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The Indian economy continues to expand. As its market continues to open to new products and services, the degree to which U.S.-based multinationals (USMNCs) will invest in Indian subsidiaries will only increase. The primary task for the tax professional that advises USMNCs is to ensure that the USMNC pays the lowest tax possible on a worldwide basis. Given that the United States has (thus far) chosen to retain its foreign tax credit system, the lowest cost structure may not always be synonymous with the structure that results in the least amount of tax in India.[1] Instead, understanding the interrelationship of the U.S. and Indian rules is fundamental to achieving the most efficient and lowest cost alternative for the USMNC.

The purpose of this article is to highlight some common transactions involving Indian subsidiaries of USMNCs and address considerations that tax counsel in India and the United States should take into account when structuring the transaction. There may be corporate, regulatory, and securities law implications to each one of these structures. However, we have restricted our scope to an analysis of the tax implications arising from each kind of transaction. Investors should ensure that the legal and tax considerations from the U.S. and Indian side are appropriately factored into the structuring of any arrangement.

Before addressing specific acquisition and reorganization structures, it is useful to briefly review some general concepts about Indian and U.S. taxation. Specifically, the Indian corporate tax rate is 33.21 percent[2] for Indian companies. Also, a dividend distribution tax of 16.61 percent is payable on distributions to both Indian-resident and nonresident shareholders. Table 1 illustrates the net amount of after-tax cash that can be distributed by an Indian corporation after payment of full corporate income and dividend distribution tax.

The Indian Income Tax Act, 1961 provides for favorable treatment of companies set up to carry on activities in specific industries. The ITA provides for direct tax incentives for operations conducted in areas classified as, for example, free trade zones (FTZs), software technology parks (STPs), or special economic zones. These benefits vary depending on the classification of the zone, and range from a deduction of 100

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[1]Given the right situation, the USMNC may prefer to structure a transaction in a manner that results in a higher Indian tax that is creditable than a lower noncreditable tax. Of course, the taxpayer always needs to be mindful that if a foreign tax is considered voluntary it is not creditable for U.S. purposes. *See generally* Treas. reg. section 1.901-2(e)(5).

[2]All tax rates in this article are inclusive of a surcharge of 10 percent and an education cess of 3 percent. The surcharge gets reduced to zero for individuals and the education cess gets reduced to 2.5 percent for nonresidents, which would affect the final tax rate. The 7.5 percent surcharge was introduced by the Finance Act 2010 and is a reduction from the previously applicable surcharge rate of 10 percent.

Table 1. Flow of Funds From Indian Corporation to Shareholder (approx.)

Particulars	Amount (US $)
Taxable income	100
Less: Corporate tax on the same (33.21%)	(33.21)
= Profits after tax (PAT)	66.79
Less: Transfer to reserve (10% of PAT)	(6.67)
= Profits available for distribution	60.12
Less: Dividend distribution tax (DDT) at 16.61% of 51.56	(8.56)
= Dividends distributed to shareholder	**51.56**

percent of profits and gains for the initial setup years, exemption from minimum alternative tax (MAT), a tax-free dividend for developers, or indirect tax benefits. Investors seeking to set up operations in India should explore the possibility of availing themselves of one of the many tax holidays on offer, especially for export-oriented undertakings and upcoming sectors such as biotechnology, software, or scientific research. Some of these benefits such as those applicable to STPs may be done away with in the coming financial year.[3]

In the United States, USMNCs are typically formed as C corporations. These corporations are subject to a top marginal income tax rate of 35 percent. Unlike many other industrialized countries, the United States does not have a territorial system. Instead, it taxes all income from all sources, including dividends paid by Indian subsidiaries to their U.S. parent corporations. USMNCs are, however, entitled to claim a credit against the U.S. tax imposed on their income from non-U.S. sources in an amount equal to the non-U.S. income taxes that they are legally liable for. These credits are often referred to as direct credits, because they are credits for taxes imposed directly on the U.S. taxpayer.[4] USMNCs can also claim a deemed paid credit for those income taxes that are legally imposed on their foreign subsidiaries, provided that the USMNC in question satisfies specific stock ownership requirements. In the case of a first-tier foreign subsidiary, the USMNC must own at least 10 percent of the voting stock of the foreign subsidiary before a deemed paid credit will be allowed.[5] In either case, a foreign tax credit is only available regarding foreign taxes that are imposed on income or taxes that are imposed in lieu of an income tax.

The Indian corporate income tax should qualify as a creditable tax for U.S. purposes, and this result is specifically provided for in the India-U.S. tax treaty.[6] The dividend distribution tax (which is imposed on the actual distribution/declaration/payment of dividends[7]) should also qualify as a creditable tax. The IRS has not ruled that the dividend distribution tax is a creditable tax.[8] Nevertheless, there are a number of data points that would suggest that a reviewing court would indeed conclude that the tax is creditable. Specifically, a review of the U.S. foreign tax credit regulations suggests that the only feature of a creditable tax that would be in doubt is the requirement that the tax be imposed on or after an event that would be considered a realization event under U.S. tax law.[9] Nevertheless, the foreign tax credit regulations appear to confirm that the realization requirement is satisfied by a tax on actual or deemed distributions, provided that the dividend is distributed out of earnings that have been realized for U.S. federal income tax purposes.[10]

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[3]The popular tax holiday for export-oriented units and STPs expired on March 31, 2010.

[4]IRC section 901. Unless otherwise noted, all code, IRC section, and Treas. reg. section references are to the U.S. Internal Revenue Code of 1986, as amended, or regulations issued under it. References to section are to the relevant sections of the Indian Income Tax Act, 1961.

[5]IRC section 902.

[6]*See* articles 2 and 25 of the India-U.S. treaty.

[7]Dividends are defined broadly under section 2(22) of the ITA and can include loans to substantial shareholders, distributions on liquidation that are attributable to accumulated profits, or any distribution of accumulated profits whether capitalized or not if such distribution results in a release of the assets of the company. This definition is broad and inclusive.

[8]Moreover, the treaty is not clear on this point as it refers to the corporate income tax and the tax imposed under the Companies Profits (Surtax) Act of 1964, not the dividend distribution tax. Nevertheless, it is helpful that the treaty specifically directs that a credit should be given for the corporate income tax, the tax is imposed under the ITA, and the legal liability for the tax falls on the corporation.

[9]Treas. reg. section 1.901-2(a)(1)(ii) requires that the tax be an income tax in the U.S. sense. To satisfy this requirement, the tax has to be likely to reach net gain. Treas. reg. section 1.901-2(a)(3). To satisfy that requirement, the tax must satisfy a realization requirement. Treas. reg. section 1.901-2(b)(2). The realization requirement may be satisfied in a number of ways, but chief among them is the imposition of the tax on or after events that would be considered realization events under U.S. tax law. Treas. reg. section 1.901-2(b)(2)(i)(A). Moreover, the dividend distribution tax is only imposed on dividends out of the corporation's earnings (less corporate income tax and the mandatory up to 10 percent reserve that has to be maintained as part of the company's general reserve). Thus, there should not be an issue of the tax being imposed on a distribution that is in reality a return of unrealized profits.

[10]Treas. reg. section 1.901-2(b)(2)(ii) and (iv), Example 4. Example 4 differs from the Indian dividend distribution tax in that the tax in the example is imposed on the shareholder, not the

(Footnote continued on next page.)

Even though a foreign tax credit should be available, the high effective Indian tax rate will result in excess credits for the USMNC unless the USMNC generates some additional low-taxed foreign-source income. Any excess credits can be carried back one year or forward 10 years.[11]

The following discussion is organized in five parts: acquisitions of Indian subsidiaries, purchases of assets from an Indian target entity, considerations in entering into an Indian joint venture, merger transactions, and spinoffs involving an Indian target entity. In each case, we address the Indian consequences first, and then address key U.S. tax considerations.

I. Acquiring an Indian Subsidiary

In a typical scenario, a USMNC will be purchasing an Indian target corporation for cash (or a combination of cash and debt instruments) from an unrelated shareholder of the Indian target corporation. See Figure 1. Although it is possible to use the USMNC's shares as part of the acquisition currency, this is atypical in the case of an Indian target corporation. There are disadvantages to using the USMNC's stock as the acquisition currency. For example, an Indian resident who exchanges stock of the Indian target corporation for USMNC stock is required to pay capital gains tax to the extent that the value of shares received is greater than the cost price (basis) of shares exchanged. Thus, the Indian resident shareholder will be in the unenviable position of being subject to taxation on his built-in gain, but lacking the cash with which to pay the tax. Also, share-for-share exchanges involving an Indian target corporation require prior governmental approval, which can add time, uncertainty, and expense to the transaction.

A. Indian Tax Considerations

In this section we address the tax consequences to the seller of the Indian target's shares, various buyer considerations, and the corollary effects of the sale on the Indian target entity itself.

1. Seller's Considerations

Taxation of income in India is governed by the provisions of the ITA as amended by the Finance Acts. According to section 4 of the ITA the total income of an individual is subject to income tax in India. Section 5 discusses the scope of total income. Section 5 states that residents are taxable in India on their worldwide income, whereas nonresidents are taxed only on Indian-source income (that is, income received or deemed to be received in India, income that accrues or arises to them in India, or is deemed to accrue or arise in India). Section 9 of the ITA is a deeming provision, which under some circumstances, deems income to have accrued or arisen in India.

Section 9(1) states that capital gains income is sourced in India if it arises from the transfer of a capital asset in India. Therefore, when there is sale of shares of an Indian company, the capital gains income from such transfer would be considered taxable in India regardless of whether the shareholder is an Indian resident or nonresident. Unlike the rules in the United States, this is true regardless of whether the seller is an Indian tax resident.

Section 45 is the charging provision for capital gains, according to which a person is considered taxable on the profits and gains derived from the transfer of a capital asset. Further, capital gains tax is payable in the tax year in which the capital asset is transferred, regardless of the year in which consideration may actually be received. This could lead to a situation in which contingent or future consideration may be subject to tax in the year of transfer of the capital asset.

Capital gains tax in India is payable at different rates depending on the holding period of the security and whether the shares are listed on the Indian stock exchange. There are also differences depending on whether the seller is an Indian resident or a nonresident.

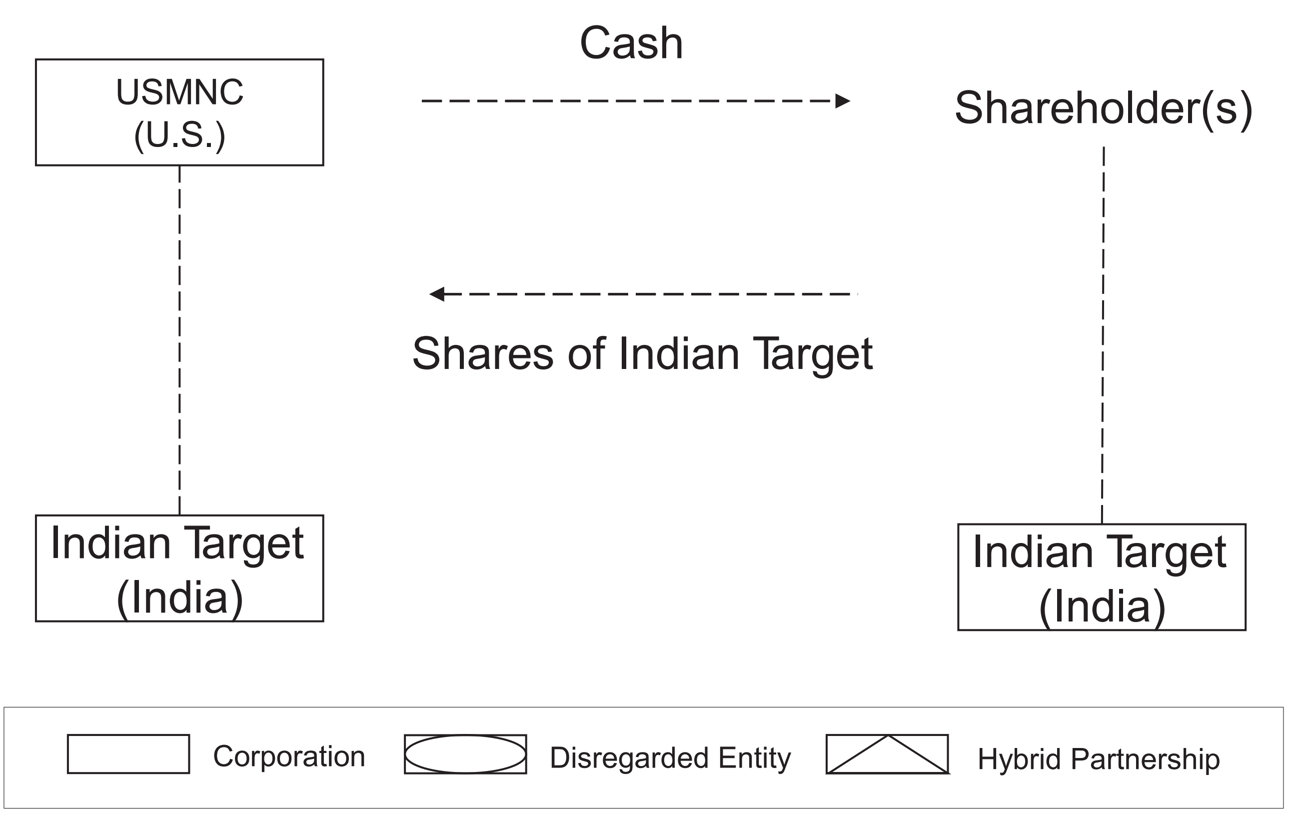
Shares held for more than 12 months are considered long-term capital assets and gains therefrom are taxable at the rate of 22.145 percent in the hands of the resident shareholder. Shares held for less than 12 months are considered short-term capital assets and gains therefrom are taxable at the rate of 33.21 percent in the hands of residents and 42.23 percent in the hands of nonresidents. The 12-month holding period applies only to specific securities[12] including shares in a company; other kinds of securities such as debentures, options, or bonds are required to be held for more than 36 months in order to qualify for the long-term capital gains tax rates. Short-term capital losses can be offset against long-term capital gains and short-term capital

distributing corporation. The tax was also imposed on both actual distributions of earnings and ''deemed'' distributions of corporate earnings. Nevertheless, the identity of the taxpayer should not be relevant to the creditability determination. Moreover, the fact that the example addresses both actual and deemed distributions whereas the Indian dividend distribution tax is only imposed on actual distributions should not matter, because the example concludes that the tax on both actual and deemed distributions satisfy the realization requirement. *See also* Rev. Rul. 78-222, 1978-1 C.B. 232; and TAM 8114016 (Dec. 18, 1980).

[11]IRC section 904(c).

[12]Under section 2(42A) of the ITA, the 12-month holding period is available only for shares held in a company, or any security listed in a recognized stock exchange in India or a unit of the Unit Trust of India established under the Unit Trust of India Act, 1963 (52 of 1963) or a unit of a mutual fund as specified or a zero coupon bond.

Figure 1. Stock Purchase for Cash



gains. Long-term capital losses can only be offset against long-term capital gains.

Listed securities are entitled to a beneficial rate of tax. Long-term capital gains are taxed at 0 percent if arising from the transfer of listed securities sold on the stock exchange. Short-term capital gains from the transfer of securities on the stock exchange results in tax at the rate of 16.61 percent. However, these beneficial rates apply only if the securities transaction tax[13] has been paid at the time of transfer.

Indian tax residents are permitted to avail themselves of indexation benefits on the sale of long-term capital assets (excluding debentures).[14] Thus, if an Indian tax resident purchased the shares of an Indian private company in 2000 for INR 1,000, and then sold those same shares in 2010 for INR 1,700, the entire INR 700 gain is not considered taxable. Instead, the shareholder is entitled to reduce his gain by the indexation allowance, which recognizes that at least some portion of the INR 700 gain was simply due to inflation.

Nonresidents may compute capital gains in a foreign currency and take advantage of the exchange rate fluctuation.[15] Thus, for example, if a U.S. person were to purchase shares of an Indian target for INR 1,000 in

[13]Securities transaction tax is applicable to the transfer of securities on the stock exchange:

- *Equity-oriented mutual funds*: Unit sellers to pay STT of 0.25 percent.
- *Debt-oriented mutual funds*: No STT.
- *Delivery-based equity*: Buyer to pay STT of 0.125 percent and seller to pay STT of 0.025 percent.
- *Nondelivery-based equity*: Day traders and arbitrageurs to pay STT of 0.025 percent.

(Footnote continued in next column.)

- *Derivative traders*: Seller to pay STT of 0.017 percent of the option premium for the sale of options, 0.125 percent of settlement prices for the sale of an option when the option is exercised, and 0.017 percent of the price for the sale of futures.
- *Government securities*: No STT.

[14]Second proviso to section 48 of the ITA.

[15]Proviso to section 48 of the ITA.

Table 2. Indian Capital Gains Tax Rates

Type of Shares	Type of Gains	Tax[a]	Section
Unlisted shares	LTCG[b]	21.115%	112
	STCG[c]	42.23%	Finance Act
Listed shares on the stock exchange[d]	LTCG	0%	10(38)
	STCG	15.836%[d]	111A
Listed shares off the stock exchange	LTCG	10.558%	112 Proviso
	LTCG (FII Investor)	10.558%	115AD(6)(iii)
	STCG	42.23%	Finance Act
	STCG (FII Investor)	31.67%	115AD(6)(ii)
Investment through Mauritius — all shares		0%[e]	Article 13 of the DTAA

[a]These rates are inclusive of the currently applicable surcharge on tax and education cess.
[b]Long-term capital gains mean gains on sale of shares held for a period of more than 12 months.
[c]Short-term capital gains mean gains on sale of shares held for a period of 12 months or less.
[d]Sale on the stock exchange will attract transaction tax at applicable rates.
[e]Provided there is no permanent establishment in India.

2000 at a time when the U.S. dollar to Indian rupee exchange rate was $1 to INR 50, and then sell those shares in 2010 for INR 1,700, when the exchange rate is $1 to INR 55, the shareholder would actually have a gain of INR 600 and not INR 700 (55 x ((INR 1,700/ 55) - (INR 1,000/50))). The U.S. person would, however, not be entitled to any indexation allowance.

The nonresident would also be eligible to set off capital gains against capital losses incurred during the relevant previous year.[16] Long-term capital losses can be set off against long-term capital gains while short-term capital losses can be set off against long-term or short-term capital gains. A capital loss that is not so set off can be carried forward to be set off against future capital gain income in the manner described above; however, the carryforward is permitted only for an eight-year period following the year in which the loss is incurred.

If the seller is a nonresident, the seller should also consider whether income tax treaties could apply to reduce the capital gains tax rate. According to section 90 of the ITA, when India has entered into an income tax treaty with another country, the provisions of the ITA will apply only to the extent that they are more beneficial. Therefore, unlike in the United States, tax treaties in India can enjoy a superior position in comparison to domestic law. Therefore, in determining the tax liability of a nonresident in India it becomes important to analyze the applicability of the relevant income tax treaty.

In the context of capital gains, India has a favorable tax treaty with Mauritius. According to article 13 of the India-Mauritius treaty, when a Mauritius resident entity transfers an Indian capital asset (such as shares of an Indian company), the gains from such a transfer are considered taxable only in Mauritius. Since Mauritius does not tax capital gains, the result is an overall beneficial position for the taxpayer. Several investors have chosen this route to make investments into India, because tax is only payable in the country of residence of the investor. The popularity of Mauritius also stems from the landmark ruling in *Azadi Bachao Andolan.*[17] In that case, the Supreme Court of India confirmed that a Mauritius company is entitled to avail itself of treaty benefits if it was granted a tax residency certificate by the Financial Services Commission in Mauritius.[18] A Mauritius-based company should be granted a tax residency certificate if it is a company holding a category 1 global business license. Further, the company is required to have at least two directors resident in Mauritius, board meetings held in Mauritius, maintain books of accounts in Mauritius, and channel banking transactions through a bank in Mauritius. Tax residency certificates have recently begun to be issued by the Mauritius tax authorities on an annual basis.[19]

[16]Section 74 of the ITA.

[17]263 ITR 706.

[18]This has been reiterated in cases such as *M/s Saraswati Holding Corporation Inc* [ITA No. 2889/Del./2007].

[19]India generally respects the rule of form over substance. Therefore, if the Mauritius company has been issued a tax residency certificate, it should generally be eligible for Indian tax

(Footnote continued on next page.)

Table 2 contains a summary of the consequences to sellers under the domestic tax laws as well as treatment when investments are made through Mauritius.

While there is a fair amount of certainty regarding investments made through Mauritius, there is a recent trend in which lower level tax authorities have begun to take an aggressive stand and have started looking at Mauritius-based structures more closely.[20] Recently, in the case of *E*Trade Mauritius Limited*, the tax authorities disregarded the existence of an intermediate shareholding company in Mauritius, and applied the provisions of the India-U.S. tax treaty even though investments were made by the Mauritian entity.[21]

In another case involving Vodafone, the existence of the Mauritius subsidiary was looked through entirely. In this case, shares of CGP Investments (a company incorporated in the Cayman Islands) were transferred by HTIL (another Cayman Islands company) to Vodafone International Holdings BV (Vodafone), a Netherlands company, for US $11.1 billion. CGP Investments held a number of indirect wholly owned subsidiaries in Mauritius through which they cumulatively held a 67 percent stake in Vodafone Essar Limited (VEL). The Indian revenue authorities issued a show-cause notice to both Vodafone and VEL as to why they should not be treated as ''assessees in default,'' the former on the ground of failure to withhold taxes at source and the latter as a representative assessee. Both VEL and Vodafone filed respective writ petitions before the Bombay High Court challenging the validity of the notice. The High Court heard the matter of Vodafone (no order has been passed regarding the VEL writ petition) and refused to quash the notice on the grounds that the tax authorities had a prima facie case. The taxpayers appealed in a special leave petition to the Supreme Court of India, which held that the tax authorities can determine the preliminary question of jurisdiction and that Vodafone can question the decision of the tax authorities before the High Court. The case is currently being heard at the lower administrative (ADIT) level by the revenue authorities. Investors should keep these rulings in mind, especially if they intend to carry out a transfer at the offshore entity level instead of at the level of the Indian company.

In view of the ruling in *Azadi Bachao Andolan*, it is arguable that treaty benefits should be available to investments made through Mauritius. Further, regarding situations such as Vodafone, there should be no tax implications under the ITA for the transfer of a non-Indian company among nonresidents since the situs of the shares would lie outside India. However, purchasing nonresidents should exercise caution and request indemnification in case the revenue authorities proceed against them on account of failure to withhold taxes.

Note that there may also be stamp duty[22] implications on the parties on the transfer of property.

2. Buyer's Considerations

There are three significant issues that buyers (like USMNCs) should consider before purchasing an Indian target. The first is the imposition of withholding tax duties on the purchaser. The second is the amendment proposed by the Indian Finance Act, 2010,[23] which could subject buyers to tax on the difference between the purchase price and the fair market value of the share when the fair market value is higher. The third consideration is one that could place limitations on the ability to introduce debt into the acquired company.

a. Withholding Tax Obligations Imposed on the Purchaser. Persons buying shares from nonresident shareholders should be aware that they may have withholding tax obligations regarding the transfer. Section 195 of the ITA mandates that tax be withheld on any taxable payments (except salary income) that are made to a nonresident. Further, in a recent Karnataka High Court decision in *Samsung Electronics and Others*,[24] the court held that withholding tax would be applicable on any payment resulting in income in the hands of a nonresident. Although the judgment refers to software payments made to nonresidents (and it is questionable whether this should be the correct legal position), the ruling could result in a potential withholding tax obligation on payments to nonresidents regardless of the income component of such payments. This results in some uncertainty for the buyer, who is, as a consequence of section 195 of the ITA, required to obtain the relevant information from the seller and determine how much tax should be withheld.[25]

treaty benefits. However, the revenue authorities have been questioning investment structures that use offshore holding companies merely to route investments. Therefore, it is always beneficial to have as much substance as possible at the Mauritius level.

[20]Indian regulatory authorities have criticized the aggressive stance taken by Indian revenue authorities regarding investments made by Mauritius entities.

[21]The Authority for Advance Rulings ruled in favor of the taxpayer in this case. *See* AAR No. 826 of 2009.

[22]Stamp duty is a tax required to be paid on any deed of conveyance. However, asset sales may or may not require stamp duty to be paid, depending on whether the transfer is accomplished through a deed of conveyance.

[23]The provision is effective from June 1, 2010, as per the Finance Act, 2010.

[24]ITA No. 2808 of 2005.

[25]In a recent development, the Delhi High Court has pronounced a conflicting ruling in the case of *Van Oord Acz India* (ITA No. 439/2008), which held that changeability is a prerequisite for section 195 to apply. Further, a special leave petition has been filed before the Supreme Court of India against the *Samsung* ruling (SLP Nos. 34310-34311 of 2009) and is currently sub judice.

Regarding capital gains, the buyer is required to ascertain the seller's cost of acquisition in order to determine the tax to be withheld at the time of making payment. Given that this information is not publicly available, buyers typically rely on a certificate provided by a chartered accountant regarding the capital gains tax liability of the seller. Buyers should consider putting a preclosing covenant in the share purchase agreement that would require the seller to provide this information before the purchaser agrees to pay the consideration at the closing of the transaction. Typically the seller would readily provide this information since the lack of information may result in the buyer withholding tax from the gross consideration paid to the seller.

The buyer could also obtain an opinion from an Indian lawyer regarding the seller's capital gains tax liability. If the Indian tax authorities consider that tax is payable, the legal opinion would indicate the buyer's good faith and belief in not withholding. This may be considered a mitigating factor if the buyer is required to pay a penalty on the tax that was not withheld.

As noted above, the seller may not be required to pay capital gains tax by virtue of being situated in a tax friendly jurisdiction such as Mauritius. However, the revenue authorities have been getting aggressive regarding the availability of tax treaty benefits, as noted above. A buyer could protect itself by obtaining a copy of the tax residency certificate before closing and obtaining a representation from the seller that states that the seller has been functioning in a manner that entitles it to Mauritius treaty benefits. A buyer could also ask for an indemnity from the seller to make good any amounts payable by the buyer as a consequence of not withholding tax, in case treaty benefits are denied. Nevertheless, the buyer should exercise caution and withhold tax, or obtain indemnities from the seller regarding the buyer's obligation to withhold, even if the seller suggests that an exemption is available.

b. Tax Trap for Purchasers Acquiring at Lower Than Market Value. According to a proposed amendment to section 56 of the ITA, there could be tax implications for purchaser companies that pay less than fair market value for acquisition of Indian shares. The tax would be levied at the slab rates (the maximum marginal rate for individuals is 30.9 percent) and at the rate of 42.23 percent for foreign companies, on the difference between fair market value and purchase price of the shares. Publicly listed companies and some types of mergers and demergers are excluded from the purview of this provision. The provision also does not apply to transfers when the difference between the fair market value and the transfer price is less than INR 50,000 (about US $1,000). However, no exceptions are provided for acquisitions, which would fall within the purview of the proposed provision.

The proposed amendment introduces a transfer-pricing-type requirement into transactions even when they take place between unrelated parties. Further, while valuation guidelines have recently been prescribed,[26] they leave open some key items that will increase the cost of doing business in India. The proposed amendment may not significantly affect investments made under the foreign direct investment route, which are subject to pricing requirements under the Indian exchange control regulations. However, the impact of this tax provision may adversely affect foreign venture capital investors who are exempt from compliance with pricing requirements imposed by the Indian exchange control regulations. The provision may also affect investments into convertible securities that enable conversion into equity at less than fair market value later.

There should be no double taxation on account of this proposed amendment under Indian law, as its impact is merely to accelerate tax to the point of purchase. When the acquirer subsequently disposes of shares, his cost of acquisition (basis of shares) would be equal to the purchase price as increased by the value of the share taxed under the proposed amendment. What nonresident acquirers should know is that levy under the proposed amendment would be under the residuary category of "other income" under the Indian tax laws, and not under the heads of capital gains or business income. Therefore, treaty provisions relating to capital gains and business income may not offer relief to nonresident taxpayers. However, they could consider taking refuge under the "other income" article according to which residuary income is typically taxable in the state of residence.[27] Assuming that the country of residence does not impose a similar tax, the impact of section 56 should to that extent be done away with.

However, if tax is levied under section 56, there may be double taxation on the nonresident in his home country because of:

- timing issues with obtaining credit (since the section 56 levy would trigger at the time of purchase and not transfer resulting in capital gains); or
- issues relating to adjustment of basis (since the nonresident's country is unlikely to adjust basis after taking section 56 into account when the residence country has the right to tax).

c. Introduction of Leverage. It is very common for buyers (whether they are U.S. based or not) to want to introduce leverage into their recently acquired Indian operation. Investors seeking to infuse debt into an Indian entity should note that such investments may be

[26] Notification No. 23/2010, dated Apr. 8, 2010.

[27] Article 21 of the OECD model treaty.

subject to the external commercial borrowings (ECB) guidelines. These guidelines are applicable to all debt instruments except for compulsorily convertible debentures and compulsorily convertible preference shares. Optionally convertible preference shares and debentures are also considered debt for the purpose of these guidelines. The ECB guidelines are very restrictive and regulate the amount of money that can be borrowed, the amount of interest that can be paid out, and the end-use restrictions. More specifically, the money borrowed cannot be used for general corporate purposes or as working capital. Therefore, it is not surprising that most of the debt investments in India are made by way of compulsorily convertible debentures, which are not subject to such onerous restrictions.

A USMNC seeking to acquire an Indian company may not be able to do so by infusion of a loan because of the end-use restrictions in the ECB guidelines. Therefore, most of the debt investments into Indian companies are made in the form of compulsorily convertible debentures, which do not fall within the purview of the ECB guidelines. Interest paid on the debentures would also be tax deductible provided that the money raised from the debentures has been used for business purposes.

From a tax perspective, it is beneficial to make debt investments into India through an offshore holding company set up in Cyprus. This is because of a beneficial provision in the Cyprus-India income tax treaty, which reduces the withholding rate on interest income to 10 percent with no further tax implications in India. Although Cyprus imposes a 10 percent corporate income tax on the receipt of the interest income, it also permits the recipient corporation a credit for the Indian interest withholding tax, so the ultimate tax liability is only the 10 percent Indian withholding tax charge.

Under Indian domestic law, the interest income in the hands of a nonresident could be taxed at rates as high as 42.23 percent absent the application of an income tax treaty. This beneficial rate of 10 percent makes the Cyprus tax treaty preferable for debt investments when compared with the Mauritius tax treaty, which does not have a favorable provision for debt. Further, the Cyprus treaty contains a capital gains exemption similar to that in the India-Mauritius tax treaty. However, Mauritius continues to be the preferred jurisdiction for investors because of the ruling in *Azadi Bachao Andolan*, which provides certainty to the applicability of Mauritius treaty benefits to companies that have been issued a tax residency certificate.

It is sometimes common to infuse debt into an entity by setting up a leveraged special purpose vehicle and having it merge with the target entity. However, in the Indian context this may be problematic because of the regulatory approval required for the setting up of a pure investment company that carries on no operations.[28] As noted above, the ECB guidelines also prohibit using debt for investing into another company. Also, the merger of two companies in India requires the approval of a high court, and the process could take about six months.

Even when debt is infused into the Indian company, Indian transfer pricing restrictions and regulatory restrictions may place limits on the repatriation of interest by the controlling USMNC.[29]

3. Corollary Impact on the Indian Target

As noted above, capital gains tax is computed by subtracting the basis or cost of acquisition from the sale price. At the point of transfer from the unrelated shareholder to the USMNC, the cost of acquisition of shares, in the hands of the USMNC, will be equal to the purchase price. This cost of acquisition will be relevant for the determination of capital gains in the hands of the USMNC, on subsequent sale of shares by the USMNC. However, the underlying assets held by the company will continue to maintain their previous cost of acquisition. Transfer of the Indian company to another buyer does not result in an increase in basis, or cost of acquisition of the underlying target's assets.

When the shares of an Indian company are transferred to another shareholder, there may be restrictions on the carryforward and setoff of losses. Under section 79 of the ITA, such losses will only be allowed if 51 percent of shareholders on the last day of the tax year in which the loss is incurred continue to remain the beneficial owners of the company on the last day of the tax year in which the loss is desired to be carried forward. However, this provision does not apply to Indian companies that are subsidiaries of a foreign company undergoing amalgamation, provided that the merged foreign entity continues to satisfy the 51 percent shareholding requirement.

B. U.S. Tax Considerations

1. Seller's Considerations

If the seller is a U.S. person, there are two primary considerations. First, if the sale of the Indian target company results in the application of the Indian capital gains tax, the seller will want to know whether or not it can claim a foreign tax credit in the United States for the tax. Second, if the Indian target happens to be a controlled foreign corporation or a passive foreign investment company for which a qualified electing

[28]When a USMNC makes investments into an Indian special purpose vehicle, it would need to comply with the exchange control regulations in the Foreign Exchange Management Act, 1999 (FEMA), read with regulations issued thereunder. Under the FEMA, most investments are permitted under the automatic route. However, investments into companies with no operations require approval from the Foreign Investment Promotion Board.

[29]Section 92 of the ITA.

fund (QEF) election has been made regarding the selling shareholder, the seller will want to determine whether the buyer intends to make a section 338(g) election for the Indian target.

a. Creditability of Indian Capital Gains Tax. To obtain a credit for the Indian capital gains tax, there are two hurdles that must be overcome. First, the seller must conclude that the Indian capital gains tax is a creditable tax under U.S. federal income tax law. Second, the seller must ensure that it has sufficient foreign-source income to absorb the credit.

i. Creditability. Regarding creditability, there are two ways the seller could be comfortable that the Indian capital gains tax is creditable under U.S. law. The first is by simply applying the U.S. regulations that define a foreign levy as a creditable tax if it is a ''tax'' and the ''predominant character of the levy is an income tax in the U.S. sense.''[30] The Indian capital gains tax can be considered a tax because it is a compulsory levy imposed by the Indian government under its authority to levy taxes.[31] It can also be considered an income tax in the U.S. sense because the tax is imposed on the gain inherent in (and not the gross revenue from the sale of) the shares that are actually sold (not on some deemed realization event) and the imposition of the tax is not dependent on the availability of a corresponding credit in the United States.[32] Alternatively, the seller could be comfortable that the tax is creditable because the India-U.S. treaty specifically requires the United States to provide a foreign tax credit for those taxes identified in article 2(1)(b) and 2(2) of the treaty. Article 2(1)(b) refers to the Indian income tax. The capital gains tax that the Indian government imposes on the sale by nonresidents of Indian target companies is considered an income tax in India. Therefore, the tax should be considered creditable under the India-U.S. treaty.

b. Sufficient Foreign-Source Income. The United States does not permit U.S. persons an unlimited foreign tax credit. Instead, the U.S. person's ability to claim a foreign tax credit is limited by an amount equal to his effective U.S. tax rate multiplied by the foreign-source income that he has in the foreign tax credit basket to which the taxes relate.[33] There are currently two foreign tax credit baskets, general[34] and passive.[35] Excess credits can be carried back one year and forward 10 years within their appropriate income baskets.[36] If the seller has foreign-source income in the appropriate basket from other activities (that is, foreign source royalties or interest payments), then it need not worry about this hurdle. Otherwise, the seller must determine how much foreign-source income will be created regarding the sale of the shares of the Indian target company. Normally, when a U.S. person sells the stock of a foreign corporation, the gain (if any) on the sale is considered to have a U.S. source, because the gain is sourced by reference to the seller's residence.[37] Although the India-U.S. treaty does not provide assistance on this point,[38] there are exceptions to the general U.S. source rule under U.S. law that may conceivably be helpful.

The exception that most commonly applies is one that is applicable to Indian targets that are currently (or were at some point during the preceding five years) considered CFCs and held by U.S. sellers that own 10 percent or more of the voting shares of the Indian target. In those cases, the seller is likely to have a ''section 1248 amount'' regarding the shares of the CFC. The section 1248 amount should equal the portion of the Indian target's earnings and profits attributable to the shares held by the seller for periods after 1962 while the seller held the shares and the Indian target was considered a CFC. To the extent that the seller has a section 1248 amount regarding the seller's shares, the gain is recast as if it were a dividend from the CFC to the selling shareholder. Normally, an actual or deemed dividend from a foreign corporation will be considered to have a foreign source.[39] To the extent the section 1248 amount is significant enough, this may provide the selling shareholder the foreign-source income necessary to claim a credit for the tax, without resorting to the other exceptions.[40]

[30]Treas. reg. section 1.901-2(a)(1)(i) and (ii).

[31]Treas. reg. section 1.901-2(a)(2).

[32]Treas. reg. section 1.901-2(a)(3).

[33]IRC section 904(a).

[34]IRC section 904(d)(2)(A)(ii).

[35]IRC section 904(d)(2)(A)(i).

[36]IRC section 904(c).

[37]IRC section 865(a).

[38]In many treaties the U.S. is a signatory to, if the counterparty is entitled to impose tax on the sale of stock of a company that is resident in the counterparty's jurisdiction, the seller is entitled (under the treaty) to consider the income from the sale as having a non-U.S. source. In these cases, the U.S. requires that this income that is ''deemed'' to arise from non-U.S. sources be placed within its own separate foreign tax credit basket that is neither active nor passive. IRC section 865(h). In the case of India, article 13 of the India-U.S. treaty does not prohibit India from imposing capital gains tax on the U.S. seller's sale of stock in an Indian target company. Article 25(3)(a) and (b) of the India-U.S. treaty provides that if a U.S. seller is subject to tax in India on income, then the income will be treated as arising from Indian sources. This would ordinarily be a helpful rule. The problem is that in the case of the India-U.S. treaty, this provision unfortunately only applies to income from royalties and fees for related services governed by article 12 of the India-U.S. treaty. It does not apply to gain from the sale of shares of an Indian target that would be governed by article 13 of the India-U.S. treaty.

[39]IRC sections 861(2)(A) and 862(a)(2). There are exceptions, however. *See, e.g.,* IRC section 904(h).

[40]Presumably the inclusion will fall within the shareholder's general foreign tax credit basket, because the E&P the inclusion

(Footnote continued on next page.)

The second exception applies to recast the entire gain (even gain in excess of the section 1248 amount) as foreign source if three requirements are satisfied.[41] First, the U.S. seller must own at least 80 percent of the voting power and value of the Indian target.[42] Second, the U.S. seller must effect the sale in India, where the Indian target is conducting an active business.[43] Third, more than 50 percent of the gross income of the Indian target for the three-year period ending with the close of the target's year preceding the year in which the sale occurred has to have been derived from the conduct of a trade or business in India.[44] Typically, the biggest difficulty in this context is determining what exactly needs to be done overseas to ensure that the second requirement is satisfied. There is less authority than one would hope for on this point. At a minimum, the seller should seek to ensure that the governing law is Indian law, and that the title to the shares passes in India. It would also be helpful if the signatories to the sales agreement executed the agreement in India.

2. Buyer's Considerations

The buyer of the Indian target will want to consider issues such as whether a holding company should be formed, whether a section 338(g) election can or should be made for the target corporation, and whether an election should be made to disregard the existence of the Indian target company.

a. Use of a Holding Company. As noted in the preceding section, the buyer should seriously consider purchasing the stock of the Indian target entity through an intervening holding company located in Mauritius or Singapore. Failure to do so will result in the buyer receiving a lower after-tax return if or when it ultimately chooses to sell the Indian business and is required to pay capital gains tax to the Indian authorities. There are other U.S. advantages to having a holding company, which are explored below.

b. IRC Section 338(g) Election. The second issue the buyer should consider is whether to make an IRC section 338(g) election for the Indian target corporation. Although very uncommon in the context of U.S. target acquisitions, there are many benefits to the buyer of a section 338(g) election for a foreign target. If the assets of the Indian entity are appreciated, the section 338(g) election has the effect of stepping up the basis in those assets to fair market value for U.S. tax purposes. That increased asset basis may then be amortized over time. This increased asset basis can be amortized for purposes of computing the target corporation's E&P, but there will not be any corresponding step-up and amortization costs for purposes of determining and calculating the Indian target's Indian tax liability. Hence, the election can hype the effective rate of tax imposed on the Indian target entity.[45] These excess credits (credits in excess of the highest U.S. marginal rate) could be used by the USMNC to offset other low-taxed foreign-source income that it generates.

Even if there is no step-up, however, the section 338(g) election can still be beneficial, because it has the effect of cleaning out the historic tax attributes of the Indian target corporation. This creates a couple of advantages. First, because it cleans out the target's historic E&P, it may permit the purchaser to repatriate cash from the Indian target as a tax-free return of capital,[46] rather than a taxable dividend to the USMNC.[47] Second, the cleansing of historic attributes reduces the administrative difficulties of trying to recreate the Indian target's preacquisition E&P and tax pools.[48] This would be a difficult exercise even if the seller happened to be a U.S. person, but may be nearly impossible to do correctly if the seller is a non-U.S. person who never maintained accounting records with sufficient detail to enable the buyer to make these calculations.

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is attributable to is in the general foreign tax credit basket. Passive income would typically have already been taxed under subpart F. The taxes should also be considered to fall within the general basket to the extent there is no gain in excess of the section 1248 amount. To the extent the gain exceeds the section 1248 amount, the gain and the associated capital gains tax should fall within the passive foreign tax credit basket. Treas. reg. 1.904-4T(2)(i)(A) provides that passive income includes ''any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248.'' *See also* Treas. reg. 1.904-5(c)(4)(iv), Example (2), which provides an example in which a U.S. shareholder sells the stock of a CFC. The example concludes that the portion of the U.S. shareholder's gain in excess of the 1248 amount is passive income.

[41]IRC section 865(f).

[42]IRC section 865(f)(1).

[43]IRC section 865(f)(2).

[44]IRC section 865(f)(3).

[45]Assume the Indian target had a single asset with a value of 100 and a basis of 0 and no liabilities. Further assume that if no section 338(g) election were made, the target would generate revenue of 20 and no expenses in the first year after the acquisition for both Indian and U.S. purposes. Also assume that an Indian tax of 8 is accrued. The foreign effective tax rate on these earnings would be 40 percent. But if a section 338(g) election were made, and if the asset had a 10-year useful life, the E&P (measured solely for U.S. purposes) would only be 10 (revenue of 20 minus 10 of depreciation deductions). The Indian tax liability would still be 8, however. Thus, the effective rate (measured solely for U.S. purposes) would be 80 percent.

[46]IRC section 301(c)(2).

[47]IRC section 301(c)(1). Given that India is a high-tax jurisdiction, this is typically only a benefit for those USMNCs that may have chronic excess credits that could expire unused or overall foreign losses under IRC section 904(f).

[48]The Indian target is supposed to maintain year-by-year E&P and tax pools that are accessed on a last-in, first-out basis for the periods before the Indian target obtains a 10 percent or greater U.S. shareholder entitled to claim indirect foreign tax credits. *See* Treas. reg. section 1.902-1(a)(10) and (13).

The section 338(g) election is a unilateral election, made at the discretion of the buyer.[49] If the seller happens to be a non-U.S. person, and the seller is not owned (directly or indirectly) by U.S. persons, then the seller will likely be unaware that an election was even made. The situation can become more complicated if the Indian target is owned (directly or indirectly) by U.S. persons. Specifically, the section 338(g) election can affect a direct or indirect U.S. shareholder of the Indian target if the target happens to be a PFIC for which a QEF election has been made. The section 338(g) election can also affect a direct or indirect U.S. shareholder if the Indian target happens to be a CFC.[50] In the former case, a section 338(g) election can cause the selling shareholder to recognize the gain that target generates on the asset sale. This could affect both the amount,[51] character,[52] and source[53] of the income that the shareholder would have otherwise recognized on the sale. In the latter case, a section 338(g) election can:

- have the effect of increasing the portion of the seller's gain that is considered ordinary income,[54] but without increasing the portion of the seller's gain that is considered foreign-source income[55];
- change the foreign tax credit basket of the ordinary income that is considered foreign source from active to passive[56];
- have the effect of reducing the seller's ability to claim deemed paid foreign tax credits[57]; and
- increase the amount of subpart F income that the seller would have otherwise recognized.[58]

It is because of the potentially negative impact to the seller that the regulations require the buyer to provide notice to some U.S. sellers before the buyer can make a section 338(g) election.[59] This notice does not have to be provided to the seller before closing, but it does need to be filed before the buyer makes the election.[60] The election is made on Form 8023 and must be filed on or before the 15th day of the ninth month beginning after the month in which the acquisition occurs.[61] For example, if the acquisition occurs on January 10, 2010, the taxpayer should file the election on or before October 15, 2010.

c. Election to Disregard the Indian Target. Currently, U.S. law permits U.S. taxpayers to make an entity classification election for some non-U.S. targets.[62] In the case of Indian target entities, Indian public limited companies are considered per se corporations, for which no alternative elective classification is permitted. Indian targets that provide all of their owners with limited liability protection possess a default corporate classification,[63] but may elect to be treated as partnerships (if they have two or more owners) or disregarded entities (if they have only one owner). If the entity's form does not provide limited liability protection for all of its owners, the entity's default classification is a partnership (if it has two or more owners)[64] or a disregarded entity (if it has one owner),[65] but the entity may elect to be treated

[49]IRC section 338(g)(2).

[50]IRC section 957.

[51]There may be an inside/outside basis disparity if the foreign company's shares were acquired after it was formed.

[52]While the sale of the stock would normally generate capital gains to the shareholder, the inclusion of the deemed-sale gain may be considered capital gain or ordinary income depending on the nature of the assets that the foreign entity is deemed to have sold. IRC section 1293(e).

[53]The capital gain recognized by a U.S. shareholder regarding sales of foreign company stock is generally considered U.S. source unless section 865(f) applies. IRC section 865(a). The deemed-sale gain that flows through as a result of the QEF election should be considered foreign source, however, if the assets deemed to be sold are owned directly by the Indian target entity and used in India. There is also the possibility for the U.S. shareholder to obtain a foreign tax credit regarding Indian taxes imposed on the deemed-sale gain. IRC section 1293(f).

[54]IRC sections 964(e) or 1248(a).

[55]IRC section 338(h)(16).

[56]If the seller's gain is less than the presection 338(g) general basket E&P of the Indian target, and one of the assets that the Indian target is deemed to have sold in the section 338(g) election is a passive income generating asset that creates subpart F income, that subpart F income is recognized before the seller computes his section 1248 amount. This can have the effect of displacing the general basket E&P that the seller would have normally recognized with passive basket income.

[57]*See, e.g.*, Chief Counsel Advice 200103031 (Oct. 18, 2000).

[58]It is only the U.S. shareholder (defined in IRC section 951(b)) that holds stock in a foreign corporation on the last day of the tax year on which the foreign corporation is still considered a CFC that has to recognize the subpart F income generated by the CFC. If a section 338(g) election is made for the Indian target, it will be deemed to have sold all of its assets on the closing date and its year will end for U.S. purposes. The seller will have to pick up his pro rata share of the subpart F income that the CFC generated up to and including the closing date. This amount would include any subpart F income that was generated on the deemed sale. *See generally* Treas. reg. section 1.338-9.

[59]Treas. reg. section 1.338-2(e)(4).

[60]Treas. reg. section 1.338-2(e)(4)(iv).

[61]IRC section 338(g)(1).

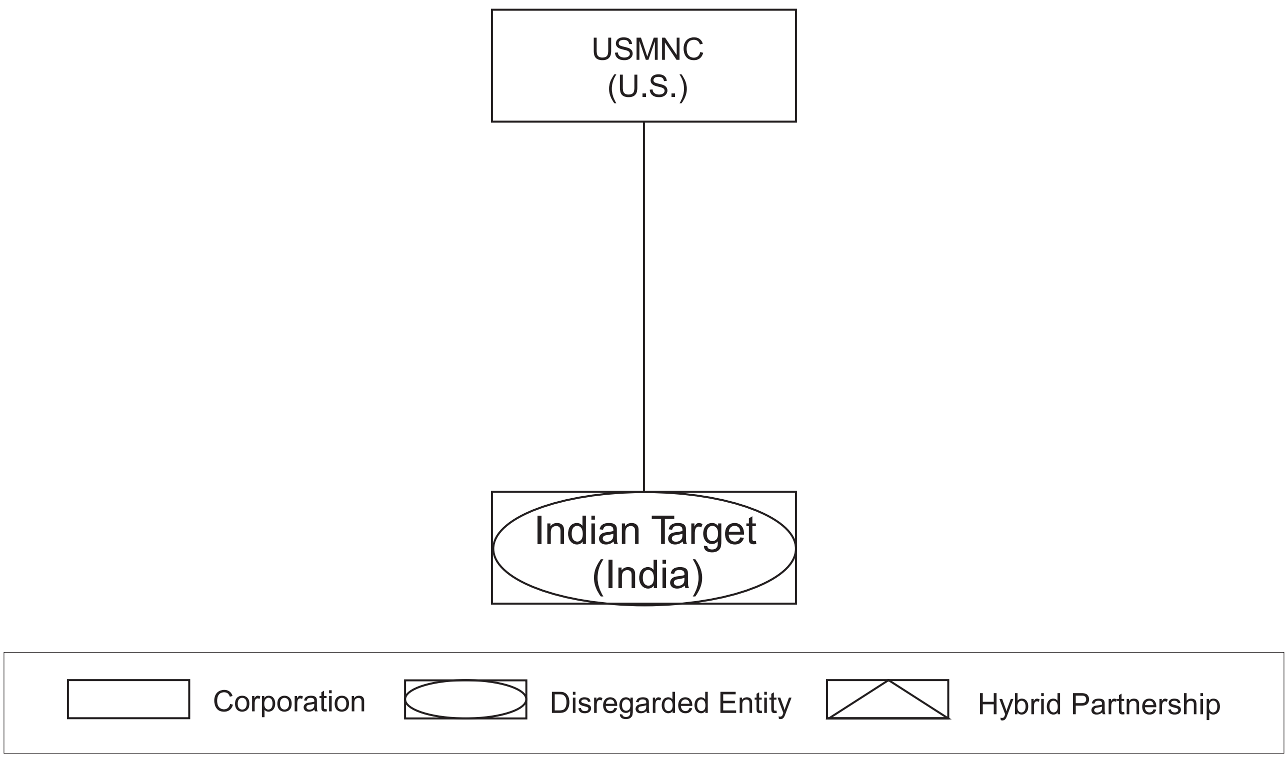
[62]Although these rules have been in existence since December 17, 1996, there have been many attempts to curtail the flexibility of these regulations. Most recently, the Obama administration has sought to eliminate the ability of taxpayers to elect to completely disregard foreign entities that are not owned directly by U.S. corporations.

[63]Treas. reg. section 301.7701-3(b)(2)(i)(B).

[64]Treas. reg. section 301.7701-3(b)(2)(i)(A).

[65]Treas. reg. section 301.7701-3(b)(2)(i)(C).

Figure 2. Electing to Disregard Directly Held Indian Target



as a corporation. Elections are made on a Form 8832 and cannot be effective any earlier than 75 days before the date that it is filed.

Whether a Form 8832 election to disregard the existence of Indian target is advisable depends on whether a section 338(g) election has been made for the target. It also depends on whether the buyer will own the Indian target directly or indirectly through a Mauritius or Singapore holding company.

If the buyer makes a section 338(g) election for the target, the earliest day on which the Form 8832 election can be effective is the day after the closing date.[66] If this date is chosen, then the target corporation will be deemed to have sold its assets and obtained its basis step-up on the closing date, and the corporation will be deemed to have liquidated into its owner immediately after the deemed asset sale.[67] If a section 338(g) election is not made, then the election can be made effective before the closing date, but the seller must agree to make the election.[68]

i. Indian target is held directly. If the Indian target is held directly by the USMNC, the advantage of making an election to disregard the Indian target as an entity separate from the USMNC is that any losses generated by the target may potentially be recognized by the USMNC on its tax return. See Figure 2. These losses can be substantial if a section 338(g) election was made for the target and the target is thus amortizing its stepped-up basis in goodwill and other self-created intangibles. However, this ability to claim losses on the USMNC's return is subject to the application of the dual consolidated loss (DCL) rules.[69] A detailed description of the DCL rules is outside of the scope of this article, but note that the IRS takes the position

[66]Treas. reg. section 301.7701-3(c)(1)(iii).

[67]Treas. reg. section 301.7701-3(g)(3)(ii).

[68]Treas. reg. section 301.7701-3(c)(2)(ii).

[69]IRC section 1503(d).

that if the entity elects to be disregarded in the middle of its tax year,[70] no portion of the loss attributable to the stub period while the entity is considered disregarded may be claimed on the U.S. tax return.[71]

The USMNC should consider other issues as well before electing to disregard an Indian target that it owns directly. Specifically, any losses generated by the Indian target will likely be considered to have a foreign source, which can dramatically decrease the USMNC's foreign tax credit limitation and its ability to claim foreign tax credits. If the losses exceed all of the USMNC's other foreign-source income, the losses can cause the USMNC to have an overall foreign loss,[72] which can hinder foreign tax credit usage but also make internal restructurings exceedingly difficult.[73]

The USMNC should also consider the impact of IRC section 987, which governs the translation of assets and liabilities when they move from one functional currency to another. If Indian target elects to be disregarded, it will very likely be considered a qualified business unit (QBU) of the USMNC, and it will likely be a QBU that uses the rupee as its functional currency. If the QBU remits earnings to the USMNC, the remittance can create section 987 gains and losses. The impact of these gains and losses should be considered before deciding to elect disregarded status.

ii. Indian target is held indirectly. If the Indian target is held indirectly, the analysis is different. The advantage of electing to disregard the Indian target is that dividend, interest, and royalty payments made by the Indian target to the holding company can be disregarded for subpart F purposes. See Figure 3. Hence, the Indian target can remit profits to a Mauritius holding company, for example, without creating foreign personal holding company income to the Mauritius entity.[74] The remittance may, however, create gains or losses under IRC section 987, unless the Mauritius holding company and the Indian target both use the same functional currency for U.S. federal income tax purposes.[75] These profits can then be kept offshore and redeployed as necessary to other locations where the cash is needed.

The downside of electing to disregard the Indian target underneath the Mauritius holding company is that the E&P and foreign tax credit pools generated by the Indian target's operations will be intermingled with the E&P and foreign tax credit pools of any other disregarded entities held by the holding company. Although this may not be troublesome if all of the jurisdictions in which the disregarded entities are operating are high tax, it can have a dilutive effect if the disregarded entities are subject to tax in jurisdictions that impose lower effective rates than India does.

II. Acquiring Assets From Indian Sub

A. Indian-to-Indian Asset Sale

The first scenario we address is an asset sale between two Indian corporations. Unless otherwise noted, assume that the purchasing entity is unrelated to the selling entity. See Figure 4.

1. Indian Consequences

a. Seller's Considerations. A primary consideration for the seller in an asset sale is whether the seller will sell all of the assets as part of a sale of a going concern (often referred to as a slump sale), or whether specific assets should be sold from within a larger group.

As noted above, the applicable capital gains tax rate depends on the holding period for the asset. Assets (excluding shares in a company and other types of securities) are considered to have been held for a long-term period if they are held for more than 36 months.[76] Gains from the transfer of long-term capital assets are taxed at the rate of 22.145 percent. Gains from the transfer of other assets are taxable at the rate of 33.21 percent in the hands of residents. Therefore, when an Indian target company transfers assets to the buyer, it would be required to pay capital gains tax at the rate of 22.145 percent or 33.21 percent depending on the period of holding of the asset.

If the transfer is structured as an asset sale, there is typically a levy of the short-term capital gains tax when assets are sold from within a block of assets.[77] This may result in a higher tax liability for the seller of

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[70]It is the tax year used by the entity that matters for Indian purposes.

[71]*See* Generic Legal Advice Memorandum 2009-011 (Oct. 9, 2009). It is not entirely clear that this interpretation of the regulations is accurate, but this happens to be the IRS's current view.

[72]IRC section 904(f).

[73]IRC section 904(f)(3).

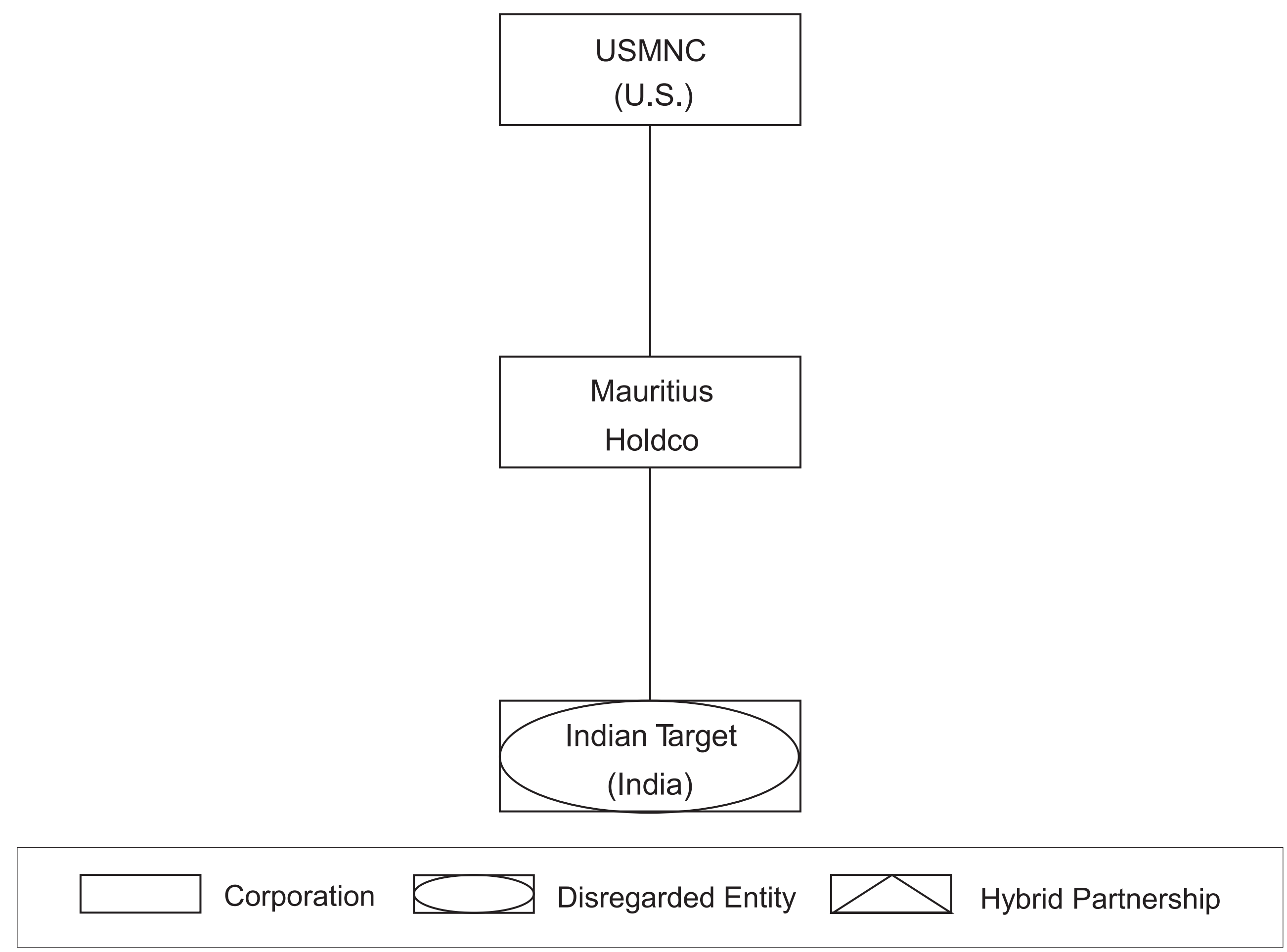
[74]IRC section 954(c)(6) of the code would currently permit the Mauritius company to avoid recognizing foreign personal holding company income to the extent the payment was not attributable to subpart F income earned by the Indian target even if the Indian target had not elected to be disregarded. As of the date of this writing, however, this provision is scheduled to expire at the end of 2010.

[75]The IRS took the position in proposed regulations that were issued in 1991 and again in regulations that were proposed in 2006 that section 987 gains could be considered foreign personal holding company income under the subpart F regime. These regulations may ultimately be found to be invalid interpretations of the governing statute to the extent they suggest that section 987 gains (in contrast to section 988 gains) can constitute foreign personal holding company income.

[76]Section 2(42A) of the ITA.

[77]Sections 50 and 50A of the ITA.

Figure 3. Electing to Disregard Indirectly Held Indian Target



assets. Therefore, from a seller's perspective it may sometimes be more beneficial to transfer the assets as part of a slump sale, especially if the undertaking has been held for a period exceeding 36 months. This would entitle the seller to a beneficial long-term capital gains tax rate of 22.145 percent on the gains from the sale of the entire undertaking.[78]

There may also be stamp duty implications on the parties on the transfer of property.

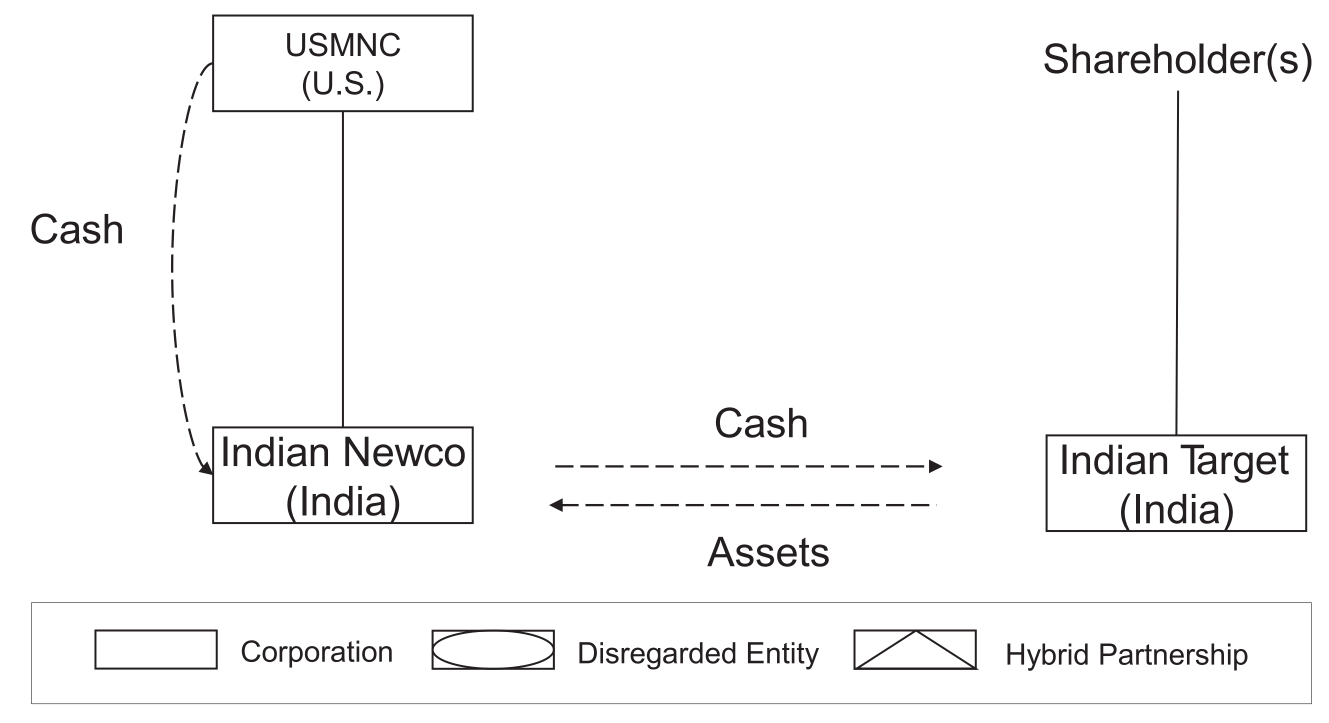
b. Buyer's Considerations. The buyer has additional concerns when purchasing assets. The buyer needs to consider whether it will be purchasing specific assets or an entire going concern.

i. Use of a holding company. As noted above, if the USMNC opts to acquire assets through an Indian subsidiary that is directly held, then there may be capital gains tax implications for the USMNC in India on subsequent exit from the Indian subsidiary by the USMNC. However, if the investment is made into a Mauritius holding company that holds the Indian subsidiary, it may result in a beneficial situation for the USMNC on exit. However, if the Indian entity is not expected to generate substantial revenues, investors may invest directly to reduce the cost of setup and maintenance of a Mauritius entity.

The holding company should be set up at the outset, that is, before making investments. If the USMNC makes a direct acquisition and subsequently seeks to transfer the Indian entity to a Mauritius holding company, the transfer would be required to be at arm's

[78]Section 50B of the ITA.

Figure 4. Asset Sale Between Two Indian Corporations



length.[79] Further, as the transfer would be by the USMNC directly, there could be capital gains implications on the arm's-length payment received. This may make it difficult for the USMNC to subsequently intersperse a Mauritius holding company into the structure, especially if the Indian company significantly increases in value after acquisition.

ii. Whether to buy assets piecemeal or as a going concern? In a slump sale the assets would be required to be transferred as a going concern, with all its assets and liabilities intact.[80] This may limit the choice of the buyer regarding which assets to purchase.

Further, this requirement mandates that no individual values be assigned for any of the assets. The Indian purchasing subsidiary would account for the excess of amounts paid over the basis in the assets as goodwill in its accounts and would not get any step-up in cost basis in the transferred assets.[81] As there is some uncertainty regarding the availability of depreciation benefits on goodwill under Indian law, the buyer may be able to claim significantly less depreciation under a purchase as a going concern compared with an asset sale, when the buyer would get a step-up in cost basis.

This may create some difficulties for the USMNC holding the Indian subsidiary because, for U.S. tax purposes, the assets will be considered to be acquired for their fair market value. Depending on how the transaction is structured from a U.S. perspective (that is, taking into account the entity classification rules and section 338(g) provisions) the purchaser will have to file a statement with the IRS allocating the consideration on Form 8594 or 8883. If the Indian target is not owned by U.S. persons, there is no need to put any verbiage in the acquisition agreement about this allocation. If the Indian target is owned by U.S. persons, then there will be some desire to obtain agreement between the USMNC and the U.S. owners of the Indian target on the purchase price allocation so that their IRS forms are consistently filed. The parties may be able to reasonably agree that the excess of any amount paid over the carrying value on the Indian books is allocable to goodwill for Indian and U.S. tax purposes. If not, then

[79]Section 92 of the ITA.

[80]Section 50B of the ITA.

[81]*Id.*

there will be some tension between the requisite allocation for Indian purposes and the required filings that the USMNC and the U.S. owners of the Indian target have to make.

However, a slump sale may have VAT benefits. The VAT in India is an indirect state level tax on the sale of goods, and is governed by the VAT legislation applicable to the particular state. Some Indian states do not consider a slump sale to be a sale of goods; consequently, the transfer of the assets as a going concern is not a VAT-able transaction. On the other hand, the sale of individual assets would generally result in VAT implications. VAT is paid by the seller of goods but is typically passed on to the buyer along with the purchase consideration. Therefore, if there is no VAT payable on the transaction, it could result in a VAT saving for the buyer.

iii. Exit options. Assuming that the Indian target liquidates after it sells its assets, the distribution of its assets may result in capital gains tax implications for the recipient shareholder.[82] The extent of capital gains tax payable by the shareholder is limited to the money or assets received as reduced by the cost of acquisition of shares and the amounts considered to be dividend income under the provisions of the ITA. Distributions are considered dividends under the ITA to the extent that they are attributable to the accumulated profits[83] of the company and subject to payment of dividend distribution tax by the company.

Choice of structure may therefore be a matter of commercial considerations and some negotiation among the parties and would also involve some number crunching.

2. U.S. Consequences

a. Seller's U.S. Considerations. If the Indian target is owned by a non-U.S. person, then there are no U.S. consequences to consider. If the Indian target is owned by one or more U.S. persons, then there are U.S. considerations. Specifically, if the Indian target is a CFC, the shareholders will want to consider whether the gain on the asset sale will result in the creation of subpart F income.[84] Regardless of whether the asset sale generates subpart F income, the U.S. shareholders will want to consider whether the Indian taxes that are imposed will be taxes for which a credit may be claimed in the United States.[85]

If the Indian target subsequently liquidates, distributing the sales proceeds to U.S. persons in the process, the shareholders will need to consider the consequences of that liquidation. Specifically, they will have to consider whether the liquidation qualifies as an inbound section 332 liquidation. They must also consider whether there is one shareholder that satisfies the ownership requirements of section 332(b)(1) (an 80 percent distributee).

To the extent the transaction qualifies as an inbound liquidation under section 332, and the sole shareholder is an 80 percent distributee, the shareholder will have to recognize income equal to the Indian target's ''all earnings and profits amount,''[86] which will include the gain that the target generated on the sale of its assets.[87] As part of that liquidation, the shareholder will have to recognize any foreign exchange gain or loss regarding the target's previously taxed income account (if any).[88] Normally, the shareholder is entitled to take a carryover basis in the distributed assets.[89] Although there is no definitive authority, the basis is likely determined by taking the historical cost basis in the assets measured in the Indian target's local currency, and then translating those amounts into U.S. dollars using the spot rupee to U.S. dollar exchange rate on the date the assets were acquired (if that is known).[90] Moreover, if the value of the distributed assets is less than their basis, the shareholder is required to take the assets with a basis equal to their value.[91] To the extent that it qualifies as an inbound liquidation under section 332, but there is a shareholder other than an 80 percent distributee, the Indian target will have to recognize gain (if there is any) on the portion of the assets distributed to

[82]Section 46 of the ITA.

[83]*Id*.

[84]The most likely scenario in which subpart F income would be generated would be regarding the sale of an asset that generates passive income, such as interest, dividends, rents, or royalties. IRC section 954(c). If the Indian target is related (within the meaning of IRC section 954(d)(3)) to the purchasing company it is also conceivable that foreign base company sales income could arise on the sale of assets that the Indian target did not develop itself. There is an exception for situations when the target is selling noninventory assets and ceases its business completely, but it is possible that this exception may not apply when the Indian target only sells one business and retains another business. Treas. reg. section 1.954-3(a)(1)(i).

(Footnote continued in next column.)

[85]*See generally* IRC section 902.

[86]Treas. reg. section 1.367(b)-2(d).

[87]Treas. reg. section 1.367(b)-3.

[88]IRC sections 959 and 986(c).

[89]IRC section 334.

[90]Chief Counsel Advice 200303021 (Oct. 1, 2001). For an excellent discussion of this issue and the different approaches and authorities, see generally, Richard L. Doernberg and Michael Thompson, ''Recognition of Foreign Currency Exchange Gains or Losses on a U.S. Inbound Event,'' *Tax Notes Int'l*, Dec. 2, 2002, p. 925, *Doc 2002-26358*, or *2002 WTD 232-14*.

[91]IRC section 334(b)(1)(B).

the shareholder.[92] The shareholder must also recognize gain equal to the excess of the value of the shares surrendered over the shareholder's basis in those shares.[93] A portion of this gain may be considered foreign source ordinary income that pulls indirect foreign tax credits with it and that may be used to shelter the U.S. tax that would otherwise be imposed on the gain.[94]

If the liquidation does not satisfy the requirements under section 332, the Indian target must recognize gain (if there is any) on the assets that are being distributed.[95] The shareholder has to recognize gain regarding the stock the shareholder surrendered.[96] Again, a portion of this gain may be recast as ordinary dividend income.[97] The dividend income may bring foreign tax credits with it that can be used by the shareholder to offset the U.S. tax that would otherwise be imposed on the transaction.[98]

b. Buyer's U.S. Considerations. For reasons described in more detail above, it may be preferable for the USMNC to form a non-Indian holding company that will, in turn, own all of the outstanding shares of an Indian private limited company that may choose to elect to be disregarded for U.S. federal income tax purposes on Form 8832. Aside from the holding company and entity classification decisions, the consequences to the purchaser are rather straightforward. The purchaser will acquire the target's assets with a stepped-up basis for U.S. tax purposes, which the purchaser will amortize for U.S. purposes. One complicating factor for the purchaser may be the acquisition of valuable intangible property (for example, patents, know-how, trade secrets, and trademarks) from the Indian target. Although it is atypical for an Indian subsidiary of a non-Indian based multinational to own intangible property,[99] it is not atypical for an Indian startup to have developed intangible property. In these cases, the purchaser will want to consider whether it may be beneficial to acquire that intangible in a non-U.S./non-Indian location, so that the return attributable to the intangible can be accrued in a low-tax environment. The manner and method in which that intangible is developed and used is outside of the scope of this article, but the primary hurdles that have to be overcome in a situation in which the intangibles are separated from the employees and active operations are transfer pricing, income characterization, and subpart F.

B. Cross-Border Asset Sale

The alternative scenario is when the USMNC wants to acquire the assets of an Indian target company, but does not want to use those assets in India. In this case, the USMNC may simply purchase the assets directly from the Indian target. See Figure 5.

1. Indian Consequences

We set forth the seller's consequences and the buyer's consequences below.

a. Seller's Considerations. From a seller's perspective, the sale of assets directly to a USMNC would result in capital gains tax implications as noted above.

b. Buyer's Considerations. Under the current Indian exchange control regulations, a nonresident is not permitted to hold Indian immovable property except through an Indian premises set up for the purpose. This may be an Indian office, branch, or subsidiary company. However, a branch in India is considered a permanent establishment of the USMNC in India. Further, the immovable property may be acquired only for the purposes of carrying on business through that property.

Under this structure, if the USMNC proposes to purchase assets directly and not through an Indian subsidiary, it may only be permitted to buy movable assets as per the Indian exchange control regime. For this purpose, intangibles constitute movable assets.

This should not involve tax consequences for the USMNC in India as it would merely amount to a purchase of capital assets by the USMNC from India. However, the Indian entity would be required to pay capital gains tax on the transfer of capital assets and tax on business income on the sale of stock in trade to the USMNC. If the USMNC intends to use the assets in India for the purpose of a business in India, it would require regulatory approval if the entity sought to be set up is a branch. Further, depending on the activities carried on regarding the plant and machinery, computers, and servers in India, there may be PE exposure for the USMNC in India. Therefore, it is advisable that a USMNC should not own any assets in India directly.

Note that the VAT is a consumption tax and is not applicable to the sale of assets outside the taxing state. Therefore, there should be no VAT implications on a direct sale to a USMNC.

2. U.S. Consequences

a. Seller's Considerations. The consequences to the target's shareholders, if they happen to be U.S. persons, are set forth in the preceding section.

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[92]IRC section 336.

[93]IRC section 331.

[94]IRC section 1248(a).

[95]IRC section 336.

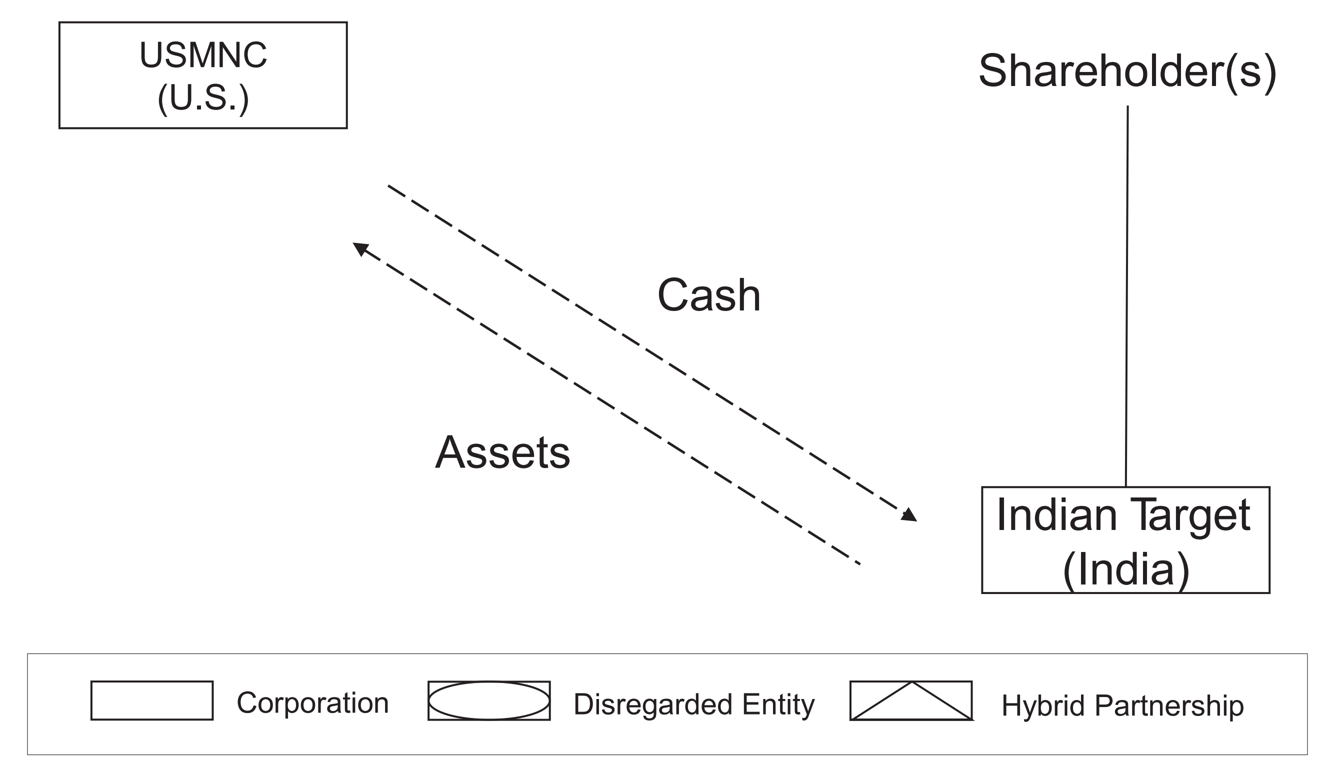
[96]IRC section 331.

[97]IRC section 1248(a).

[98]IRC section 960.

[99]Typically, a non-Indian multinational would not transfer legal title or the economic rights to intangible property to its Indian subsidiary. Instead, the Indian subsidiary may be granted a royalty bearing or royalty free license.

Figure 5. Purchase of Indian Assets by USMNC



b. Buyer's Considerations. The consequences to the purchaser are quite straightforward — the USMNC will take the assets acquired with a basis equal to the purchase price.

III. Indian Joint Venture Entities

An alternative structure is one in which the USMNC and another unrelated party contribute cash and/or other property to a joint venture entity to commence operations in India. See Figure 6A. A joint venture is the coming together of two or more businesses for a specific purpose, which may be for a limited duration. The purpose of the joint venture may be for the entry of the joint venture parties into a new business, or the entry into a new market, which requires the specific skills, expertise, or the investment of each of the joint venture parties. The execution of a joint venture agreement setting out the rights and obligations of each of the parties is usually a norm for most joint ventures. The joint venture parties may also incorporate a new company that will engage in the proposed business. In such a case, the bylaws of the joint venture company would incorporate the agreement between the joint venture parties.

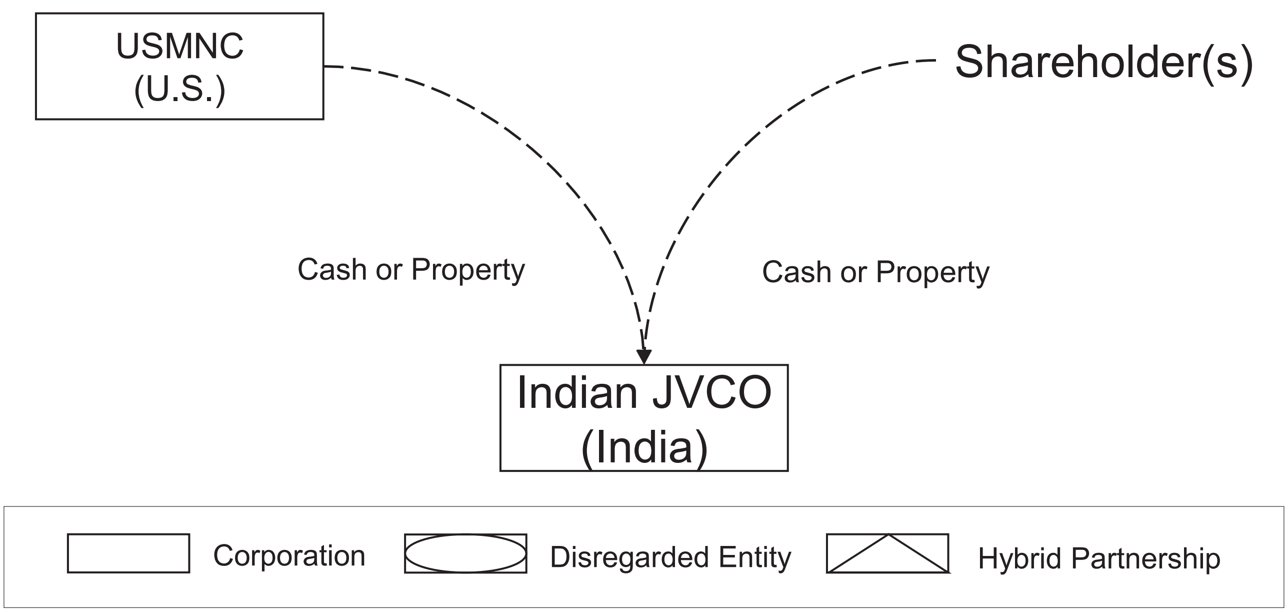
A. Indian Tax Considerations

There are at least four distinct questions that need to be answered regarding the Indian joint venture. First, the joint venture vehicle has to be chosen. Second, a choice needs to be made regarding how to transfer assets and liabilities to the joint venture vehicle. Third, consideration has to be given as to whether intangible property needs to be provided to the joint venture entity and, if so, how that is accomplished. Finally, exit strategies need to be considered.

1. Choosing the Joint Venture Vehicle

The first question that has to be addressed, from an Indian and U.S. perspective, is the type of entity to be formed as the joint venture vehicle. As noted above, it may behoove the USMNC to own its interest through a holding company in Mauritius or Singapore. If the other nonresident party has a similar desire, that Mauritius or Singapore holding company could serve as the joint venture vehicle. See Figure 6B. It is unlikely that the other party will have a similar desire if the joint venture party is an Indian resident individual. This is because the Indian individual is subject to India's exchange control rules. Under these rules, the Indian individual is prohibited from transferring money to

Figure 6A. Setting Up Indian Joint Venture Entity



Mauritius and may only transfer money to other jurisdictions in amounts up to US $200,000 in any calendar year.[100] Even Indian companies may be reluctant to own their joint venture interest through a Mauritius entity. Although it is not illegal for them to invest in an offshore company that reinvests the funds in India, India's Reserve Bank does not favor such structures and so the joint venture vehicle may have difficulty under the overseas direct investment regulations when it attempts to invest in India. It is also not tax efficient from an Indian perspective to structure the investment in this manner, unless the money is sought to be retained offshore in the Mauritius entity. Thus, in the event that the joint venture partner happens to be an Indian individual or company, the alternative structure depicted in Figure 6C may be preferred.

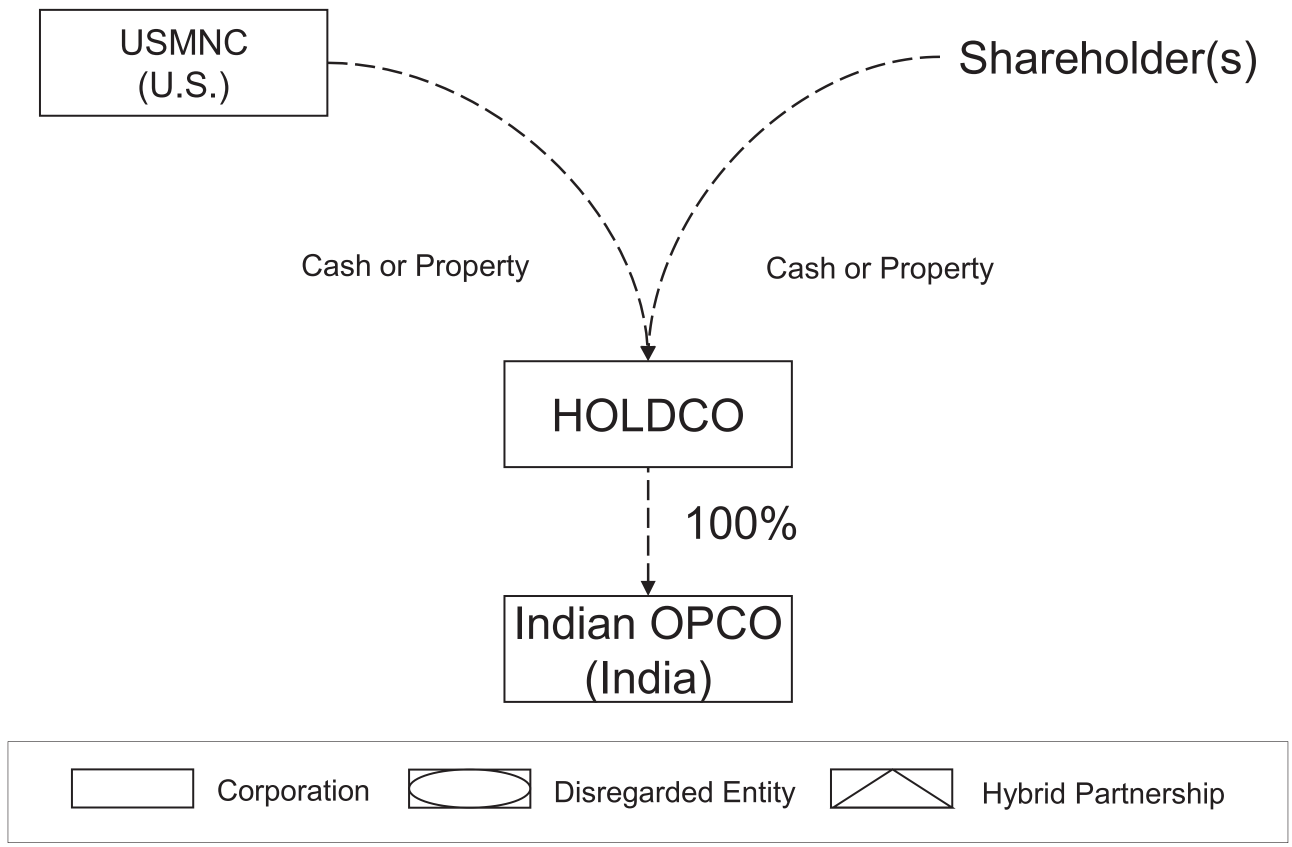
Regardless of whether the parties agree to make a holding company the joint venture entity, the parties will have to choose the form of entity they want to use for the actual Indian operations. If two foreign companies set up an Indian company to invest in India, from a tax perspective, the entity is treated in almost all respects on par with a company having Indian resident shareholders. By and large foreign direct investments are now permitted in almost all the sectors in India under the automatic route barring some exceptional cases such as retail, defense, housing and real estate, and print media in which investment is either prohibited or subject to some restrictions. If the investment is not in accordance with the prescribed guidelines, approval must be obtained from the Foreign Investment Promotion Board.

There are many options available for setting up an entity to do business in India: branch office, liaison office, corporate entity taking the form of a public or private limited company, or a limited liability partnership. An unincorporated joint venture could also take the form of an association of persons, which is generally not a tax efficient way of doing business. Foreign investors seeking to set up these entities would be governed by the provisions of the Foreign Exchange Management Act, 1999 (FEMA), read with the regulations issued thereunder. The advantages and disadvantages of each are described below.

a. Branch Office. A branch is considered an extension of the foreign entity in India and is defined in section 2(9) of the Indian Companies Act, 1956. Under the FEMA, a foreign company desiring to set up a branch office would have to obtain prior approval of the Reserve Bank of India (RBI). The RBI is generally cautious about granting a foreign company approval to set up a branch office in India and grants approval only if the activities of the branch are restricted to the activities laid out by the RBI in this regard, which include export and import of goods, rendering professional and

[100]This is under the Indian Liberalised Remittance Scheme provided under the Foreign Exchange Management Act, 1999 (FEMA).

Figure 6B. Setting Up Offshore Holding Company for Joint Venture in India



consultancy services, carrying out research work, and promoting collaborations. If the RBI believes that the proposed activities of the branch office would fall outside the scope of permitted activities, it could reject the application for setting up a branch office in India and instruct the foreign company to alternatively set up a subsidiary in India.

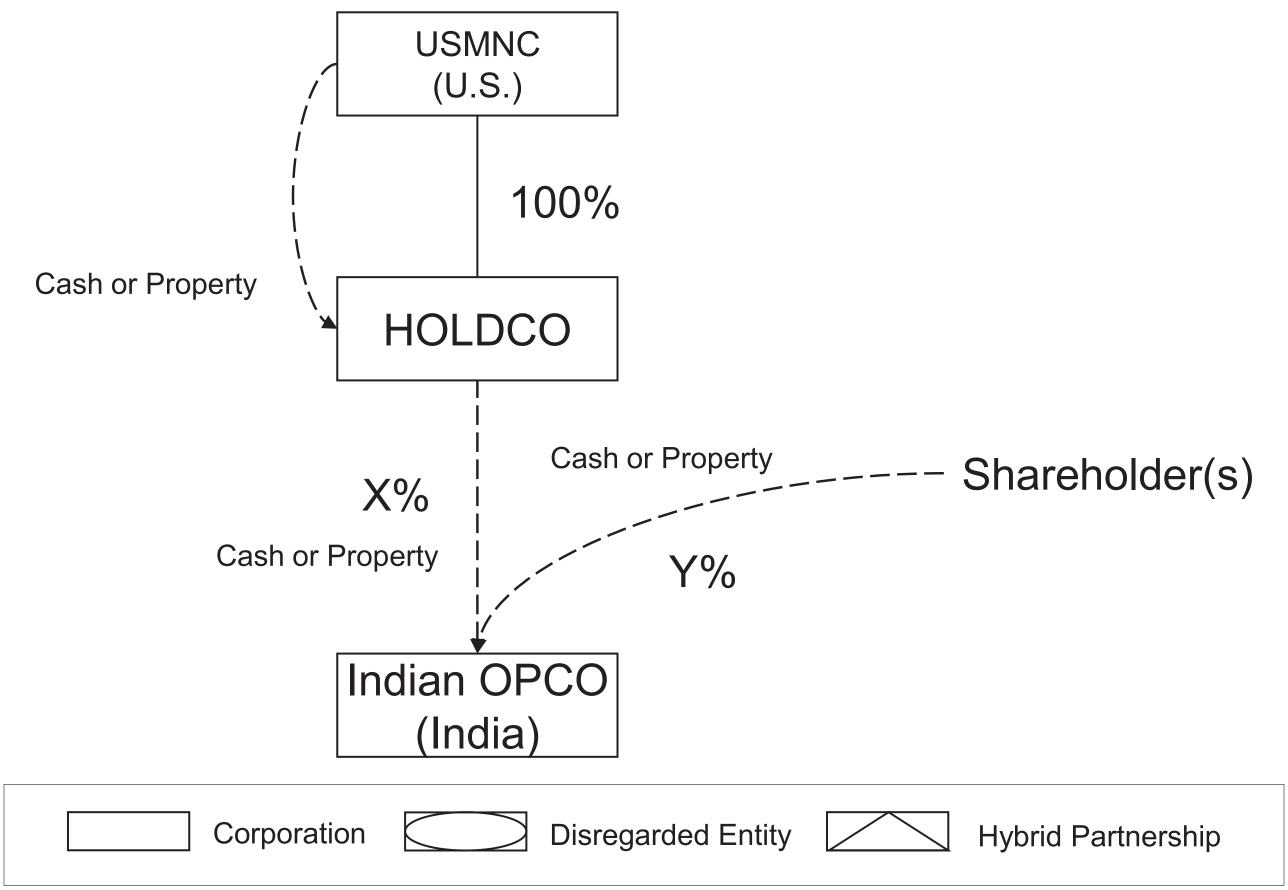
The advantage of a branch is that the USMNC would be allowed to repatriate profits, net of Indian taxes, provided that the relevant documents are submitted to the Indian authorized dealer (a bank). Subsequently, if the USMNC wishes to conduct business through a subsidiary, the branch may be wound up and a subsidiary entity incorporated. Winding up of a branch requires disclosures to be made with the relevant authorized dealer, particularly if remittances are required to be made from India at the time of winding up.

From a tax perspective, if the USMNC contributes branch assets to the Indian company in exchange for shares, the USMNC may be required to pay capital gains tax to the extent that the shares issued are of a value greater than the cost of acquisition of branch assets. Alternatively, the USMNC could transfer the assets to the company under an asset sale or slump sale, the tax implications of which have been analyzed above. In both situations, prior regulatory approval may be required since it may result in the USMNC acquiring shares of an Indian company for consideration other than cash.[101]

Further, a branch would be considered the PE of the USMNC in India and its income would be taxable at the rate of 42.23 percent (in contrast to the 33.21 percent payable by an Indian company). However, the branch is not considered a separate entity so there would be no further tax on distributions made by the

[101]In the U.S., it may be common for a parent company to contribute assets without the issuance of shares by the company. However, in India, it is typical to issue shares, in which case there may be a possibility of capital gains tax if the value of shares issued is greater than the cost of acquisition of transferred assets.

Figure 6C. Joint Venture Between USMNC and Indian Shareholders



branch to the USMNC. India does not currently levy a branch profits tax. The branch and the USMNC would be considered related parties for Indian tax purposes. Therefore any interactions between them would be required to be carried out at arm's length according to Indian transfer pricing regulations.

b. Liaison Office. A liaison office (LO) is suitable for foreign companies that wish to set up a representative office in India to act as a facilitator between the parent/holding company and its operations/proposed markets within India. As noted above, the setting up of an LO is governed by the regulations, and would require prior approval by the RBI. Such approval is granted by the RBI on a case-by-case basis and accorded only if the activities of the LO are restricted to the activities laid out by the RBI in this regard. An LO in India is allowed to carry on limited activities related to representing the parent company in India, promoting export and import from India, and acting as a communication channel. An Indian LO cannot carry on any trading, commercial, or industrial activity in India or earn any income from the day-to-day activities carried on by it in India. All the expenses of the LO have to be met out of remittances from abroad.

As the LO cannot have any income in India and as the expenses of the LO are required to be borne by the foreign company, there should be no income tax implications for the LO in India. However, Indian courts have tended to look at the nature of activities carried on by the LO in India to determine whether such activities should result in the creation of a PE. In *UAE Exchange Centre v. Union of India*,[102] the Delhi High Court held that an LO was not the PE of the foreign entity in India as its activities were auxiliary in nature. The Indian LO in this case was engaged in facilitating remittance of funds to residents of the U.A.E. There

[102]313 ITR 94 (Delhi HC).

have been other cases such as *KT Corporation*[103] and *IKEA Trading*[104] that have held that an LO should not be considered to be a PE. The principle underlying all these rulings seems to be that the LO should carry out a very limited range of commercial activities and should as far as possible only act in a representational capacity. An increased involvement of the LO may result in greater PE exposure for the USMNC in India.

c. Indian Corporate Entity. An Indian corporate entity is the simplest and most common form of entity in India. The preferred vehicle would be a private limited company so that the entity could make an entity classification election as a partnership or disregarded entity for U.S. federal income tax purposes.

In the event that the joint venture is set up as an Indian company, a corporate tax rate of 33.21 percent is presently applicable. A dividend distribution tax (DDT) of 16.61 percent is payable on distribution of dividends to the shareholders.[105] The liability for this tax is imposed on the corporation, not the shareholder. However, such dividend income is then tax exempt in the hands of the shareholders irrespective of their residential status. DDT is payable regardless of whether the company making the distributions is otherwise chargeable to tax.

d. Limited Liability Partnerships. It is possible to enter into joint venture arrangements that do not involve the set-up of companies. Recently there has been introduction of the limited liability partnership regime in India. The Indian LLP embodies more features of a corporation compared with its counterparts in other countries. Investments into an LLP may involve the same foreign direct investment restrictions as are applicable to companies. However, for tax purposes the LLP would be considered as a partnership.

If the joint venture is made into an LLP, tax would be levied at the LLP level. However, as the LLP is considered a partnership for Indian tax purposes, there should be no further implications at the limited partner level. Further, the rate applicable to an LLP is lower than that applicable to a company (at 31 percent). There is also no incidence of DDT or MAT, which may make the LLP a better investment structure. However, the Finance Act 2010-2011 has introduced a provision under which an LLP may not make distributions to its partners, out of accumulated profits, for a period of three years from the date of conversion of a company into an LLP. Further, while the Finance Act 2010-2011 has introduced provisions for exemption on conversion of a company into an LLP, the exemption has only been extended to conversion of turnover divided by total sales divided by gross receipts of less than US $120,000 in any of the preceding three years. This provision could limit the tax exemption to very small companies.

Given the more favorable tax regime applicable to LLPs, one would logically assume that the USMNC would want to own its investment in the LLP directly or through a Mauritius holding company. The difficulty is that the foreign exchange rules do not currently permit non-Indian persons to own an interest in an LLP.[106] If that restriction is lifted, India will likely witness a large and significant shift to the LLP form of doing business. At the same time, however, an LLP may not be the best vehicle to take the Indian business public since Indian laws do not currently permit listing of an LLP. Further, conversion of an LLP into a company that could then be listed may not only turn out to be a tax inefficient process, but also result in a deterrence to listing since the listing process may require fulfillment of conditions such as track record, minimum net worth, or minimum distributable profit for the last three years, which the new company would be unable to fulfill.

e. Association of Persons. Section 2(31) of the ITA defines the term ''person'' to include an association of persons or a body of individuals, whether incorporated or not.[107] The Supreme Court of India has held[108] that in order to constitute an association, persons must join in a common purpose or common action and the object of the association must be to produce income. Thus, a consortium formed by two or more companies could be chargeable to tax as an association of persons (AOP). Section 6(2) of the ITA also provides that an AOP will be considered to be resident in India, except in cases when the whole of the management and control of the affairs of the AOP is situated outside India. Thus, an AOP is considered to be resident in India even if a fraction of its control and management is situated in India. This is important since a resident is taxed in India on its worldwide income.

If the joint venture is structured as a contractual arrangement, the venture could be considered as an AOP for Indian tax purposes. In this case, the entire income of the AOP could be subject to tax in India if even a portion of the AOP is situated in India. This treatment may apply even though a treaty exists between India and the country in which the nonresident

[103] 181 Taxman 94.

[104] [2009] 308 ITR 422.

[105] Section 115 O of the ITA.

[106] The government is considering allowing 49 percent foreign investment in LLPs with prior approval. *See* ''LLPs with FDI may not get to float arms,'' *Economic Times*, Mar. 16, 2010, *available at* http://economictimes.indiatimes.com. However, no formal announcement has been made by the government as of the writing of this article.

[107] Subclause (v) of section 2(31).

[108] *CIT v. Indira Balkrishna*, 39 ITR 546.

investor is situated. In *Geoconsult ZT GMBH*, an Austrian entity entered into a joint venture agreement with two Indian entities. It was argued that no PE of the nonresident existed in India, according to the provisions of the Austria-India income tax treaty. However, the court held that the activities carried on by the residents and the nonresident entity amounted to an AOP under section 2(31)(v) of the ITA. Therefore, the entire income of the AOP was considered subject to tax in India.

2. Contributing Assets Into Joint Venture

Typically, joint ventures may involve the infusion of cash, property, or services by the parties. However, in India a nonresident may only make cash investments into an Indian company. Noncash investments would require the USMNC to obtain regulatory approval, which may be a cumbersome process. The joint venture entity would issue shares to the investor in exchange for the contribution of cash. In the event that approval is obtained and contributions are made in the form of assets, shares would be issued at the value recorded by the company regarding such assets.

The most straightforward approach in many cases is thus to cause the USMNC to contribute cash to the Indian entity (either directly or through a holding company) and then have the Indian entity use the contributed cash to purchase whatever assets the USMNC would have otherwise contributed. However, depending on the kind of assets being purchased, there could be customs duty payable on the purchase. The U.S. implications of this arrangement are addressed below. In this regard, according to the Indian transfer pricing regulations, the Indian joint venture and the foreign shareholders would be considered associated enterprises and any transactions between them would be required to be conducted on an arm's-length basis.

3. Making Intangible Property Available to Joint Venture

It may be that the USMNC or the joint venture partner needs to provide intangible property (that is, patents, know-how, or trademarks) to the joint venture entity in order to enable it to operate without danger of infringement. In a 50/50 joint venture in which both parties have valuable intangibles that the joint venture needs and the parties value equally, they may each choose to contribute a license to the joint venture vehicle so that the joint venture need not pay an ongoing royalty for the use of the intangibles. Typically this would be accomplished by having the USMNC and the other partner contribute equal amounts of cash to the joint venture vehicle and then cause the joint venture vehicle to purchase a license to use the USMNC's intangible from the USMNC and a license to use the partner's intangible from the partner. From an Indian perspective, the intangible can be capitalized in the books of the Indian entity and depreciated over its useful life. While implementing any such arrangement, the Indian transfer pricing implications may need to be kept in mind, which would also determine the transfer price for purchase of the intangible as well as the license of the same to other associated nonresident entities within the joint venture group.

Alternatively, the economic arrangement may be such that one or both parties license the intangible to the joint venture company in exchange for a running royalty expressed as a percentage of net sales or units produced. From an Indian tax perspective, the Indian joint venture company will be required to withhold tax at the rate of 10.558 percent (including surcharge), which can be reduced to 10 percent under the terms of applicable treaties. The joint venture company should be able to get a tax deduction for the royalty payment made. Further, the amount of royalty payments that may be permitted to be made will be subject to transfer pricing regulations.

Finally, it may be that one party simply needs to grant a license to ''practice'' the intangible and not otherwise exploit it. For example, in a typical contract manufacturing arrangement in which the Indian entity is producing goods in India but using the USMNC's patents, the USMNC may provide the Indian entity with a royalty-free license to ''practice'' the patent in India for the sole purpose of making goods for the USMNC. In this case, the Indian entity would not have any other rights to exploit the intangible, and the Indian entity would not pay any royalty for the use of the intangible. Instead, the USMNC would be compensated for the use of the intangible because the Indian entity would charge a lower transfer price when it sells the finished products to the USMNC than it otherwise would have if it actually owned the intangibles.

In these kinds of arrangements it would be important to keep in mind the AOP concept contained in Indian tax law. The Indian ITA does not contain a definition of the term ''AOP.'' However, in cases such as *Indira Balakrishna v. CIT*[109] it has been held that an AOP would be constituted if two or more persons come together for the common purpose or common action intended at production of income. In the situation described above, the collaboration between the USMNC and Indian entity may result in the constitution of an association of persons, depending on the terms of the arrangement between the parties.

Further, an AOP is considered to be resident in India under section 6 of the ITA, unless its whole control and management is situated outside India. Therefore, if any part of the control and management of the AOP is situated in India, the AOP may be considered resident in India and its worldwide income subject to tax in India. Parties should keep in mind while negotiating the terms of their collaboration agreement that

[109](1960) 39 ITR 546 (SC).

constitution of an AOP in India may bring the entire income from the arrangement subject to tax in India.

4. Exit Strategies

In any joint venture situation, it is very wise to consider exit strategies. Will one party sell to the other? Will the joint venture company go public? Will the company simply liquidate after it has achieved its purposes? We explore some of the more common exit strategies below.

a. Sale of Shares. As noted above, the capital gains tax in India is levied at differing rates depending on the period of holding of the capital asset. For securities, rates may also differ depending on whether the shares are sold on or off the stock exchange. When the USMNC makes investments into an Indian private limited company, a sale of its shares may result in capital gains implications of 21.115 to 42.23 percent, assuming that the shares are held directly and not through an offshore holding company. However, lower tax rates may apply if the transfer takes place under the listing of the company. There are no Indian tax consequences to the conversion of an Indian private limited company into a public limited company and listing of the company. Further, there is zero tax on transfer of shares on the stock exchange provided that such shares have been held for a period greater than 12 months.[110]

Another option may be to execute a tax-free merger of the Indian target entity into another Indian entity. However, the tax benefits under this option would be available only if the merger is into another Indian entity, or if the USMNC merges into the Indian entity. Currently, Indian corporate and tax laws do not permit merger of an Indian entity into a foreign entity. See Section IV of this article for a more detailed discussion on mergers and acquisitions.

There are no provisions that enable an LLP to be listed on the stock exchange. Transfer of interests in the LLP should result in capital gains implications for the transferor, to the extent that the distributions on exit are greater than the cost of acquisition of the interests.

b. Option to Acquire Shares of JV Partner. Under a recent interpretation taken by the regulatory authorities, Indian companies are not permitted to issue options (warrants) to foreign investors unless approval is obtained from the Indian regulatory authorities. However, an investor may be able to obtain an option to acquire shares under a contractual arrangement such as a share purchase agreement. Options acquired under such contractual arrangements would be subject to pricing restrictions at the time of exercise.[111]

c. Sale of Assets Followed by Liquidation. The Indian entity could sell its assets and make distributions to its shareholders on liquidation. This would result in capital gains tax implications of 22.14 to 33.21 percent for the Indian entity on transfer of assets, depending on the period of holding of the asset and the difference between the cost of acquisition and sale price of the assets. When the company liquidates, treatment of distributions would be according to section 46 of the ITA. Under this provision, there should be no tax implications for the company on liquidation while the nonresident shareholders would be chargeable under the head capital gains in the range of 21.115 to 42.23 percent (which could be reduced to nil if the shareholder is based in a tax favorable jurisdiction like Mauritius). However, the amounts chargeable to capital gains tax in the hands of the shareholders would be equal to the distributed amounts as reduced by the amounts attributable to accumulated profits and considered to be dividends under section 2(22) of the ITA. To the extent that there are amounts attributable to accumulated profits, the company would be required to pay dividend distribution tax at 16.61 percent at the time of liquidation. Such an exit after liquidation may require the prior approval of the Foreign Investment Promotion Board.

B. U.S. Tax Considerations

There are many issues that must be considered from a U.S. perspective in structuring the joint venture. The first issue is whether the USMNC wants to treat the joint venture operation as a partnership or as a corporation for U.S. federal income tax purposes. Because of the U.S.'s entity classification regulations, the choice for Indian purposes is not determinative for U.S. federal income tax purposes. The second issue is how the transfer of assets to the joint venture will be taxed in the United States. The third issue is how royalties will be taxed in the United States if they are charged. The final issue is how various exit strategies will be taxed in the United States. Each issue is described below.

1. Entity Classification

The analysis as to whether the USMNC prefers to treat the joint venture as a flow-through entity or as a regarded corporation will typically involve the same considerations discussed in Section I of this article — that is, whether and to what extent the USMNC wants to flow losses through onto its U.S. tax return. There are additional considerations, however. One issue that drives a number of structuring decisions in the joint venture context is the application (or possible nonapplication) of the foreign tax credit look-through rules.[112] The application of these rules will depend on the USMNC's percentage ownership of the joint venture vehicle and the entity classification of the vehicle.

[110] *See* sections 111A and 112 of the ITA.

[111] This pricing is required to be conducted in accordance with the ex-CCI guidelines.

[112] IRC section 904(d)(3) and (d)(4). *See also* Treas. reg. section 1.904-5.

a. Joint Venture Company Is Considered a Corporation. If the joint venture company is considered a corporation, then the USMNC will only be permitted to minimize double taxation and claim deemed paid foreign tax credits regarding the entity's earnings if the USMNC owns at least 10 percent of the voting stock of the joint venture entity.[113] It is voting power (not value) that counts for this purpose. If the USMNC satisfies this minimum ownership threshold, but the joint venture vehicle is not a CFC, then the entity will typically be referred to as a 10/50 company. Dividends from both CFCs and 10/50 companies can qualify for look-through treatment under the code. As such, the dividends and associated foreign tax credits can be considered to fall within the general basket in the hands of the USMNC, provided those earnings were considered general basket earnings in the hands of the CFC or 10/50 company.[114]

There is a significant distinction between CFCs and 10/50 companies in the case of payments other than dividends, however. While interest, rents, and royalties received by the USMNC from a related CFC can qualify for look-through treatment,[115] there is no similar provision for 10/50 companies. Unless the USMNC can qualify the receipt of the income as general basket income without relying on the look-through rules,[116] this distinction may cause the USMNC to carefully consider whether corporate form is the best classification for the joint venture entity.

b. Joint Venture Company Is Considered a Partnership. If, on the other hand, the joint venture company is considered a partnership, different foreign tax credit and look-through rules apply. The USMNC should be able to claim a direct foreign tax credit for its distributive share of any Indian income taxes imposed on the partnership's activities.[117] There is no requirement that the USMNC own some minimal percentage ownership of the partnership to claim the credit.

The distributive share of partnership income and foreign tax credits is not necessarily going to be general just because the joint venture is engaged in active operations, however. Instead, in order for the USMNC to look through the partnership and ensure that its distributive share of profits and credits is in the general foreign tax credit basket, the USMNC must own at least 10 percent of the value of the partnership,[118] or, alternatively, the USMNC must establish that it is holding the partnership interest in the active conduct of a trade or business.[119] For this purpose, value is measured as the combination of a capital and profits interest. Thus, to qualify, the USMNC must have the right to at least 10 percent of partnership profits and 10 percent of partnership capital. Interestingly, the USMNC's ability to vote on matters is not relevant for this purpose.

Payments made by the partnership to the USMNC outside of the USMNC's capacity as a partner (such as rents, royalties, and interest) are characterized for foreign tax credit purposes under a different set of rules.[120] To obtain look-through treatment, the following requirements must be satisfied. First, the payment must be received by the USMNC or a member of the USMNC's controlled group. For this purpose, the USMNC's controlled group consists of the USMNC and other domestic corporations that are in chains of ownership described in section 1504 in which the parent owns at least 50 of the vote and value of its subsidiary.[121] Importantly, the controlled group does not include foreign corporations or other partnerships. Second, the payment must have been entitled to look-through treatment if the partnership were considered a foreign corporation.[122]

If the other joint venture partner is not a U.S. individual or corporation, the practical import of the second requirement is that if the USMNC owns 10 percent of the value of the partnership, but owns less than 50 percent of the voting power or value of the partnership, the payments will not be entitled to look-through treatment. This is because the partnership, if it were considered a foreign corporation, would be considered a 10/50 company, and not a CFC, the payments from which are entitled to look-through treatment. One possible approach to resolving this conundrum is to ask that the non-U.S. joint venture partner own its percentage interest in the joint venture vehicle through a domestic partnership. See Figure 7. This way, even though the USMNC owns less than 50 percent of the venture, the Indian joint venture vehicle would be considered a CFC if it were deemed to be a foreign corporation and, hence, the look-through rules should apply.

c. Creditability of Indian Taxes. For reasons noted above regarding the Indian tax consequences, the most likely vehicle for U.S. corporations investing into India is the Indian corporation (private or public). As noted above, India imposes both an income tax and a dividend distribution tax. Both taxes should be considered

[113]IRC section 902(a).

[114]IRC section 904(d)(3) and (4).

[115]IRC section 904(d)(3). Treas. reg. section 1.904-5.

[116]If the USMNC is in the business of licensing its intangibles to others, it is possible that royalties could qualify as general basket income in the USMNC's hands even without reference to the look-through rules. Treas. reg. section 1.904-4T(b)(2)(iii).

[117]IRC section 901(b)(5).

[118]Treas. reg. section 1.904-5(h)(1).

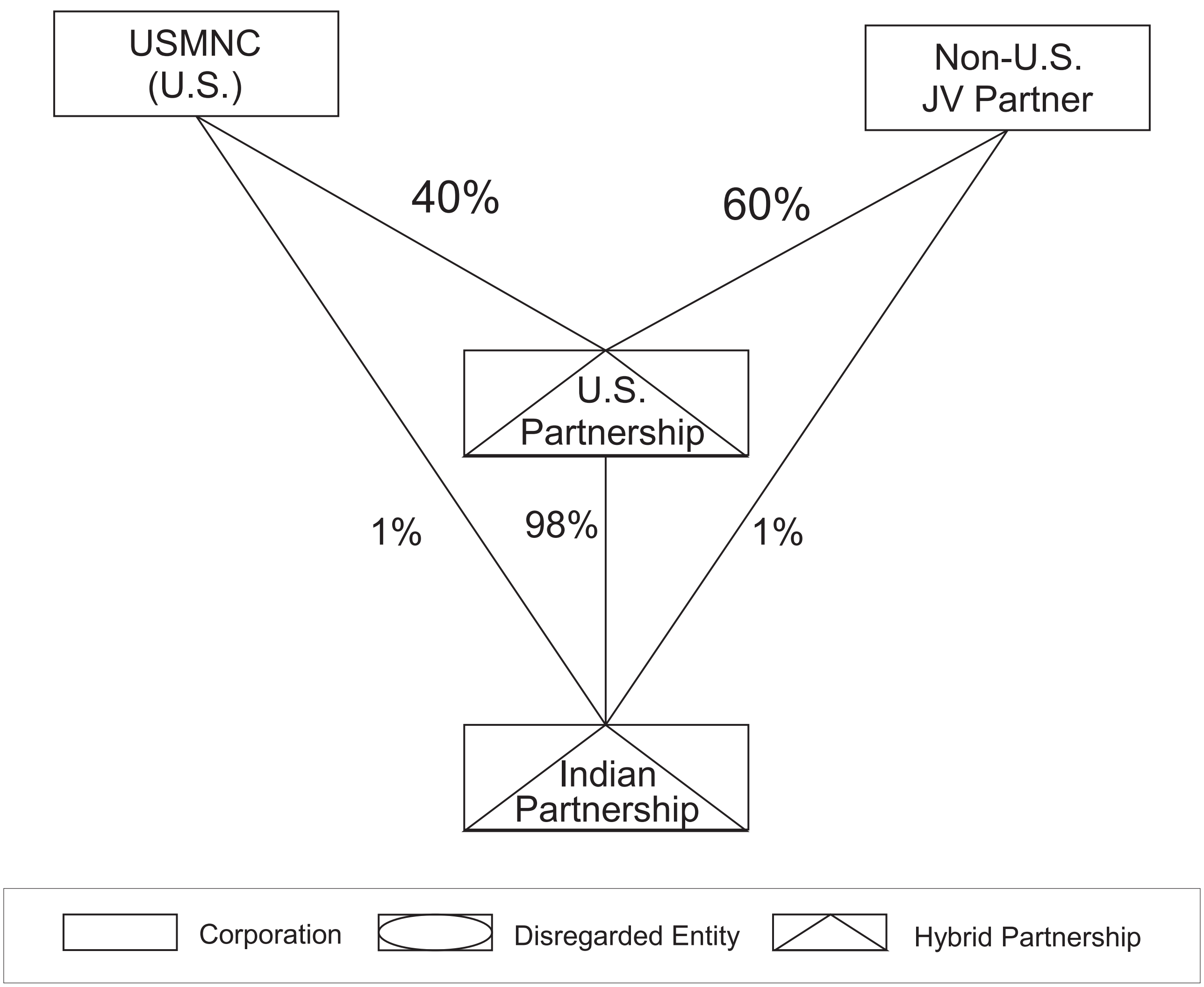
[119]Treas. reg. section 1.904-5(h)(2)(ii).

[120]Treas. reg. section 1.904-5(h)(1).

[121]Treas. reg. section 1.904-5(h)(1), *cross-referencing* Treas. reg. section 1.904-5(a)(3) *cross-referencing* IRC section 1504(a)(1).

[122]Treas. reg. section 1.904-5(h)(1).

Figure 7. Setting Up U.S. Partnership for Joint Venture Between U.S. and Non-U.S. Partners



creditable taxes for U.S. purposes. The dividend distribution tax is imposed on the distributing Indian corporation, not the shareholder of the Indian corporation. Hence, if the Indian company is considered a corporation (or held through a holding company that is considered a corporation), the only way that the USMNC can claim a credit for the tax is if the USMNC happens to satisfy the ownership requirements for the indirect foreign tax credit under section 902 of the code.[123]

[123]IRC section 902(a) and (b).

Conversely, if the joint venture entity were considered a partnership, then the USMNC would be entitled to claim a direct credit under section 901 regardless of its ownership percentage.

2. Transferring Assets to Joint Venture Vehicle

An Indian nonresident, like the USMNC, cannot transfer assets to an Indian company in exchange for shares without significant difficulty. A more expedited process, therefore, is to cause the USMNC to contribute cash equal in value to the property that the USMNC would have otherwise contributed and then cause the joint venture vehicle to use that cash to purchase the assets from the USMNC. From a U.S. perspective, this circular flow of cash can be disregarded,[124] such that the USMNC can be considered as having contributed the property directly to the Indian joint venture vehicle, regardless of whether it is structured as a foreign corporation or a partnership.

Just because the circular flow of cash can be disregarded for U.S. purposes does not end the inquiry, however. Instead, the nature of the property transferred and the classification of the transferee as a corporation or partnership will determine the U.S. tax consequences of the transfer.

a. Joint Venture Vehicle Is a Foreign Corporation. If the joint venture vehicle is considered a foreign corporation, the USMNC will likely want to qualify the transfer of its assets to the entity as a tax-deferred transfer. It is possible to structure the outbound transfer of the assets as a transaction described in section 351 of the code. This is a necessary, but not necessarily sufficient, condition. Tax-deferred treatment will only be possible to the extent the USMNC is transferring assets that are not considered intangibles described in section 936(h)(3)(B), inventory property, accounts receivable, foreign currency or property denominated in a foreign currency, or lease agreements. The USMNC must also ensure that the transferred property is not a component part of a foreign branch with previously deducted losses,[125] the property does not have any deferred intercompany gain associated with it,[126] and that the transfer of the property will not cause any income recapture to the USMNC.[127]

b. Joint Venture Vehicle Is a Foreign Partnership. Tax-deferred treatment is easier to achieve with a foreign partnership. If the joint venture vehicle is a foreign partnership, assets, including intangibles, can be transferred to the partnership on a tax-deferred basis.[128]

3. Exit Strategies

If the exit strategy involves the USMNC purchasing the joint venture partner's interest in the Indian target, the buyer needs to start by thinking through what type of entity that it is purchasing. Although the joint venture vehicle may be a private limited company for Indian purposes, it may have elected to be treated as a partnership for U.S. federal income tax purposes. If it is treated as a partnership for U.S. purposes, the buyer will want to ensure that if the joint venture's assets have appreciated, the buyer obtains a stepped-up basis for those assets. If the entity that is purchasing the joint venture interest happens to own all of the remaining interests in the vehicle, then the step-up will occur automatically because the purchaser will be considered to be purchasing a pro rata portion of the assets of the joint venture.[129] If not, then the purchaser will want to consider a section 754 election so that the purchase price can be pushed down onto the assets.

If, instead, the joint venture vehicle is considered a corporation for U.S. federal income tax purposes, then the USMNC should bear in mind that a section 338(g) election will not be available unless the USMNC held 20 percent or less of the joint venture vehicle prior to the purchase. In this case, the USMNC could consider using a taxable liquidation to achieve a partial step-up. If the USMNC ensures that the entity that purchases the joint venture partner's interest is different than the entity that owns the USMNC's interest, such that the requirements of section 332 are not satisfied (that is, there is no single 80 percent distribute-shareholder), the USMNC could then cause the joint venture vehicle to elect to be treated as a partnership. This election would cause the joint venture vehicle to be deemed to liquidate in a taxable liquidation for U.S. tax purposes. This will then trigger gain recognition at the corporate[130] and shareholder[131] levels. The joint venture vehicle's gain in its assets likely will not give rise to subpart F income, provided they are assets used in the active conduct of a trade or business. Nevertheless, the basis in all of the joint venture vehicle's assets will be stepped up to fair market value. The shareholders will have to recognize gain equal to the excess of the value of their shares over their basis in those shares. There should not be any gain for those shares that were recently purchased. There will be a gain for the historic shares. That gain may be recast as dividend income[132] and may pull significant credits with it.[133] Thus, whether a taxable liquidation is a good or a bad idea depends on the particular facts of the taxpayer's situation.

If the USMNC is the one selling its interest, it will want to consider the Indian tax consequences of the sale first, and then overlay the U.S. subpart F and foreign tax credit considerations before the sale occurs. For example, assume the joint venture vehicle happens to be considered a partnership for U.S. federal income

[124] *See, e.g.*, *D'Angelo Associates, Inc. v. Commissioner*, 70 T.C. 121 (1978).

[125] IRC section 367(a)(3)(C).

[126] Treas. reg. section 1.1502-13(c).

[127] If the USMNC has an overall foreign loss under section 904(f)(1), recapture could be triggered under IRC section 904(f)(3). Alternatively, the transfer of depreciated property can result in recapture. Treas. reg. section 1.367(a)-4T(b).

[128] IRC section 721(c). The U.S. Congress has provided the Treasury Department with authority to promulgate regulations regarding outbound transfers of intangibles to partnerships but, thus far, they have not done so. *See* IRC section 367(d)(3).

[129] Rev. Rul. 99-6, 1999-1 C.B. 432.

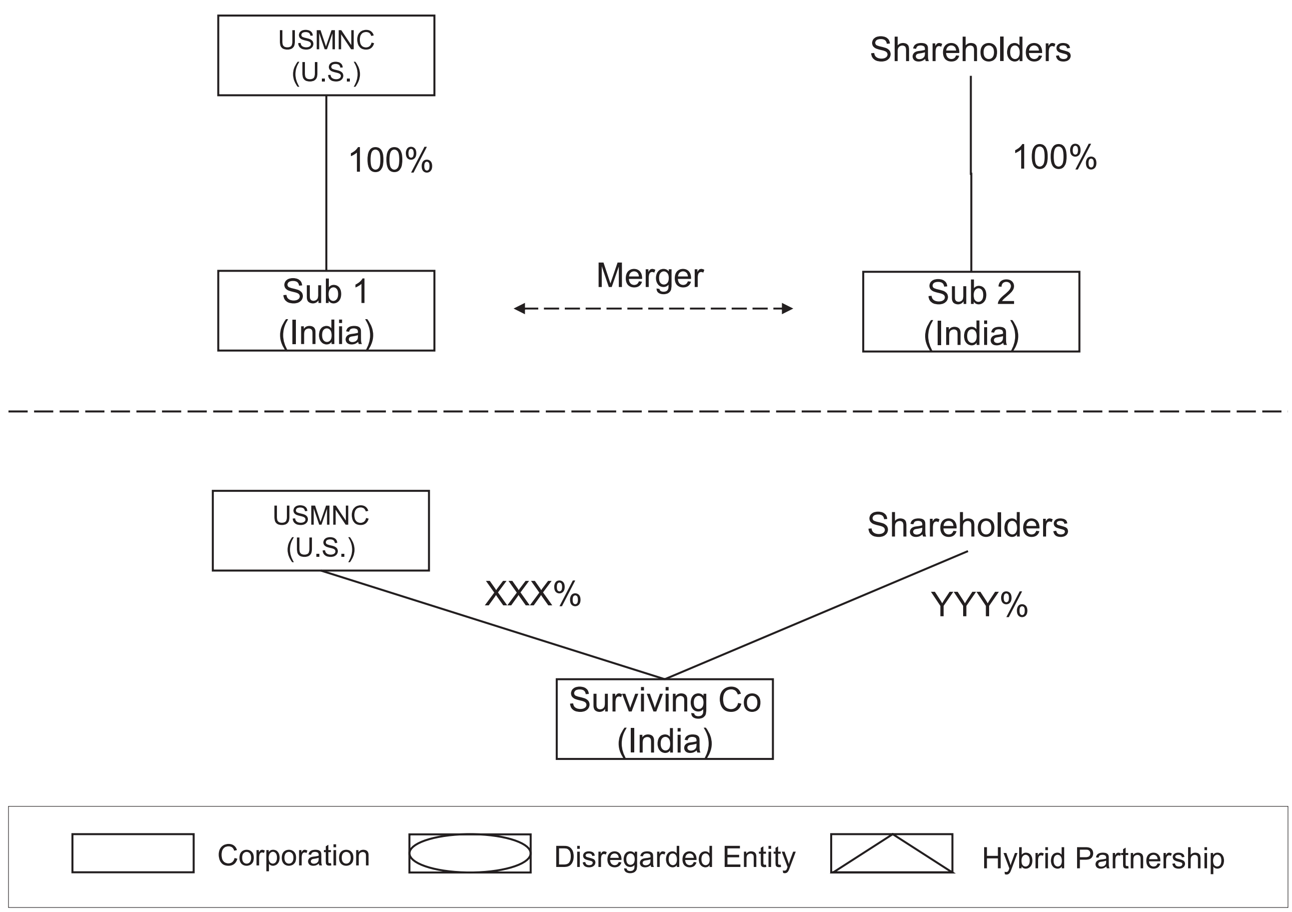
[130] IRC section 336.

[131] IRC section 331.

[132] IRC sections 964(e) or 1248(a).

[133] IRC sections 902 and 960.

Figure 8. Merger of Indian Entities



tax purposes, and the USMNC happens to hold its interest in the Indian joint venture vehicle indirectly through a Mauritius holding company. It may be that the sale by the Mauritius holding company of its interest in the Indian joint venture entity generates Indian capital gains tax, but avoids any current U.S. federal income tax (due to the application of the subpart F rules that look through sales of partnership interests to their underlying assets).[134] Thus, it is possible that the USMNC may be better off incurring the present imposition of the Indian capital gains tax but deferring the imposition of a current U.S. tax that would otherwise arise if the shares of the Mauritius entity were sold.[135]

IV. Mergers of Indian Entities

The USMNC may own an Indian subsidiary that it wants to merge or combine with an unrelated Indian target corporation. See Figure 8.

A. Indian Tax Considerations

1. Mechanics of a Merger

The term ''merger'' is not defined under the Companies Act, 1956; the ITA; or any other Indian law.

[134]IRC section 954(c)(4).

[135]This would be the case if there were a difference between the basis in the Indian joint venture entity, measured for Indian purposes, and the basis that the Mauritius entity was considered to have in the joint venture's assets by virtue of the look-through rules. Moreover, the taxpayer in this case could conceivably have its cake and eat it too if it were to cause the Mauritius entity to undergo an F reorganization under which the Mauritius entity was transferred to a newly created CFC, and then elected to be disregarded. These steps would almost certainly be considered an F reorganization. *See generally* Rev. Rul. 87-66, 1987-2 C.B. 168, and prop. Treas. reg. section 1.368-2(m).

(Footnote continued in next column.)

Very often, the terms ''merger'' and ''amalgamation'' are used synonymously. An amalgamation is a merger of one or more companies with another company, or the merger of two or more companies to form one more company whereby the assets and liabilities of the merging company or companies (amalgamating companies) become vested in the merged company (the amalgamated company). The amalgamating companies all lose their identity and emerge as the amalgamated company; though in some transaction structures the amalgamated company may be one of the original companies. The shareholders of the amalgamating companies become shareholders of the amalgamated company.

An amalgamation in India takes place under the procedure in section 394 of the Companies Act. This section requires the approval by a court of a scheme of amalgamation. This process may take about six to eight months.

2. Tax Implications of a Merger

A merger may be approved by the court for the purposes of the Companies Act. However, to qualify for tax benefits it would need to satisfy the conditions contained in section 47 of the ITA.

The ITA contemplates and recognizes the following types of activities in relation to mergers and acquisitions:

- slump sale or asset sale;
- transfer of shares;
- amalgamation (that is, a merger that satisfies the conditions noted below[136]); and
- demerger or spinoff.

As noted above, there are tax implications in India consequent to a slump sale, asset sale, and transfer of shares. However, amalgamations and demergers are considered tax-free transactions, provided that they satisfy the conditions in section 47 of the ITA.

As noted above, section 45 of the ITA is the charging provision relating to the taxation of capital gains in India. According to section 45, a person is considered taxable on the profits and gains arising from the transfer of a capital asset situated in India. Section 47 excludes some kinds of transfers from the definition of transfer, as a consequence of which gains therefrom are not subject to capital gains tax.

Under the provisions of section 47, there is no capital gains tax implication on the merger of a foreign company into an Indian company. However, a similar exemption is not contained regarding the merger of an Indian company into a foreign company. This is also mirrored in Indian corporate laws that restrict the merger of an Indian company into a foreign company.

Although the recently introduced bill to reform corporate laws in India does contemplate allowing an Indian company to merge with a foreign company, the tax laws would be required to be amended to take such a possibility into consideration.

The exemption provided under the ITA is for the transfer of assets of an amalgamating company to an amalgamated company, and for the extinguishment of shares of shareholders of the amalgamating company in consideration of shares of the amalgamated company. However, there are some conditions that need to be satisfied in order to claim an exemption from capital gains tax:

- all property of the amalgamating company or companies immediately before amalgamation should become property of the amalgamated company by virtue of the amalgamation;
- all liabilities of the amalgamating company or companies immediately before the amalgamation should become the liabilities of the amalgamated company by virtue of the amalgamation; and
- shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies should become shareholders of the amalgamated company by virtue of the amalgamation.

The exemption from gain only applies at the shareholder level to the extent that the shareholder receives equity in consideration. The exemption should still be available even when the shareholder is allotted bonds or debentures in addition to shares of the amalgamated company since the section does not require that only shares of the amalgamated company should be allotted.[137] However, there is no case law on the subject and there continues to be a possibility of litigation.

Further, under section 47(via), when a foreign holding company transfers its shareholding in an Indian company to another foreign company as a result of an amalgamation, such a transfer of the capital asset (that is, shares in the Indian company) would be exempt from capital gains tax in India, if the transaction satisfies the following conditions:

- at least 25 percent of the shareholders of the amalgamating foreign company continue to be the shareholders of the amalgamated foreign company; and
- such transfer does not attract capital gains tax in the country where the amalgamating company is incorporated.

While the definition of amalgamation under section 2(1B) requires that 75 percent (in terms of value of

[136]Section 2(1B).

[137]*See* Kanga, Palkhivala, and Vyas, *The Law and Practice of Income Tax*, 9th ed. (Butterworths & Co. Ltd.: Delhi, 2004).

shares) of the shareholders of the amalgamating company should become the shareholders in the amalgamated company, this section specifies 25 percent of the number of shareholders as the corresponding figure.

Further, regarding the losses in the amalgamating company, section 72A of the ITA provides that in case of the amalgamation of a company owning an industrial undertaking[138] with another company, the accumulated loss and the unabsorbed depreciation of the amalgamating company is deemed to be the loss/allowance for depreciation of the amalgamated company. The amalgamated company would then be entitled to carry forward such loss and depreciation, and set off such amounts against its future profits. However, for this entitlement, the amalgamated company must fulfill the following conditions:

- It must hold three-fourths of the book value of the fixed assets that it acquired from the amalgamating company continuously for a period of five years from the date of amalgamation.
- It must continue to carry on the business of the amalgamating company for a minimum period of five years from the date of amalgamation. This would imply that if the amalgamating company were engaged in more than one business before amalgamation, the amalgamated company would be required to carry on all of those businesses.
- It must fulfill such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for a genuine business purpose.

Further, the amalgamating company:

- must have been engaged in the business, in which the loss occurred or depreciation remained unabsorbed, for three or more years; and
- must have held continuously, on the date of amalgamation, at least three-fourths of the book value of the fixed assets held by it two years before the date of amalgamation.

It is now common practice to issue employee stock options, especially in industries such as software. The merger of companies may involve the restructuring of such employee stock options. Section 45 could also result in Indian tax on gains from such a restructuring, which may be considered a transfer for the purposes of the ITA. Therefore, if the assets are considered to be situated in India, this may result in Indian tax implications on any gains to the employees from such restructuring.

B. U.S. Tax Considerations

The primary issue that U.S. persons need to consider regarding the amalgamation of two Indian companies is whether or not the amalgamation can be considered a tax-free reorganization described in section 368 of the code. Although there are a number of possible subsections of section 368 that could be implicated, the ones that are most likely to apply are:

- section 368(a)(1)(A)[139];
- section 368(a)(1)(C); and
- section 368(a)(1)(D).[140]

A thorough analysis of these different reorganization forms is outside of the scope of this article. What is important is that a combination of two Indian companies occurring under the Indian amalgamation provisions results in the cessation of the legal personalities of the amalgamating companies and the creation of a single new amalgamated company with its own legal personality. This is different from U.S.-style mergers, in which a target corporation formed under the laws of the state of Delaware merges with and into an acquiring corporation formed under the laws of the state of New York, the target company ceases to exist, and the acquiring corporation continues its existence.

Thus, for U.S. purposes, the taxpayers have to analyze the transaction as if both amalgamating companies transferred their assets to a newly created corporation in exchange for shares of that newly created corporation, and then each of the amalgamating companies distributed the shares of the newly created corporation to their shareholders in liquidation. The ramifications of analyzing the transaction this way are important. For example, in a U.S.-style merger, only the target corporation and its shareholders will have a taxable event if the transaction does not qualify as a reorganization described in section 368. That is not the case in an Indian-style amalgamation transaction. In an Indian amalgamation, both amalgamating companies and their shareholders will have a U.S. taxable event unless the transaction qualifies as a tax-free reorganization. Also, it is possible to structure a U.S.-style

[138]Industrial undertaking means an undertaking engaged in the manufacture or processing of goods, the manufacture of computer software, generation or distribution of electricity/power, or telecommunications services. This does not cover undertakings in the software service sector and other service sectors.

[139]Section 368(a)(1)(A) only applies to a merger or consolidation. Under current law, a transaction under which all of the assets of a target corporation are transferred by operation of law to another corporation can be considered a merger even if that transaction occurs by operation of the laws of a foreign country.

[140]This form of reorganization would only be applicable if one or more shareholders of the amalgamating companies controls the resulting amalgamated company. For this purpose, ''control'' means ownership of at least 50 percent of the voting power or value of the amalgamated company. IRC sections 368(a)(1)(D), (a)(2)(H), and 304(c).

merger such that the only consequence of failing to qualify for reorganization treatment is shareholder-level taxation.[141] That is not the case in an Indian amalgamation. In an Indian amalgamation, if the transaction did not qualify as tax-free the gain would be recognized (for U.S. purposes only) at the corporate and shareholder levels for both companies.[142]

Assuming that the amalgamation is considered a reorganization of each of the amalgamating companies with and into a newly created corporation, the U.S. shareholders must consider the impact that section 367 will have (if any) on the transaction. Section 367 and the regulations promulgated thereto are complex, and a thorough description of these rules is outside of the scope of this article. Nevertheless, the subsection of section 367 that will most likely apply to an amalgamation of two Indian entities is section 367(b). Under this provision, the shareholders of each amalgamating entity must ascertain whether they (or their U.S. shareholders if the Indian company happens to be held through a non-U.S. holding company) have a section 1248 amount (defined above) regarding the stock of the amalgamating company before the amalgamation occurs. A shareholder can possess a section 1248 amount regarding stock of a foreign corporation that is not currently a CFC, but was a CFC in the past five years. If the shareholder (or its U.S. shareholder in the case of a non-U.S. holding company) has a section 1248 amount regarding the stock of the amalgamating entity, the shareholder will have to recognize income as a result of the amalgamation unless the surviving Indian amalgamated company is a CFC and the shareholder (or its U.S. shareholder) owns at least 10 percent of the voting power of the amalgamated company.[143]

V. Spinoffs of Indian Operations

In some cases, the USMNC may want to engage in a divisive transaction under which it wants to separate a particular trade or business (Business A) that is being conducted by the Indian target from another business (Business B) being conducted by that same Indian target. See Figure 9. This will often occur when, for example, the USMNC is undergoing a fairly radical corporate structure change. Perhaps the USMNC wants to sell off a particular business line or, alternatively, distribute a particular business line to its public shareholders. In either case, the Business A and Business B activities conducted by the USMNC around the world must be separated and the Indian target is one component part of that overall plan.

A. Indian Tax Considerations

1. Mechanics of a Demerger

A demerger is the opposite of a merger, involving the splitting up of one entity into two or more entities, or hiving off a division into another existing entity. An entity that has more than one business may decide to spin off one of its businesses into a new entity or an already existing entity. The shareholders of the original entity would generally receive shares of the new entity or the existing entity to which the business have been hived off. These shares would be issued directly to the shareholders of the original entity. They would not be issued first to the original company, and then distributed by the original company to the shareholders.

The procedure for executing a demerger is similar to the procedure involving the merger of two companies. A scheme of demerger must be filed with the relevant High Court according to the procedures contained in section 391-394 of the Companies Act. After approval by the High Court, the company demerges and the title in the demerged assets automatically passes to the transferee entity. It is possible to demerge to a sister entity and there is no requirement that the demerged assets must be transferred to an entirely new company. In a situation when demerged assets are transferred to a parent company, the benefits of section 47 of the ITA may have to be applied by placing reliance on case law as the statutory provision extends primarily to demerger to sister entities. It has been held in some cases interpreting section 47 that the conditions relating to demerger cannot apply when there is impossibility of performance. For example, if a business is demerged into the parent entity, the parent entity cannot issue shares to itself. Notwithstanding this technicality, it should be considered eligible for the benefits of section 47.

2. Tax Implications of a Demerger

A spinoff or demerger can be accomplished tax free from an Indian perspective if it complies with the conditions specified in the ITA. The term ''demerger'' in relation to companies is defined by section 2(19AA) of the ITA to mean the transfer under a scheme of arrangement under the merger provisions by a demerged company of one or more of its undertakings, to any resulting company, in such a manner that:

- all the property of the undertaking[144] being transferred by the demerged company immediately before the demerger becomes the property of the resulting company by virtue of the demerger;

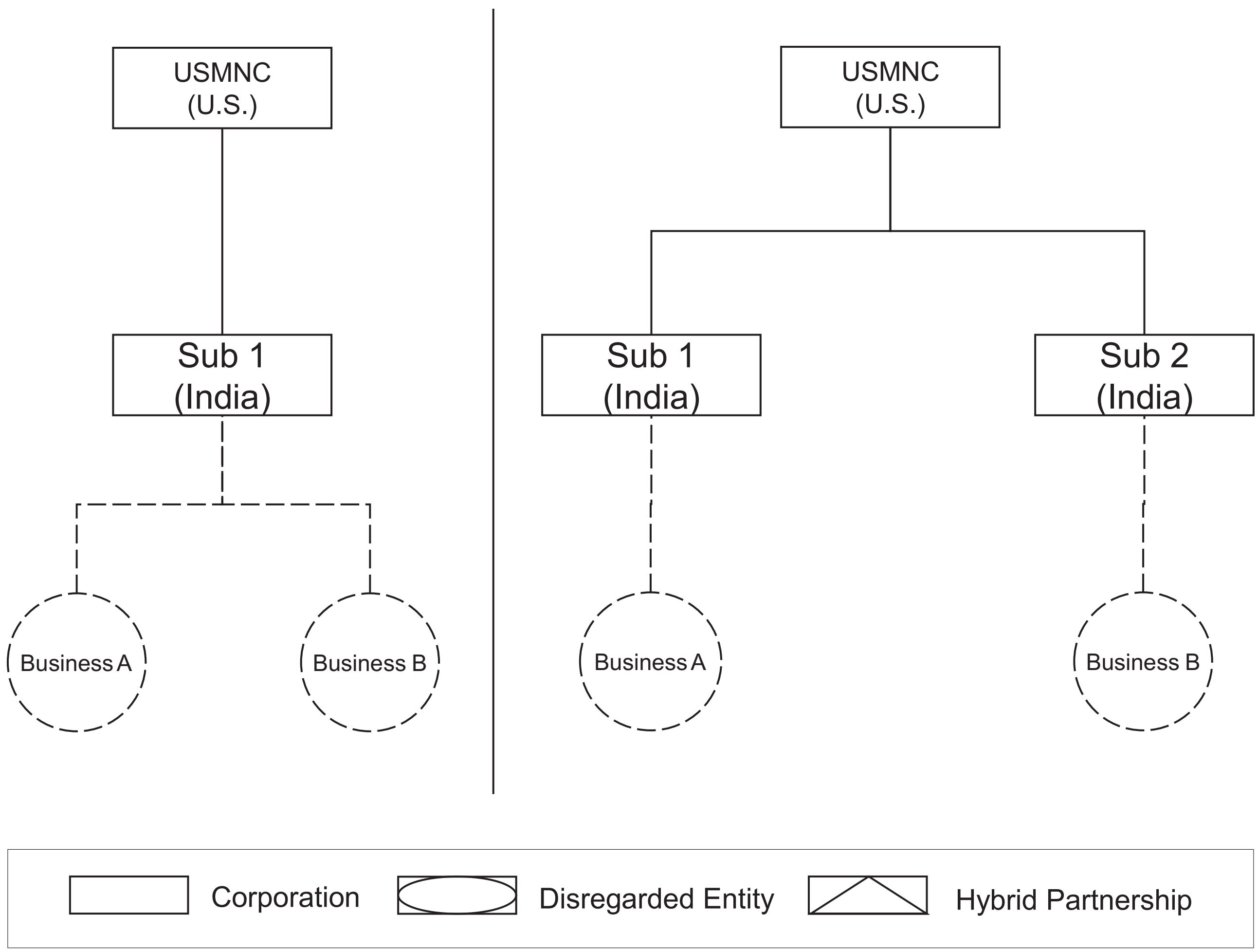
[141]Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 79-273, 1979-2 C.B. 125; and Rev. Rul. 90-95, 1990-2 C.B. 67.

[142]Rev. Rul. 69-6, 1969-1 C.B. 104.

[143]Treas. reg. section 1.367(b)-4(b)(1)(B).

[144]The term ''undertaking'' would include any part of an undertaking, any unit or division of an undertaking, or a business activity as whole, but does not include individual assets or liabilities that do not constitute a business activity.

Figure 9. Spinoff of Indian Operations



- all the liabilities[145] relating to the undertaking being transferred by the demerged company immediately before the demerger become the liabilities of the resulting company by virtue of the demerger;
- the property and the liabilities of the undertaking being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;
- the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;
- the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for the resulting company or its subsidiary) become shareholders of the resulting company(ies) by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;
- the transfer of the undertaking is on a going concern basis; and

[145]The term ''liabilities'' would include liabilities and specific loans/borrowings incurred or raised for the specific business activity of the undertaking. In case of a multipurpose loan, the value of the loan will be included and bears the same proportion as the value of the demerged assets to the total assets of the company.

- the demerger is in accordance with the conditions, if any, notified under subsection (5) of section 72A by the central government in this behalf.

Section 2(19AAA) of the ITA defines the term ''demerged company'' to mean a company, whose undertaking is transferred, under a demerger, to a resulting company. Section 2(41A) defines a resulting company to mean one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company.

The ITA contains some tax beneficial provisions for a demerger. If the demerger fulfills the conditions listed above, the transfer of assets by the demerged company to a resulting company, which must be an Indian company, is exempted from capital gains tax under section 47(vib) of the ITA.

A spinoff or demerger can be accomplished tax free from an Indian perspective if it complies with the conditions specified in the Income Tax Act.

Further, when a demerger of a foreign company occurs, in which both the demerged and resulting companies are foreign, but the assets demerged include or consist of shares in an Indian company, the transfer of these shares is exempt from capital gains tax in the hands of the demerged company under section 47(vic) of the ITA if the following conditions are satisfied:

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

Since such a demerger would not occur in India and hence the provisions of the Companies Act would not be applicable, the requirement of the application of the merger provisions to such a demerger is not required to be satisfied.

Regarding the losses contained in the demerged entity, section 72A(4) of the ITA provides a benefit for demergers. However, in the case of a demerger, the company does not need to satisfy any conditions similar to those applicable to mergers. In the case of a demerger:

- when such loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting company, the company will be allowed to be carried forward and set off in the hands of the resulting company; and
- when such loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, the company will be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company, and be allowed to be carried forward and set off in the hands of the demerged company or the resulting company.

B. U.S. Tax Considerations

To the extent that taxpayers wish to separate a single corporate entity (be it foreign or domestic) into two or more regarded corporations in a transaction that is considered tax free, one must look at section 355 of the IRC. Again, the intricacies of section 355 are outside of the scope of this article. Instead, we highlight some issues unique to the Indian demerger provisions that taxpayers should consider in determining whether section 355 applies.

1. Application of Substance-Over-Form Provisions

The typical way in which a spinoff of a business (as opposed to a preexisting old and cold subsidiary) takes place in the United States is for the corporation (Distributing) to transfer the assets that are to be spun off to a newly created wholly owned subsidiary (Controlled) in exchange for shares of that subsidiary. Distributing then distributes the shares of Controlled to its shareholders. Sometimes the distribution is made on a pro rata basis, and sometimes it is not.

That is not what occurs under the Indian demerger statute, however. Under the Indian demerger statute, Distributing's assets are automatically transferred by operation of law to a sister company that may be newly created or may be preexisting and old and cold. The shares of the company acquiring the assets of Distributing are issued directly to the shareholders of Distributing. In all events, U.S. taxpayers will want to try and structure the transaction as a divisive reorganization that qualifies under both sections 355 and 368(a)(1)(D).

This is when the U.S. concept of applying tax rules to the substance of a transaction, rather than its form, can actually help taxpayers fit a round peg (a transaction structured to qualify under the formalistic provisions of Indian law) into a square hole (the U.S. tax-free reorganization provisions). The IRS and reviewing courts have been quite good about permitting taxpayers to look beyond the formal steps undertaken solely to comply with foreign law and nevertheless qualify their transactions as tax-free transactions governed by sections 355 and 368(a)(1)(D).

For example, in Rev. Rul. 77-191,[146] the IRS stated that a transaction satisfied the requirements under sections 355 and 368(a)(1)(D) even though the transaction did not follow the standard pattern for such reorganizations in the United States. Instead, Distributing distributed one of its businesses to its shareholders in partial redemption of their shares. The shareholders immediately contributed their business to a new Controlled corporation. The IRS treated the transaction as if Distributing had transferred the business to Controlled in exchange for all of Controlled's stock, and then distributed Controlled to Distributing's shareholders. The IRS has frequently cited this revenue ruling to conclude that a transaction that, at the end of a series of steps, satisfies the elements of sections 355 and 368(a)(1)(D) should qualify under those sections as a tax-free reorganization even though extraneous steps are interposed or reordered to comply with local law.

2. Application of Section 367 Provisions

There are two separate sets of provisions that need to be considered under section 367. The first set of regulations was alluded to above regarding mergers and is found in Treas. reg. section 1.367(b)-4. These regulations should not apply to simple pro rata distributions of Controlled stock by Distributing that are not part of a larger divisive section 368(a)(1)(D) reorganization. This regulation would also not apply if neither Distributing nor Controlled were CFCs and if neither possessed section 1248 shareholders. The regulation would apply, however, to transactions that are component parts of a divisive section 368(a)(1)(D) reorganization (that is, a situation when Distributing transfers assets to Controlled and then distributes Controlled shares to Distributing's shareholders).

The second set of regulations is found in Treas. reg. section 1.367(b)-5. These provisions can apply to a section 355 distribution of a preexisting Controlled corporation. It can also apply to a divisive section 368(a)(1)(D) reorganization. In either case, the purpose of the regulation is to ensure that the section 1248(a) amount regarding the shares of Distributing and Controlled is either preserved or taxed if it cannot be preserved.

Conclusion

Investment by USMNCs into India is likely to increase substantially over time as the Indian economy expands. Taxpayers should think through the interaction of the Indian and U.S. tax rules (including the taxes on exit) before they structure their investments in India. The Indian Direct Taxes Code is currently under discussion. Intended as a reformative legislation that would rework Indian tax law, the draft bill came under criticism for the sweeping nature of changes proposed. However, it appears that the Indian Finance Ministry is working at redrafting the bill and proposes to have it enacted by April 2011.[147] ◆

[146] 1977-1 C.B. 94.

[147] This article does not discuss the provisions of the Direct Taxes Code bill, which is still under revision, rendering any form of analysis premature.