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Draconian tax code sends chill through Indian M&A

Indian regulators have long been criticised for heavy-handed meddling. Tax authorities are poised to assume the mantle of the most authoritarian among all regulators with a tax proposal that could wipe out all cross-border M&A in India. Manju Dalal reports.

The Direct Tax Code, to be implemented in India on April 1 2011, sounds harmless. The code however is putting the fear of god into M&A bankers, as it could give unfettered powers to the taxman to scrutinise every leg of an acquisition.

Market participants are also concerned that authorities are looking to make their new rules retroactive, potentially reopening cases that happened as far back as seven years.

The proposed tax code incorporates the general anti-avoidance rules (Gaar) and will assess structures used in cross-border M&A deals.

Typically, cross-border M&A transactions involves the use of tax-efficient offshore SPVs. The structure allows entities to sell assets to themselves (to the offshore vehicle) and control the price of that sale, which can also cut their tax bill.

Observers believe this regulatory approach will be subjective and will introduce a lot of uncertainties and risk to cross-border M&As involving Indian firms.

“Gaar is worded in such a way that many global acquisitions will get trapped in its purview,” said Bijal Ajinkya, head of tax practice at Nishith Desai Associates, a Mumbai-headquartered law firm.

The concerns stem from a litigation relating to Vodafone’s acquisition in March 2007 of a 67% stake in Indian cellular operator Vodafone Essar (formerly known as Hutchison Essar) for US$11.1bn.

Vodafone’s purchase of the stake from Hong Kong’s Hutchison Whampoa involved a series of agreements involving entities in tax havens such as Mauritius and Cayman Islands.

The structure involved Vodafone buying 100% of Cayman Islands-registered CGP Investments, which in turn held stakes in Mauritian and Indian entities that ultimately held the 67% stake in Vodafone Essar.

The sale and purchase agreement between Vodafone and Hutchison was with an entity outside India and therefore would be outside the jurisdiction of the Indian tax authorities.

However, Vodafone is now facing a US$2bn tax demand from the Indian authorities claiming that the tax should have been withheld at source by Vodafone as it was buying an Indian asset.

Vodafone is contesting the claim, but is not the only company facing such a demand. Tax authorities are believed to have also raised similar demands on other M&As involving E*Trade, General Electric and Aditya Birla Nuovo.

Should the Indian courts rule in favour of the tax authorities, it will open up a can of worms with around 400-odd companies that might be in a similar situation as Vodafone.

Some insurance companies such as AIG are believed to be offering insurance against such tax demands, but experts feel these are not long-term solutions.

There is also the potential conflict arising from the implementation of the Gaar provisions with the double taxation avoidance treaties that India has with 70-odd countries.

“Gaar are quite draconian rules that have not even been implemented by the US and the UK,” said a Mumbai tax consultant who deals with international taxation matters.

“The new code also attempts to tax offshore transactions, which could hypothetically result in an indirect transfer of a capital asset situated in India. It seems that the objective behind the provision is to specifically target foreign M&A having underlying Indian subsidiaries or interests,” said Ajinkya.

Currently, foreign companies only partly controlled from India are liable to pay taxes in India. However, the new tax code will force even a foreign company with indirect shareholding links with an Indian company to pay tax in India.

This might also bring share swap transactions (linked to an Indian company) between two foreign companies under the scanner. Under the existing rules gains arising out of share swaps between two parties involved in an M&A are tax exempt.

However, the new tax code proposes that such share swaps should be in accordance with the Companies Act, 1956 for the gains to be tax exempt.

Thankfully, the new tax code is in the proposal stage and the government is seeking public comment up to October 31. Should there be enough pressure and lobbying, the government might be forced to make changes, but it is not clear if the Gaar provisions will be done away with.

The proposed tax code will be placed for legislative approval before the Indian parliament in the winter session, which typically begins in the third week of November.