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Code threatens taxing time for M&A deals

Rajesh Bhayani / Mumbai August 19, 2009, 0:38 IST

The draft Direct Taxes Code aims to make tax administration simpler, but tax experts are unanimous that it would make life much more complicated for companies planning restructuring or mergers and acquisitions.

Reasons: Certain provisions of the code would delay the negotiation process, increase the tax liabilities and introduce uncertainties due to the General Anti-Avoidance rules (GAAR).

Nishith Desai, international corporate and tax lawyer, said "Negotiating M&A deals will become extremely complex and time-consuming, given the way in which new capital gains provisions have been drafted and the GAAR provisions have been introduced."

Consider these provisions:

The code has differentiated between a business capital asset and investment asset. It says only transactions relating to investment assets (property, shares etc) will enjoy capital gains tax exemptions. Therefore, any transfer of a business capital asset (all tangible and intangible capital assets) that take place in corporate re-organisations will not get capital gains tax waiver, unlike the existing system.

The code proposes to bring leverage transactions to buy Indian assets or shares of Indian companies under the tax net. The provisions say that even transactions such as offshore lending between two non-residents can be taxed in India, if the lending is used for earning income from any source in India.

Deviating from the existing provisions of the Income Tax Act, the new code has proposed to tax interest payments by non-residents where the debt has been used to earn income from any source in India. This is likely to have a serious impact on cross-border leveraged buy-outs.

Consider an example where a US company makes a bond issue in that country to mobilise funds to invest in shares of an Indian company. Since these investments would result in the earning income (say, dividends or capital gains) from an Indian source, interest payments on bonds can now be taxable in India under the code. The other complication is that all bond-holders' income will be subject to tax deducted at source and they will have to file tax returns in India.

The much-feared GAAR rules give almost unlimited power to income tax authorities (such as the Commissioner of Income Tax) to disregard specific legal entities or individual steps in a series of transactions. It also gives them powers to re-characterise and re-allocate income between parties apart from re-characterising legal instruments used in transactions. It has been indicated that the GAAR rules even permit the tax authorities to disregard provisions of a double tax avoidance treaty between India and any other country. This means that uncertainties will persist on the view the income tax authorities will take on a particular negotiation -- making the valuation process extremely time-consuming.

Domestic M&As could also be affected by capital gain provisions. Earlier, transactions between a holding company and a subsidiary would be tax-free so long as the parent company had owned the latter 100 per cent for eight years from the date of transfer.

The eight-year requirement has now been eliminated, which means the transaction would be taxed the moment the parent company ceases to hold 100 per cent of the subsidiary.

Desai said deals would still take place but “negotiating tax indemnities and liabilities would become critical in M&A deals considering the changes in successor liability provisions and that the authorities have power to disregard any transaction or structure under GAAR provisions.”

Others agreed, though not fully. Girish Vanvari, Executive Director and head M&A tax, KPMG India, said, “The code is giving a clear message that if you earn in India, you pay tax on it. In such a scenario, deals would happen if there are other commercial synergies. But while negotiating deals one has to factor in the tax burden; over-creative tax planning won’t be possible now.”

He, however, said the wide powers proposed to the commissioner of income tax under GAAR should be properly defined. Sanjay Sakhuja, CEO, Ambit Corporate Finance, said “Tax efficiency is important in M&As, but is not the sole factor. Deals would still happen.”

Double tax treaties under a cloud
The Direct Taxes Code, if implemented the way it has been drafted, can override each of the 75 double tax avoidance agreements (DTAAs) that India has signed. This is because the code has proposed that neither a DTAA nor the code shall have a preferential status by reason of it being a treaty or law.

Instead, the code adopts the later-in-time doctrine, implying that the provisions of the new 2011 law could override every tax treaty that India has signed in the past. Under the present law, the tax treaty overrides the Income Tax Act if more beneficial. Now it is proposed that later changes in the Direct Taxes Code can override the treaty.

Therefore, in the case of a conflict between the provisions of a treaty and the provisions of the code, the one that is later in point of time will prevail. This means whenever there is some dispute regarding the provisions of the treaty, the code will prevail with respect to all 75 treaties signed in past.

The GAAR provisions also permit the tax authorities to disregard provisions of DTAA that India has signed.

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