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OUTBOUND M&AS - Firms look out for ways to dodge the taxman

Cos consider holding firms abroad to save on tax; Bermuda, Cayman Islands and Isle of Man are seen as 'tax havens'

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TAXING ISSUES

How can double taxation on dividends be avoided?

	International holding company owns subsidiary	Indian co. directly owns subsidiary
Subsidiary profits	100	100
Tax at subsidiary (35%)	35	35
Dividend paid	65	65
Tax paid in holding co. location	*	22
Less credit for tax paid at subsidiary	na	0
Tax paid	35	57

*No taxes are due at holding company location as that country does not tax dividends received. As long as the dividends stay at the holding company, no additional taxes are due.

na: not applicable

Source: Illustrative example from Ernst & Young Pvt Ltd's outbound tax advisory group

How can capital gains tax on exit be minimized?

	EU holding company owns subsidiary	Indian co. directly owns subsidiary
Capital gain on sale of foreign subsidiary	100	100
Tax paid at holding company	0	22.44
Tax paid*	0	22.44

*Tax incidence varies by country

Source: Illustrative example from KPMG India Pvt Ltd

D eclan Gavin, partner with Ernst & Young Pvt.

Ltd's new Indian out bound tax advisory group, is in Mumbai's Oberoi Hotel lobby listening to a conversation at an adjoining table, where a man is telling five others sitting around, "We were looking to use a holding company in Cyprus and Mauritius to save taxes on this acquisition. We decided on Cyprus." Gavin takes a sip of his coffee. "You've got people making acquisitions in a hurry and there's not necessarily a lot of focus on tax," he says.

Some Indian firms have been duly paying attention to taxes as they make acquisitions abroad. And many have created or have considered creating holding firms to save on tax. "Progressive and sensible companies should treat tax planning (benefits surrounding a merger) like the proverbial icing on the cake," says Milind Sarwate, chief of human resource and strategy at consumer products firm Marico Ltd. But many company heads limit their thinking to what tax experts call "comfortable locations". And other companies, newer to the world of outbound acquisitions, don't even think about tax.

"Sometimes we have seen a tendency in India (towards) what we call, ho jayega (it will happen)," says Nishith Desai, founder and head of the international law firm, Nishith Desai Associates, which has a globalization practice.

"Without tax planning, the fundamental commercial proposition gets distorted because if you do not get the right tax credit you end up paying double the tax," says Desai.

Experts argue that as Indian firms enter the global arena, they need to manage their taxes with the same level of diligence as their competitors across the world. The fact that Indian firms are increasingly buying companies larger than themselves only makes this more important, they add.

Corus was more than twice the size of its acquirer Tata Steel Ltd and Novelis Inc. was about three-and-a-half times the size of Hindalco Industries Ltd.

To finance such deals companies usually create holding firms to access finance. "The banking system is still behind in India, particularly for crossborder acquisitions," says Desai, adding that to get finance from an Indian bank is still problematic when a firm wants to make an overseas acquisition larger than itself.

Holding firm structure When experts talk about tax planning related to outbound acquisitions, their focus is mainly on the holding firm structure. Unlike other countries, dividends paid back to India from an overseas subsidiary are hit with a tax demand for the second time, and holding firms are a way to avoid that double tax. A holding company structure can help companies reduce tax incidence on dividends, interest, capital gains and royalties or at least defer taxes. "I can invest those (profits) in world markets," says Sudhir Kapadia, head of tax at KPMG India Pvt.

Ltd. "I need not bring those directly back to India." There's always the risk that laws change in countries where the holding firms are incorporated; laws related to transfer pricing are always changing. While tax planning is part of what companies making overseas acquisitions have to do, it can't be a first step. "Tax structuring is not a matter of tax alone. It's a combination of strategy, law and tax," says Desai, who adds that firms often mistakenly assume that the law is the same as in India and other countries.

Tax consultants and lawyers often work as a team. Firms need to consider their plans to take the target company public, for example, and issues such as laws related to intellectual property rights when choosing a country where the holding firm can be based.

"The first (question) is: what is ultimately the game plan," says mergers and acquisitions (M&A) lawyer Nitin Potdar, who works with J Sagar Associates. "Whether it is to raise funds, do a leveraged buyout, or do some different kind of restructuring." Experts say companies should place greater weight on familiar countries or those in which they have offices as well as places that allow better tax treatment on debt. "Tax doesn't lead, the operational (objective) has to lead," Gavin of E&Y says. If the firm is acquiring assets, the tax discussion starts with a look at the tax and legal implications of a direct purchase, and whether the acquired company is to be structured as a branch or subsidiary. "The advantage of having a branch is that all foreign losses (which would normally be the case in the early stages of business) can be set off against Indian profits and (when the 'branch' turns prof itable) foreign taxes will be creditable in India," Desai explains.

"However, it can also expose the parent company to the liabilities of the branch. (A) Subsidiary (route) solves the liability problem to an extent but leaves foreign tax credit issues open," he adds.

If the Indian company decides against a branch, then it may look at possible locations for holding companies that will make the acquisition—the main purpose of this is to avoid double tax. Such countries fall into two categories: treaty and non-treaty countries. The latter includes Bermuda, Cayman Islands and Isle of Man, and many in this group are known as 'tax havens', which Gavin of E&Y says can have a stigma, with companies setting up holding firms here being seen as being "too aggressive".

The list of treaty countries includes the UK, Luxembourg, Switzerland, Cyprus and Mauritius. When choosing a location, experts also focus on countries that have favourable capital gains tax treatment or exemptions.

Preferred location For instance, Singapore could be the location if the acquisition itself is happening in a country that does not have dividend withholding tax.

Singapore does not tax on offshore dividend income. The Netherlands and the UK could be beneficial for European acquisitions, while Switzerland and Ireland, both countries with a strong intellectual property regime would be strong contenders for firms concerned with intellectual property.

For companies making an acquisition in the US, Cyprus might be the perfect choice for the location of the holding company as it has a tax treaty which reduces dividend withholding tax to 15% (compared with 30% for Mauritius).

Given the complexity, many companies have improved inhouse expertise on international tax. Prabal Banerji, chief financial officer at the Hinduja Group, says tax planning "has become more aggressive".

Company heads focus, however, on the more immediate taxes and less on the potential capital gains tax upon exit. India has been in the mood for buying, not selling.

"No acquisition is done only for the purpose of tax," says S.

Durgashanker, senior vicepresident of M&A at auto firm Mahindra & Mahindra Ltd. According to him, tax planning can't be the first step or the last. "But there will always be an effort to optimize taxes."