in *Moody's Analytics Inc, USA, In re*⁴⁹ found that since an earn-out consideration is a part of the sale consideration, it will form part of the capital gains and the rules of taxing capital gains would be applicable.

At the same time, if consideration structured as an earn-out is not determinable at the time of transfer, the fair market value of the shares on the date of transfer shall be considered the full value consideration for the purposes of the ITA.

V. When will an Earn-out be Taxed?

Besides issues arising out of ambiguity in the characterization of such income, the taxation of earn-outs also sees challenges such as the year of taxability of the income or even the quantification of the deferred payment and consequent revisions to the purchase price. In other words, in case earn-out payments are not made in the future due to underperformance of the company, the capital loss so generated creates no tax benefit for the seller since the capital gain is deemed to accrue in the year of transfer of shareholding.

The question whether the entire sale proceeds including the contingent consideration receivable in three succeeding years was to be considered for the purpose of levy of capital gains was placed before the

Delhi High Court in *Ajay Guliyia v. Asst. Commissioner of Income Tax*.⁵⁰ The court, citing *Ashokbhai Chimanbhai*,⁵¹ found that a conjoint reading of Section 45 and Section 48 of the ITA indicates that the full value of consideration received or accruing in any year as a result of transfer of the capital asset shall be taxed in the year in which transfer takes place irrespective of the year of accrual or receipt. The court also took into account that there was no material on the record suggesting that the title to the shares would revert to the seller if the entire consideration or part is not paid. Therefore, the true nature of the transaction was determinable at the point of transfer and the adoption of a deferred payment mechanism would not detract from the chargeability of the shares when sold. Consequently, the income would be accrued at the time of transfer of the shares, and the whole sale consideration would be subject to capital gains tax.

A contrary position has been adopted recently by the Bombay High Court in *CIT v Hemal Raju Shete*.⁵² In this case, deferred consideration was payable to the Respondent-taxpayer over a period of four years and the agreement was clear in providing that the deferred consideration to be received in the four years would be dependent upon the profits made by the company concerned in each of the years. The Hon'ble High Court, relying on the Supreme Court decisions in *Morvi Industries*⁵³ and *ED Sasson & Co*.⁵⁴ found that the amount sought to be taxed was the maximum amount receivable by the Respondent-taxpayer and not an assured consideration to be received. Therefore the amount sought to be taxed did not meet the test of accrual i.e. whether there is a right to receive the amount though later and whether such right is legally enforceable. The Court held that the whole amount cannot be said to have accrued to the Respondent-taxpayer as it was not certain if he would be entitled to the maximum amount and therefore could not be taxed in the assessment year of transfer.

49. In re *Moody's Analytics Inc, USA*, AAR/AAR No. 1186-1187-1188 of 2011/2011 (31 July 2012, Authority for Advance Rulings).

50. *Ashok Guliyia v. Asst Comr of Income Tax*, ITA 423/2012 (Delhi High Court).

51. *CIT v Ashokbhai Chimanbhai*, 56 ITR 42 (Supreme Court of India).

52. *CIT v Hemal Raju Shete*, ITA 2438/2013 (Bombay High Court).

53. *Morvi Industries Ltd. v. CIT*, 82 ITR 835 (Supreme Court of India).

54. *ED Sassoon & Co v. CIT*, 26 ITR 27 (Supreme Court of India).

VI. Conclusion

As it currently stands, the Indian tax regime places potential liability to pay tax for the entire consideration on the sellers. This often leads to a tax outflow for the seller which is disproportionate to cash inflow. Furthermore, the tax regime provides no mechanism for recovery of tax paid in the event of reduced

consideration linked to the underperformance of the business. The Union Budget 2016-2017, for the first time since the 2012 Finance Bill provided the Government with an opportunity to create clarity with regards the taxation of such earn-out arrangements. However, no such provisioning is found in the Finance Act 2016.

6. Carry Forward of Losses in case of M&A Transactions

I. Introduction

The general rule is that the unabsorbed depreciation⁵⁵ allowance of the previous owner of a business cannot be carried forward and set off by the successor, and a business loss can be carried forward and set off against the business profits of a subsequent year only by the taxpayer who has incurred the loss. However, certain provisions of the ITA provide exceptions to this rule in case of certain M&A transactions or business reorganizations. This section shall examine such provisions.

II. Mergers

Section 72A of the ITA provides that in case of the amalgamation of a company owning an “*industrial undertaking*” with another company, the amalgamated company will be allowed to carry forward and set-off the accumulated loss⁵⁶ and unabsorbed depreciation of the amalgamated company against its profits, if the following conditions⁵⁷ are fulfilled:

- the amalgamated company shall continuously hold at least 3/4^{ths} in value of the assets of the amalgamating company for a minimum period of 5 years from the date of amalgamation;
- the amalgamated company shall continue the business of the amalgamating company for at least 5

years from the date of amalgamation;

- the amalgamating company should have been engaged in the business for at least 3 years during which the accumulated loss had occurred or the unabsorbed depreciation had accumulated;
- the amalgamating company should have continuously held on the date of amalgamation, at least 3/4^{ths} of the book value of the fixed asset, which it had held 2 years prior to the date of amalgamation; and
- any other conditions which may be prescribed by the Central Government to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose.

The Central Government has exercised the power vested in it under Section 72A(2)(b)(iii) to prescribe the below two conditions under Rule 9C of the Income Tax Rules, 1962 (“**Rules**”):

- The amalgamated company shall achieve the level of production of at least 50% of the installed capacity of the industrial undertaking of the amalgamating company before the end of 4 years from the date of amalgamation and shall continue to maintain this minimum level of production till the end of 5 years from the date of amalgamation.⁵⁸

It is open to the amalgamated company to make an application to the Central Government for relaxation of the above conditions relating to the requisite level of production and/or the aforesaid period of 4 years having regard to the genuine efforts by the amalgamated company to attain the prescribed level of production and the attendant circumstances preventing the same.

55. “*Unabsorbed depreciation*” means so much of the allowance for depreciation of the amalgamating company or demerged company, as the case may be, which remains to be allowed and which would have been allowed to such company, as the case may be, under the provisions of the ITA, if the amalgamation or demerger had not taken place.

56. “*Accumulated loss*” means so much of the loss of the amalgamating company or the demerged company, as the case may be, under the head “Profits and gains of business or profession” (not being a loss sustained in a speculation business) which such company would have been entitled to carry forward and set off under the provisions of Section 72 of the ITA if the amalgamation or demerger had not taken place.

57. Prescribed under Section 72A(2) of the ITA.

58. In *Bayer Material Science P. Ltd. v. ACIT* (2013) 142 ITD 22 (Mum) (Trib), it was held that it was not open to the AO to raise an objection as to the non-compliance of Rule 9C(a) before completion of the fourth year from the date of amalgamation.

- the amalgamated company shall furnish to the Assessing Officer a certificate in the prescribed form, duly verified by an accountant, with reference to the books of account and other documents showing particulars of production, along with the return of income for the assessment year relevant to the previous year during which the prescribed level of production is achieved and for subsequent assessment years relevant to the previous years falling within 5 years from the date of amalgamation.

If case of non-compliance of any of the above conditions, any set-off of loss or allowance of depreciation availed by the amalgamated company in any previous year would be treated as the income of the amalgamated company for the year in which the non-compliance occurs.⁵⁹ For these losses to be eligible for carry forward and set-off, the undertaking must qualify as an “*industrial undertaking*” which has been defined under Section 72A(7)(aa) as “*any undertaking which is 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, business of providing telecommunication services, mining, and the construction of ships, aircraft or rail systems*”. Thus, any business or undertaking which does not fall under this definition of “*industrial undertaking*”, such as an undertaking providing services either in the information technology sector or other service sectors, is not eligible for the carry forward of losses.

Since, the definition of “accumulates losses” only covers losses under the head “Profits and gains of business or profession” or business losses, the benefit of carry forward and set off of any capital loss of the amalgamating company against the profits of the amalgamated company is not available under this section.

Further, carrying forward and setting off of losses under Section 72A is fraught with practical difficulties such as obtaining the sanction of the competent court for the proposed scheme of amalgamation. This can be a time consuming process, especially if the amalgamated and amalgamating companies are in different states, in which case the application for grant of approval will be required to be filed in the competent court of both states. The above conditions pertaining to continuation of business and holding of assets post the amalgamation (including the conditions prescribed by the Central Government under Rule 9C of the Rules) also add to challenges faced by the amalgamated company which faces the risk of having to pay tax on the amount of loss or depreciation already set-off or allowed, in addition to the disallowance of the carry forward of the balance of the loss or depreciation in case of any non-compliance.

III. De-mergers

Section 72A(4) of the ITA provides that in case of a demerger, the accumulated losses and unabsorbed depreciation directly relatable to the undertaking that is being transferred under the demerger, shall be allowed to be carried forward in the hands of the resulting company.

If the loss or unabsorbed depreciation cannot be directly attributed to the said undertaking, the same shall be apportioned between the demerged and resulting company in the same ratio in which the assets of the undertaking have been retained by the demerging company and transferred to the resulting company and shall be allowed to be carried forward and set off in the hands of the demerged company and the resulting company, as the case may be.

There is no requirement to comply with the conditions prescribed with regard to amalgamations to avail of the benefit provided under Section 72A(4).

59. Section 72A(3) of the ITA.

IV. Section 79 of the ITA

In addition to the above, even if the above conditions are not complied with, Section 79 of the ITA provides that accumulated business losses of a company may still be carried forward to the next financial year pursuant to a change in shareholding on the fulfilment of the following conditions:

- the company is a company in which public are not substantially interested;⁶⁰ and
- 51% of voting shares held by the previous shareholder (prior to change in shareholding) are continued to be held “beneficially” by the same shareholder.

The basic intent of the section is to suppress the mischief of taxpayers acquiring control over a company which has incurred losses only to reduce their tax liability.⁶¹ This application of this section is irrespective of the mode through which the change in shareholding is effected. Hence, in addition to amalgamations and demergers, Section 79 also applies in case of a share sale. Section 79 is of particular significance to foreign investors looking to make Foreign Direct Investments (“FDI”) into start-ups which have been incorporated as private limited companies, as a significant distortion of the shareholding pattern of the Indian company during various rounds of funding, results in inability to carry forward and set off the losses incurred against future profits. This adds to the risk faced by the promoters and investors of start-ups, and a carve-out from Section 79 has often been requested in order to promote FDI into India.⁶²

The provisos to this section clarify that this section is not applicable where:

- A change in the voting power takes place as a result of:
 - » the death of a shareholder; or
 - » a gift of shares by a shareholder to a relative.
- There is a change in the shareholding of an Indian subsidiary of a foreign holding company on account of the amalgamation or demerger of the foreign holding company, provided that 51% of the shareholders of the amalgamating or demerged foreign company continue to be the shareholders of the amalgamated or resulting foreign company.

Since the proviso is restricted to amalgamation and demerger, in case of a substantial change in the shareholding pattern of an Indian subsidiary due to the sale of its shares by its foreign parent, the carry forward of losses may not be allowed under Section 79, even if the shares are sold to another group company.⁶³ While structuring the reorganization of a foreign company which has an Indian subsidiary (including purely offshore transactions), it is important to evaluate the applicability of this section, along with any indirect tax implications that may arise from such a restructuring.

It is pertinent to note that no requirement as to the minimum percentage of shareholding that these 51% shareholders of the amalgamating company should hold in the amalgamated company, or the time period for which such shareholders are required to continue holding shares in the amalgamated company has been specified.

There have been divergent judicial pronouncements regarding the import of the words “beneficially held” which are used in Section 79, and this ambiguity assumes particular significance in the context of intra-group restructuring undertaken through M&A transactions.

60. Section 2(18) of the ITA defines the term “company in which the public are substantially interested”. Any company such as closely held company, which has not been included under Section 2(18) should be a company in which the public are not substantially interested.

61. *CIT v. Italindia Cotton Co. P. Ltd.* (174 ITR 160)

62. Untangle Tax Issues For E-commerce Sector, available at <http://businessworld.in/article/Untangle-Tax-Issues-For-E-commerce-Sector/02-03-2016-91604/>

63. *YUM Restaurants (India) Pvt. Ltd. v. ITO* ITA No. 349/2015.

In *CIT v. Amco Power Systems Ltd.*,⁶⁴ the Karnataka High Court took the view that the language employed under Section 79(a) states that 51% of the voting power should be beneficially owned by the same person (before and after change in shareholding), and that the section does not require that 51% of shares should be held by the same person. It was accepted that shareholding pattern is different from the voting power of a company and a reduction in the shareholding had not led to a change in the voting power.⁶⁵

In *CIT v. Select Holiday Resorts*⁶⁶, the Delhi High Court examined the applicability of section 79 to a reverse merger situation and held that since the shareholders of the parent company had always beneficially held the shares of the taxpayer, a reverse merger of the holding company into the taxpayer does not result in any prohibition on the carry forward and setting off of loss against the future profits of the amalgamated company.⁶⁷

However, the Delhi High Court in the case of *YUM Restaurants (India) Pvt. Ltd. v. ITO*⁶⁸ and the Mumbai Tribunal in the case of *Just Lifestyle v. DCIT*⁶⁹ have taken a contrary view on this issue. These judgments are based on the view that since a company is a separate legal entity, the parent company and its shareholders should be viewed as distinct and separate persons. The Mumbai Tribunal has also sought to limit the scope of the judgment in *Select Holiday*, on the basis that in *Select Holiday* the change in shareholding was on account of a merger, which is akin to the death of a shareholder.

64. *CIT v. Amco Power Systems Ltd.* [2015] 62 taxmann.com 350 (Karnataka)

65. On the basis that the board of the subsidiary was controlled and managed by its 100% parent, even after a change in shareholding, the Karnataka High Court held Section 79 to be applicable.

66. *CIT v. Select Holiday Resorts* [2013] 35 taxmann.com 368 (Delhi)

67. In this case, 98% of the taxpayer's shares were held by a holding company, which was further held by 4 family members. Consequent to the merger of the holding company into taxpayer, the resulting company was wholly held by the 4 family members. The 4 family members exercised control and management over the taxpayer before the merger, and on the resulting company post the merger. The Delhi High Court held that since the shareholders beneficially entitled to 98% of the shares of the taxpayer continued to be the same, there should be no prohibition on the carry forward and setting off of loss.

68. *Supra note 8.* The transfer of shares of the taxpayer by one intermediate holding company to another intermediate holding company which was also held by the same global holding company was held to disallow the carry forward and set off of losses of the taxpayer.

69. *Just Lifestyle v. DCIT* ITA No.2638/Mum/2012

7. Mergers and Acquisitions - ESOP / Employee taxation

I. Introduction

M&A's often involve transfer of employees. When employees are transferred, there are several considerations involved: (a) whether the transfer of employees is to be effected as part of the acquisition or whether it should be by way of resignation and re-hire; (b) whether the stock / similar incentives granted to the employees are proposed to be continued and if not, how are the employees proposed to be compensated for termination of such incentives; (c) how to incentivize employees to continue their employment post acquisition; (d) what are the withholding tax obligations of the transferor and transferee entities; etc. These aspects need to be analyzed on a case-to-case basis in light of commercial, strategic, legal, regulatory and tax implications involved. This article focusses on some of the key implications from a tax perspective, particularly, withholding tax obligations of the transferor and transferee entity.

Tax implications could differ depending on the manner in which M&A is structured. In case of M&A by way of merger, demerger, slump sale, asset sale, etc., employees are transferred from one corporate entity to another. In case of transfer of shares, there is no change in the corporate entity by whom the employees are engaged. However, there is change in control / management governing the corporate entity involved.

II. Taxation of Employees

Before delving into taxation in case of M&A, we outline below basic principles relating to taxation of employees.

Normally, employment income, including salary and perquisites (both monetary and non-monetary) of resident employees are subject to tax in the hands of the employee as salary income at the maximum

marginal rate of 30% (excluding surcharge and cess). Such taxes are required to be withheld by the employer. If there are any non-monetary incentives / perquisites, taxes with respect to such incentives / perquisites are also required to be withheld they could be withheld from the monetary payments (if sufficient) or the employee could be asked to pay the equivalent amount to the employer. Alternatively, at the option of the employer, they could be borne by the employer wholly / partially.

Having said that, taxation of perquisites like employee stock option plan ("ESOPs") are not triggered till they are contingent in nature. ESOPs are an option given to employees to purchase the stock of the employer / parent company of the employer for nil consideration or for a consideration which is significantly less than the fair market value of such stock. The ability to exercise such option is subject to satisfaction of conditions prescribed by the entity issuing ESOPs. Generally, one of the conditions include continuation in employment for a certain number of years, which is called the vesting period. When the option is exercised (after completion of the vesting period), the issue of stock is subject to tax (as salary income) on the difference between the fair market value of the stock and the exercise price (if any) payable by the employee at the time of exercise of ESOPs. The employer is required to withhold the tax so payable. Therefore, liquidity may become a matter of concern as salary and other monetary incentives relating to the employee (which are generally payable on a month-on-month basis) may not be sufficient for withholding taxes.

It may be noted that non-fulfilment of withholding tax obligations by the employer could lead to liability for the withholding tax amount, interest at 12% per annum and penalty up to 100% of the tax amount.

III. M&A Involving Transfer of Employees from One Corporate Entity to Another

In such cases, taxation of the employee and withholding tax obligations of the employer would depend on how various employee incentives, including ESOPs are proposed to be transitioned and / or changed.

In case of employee incentives not connected with stock or in case of cash incentives which are connected with stock merely for quantification purposes (for example, stock appreciation rights, where employees may be paid a certain multiple of the appreciation in stock value on monthly / quarterly / yearly basis), they may be modified / terminated as part of the terms of the M&A. Such modification / termination may / may not involve payment to employees in lieu of the modification / termination. If any payments are involved, the transferor or transferee entity, whichever is responsible for making such payments would have to withhold tax from such payments.

In case of ESOPs, depending on the terms of the M&A agreed between the transferor and the transferee entities, ESOPs granted to employees by the transferor entity may either be terminated with or without a cash payout / ESOPs may be granted by the transferee entity on similar / different terms and with / without recognition for the period of service rendered as an employee of the transferor entity.

IV. Extinguishment of ESOPs in Transferor Entity

Gains arising from the transfer of a 'capital asset' are taxable as capital gains. 'Transfer' of capital assets includes exchange or relinquishment of the capital assets and extinguishment of rights therein.

However, in the context of M&A, termination / forfeiture of ESOPs granted by the transferor entity without a cash payout / in lieu of receiving ESOPs of the transferee entity should not be taxable as capital gains for the following reasons: (a) stock options merely confer contingent rights and therefore, there should be no 'capital asset' being transferred; (b) the monetary value of stock options are not determinable and therefore, as per the ruling of the Supreme Court in the landmark case of *B.C. Srinivasa Setty*⁷⁰, capital gains should not be levied when the computation mechanism fails; (c) relinquishment and extinguishment apply only to circumstances where the rights of the person holding the 'capital asset' come to an end without extinguishment of the 'capital asset' itself.

However, if the termination / forfeiture of ESOPs granted by the transferor entity is made for cash payout, such payout will be taxable as salary income in the hands of the employee and consequently, subject to withholding tax in the hands of the transferor entity.

V. Grant of ESOP in Transferee Entity

There should be no tax liability at the time of grant of ESOPs as stock options merely confer contingent rights. It is only upon the exercise of stock options by the employees (after the completion of the vesting period) that tax liability should arise in India. At the time of such exercise, the transferee entity shall be required to withhold applicable tax.

VI. Transition Payments

If any payments are due and payable to employees by the transferor entity, but are paid by the transferee entity post acquisition, the payment should normally not be liable to TDS in the hands of the transferee entity, particularly if: (i) there are no agreements between the transferor entity, the transferee entity and the employees or other evidence reflecting

70. (1981) 128 ITR 294 (SC)

an understanding that the transferee entity is making such payment to the employees on behalf of the transferor entity; and (ii) the transferee entity makes such payment without being under an obligation contractually/ otherwise to do so. As held by the High Court of Andhra Pradesh in the case of *V.R. Ganti*⁷¹, “[t]he answer to such questions would depend upon whether the amount was paid by the employer or the former employer to the employee qua employee for something done as employee or in his capacity other than that of an employee”. However, if there is some contractual/ other obligation on account of which such payment is made by the transferee entity on behalf of the transferor entity, the payment would be liable to TDS in the hands of the transferee entity at the time of payment.

VII. M&A not Involving Transfer of Employees from One Corporate Entity to Another

Acquisition by way of transfer of shares do not involve any change in the corporate entity which engages employees. However, there is change in control / management governing the corporate entity involved. In these cases, there are generally no extinction / change in employee incentives, including ESOPs. However, if ESOPs are granted by the parent entity and if the share transfer involves change in the parent entity of the target company, the considerations outlined above in case of transfers of employees from one corporate entity to another would become relevant vis-à-vis such ESOPs.

VIII. Conclusion

In light of potential consequences of non-fulfilment of withholding tax obligations, it becomes important to carefully evaluate all monetary and non-monetary incentives of employees both before and after the acquisition, along with modifications pursuant to the acquisition. Further, acquisition documentation should be robust, with possible non-compliance by the transferor / transferee factored in, along with indemnities / other clauses to address potential future risks.

71. [1995] 82 Taxman 37 (AP)

8. Drafting Tax Representations and Taxation of Indemnity Payments

I. Introduction

Is the key to any document just getting all that the client wants? It's not. While having all the commercials that have been agreed to between the parties in place is important, it is equally important that the client's rights and obligations are safeguarded. Foreseeing the future and analyzing various permutations and combinations that could arise in the future and then providing sufficient protection to the clients in such situations is not only important but also necessary.

In case of an international M&A transaction, tax representations and indemnity payments are of key importance. Let's take the example of a share sale of an Indian company which is taking place between two non-residents. This means that shares of an Indian company held by a non-resident are being sold to another non-resident. In such a case, from an Indian tax perspective, there is a capital gains tax implication for the non-resident seller in India. However, if the seller is resident in a favorable tax treaty jurisdiction with India, it should be possible for it to avail the benefit of the tax treaty with India and end up paying no taxes at all on the share sale. Thus, there should be no withholding tax obligation on the buyer by virtue of no tax being payable on the transaction. However, on what basis can the buyer decide to not withhold any taxes from the payment consideration for the share purchase. This is where tax representations become important – it is based on those representations that the buyer decides not to withhold any taxes. However, this does not preclude the tax department in India to issue notices to the buyer for not withholding taxes. In such a case, a tax indemnity becomes important as the payment that the buyer may be required to make to the Indian tax department should be indemnified by the seller as the seller is the one who has the final liability to pay tax in India.

II. Tax & Business Representations

As discussed above, in offshore M&A deals where the underlying asset which is the subject matter of the sale is Indian shares, tax representations become crucial. Only on the basis of these representations will the buyer be able to ascertain whether it should withhold any taxes while paying the consideration to the seller.

Usually, in offshore M&A deals, the seller will take benefit of the DTAA such that there is no withholding requirement and the buyer can make payment of the consideration amount in full to the seller. In such a situation, some representations that become absolutely non-negotiable are:

Residency: The seller should represent that it is a taxable person under laws of the foreign country in which it is a resident and is eligible to claim benefits of the relevant DTAA. It is not a resident of India and will not become a resident of India in the year the sale of shares takes place, it does not have a permanent establishment in India, its place of effective management is not in India and it does not have a business connection in India as defined under the ITA. If the seller is a resident of India or has a permanent establishment in India, the benefit of the DTAA may not be available to the seller and hence there should be a requirement to withhold taxes by the buyer while paying the consideration to the seller. Hence, all the above representations are a must-have for the buyer to not withhold any taxes from the consideration amount.

Tax Residency Certificate: The seller should represent that it is holding a valid Tax Residency Certificate (“TRC”) and shall continue to hold a valid TRC at the time of the sale of the shares. Having a TRC is mandatory requirement for availing benefit of the

treaty, without which treaty benefits may be denied. Practically, this factor becomes very important from a timeline perspective, as authorities in respective countries may take a certain period of time (which could be anywhere between a few days to a few months) to issue a TRC. The TRC should contain all the information that has been prescribed under the Income Tax Rules, 1962 (“ITA Rules”).⁷² To the extent certain details are not present in the TRC, the seller should then issue a Form 10F specifying those details to the buyer.

Board meetings and Board of Directors: The seller should provide representations stating that it is controlled and managed by its board of directors, all meetings of the board of directors of the seller are held and chaired outside of India. Further, the key management decisions that are necessary for conduct of business of the seller are taken by its Board of Directors. This representation is an extension of the residency representation. This is because if the board of the company is taking decisions sitting in India, it could result in the seller company being resident in India and hence treaty benefits may not be applicable. Consequently, the buyer should be withholding taxes from the payment consideration.

Tax proceedings: The seller should represent that all taxes payable by it in India have been discharged and no proceedings are pending against it in India.

Tax Returns: All non-residents claiming treaty relief should file tax returns in India and the seller should provide a representation to that extent.

Capital asset: the seller should represent that the shares are held by it as a capital asset and not as stock-in-trade. If they are capital asset, the gains should be considered to be capital gains where as in case they are held as stock, it should be business income for the seller and accordingly subject to different tax consequences.

Certain other representations such as title to the shares, shares are free from all encumbrances, the shares were acquired by the seller in compliance

will all laws in India should also be taken from the seller. Further, the seller should also provide for representation in respect of organization and authority such as it is duly organized and validly existing in the jurisdiction of incorporation, the seller was a non-resident at the time of acquisition of the shares which are being sold.

III. Tax Indemnity

Typically, indemnities are provided for a breach of any of the representations and warranties that the parties make in the agreement. The affected party (commonly referred to as the “**Indemnified Party**”) in such a case claims indemnity for losses that it had to incur due to such a breach which then becomes payable by the other party (commonly referred to as the “**Indemnifying Party**”). The process for claiming indemnity is laid out under the indemnity provisions in the document which need to be followed. However, when it comes to tax indemnities, one needs to go one step further. This is because of the risk of a demand being raised by the tax authorities for not withholding taxes from the consideration amount that was paid to the seller. In such situations, it is important that the buyer is well protected as it was because of the representations that were made by the seller that the buyer did not withhold any taxes. Accordingly, in such circumstances, it is the buyer who will receive the demand notice from the tax authorities for non-payment of taxes.

While the buyer will always want to get the most from the indemnity provisions, it is important from the seller’s side that the liability is limited to the extent necessary. While we all agree that if taxes are payable, it is the liability of the seller but that does not mean that the seller provides for an unlimited liability to the buyer in the indemnity provisions. What needs to be understood is that the tax is applicable only on the capital gains amount and not on the consideration amount that is paid. Therefore, the seller should limit its indemnity payment to such amount. However, for assessment proceedings to begin in India, it can take up to 2 years after the return of income is filed and if at that time

72. Rule 21AB of the ITA Rules

a demand is raised, there may be interest and penalty also that may be applied on the tax demand by the income tax authorities. While there cannot be an absolute estimation of this, what can be taken into account is total tax payable plus interest at the rate of 12% per annum along with penalties which can be capped at 100% of the tax amount. Another way of limiting the liability is providing for liability up to the amount of consideration paid. This limit would subsume the interest and penalty amount also.

The next important aspect to be considered is the time limit for which the indemnity provisions will remain applicable. While there is no timeline prescribed under law for withholding obligations, indemnity provisions are usually negotiated to remain in force for a period of 7 years from the date on which the transaction takes place. The 7 year period is provided for keeping in mind that the revenue department in India has the power under the ITA to re-open assessment proceedings up to a maximum period of 6 years [from the year in which assessment is made]. The additional one year is because the return of income in which the transaction will be disclosed is the next financial year after the transaction has taken place i.e. for a transaction that takes place in December 2015, the return of income will be filed in the next financial year i.e. 2016-17. Therefore the additional one year is added to the 6 year period.

From a buyer's perspective, in case a demand notice is received and assessment proceedings are initiated, the indemnity provisions should provide that the indemnity will continue to remain in force till such time that a final non-appealable order has been received or indemnity amount has been paid by the seller, and the seven year limitation should not apply. However, from a seller's perspective, it is important that a carve out is made in the clause stating that in the event of a favorable decision being obtained and no appeal has been filed in respect of such decision or a non-appealable order has been received the indemnity provisions will automatically fall away.

The next point for consideration is how the indemnity payment should be treated in the books of the buyer once the seller pays such amount. While there is limited jurisprudence on this point, recently, the Authority for Advance Rulings in the case of *In Re: Aberdeen Claims Administration Inc.* held that payments received out of a contractual settlement should be considered to be capital receipts and should not be taxable in the hands of the receiver. Applying the same principle, in case of an indemnity payment under a contract, there should be no tax in the hands of the receiver of such payment considering that the indemnity amounts should not be regarded as payments in lieu of loss of business or revenue.

9. Mergers and Acquisitions – Non-compete and Depreciation – Tax Issues

I. Introduction

In M&A transactions, it is frequently seen that parties enter into non-compete agreements or insert non-compete clauses in transaction documentation whereby non-compete rights are transferred. A non-compete right encompasses a right under which one person is prohibited from competing in business with another person for a stipulated period. It would be the right of the latter person to carry on a business in competition but for such agreement of non-compete. Therefore the right acquired under a non-compete agreement is a right for which a valuable consideration is paid. Generally, non-compete fee is paid for a definite period. The idea is to see to it that the business of the acquirer of the non-compete right is put on a firm footing, by avoiding competition, thus enabling such business to sustain later on.

In order to determine the taxability of transactions involving non-compete provisions, there are several considerations involved: (a) what would be the tax treatment in the hands of the person receiving a sum, in cash or in kind, to refrain from competing in business (b) what would be the treatment of expenditure incurred in the acquisition of a non-compete right; (c) what would be the tax implications in case the expenditure incurred on a non-compete right is characterized as revenue expenditure; (d) what would be the implications in case the expenditure incurred on a non-compete right is characterized as capital expenditure; etc. These aspects need to be analyzed on a case-to-case basis in light of commercial, strategic, legal, regulatory and tax implications involved. This article focuses on some of the key implications from a tax perspective.

II. Taxation of Non-compete Receipts

The ITA provides that sums received, or receivable, under an agreement for not carrying out any activity in relation to any business⁷³; or for not sharing any know-how, patent, copyright, trade-mark, licence, franchise or any other business or commercial right of a similar nature or information or technique likely to assist in the manufacture or processing of goods or provision of services shall be income chargeable to income tax under the head “Profits and gains of business or profession”. The ITA provides for exceptions for receipts on account of transfer of the right to manufacture, produce or process any article or thing or right to carry on business chargeable under the head of “Capital gains” as well as for sums received as compensation from the multilateral fund of the Montreal Protocol on Substances that Deplete the Ozone Layer. However, save for these limited exceptions, receipts under non-compete agreements / clauses, including under most M&A transaction documents, would be chargeable to income tax under the head of “Profits and gains of business or profession”.⁷⁴

The relevant portions of Section 28(va) are reproduced hereinbelow:

■

“28. The following income shall be chargeable to income-tax under the head “Profits and gains of business or profession”,—

.....

(va) any sum, whether received or receivable, in cash or kind, under an agreement for—

73. The Finance Bill, 2016, as passed by the Lok Sabha seeks to expand the scope by including any agreement for not carrying out any activity in relation to profession as well.

74. Section 28(va) of the ITA.

- a. *not carrying out any activity in relation to any business; or*
- b. *not sharing any know-how, patent, copyright, trade-mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services:*
-”

III. Taxation of Non-competive Expenditure

The more contentious issues regarding non-competive fees revolve around their treatment when a person incurs expenditure in acquiring non-competive rights. The first stage of analysis would involve ascertainment as to whether such expenditure is to be regarded as expenditure on the capital account or expenditure on the revenue account.

A. Non-competive Expenditure – Revenue or Capital?

There is no single criterion or test to determine whether a particular expenditure is to be characterized as having been made on the revenue account or the capital account. Such a determination would be dependent on the nature of the transaction, looking at the aim and object of expenditure and the commercial necessities of making such expenditure.

If the advantage accruing pursuant to the expenditure consists merely in enabling the management and conduct of the business, while leaving the fixed capital untouched, it would be taken to having been made on the revenue account. For example, in the context of an amalgamation, non-competive fees paid to a high ranking official of the amalgamating companies, who had full knowledge of the entire operations, has been held to be a commercial decision in respect of performing of the business of the amalgamated company, and therefore held to be expendi-

ture made on revenue account.⁷⁵

Conversely, courts have commonly held non-competive expenditure as having been made on capital account when the advantage that accrues is akin to that provided by a capital asset. For example, a non-competive arrangement for a substantial period of time, especially with a person who could otherwise have provided substantial competition to the acquirer of the non-competive right, has been held to be capital expenditure.⁷⁶

Therefore, the determination of whether a particular non-competive expenditure is to be treated as revenue or capital is a fact-specific determination dependent on the commercial of the transaction, with particular focus on the advantage that accrues pursuant to the non-competive right.

B. Non-competive Expenditure as Revenue Expenditure

In case expenditure incurred on the acquisition of a non-competive right is characterized as revenue expenditure, then as per Section 37 of the ITA, such expenditure which is wholly and exclusively used for the purposes of the business or profession shall be allowed in computing the income chargeable under the head of “Profits and gains of business or profession”. Therefore, the taxable income will be reduced by the amount of such expenditure.

C. Non-competive Expenditure as Capital Expenditure

In case expenditure incurred on the acquisition of a non-competive right is characterized as capital expenditure, the main question that arises is whether such non-competive right can be regarded as a capital asset on which depreciation can be claimed under Section 32 of the ITA. The relevant portions of Section 32 are reproduced hereinbelow:

75. Carborandum Universal Ltd. vs. Jt. CIT, Tax Case (Appeal) No. 244 of 2006, 1997-1998, decided on 10.09.2012 (High Court of Madras).

76. Sharp Business System vs. The Commissioner of Income Tax – III, [2012] 211 TAXMAN 576 (Delhi) (High Court of Delhi).

“32. (1) In respect of depreciation of—

- i. buildings, machinery, plant or furniture, being tangible assets;
- ii. know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after the 1st day of April, 1998,

owned, wholly or partly, by the assessee and used for the purposes of the business or profession, the following deductions shall be allowed....

.....

- iii. in the case of any block of assets, such percentage on the written down value thereof as may be prescribed

.....

Provided also that the aggregate deduction, in respect of depreciation of buildings, machinery, plant or furniture, being tangible assets or know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets allowable to the predecessor and the successor in the case of succession referred to in clause (xiii), clause (xiiib) and clause (xiv) of section 47 or section 170 or to the amalgamating company and the amalgamated company in the case of amalgamation, or to the demerged company and the resulting company in the case of demerger, as the case may be, shall not exceed in any previous year the deduction calculated at the prescribed rates as if the succession or the amalgamation or the demerger, as the case may be, had not taken place, and such deduction shall be apportioned between the predecessor and the successor, or the amalgamating company and the amalgamated company, or the demerged company and the resulting company, as the case may be, in the ratio of the number of days for which the assets were used by them.”

Currently, for the intangible assets, the rate of depreciation prescribed under the Income Tax Rules, 1962 is 25% on the written down value of the assets.

The most controversial aspect with regard to non-compete right which has been characterized as a capital asset is whether it can be regarded as a business or commercial right of a similar nature as know-how, patents, copyrights etc. such that it is eligible for depreciation in terms of Section 32 of the ITA.

In the case of *Sharp Business System vs. The Commissioner of Income Tax-III*⁷⁷, the Delhi High Court, while looking at a standalone non-compete arrangement held that a non-compete right cannot be said to be of the same nature as know-how, patent, copyright etc. and hence, no depreciation under Section 32 can be claimed on the amount incurred in acquisition of such a right.

In contrast, in the case of *Pentasoftware Technologies Ltd. vs. The Deputy Commissioner of Income Tax*⁷⁸, the Madras High Court, while considering a composite agreement for the transfer of software and training divisions of a business to the assessee, including copyrights, trademarks, and non-compete rights, observed that the non-compete clause in the agreement must be read as a supporting clause to the transfer of copy rights and patents. Therefore, the Court herein, while taking the non-compete right to be a commercial right similar in nature to patents, copyrights etc., held that such non-compete right is eligible for depreciation in terms of Section 32(1)(ii) of the ITA.

Thereafter, in the case of *Commissioner of Income Tax, Bangalore vs. Ingersoll Rand International Ind. Ltd.*⁷⁹, the Karnataka High Court, while contemplating a business transfer agreement keeping in mind the decisions in Sharp and Pentasoftware cited hereinabove, took forward the logic employed by the Madras High Court in Pentasoftware, held a non-compete right to be eligible for depreciation in terms of Section 32(1)(ii) of the ITA by virtue of it being a commercial right similar in nature to patents, copyrights etc. However, while the Madras High Court in Pentasoftware made the determination of the non-compete right

77. [2012] 211 TAXMAN 576 (Delhi).

78. [2014] 222 TAXMAN 209 (Mad).

79. [2014] 48 taxmann.com 349 (Karnataka).

as an intangible asset of a similar nature as know-how, patents etc. dependent on it being a part of a composite agreement involving the transfer of such intangible assets as well, the Karnataka High Court here has not made that distinction. Following the logic of the Karnataka High Court, it would appear that a non-compete right, once determined to be a capital asset, would be eligible for depreciation in terms of Section 32(1)(ii) of the ITA even if it were to be transferred as a standalone right.

In the case of most M&A transactions, non-compete rights would form part of a gamut of rights being transferred, which would typically involve intangible assets such as know-how, patents etc. Therefore, employing the reasoning applied by the Madras High Court in *Pentasoft* and the Karnataka High Court in *Ingersoll Rand*, it seems reasonable that such non-compete rights as acquired under the M&A transaction documents, should be treated as capital assets eligible for depreciation in terms of Section 32 of the ITA (assuming other requirements under the ITA are met).

However, as elucidated hereinabove, there is a dichotomy in the approach of different High Courts to the treatment of non-compete rights with respect to eligibility for depreciation in terms of Section 32 of the ITA, with the Madras High Court position in *Pentasoft* being towards the middle end of the spectrum, the ends of which are occupied by the positions taken by the Delhi High Court in *Sharp* and by the Karnataka High Court in *Ingersoll Rand*.⁸⁰

IV. Conclusion

The taxation of receipts in pursuance of non-compete agreements / clauses is covered under Section 28(va) of the ITA save for certain exceptions mentioned therein.

However, the situation is not as clear with respect to expenditure incurred on the acquisition of a non-compete right. The first step to be taken is ascertain whether such expenditure needs to be characterized as revenue expenditure or capital expenditure. If treated as revenue expenditure, then such expenditure is allowable in the computation of total income under the ITA. If treated as capital expenditure, there remains a grey area as to whether non-compete rights can be treated as capital assets eligible for depreciation (thereby reducing the taxable income) or as capital assets not eligible for depreciation. As elucidated above, there is a variance of opinion on this issue among the different High Courts in India.

In order for non-compete rights to be treated as capital assets eligible for depreciation, it would be preferable to structure M&A transaction documents in a manner such that the non-compete rights are transferred as part of a composite agreement wherein other assets, especially intangible assets such as know-how, patents etc. are also transferred. Such structuring would strengthen the case for the non-compete right to be treated as a capital asset eligible to depreciation in terms of Section 32 of the ITA.

80. Further, another point to be noted is that Section 28(va)(a) specifically provides for non-compete receipts and Section 28(va)(b) specifically provides for receipts on account of non-sharing of intangible assets such as know-how, patents etc. However, such wording as found in Section 28(va)(a) is not to be found in Section 32(1)(ii), although it contains wording similar to Section 28(va)(b) with respect to intangible assets. However, the Madras and Karnataka High Courts have read in the concept of non-compete rights as intangible assets of a similar nature such as know-how, patents etc. in the cases cited hereinabove.

10. Anti-Abuse Rules to be Considered in an M&A Transaction

I. Introduction

Several specific and general anti-abuse rules have been proposed and / or enacted by India to check tax avoidance in domestic as well as cross-border transactions. The effect of these measures may vary from re-characterization of income earned in a transaction to having the transaction rendered void against a claim by the income tax authorities. Therefore, the following key anti-abuse rules may need to be borne in mind by companies looking to engage in M&A transactions in India.

II. Successor Liability Concerns

As a general rule, where a business is succeeded by any other entity (whether by slump sale or itemized sale), which subsequently continues to carry on that business, the predecessor is assessed for the income of financial years prior to the date of succession and the successor is assessed on the income of the financial years after the date of succession. In the case of a “slump sale” or the transfer of a business undertaking (comprising such combination of assets and liabilities that is capable of being run independently for a foreseeable future), the successor may also be liable for the historical indirect tax liabilities (customs, excise and service tax) in respect of the financial year in which the succession took place up to the date of such succession as well as the financial year immediately preceding that year in the event that the predecessor cannot be found or where the predecessor has been assessed but the tax cannot be recovered from him.

As a measure to check the possibility of assets and / or liabilities of a business being transferred by a taxpayer with the intention to defraud the revenue authorities, Section 281 of the ITA states that any

transfer of assets during the pendency of income tax assessment proceedings shall be void as against any claim on such assets in respect of any income tax / interest / penalties payable by the transferor. Therefore, if any tax litigations are pending against the business or any portion thereof, the requirement to obtain a no-objection certificate (“NoC”) from the income tax authorities may need to be evaluated by the parties to the transaction keeping in mind the timelines involved and the consequences of Section 281 of the ITA being invoked against the transaction.

Mergers, on the other hand, are currently court-driven procedures in India. At present, companies are required to approach the jurisdictional High Courts in order to seek approval for a merger. Considering that such High Courts seek the approval of the income tax authorities and other regulatory authorities before approving the merger, a specific NoC need not be sought by the parties to the transaction in the case of a merger. However, being a court-driven process, it may take anywhere between 6 months to a year to obtain approval from the jurisdictional High Courts in respect of a merger.

It is to be noted that with the notification of such provisions under the Companies Act, 2013 that relate to the National Company Law Tribunal (“NCLT”) merger petitions (including for cross border mergers) will need to be filed before the NCLT rather than the jurisdictional High Courts. However, the requirement to notify the income tax authorities of the merger shall remain even under the proposed new rules governing mergers in India.

III. Domestic Transfer Pricing Rules

Where a private company (or public unlisted company or other such company which is not defined as a “company in which the public are substantially

interested”) receives shares of a private company (or public unlisted company or other such company which is not defined as a “company in which the public are substantially interested”):

- i. Without consideration, where the aggregate fair market value of the shares exceeds INR 50,000 (USD 748.5); or
- ii. For a consideration that is less than the aggregate fair market value of the shares by INR 50,000 (USD 748.5);

The difference between the fair market value of the shares and the consideration paid by the private company or public unlisted company for the receipt of the shares shall be taxed as ‘other income’, at the rate of 30% (exclusive of surcharge and cess) in the case of domestic companies; and at the rate of 40% (exclusive of surcharge and cess) in the case of non-resident companies.

Likewise, where a private company (or public unlisted company or other such company which is not defined as a “company in which the public are substantially interested”) receives from an Indian resident any consideration for issue for shares that exceeds the face value of such shares, the difference between the consideration received by the private company and the fair market value of the shares shall be taxed as ‘other income’ except in certain specified circumstances.

IV. Anti-Abuse Rules under DTAA

Where parties to a transaction are relying on benefits under a DTAA that India may have signed with another jurisdiction, such parties should consider whether benefits under the DTAA may be denied on the ground of substance requirements. For instance, the limitation on benefits (“**LoB**”) clause under the India-Luxembourg DTAA permits the benefits under the DTAA to be overridden by domestic anti-avoidance rules.

Further, even the erstwhile Article 13 of the India-Singapore DTAA which afforded capital gains benefits to Indian investments until the renegotiation of the India-Mauritius DTAA⁸¹ denied such benefits to Singapore resident companies which did not meet the prescribed threshold of total annual expenditure on operations.

While the India-Mauritius DTAA has recently been renegotiated to remove the capital gains benefit available under the erstwhile Article 13 of the DTAA with effect from financial year 2017-18, the benefit of a 50% reduction in the domestic tax rate applicable to capital gains from transfer of shares is available during a two year transition period from April 01, 2017 to March 31, 2019. However, this benefit is available only to such Mauritius residents which are (a) not shell/conduit companies and (b) satisfy the main purpose and bona fide business test.

A Mauritius resident may be deemed to be a shell/conduit company if its total expenditure on operations in Mauritius is less than INR 2,700,000 (approximately USD 40,000) in the 12 months immediately preceding the alienation of shares.

V. The General Anti-Avoidance Rule

The General Anti-Avoidance Rule (“**GAAR**”), contained in Chapter X-A of the ITA authorizes the income tax authorities to tax ‘impermissible avoidance arrangements’ i.e., arrangements where the main purpose is to obtain a tax benefit; and which:

- a. create rights or obligations which are not ordinarily created between persons dealing at arm’s length,
- b. result directly or indirectly in the misuse or abuse of the provisions of the ITA,
- c. lack commercial substance or are deemed to lack commercial substance, in whole or in part, or

^{81.} Benefits under the India-Singapore DTAA were coterminous with those under the India-Mauritius DTAA.

- d. are entered into or carried out by means or in a manner that is not ordinarily employed for *bona fide* purposes.

While applying GAAR, tax authorities may disregard entities in a structure, deny benefits available under the DTAA, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, treat debt as equity and *vice versa*.

Under the Indian Income Tax Rules (“ITR”) special exemptions from the GAAR is available in certain circumstances including:

- a. where the tax benefit arising to all parties to the arrangement does not exceed a sum of INR 30 million (approximately USD 450,000) in the relevant financial year;
- b. where investments are made prior to April 1, 2017; and
- c. for non-residents directly or indirectly investing in offshore derivative instruments (such as participatory notes issued by Foreign Portfolio Investors (“FPIs”) / Foreign Institutional Investors (“FIIs”)). However, FPIs/ FIIs claiming benefits under a DTAA may be scrutinized under the GAAR.

It is also important to note that even if certain prior investments are grandfathered, any corporate arrangement may become subject to scrutiny under the GAAR on its implementation starting April 1, 2017. Therefore, in light of the

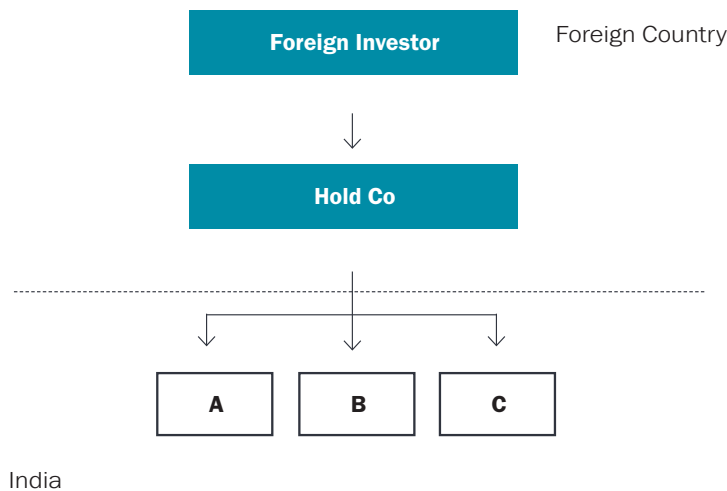
GAAR, it would be advisable that the commercial rationale behind each step in the corporate arrangement should also be adequately documented.

Some examples illustrating the applicability of the GAAR to various corporate situations have been outlined below.

Illustrations:

Illustration 1

Facts: A Foreign Investor which is in the activity of investing in various markets has a Holding Company (“Hold Co”) set up in another foreign jurisdiction whose treaty with India provides certain specific benefits in relation to capital gains. Hold Co. also has investments in various other jurisdictions, apart from India. The Foreign Investor carries out research with respect to the investments that it can make and provides this research to the Holding Company who then decides to make an investment. Hold Co. also obtains various services from third parties such as lawyers, accountants, consultants to assist in evaluation of investment opportunities. Hold Co. has a Board of Directors that meets in that country and reviews all the activities and reports to undertake the investment. It however has limited manpower which is used for the research activity. Hold Co. sells shares it holds in the Indian companies but by virtue of the treaty the capital gains is taxable in the country in Hold Co. is set up and there being no capital gains in that country, the capital gains so earned by Hold Co. is not subject to tax.



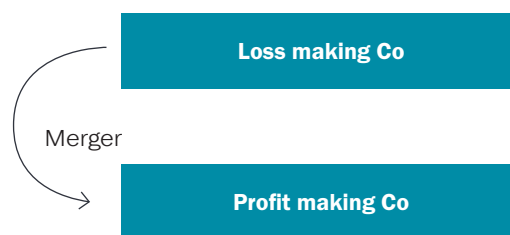
Issue: Whether making investment in India through the Hold Co can be considered to be an ‘impermissible avoidance arrangement’?

Interpretation 1: Hold Co. has investments in various jurisdictions and it can be seen that it is actively engaged in making the investment decisions. Hold Co. is also following the laws relating to commercial substance as provided for in the country in which it has been set up. It cannot be said that the Hold Co lacks commercial substance and the main purpose for making the investment in to India is to obtain a tax benefit. The arrangement hence cannot be considered to be an ‘impermissible avoidance arrangement’ and hence GAAR should not be applicable.

Interpretation 2: Hold Co. does not have any significant manpower or other activities that it can be shown to have undertaken. Further, there are no reasons set out as to why the Hold Co. is has been set up in such treaty jurisdictions have favorable capital gains tax treaty benefit with India. In the absence of such conditions being met, the GAAR may still be invoked in this case.

Illustration 2

Facts: F is a loss making company which merger into a profit making company resulting in offsetting of profits, lower profits and lower tax liability of the merged company. The conditions under section 72A of the ITA are otherwise fulfilled.



Issue: Will the losses be disallowed under the GAAR?

Interpretation 1: The amalgamation of the companies is done under a Court approved process. As part of the merger, the Court has provided an opportunity for the tax authorities to be represented and provide

inputs. If the Court has already provided approval for the amalgamation, it is presumed that the Court has already gone into the *bona fides* of the transaction. In such situation, the provisions relating to GAAR can no longer be applied to treat the transaction as an impermissible avoidance arrangement’.

Interpretation 2: Even if the Court has sanctioned the amalgamation, it would be permissible for the tax authorities to examine whether the main purpose of the transaction is only to obtain a tax benefit. If for example, it is established that there is no other purpose to undertake the transaction other than to obtain the benefit of losses, the arrangement should be considered to be an ‘impermissible avoidance arrangement’ and hence GAAR should be applicable.

Illustration 3

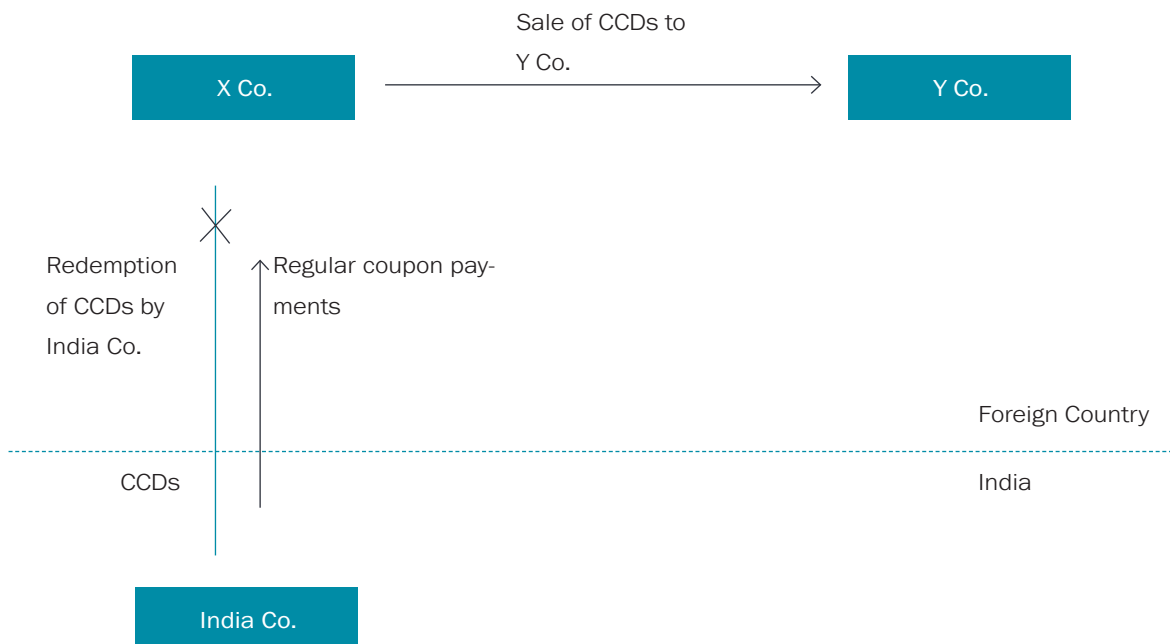
Facts: Foreign direct investment is made by X Co, a resident of a treaty country for tax purposes, in India Co., an unrelated company incorporated in India through the use of Compulsorily Convertible Debentures (“CCDs”), which are debt-like in character under conversion to equity. Such CCDs entail an annual coupon payment of 14%. Redemption of the CCDs or sale of the CCDs to Y Co., a country resident in Y, may be considered to be the transfer of a capital asset.

The relevant treaty provides that (a) transfer of shares may be taxable in the source country; and (b) transfer of any other assets (not specified in the capital gains provisions) shall only be taxable in the country of residence.

Given that CCDs should not be considered 'shares' as per the relevant paragraphs of the relevant treaty, the capital gains arising from the sale or redemption of the CCDs should not be subject to tax in India under the relevant treaty. However, expenditure incurred towards the payment of interest or redemption premium on the CCDs may be claimed as expenditure by the India Co.



















Issue: Whether the benefits under the treaty will be available to India Co. on application of the GAAR? Whether deductions claimed in respect of expenditure incurred on the payment of interest will be disallowed by the Indian tax authorities under the GAAR?

Further, where the X Co. is carrying out substantial business activities and is also following the laws relating to commercial substance as provided for in the country of residence, it cannot be said that the X Co lacks commercial substance and that the main purpose for making the investment in to India is to obtain a tax benefit. Therefore, benefits under the relevant treaty should be available in respect of the capital gains from the transfer of CCDs.



Interpretation: An evaluation of whether India Co. should have raised funds through equity instead of as a loan should generally be left to commercial judgment and GAAR should not be attracted in this case. Further, the coupon payments are being made regularly and on an arm's length basis. Therefore, to the extent that commercial rationale has been supplied for the use of CCDs rather than equity, the expenditure incurred in respect on interest payments / redemption premium should not be disallowed under the GAAR.

The following research papers and much more are available on our Knowledge Site: www.nishithdesai.com

	Fund Structuring and Operations		E-Commerce in India		The Curious Case of the Indian Gaming Laws
	July 2016		July 2015		September 2015
	Corporate Social Responsibility & Social Business Models in India		Joint-Ventures in India		Outbound Acquisitions by India-Inc
	March 2016		November 2014		September 2014
	Internet of Things		Doing Business in India		Private Equity and Private Debt Investments in India
	April 2016		June 2016		June 2015

NDA Insights

TITLE	TYPE	DATE
Thomas Cook – Sterling Holiday Buyout	M&A Lab	December 2014
Reliance tunes into Network18!	M&A Lab	December 2014
Sun Pharma –Ranbaxy, A Panacea for Ranbaxy’s ills?	M&A Lab	December 2014
Jet Etihad Jet Gets a Co-Pilot	M&A Lab	May 2014
Apollo’s Bumpy Ride in Pursuit of Cooper	M&A Lab	May 2014
Diageo-USL- ‘King of Good Times; Hands over Crown Jewel to Diageo	M&A Lab	May 2014
Copyright Amendment Bill 2012 receives Indian Parliament’s assent	IP Lab	September 2013
Public M&A’s in India: Takeover Code Dissected	M&A Lab	August 2013
File Foreign Application Prosecution History With Indian Patent Office	IP Lab	April 2013
Warburg - Future Capital - Deal Dissected	M&A Lab	January 2013
Real Financing - Onshore and Offshore Debt Funding Realty in India	Realty Check	May 2012
Pharma Patent Case Study	IP Lab	March 2012
Patni plays to iGate’s tunes	M&A Lab	January 2012
Vedanta Acquires Control Over Cairn India	M&A Lab	January 2012
Corporate Citizenry in the face of Corruption	Yes, Governance Matters!	September 2011
Funding Real Estate Projects - Exit Challenges	Realty Check	April 2011

Research @ NDA

Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Research has offered us the way to create thought leadership in various areas of law and public policy. Through research, we discover new thinking, approaches, skills, reflections on jurisprudence, and ultimately deliver superior value to our clients.

Over the years, we have produced some outstanding research papers, reports and articles. Almost on a daily basis, we analyze and offer our perspective on latest legal developments through our "Hotlines". These *Hotlines* provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our *NDA Insights* dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction.

We regularly write extensive research papers and disseminate them through our website. Although we invest heavily in terms of associates' time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with a much needed comparative base for rule making. Our *ThinkTank* discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged.

As we continue to grow through our research-based approach, we are now in the second phase of establishing a four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. The center will become the hub for research activities involving our own associates as well as legal and tax researchers from world over. It will also provide the platform to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear from you about any suggestions you may have on our research reports.

Please feel free to contact us at
research@nishithdesai.com

Nishith Desai Associates

LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI

93 B, Mittal Court, Nariman Point
Mumbai 400 021, India

tel +91 22 6669 5000
fax +91 22 6669 5001

SILICON VALLEY

220 S California Ave., Suite 201
Palo Alto, California 94306, USA

tel +1 650 325 7100
fax +1 650 325 7300

BANGALORE

Prestige Loka, G01, 7/1 Brunton Rd
Bangalore 560 025, India

tel +91 80 6693 5000
fax +91 80 6693 5001

SINGAPORE

Level 30, Six Battery Road
Singapore 049 909

tel +65 6550 9856

MUMBAI BKC

3, North Avenue, Maker Maxity
Bandra-Kurla Complex
Mumbai 400 051, India

tel +91 22 6159 5000
fax +91 22 6159 5001

NEW DELHI

C-5, Defence Colony
New Delhi 110 024, India

tel +91 11 4906 5000
fax +91 11 4906 5001

MUNICH

Maximilianstraße 13
80539 Munich, Germany

tel +49 89 203 006 268
fax +49 89 203 006 450

NEW YORK

375 Park Ave Suite 2607
New York, NY 10152

tel +1 212 763 0080