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Tax code may make M&As burdensome

By **Anto T Joseph**

The new direct tax code is likely to burden both Indian and international mergers and acquisitions (M&As) involving domestic firms with higher tax demands. While the code seeks to tax every offshore transaction resulting in an indirect transfer of a capital asset in India, it gives more powers to tax sleuths.

The code also seeks to tax profits from a slump sale — sale of an undertaking for a lumpsum consideration — as business profits rather than capital gains.

Many experts have raised concerns about the General Anti-Avoidance Rules (GA-AR), which the code has sought to introduce. These rules empower tax commissioners to declare an arra-ngement as 'impermissible' if the same has been entered with the objective of obtaining tax benefits and it lacks commercial substance.

"The burden of proof is on the taxpayer, who has to establish that obtaining a tax benefit was not the main purpose of the arrangement," Nishith M Desai of Nishith Desai Associates told Financial Chronicle.

Desai said some provisions of the code have provided unfettered authority to the tax authorities. "They can re-characterise and re-allocate income between parties, and re-characterise equity into debt and vice-versa. They can also disregard specific legal entities or individual steps in a series of transactions," says Desai.

According to Nitin Potdar, senior corporate lawyer and partner of J Sagar Associates, the broad and elaborate provisions of GAAR will be taken cautiously by the industry as they confer wide discretionary powers. "One will have to wait and see how the revenue enforces the provisions of GAAR in particular on cross-border transactions. Language used is certainly a deterrent," he said.

At present, transfer of shares of an Indian company pursuant to an offshore merger of two foreign firms is tax exempt, subject to certain conditions. According to Desai, due to a possible drafting error, such transfer of shares will not qualify for tax exemptions under the code.

Harish HV, partner, mer-gers & acquisitions, said the code would definitely impact the mergers and acquisitions. "If a foreign company buys an Indian company or shares, the selling party will have to pay tax. The new tax code, when implemented, will surely require more tax planning," he said.

According to the draft code, profits from a slump sale will be taxed as business profits rather than capital gains. "This means the seller will have to pay higher taxes. At current rates, long-term capital gains attract 10 per cent tax, while business profits attract 35 per cent. But then, the draft also proposes to bring down the tax rates," says Harish.

The draft code has endorsed the government thinking that it is losing a lot of tax money, since the existing tax laws are lenient. "It is clear that the government wants to minimise excessive tax planning done by foreign companies when they indulge in M&As with companies having underlying Indian subsidiaries or interests. Also, it didn't want to engage in a long legal battle to seek tax payments," said a merchant banker in Mumbai, who didn't want to be quoted.

He cited the Vodafone case, which is still subjudice, and where the Indian tax authorities raised a huge tax demand.

Potdar said the proposal to override tax treaties with other countries would add unnecessary anxiety and concern for non-resident taxpayers.

However, he said the provision for upfront determination of arms-length pricing methodology in international transaction is a progressive step. Potdar said the aim to improve and simply tax system is also a welcome step, and will certainly go a long way in ensuring greater compliance.

"Widening the scope of the term 'amalgamation' and introduction of 'business re-organisation' will offer options for structuring and thereby facilitate M&A activities," he said.

"The code seeks to tax every offshore transaction resulting in an indirect transfer of a capital asset situate in India. It seems the object behind this provision is to specifically target foreign M&As having underlying Indian subsidiaries or interests," said Nishith Desai Associates in a note.