Research

Tax Issues in M&A Transactions

May 2022
Research

Tax Issues in M&A Transactions

May 2022
About NDA

We are an India Centric Global law firm (www.nishithdesai.com) with four offices in India and the only law firm with license to practice Indian law from our Munich, Singapore, Palo Alto and New York offices. We are a firm of specialists and the go-to firm for companies that want to conduct business in India, navigate its complex business regulations and grow. Over 70% of our clients are foreign multinationals and over 84.5% are repeat clients. Our reputation is well regarded for handling complex high value transactions and cross border litigation; that prestige extends to engaging and mentoring the start-up community that we passionately support and encourage. We also enjoy global recognition for our research with an ability to anticipate and address challenges from a strategic, legal and tax perspective in an integrated way. In fact, the framework and standards for the Asset Management industry within India was pioneered by us in the early 1990s, and we continue remain respected industry experts. We are a research based law firm and have just set up a first-of-its kind IOT-driven Blue Sky Thinking & Research Campus named Imaginarium AliGunjan (near Mumbai, India), dedicated to exploring the future of law & society. We are consistently ranked at the top as Asia’s most innovative law practice by Financial Times. NDA is renowned for its advanced predictive legal practice and constantly conducts original research into emerging areas of the law such as Blockchain, Artificial Intelligence, Designer Babies, Flying Cars, Autonomous vehicles, IOT, AI & Robotics, Medical Devices, Genetic Engineering amongst others and enjoy high credibility in respect of our independent research and assist number of ministries in their policy and regulatory work. The safety and security of our client’s information and confidentiality is of paramount importance to us. To this end, we are hugely invested in the latest security systems and technology of military grade. We are a socially conscious law firm and do extensive pro-bono and public policy work. We have significant diversity with female employees in the range of about 49% and many in leadership positions.
Tax Issues in M&A Transactions

Asia-Pacific:
Most Innovative Law Firm, 2016
Second Most Innovative Firm, 2019

Asia Pacific:

Deal of the Year: Private Equity, 2020

Asia-Pacific:

Asia-Pacific:

Ranked

Global Though Leader — Vikram Shroff
Thought Leaders-India — Nishith Desai, Vaibhav Parikh, Dr. Milind Antani

Fastest growing M&A Law Firm, 2018

Asia Mena Counsel: In-House Community Firms Survey:
Only Indian Firm for Life Science Practice Sector, 2018
Please see the last page of this paper for the most recent research papers by our experts.

Disclaimer

This report is a copy right of Nishith Desai Associates. No reader should act on the basis of any statement contained herein without seeking professional advice. The authors and the firm expressly disclaim all and any liability to any person who has read this report, or otherwise, in respect of anything, and of consequences of anything done, or omitted to be done by any such person in reliance upon the contents of this report.

Contact

For any help or assistance please email us on concierge@nishithdesai.com or visit us at www.nishithdesai.com

Acknowledgements

Ashish Sodhani
Ashish.Sodhani@nishithdesai.com

Ipsita Agarwalla
ipsita.agarwalla@nishithdesai.com
Contents

1. INTRODUCTION 01
   I. Merger 02
   II. Demerger 06
   III. Share Sale 08
   IV. Slump Sale 12
   V. Asset Sale 15
   VI. Comparative Analysis 17

2. TAX ISSUES IN DOMESTIC M&A 19
   I. Allotment of securities or payment of cash consideration to shareholders of amalgamating company 19
   II. Part consideration paid directly to shareholders of demerged company 20
   III. Availability of MAT credit 20
   IV. Merger of Limited Liability Partnership into a company 21

3. TAX ISSUES IN CROSS BORDER M&A 22
   I. Introduction 22
   II. Claiming Treaty Benefits: Requirements and Procedure 23
   III. Withholding Tax Obligations 24
   IV. Most favoured nation (“MFN”) clause 26
   V. Structuring Investments into India – Suitable Holding Company Jurisdictions 27
   VI. Representative Taxpayer / Assessee 30
   VII. Provisions for Cross-Border Mergers 32
   VIII. Tax Indemnities on Transfer 34

4. INDIRECT TRANSFER PROVISIONS 35
   I. Introduction 35
   II. 2015 Amendments 35
   III. Prevailing Issues 37
   IV. Current Situation 38
   V. Revocation of retroactivity of indirect transfer provisions 39

5. TAXATION OF EARN-OUT ARRANGEMENTS 41
   I. Introduction 41
   II. Issues in the Tax Treatment 41
   III. Earn-outs in Employment Agreements 41
   IV. Earn-outs as Purchase Consideration 42
   V. When will an Earn-out be Taxed? 42
   VI. Conclusion 43

6. CARRY FORWARD OF LOSSES IN M&A TRANSACTIONS 44
   I. Introduction 44
   II. Mergers (Amalgamations) 44
   III. Demergers 45
   IV. Changes in Shareholding Pattern 46
7. ESOPS AND EMPLOYEE TAXATION IN M&A

I. Introductions 48
II. Taxation of Employees 48
III. Transfer of Employees between Corporate Entities in M&A 49
IV. Extinguishment of ESOPs in Transferor Entity 49
V. Grant of ESOP in Transferee Entity 49
VI. Transition Payments 50
VII. M&A not involving Transfer of Employees 50
VIII. ESOPs granted to employees of start-ups 50
IX. Conclusion 51

8. DRAFTING TAX REPRESENTATIONS AND TAXATION OF INDEMNITY PAYMENTS

I. Introduction 52
II. Tax and Business Representations 52
III. Tax Indemnity 53

9. TAXATION OF NON-COMPETE PAYMENTS IN M&A

I. Introduction 56
II. Taxation of Non-Compete Receipts 56
III. Taxation of Non-Compete Expenditure 56
IV. Conclusion 59

10. DEPRECIATION ON GOODWILL

I. Introduction 60
II. Treatment under the ITA 60
III. Changes by Finance Act, 2021 61

11. TAX ISSUES UNDER INSOLVENCY AND BANKRUPTCY CODE

12. ANTI-ABUSE RULES TO BE CONSIDERED IN AN M&A TRANSACTION

I. Introduction 64
II. Successor Liability 64
III. Transfer Pricing Regulations and Section 56 65
IV. General Anti-Avoidance Rules 66
1. Introduction

Mergers and acquisitions (“M&A”) are a permanent feature of markets globally, and India is no exception. The nature and scale of M&A are reflective of global economic conditions, and hence prevalent trends in M&A are indicators of underlying economic causes. In India, regulatory and policy changes introduced by the government have spurred international as well as domestic M&A activity.

In the post-Covid world, M&A prospects have undergone a transformation, and found a conducive environment in the form of positive government intervention, a visibly buoyant stock market, and a relatively stable banking system. Statistically, 598 deals worth $112.8 billion were struck in India in 2021, with the highest ever record of 23 deals being valued above $1 billion. Of the aggregate, domestic M&A activity saw the highest annual volume record of 321 deals, as compared to 208 domestic deals in 2020. Inbound M&A peaked at $68.47 billion. While the UK was target nation for Indian companies for outbound M&A deals, with $2.18 billion, the US acquired up to $31.58 billion in India. The first quarter of 2022 saw M&A hitting a four-year high at $30.3 billion, with M&As involving domestic companies at $23.7 billion, domestic M&A at $12.1 billion and inbound M&As at $11.6 billion, with US acquiring 70% of the inbound M&As worth $8.2 billion.

Tax has long been a key factor governing and guiding the shape of India-focused M&A. With global changes in tax law, and paradigm shifts in global and Indian tax policy, administration and adjudication, the role of tax as a strategic planning tool in M&A is only expected to increase. Our paper – Mergers and Acquisitions - addresses legal and regulatory considerations surrounding M&A in India. In this paper, we dive deep into tax considerations relevant for India-focused M&A, which is a complex subject in itself.

The (Indian) Income tax Act, 1961 (“ITA”) contains several provisions that deal with the taxation of different categories of M&A. In the Indian context, M&A can be structured in different ways and the tax implications vary based on the structure that is adopted for a particular transaction.

The ways in which M&A transactions can be undertaken are:

i. **Amalgamation or Merger:** This entails a court-approved process whereby one or more companies merge with another company, or two or more companies merge, to form one company;

ii. **Demerger:** This entails a court-approved process whereby the business or undertaking of one company is demerged out of that company, into a resulting company;

iii. **Share Purchase:** This envisages the purchase of shares of a target company by an acquirer;

iv. **Slump Sale:** This entails a sale of a business or undertaking by a seller as a going concern to an acquirer, without specific values being assigned to individual assets; and

v. **Asset Sale:** An asset sale is another method of transfer of business, whereby individual assets or liabilities are cherry-picked by an acquirer.

---

5. This paper does not examine modes of undertaking internal restructuring such as capital reduction, and buyback. All rates of tax mentioned in this paper are exclusive of applicable surcharge and cess, unless mentioned otherwise.
In the sections that follow, we have provided further insights into each of these methods.

I. Merger

A merger of companies is typically conducted through a scheme of arrangement under Sections 230 to 232 of the (Indian) Companies Act, 2013 (“CA, 2013”), and requires approval of the National Company Law Tribunal (“NCLT”).

By notification dated December 15, 2016, the Ministry of Corporate Affairs (“MCA”) notified Section 233 of the CA, 2013 which provides for Fast Track Mergers (“FTM”). FTM is a new concept which allows for mergers without the approval of the NCLT, in case of a merger between (i) two or more small companies, (ii) a holding company and its wholly-owned subsidiary, and (iii) such other class of companies as may be prescribed. An FTM only requires approval of the shareholders, creditors, liquidator and the Registrar of Companies (“ROC”) which takes substantially lesser time than obtaining approval from the NCLT. Having said that, at the time of registration of the merger approved under FTM with the Central Government, an FTM may be converted to a regular process merger requiring the NCLT’s approval if the Central Government finds that it is against public interest, against the creditors’ interests, or if anyone else files an objection with the NCLT.

The ITA does not use the term “merger” but defines an “amalgamation” under Section 2(1B) as the merger of one or more companies with another company, or the merger of two or more companies to form a new company. For the purpose of the ITA, the merging company is referred to as the ‘amalgamating company’, and the company into which it merges, or which is formed as the result of the merger is referred to as the ‘amalgamated company’.

Recently, the SC (“SC”) has held that the outer shell of a corporate entity ceases to exist after amalgamation. The SC differentiated amalgamation from winding up of a corporate entity, based on the fact that although the outer shell of the entity is destroyed, the corporate venture continues to exist in the form of a new or the existing transferee entity.  

The ITA provides that an ‘amalgamation’ must satisfy both the following conditions:

i. All the properties and liabilities of the amalgamating company immediately before the amalgamation must become the properties and liabilities of the amalgamated company by virtue of the amalgamation; and

ii. Shareholders holding at least 3/4th in value of shares in the amalgamating company (not including shares held by a nominee or a subsidiary of the amalgamated company) become shareholders of the amalgamated company by virtue of the amalgamation.

It is only when a merger satisfies all the above conditions, that the merger will be considered an ‘amalgamation’ for the purposes of the ITA. Where a merger qualifies as an amalgamation, subject to fulfilling certain additional conditions, the amalgamation may be regarded as tax-neutral and exempt from capital gains tax in the hands of the amalgamating company and in the hands of its shareholders (discussed below). In certain circumstances, the amalgamated company may also be permitted to carry forward and set off losses and unabsorbed depreciation of the amalgamating company against its own profits.

In the context of a merger / amalgamation, Section 47 of the ITA specifically exempts the following transfers from capital gains tax:

iii. Transfer of capital assets, in a scheme of amalgamation, by an amalgamating company to the amalgamated company, if the amalgamated company is an Indian company.

---

6. PCIT vs Mahagun Realtors (P) Ltd. Special Leave Petition (C) No. 4063 of 2020.
7. Please refer to Part 6 for further details on carry forward of losses in the M&A context.
8. Section 47(vi) of the ITA.
1. Introduction

In such case, the cost of acquisition of the capital assets for the amalgamated company will be deemed to be the cost for which the amalgamating company had acquired such assets, increased by any cost of improvement incurred by the amalgamating company. Further, the period of holding of such assets by the amalgamated company (for determination of short term or long term nature of gains arising at the time of their alienation) would include the period for which the assets had been held by the amalgamating company.

iv. Transfer by a shareholder, in a scheme of amalgamation, of shares of the amalgamating company if both the conditions below are satisfied:

- The transfer is made in consideration for allotment of shares to the shareholder in the amalgamated company (except where the shareholder itself is the amalgamated company); and
- The amalgamated company is an Indian company.

For such shareholders, the cost of acquisition of shares of the amalgamated company will be deemed to be the cost at which the shares of the amalgamating company had been acquired by the shareholder; and the period of holding of the shares of the amalgamated company will include the period for which shares of the amalgamating company has been held by the shareholders.

The SC of India in Grace Collis has held that a transfer of shares of the amalgamating company constitutes an "extinguishment of rights" in capital assets and hence falls within the definition of 'transfer' under Section 2(47) of the ITA but has been specifically exempted from capital gains tax by Section 47(vii) of the ITA. Consequently, if an amalgamation does not meet the conditions of the exemption under Section 47, the transfer of shares could be regarded as a taxable transfer under the ITA.

v. Transfer of shares held in an Indian company by an amalgamating foreign company, in a scheme of amalgamation, to the amalgamated foreign company if both the conditions below are satisfied:

- At least 25% of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company. Hence, when read along with the definition of 'amalgamation' in Section 2(1B), shareholders of the amalgamating company holding 3/4th in value of shares who become shareholders of the amalgamated company must constitute at least 25% of the total number of shareholders of the amalgamated company.
- Such transfer does not attract capital gains tax in the amalgamating company's country of incorporation.

vi. Transfer of shares in a foreign company in an amalgamation between two foreign companies, where such transfer results in an indirect transfer of Indian shares. The conditions to be satisfied to avail exemption from capital gains tax liability are the same as in point (iii) above.

In both cases (iii) and (iv), the cost of acquisition of the shares for the amalgamated foreign company will be deemed to be the cost for which the amalgamating foreign company had acquired such shares, and the period of
holding of such shares by the amalgamated foreign company would include the period for which the shares had been held by the amalgamating foreign company.\textsuperscript{19}

However, there is no exemption for shareholders of the amalgamating foreign companies similar to the exemption for shareholders in case (ii) above. Based on this conspicuous absence of an exemption, read with the SC's decision in \textit{Grace Collis}, it appears that an amalgamation between foreign companies although can be tax neutral in India for the amalgamating foreign company, will result in Indian capital gains tax for the shareholders of the amalgamating foreign company.

Other considerations:

\textbf{A. Indirect Taxes}

Since a business is transferred on a 'going concern' basis under an amalgamation, the Goods and Service Tax ("GST") should not be applicable. Further, Section 18(3) of the Central Goods and Service Tax Act, 2017 ("CGST Act") in relation to availability of input tax credit provides that where there is a change in the constitution of a registered person on account of an amalgamation, the registered person shall be allowed to transfer the unutilized input tax credit in his electronic credit ledger to such amalgamated company, subject to certain conditions being met.

\textbf{B. Stamp Duty}

The Constitution of India divides the power to levy stamp duty between the Central Government and the state governments.\textsuperscript{20} The Indian Stamp Act, 1899 ("ISA") is a central enactment and states may adopt the ISA with amendments as they deem fit. For example, states like Punjab, Haryana, and the Union Territory of Delhi have adopted the ISA with or without modification, and states like Maharashtra, Kerala, Rajasthan have their own stamp acts. Stamp duty is a type of tax / levy which is paid to the government for transactions performed by way of a document or instrument under the ISA or provisions of respective state's stamp acts. Stamp duty is payable on execution of a conveyance or deed.

Applicability of stamp duty on NCLT orders sanctioning a scheme of amalgamation has been a contentious issue. While a few state acts like those of Maharashtra, Rajasthan, and Gujarat have specific entries for conveyance on merger, Delhi and some other states do not have such specific entries. The SC in \textit{Hindustan Lever}\textsuperscript{21} held that a scheme of merger sanctioned by the court (as was then required) is an ‘instrument’ and that state legislatures have the authority to levy stamp duty on such orders. The Court has held that the undertaking of the transferor company stands transferred with all its movable, immovable and tangible assets to the transferee company without any further act or deed and accordingly, the scheme of arrangement would be an ‘instrument’ under the ISA. By the said ‘instrument’ the properties are transferred from the transferor company to the transferee company, the basis of which is the compromise or arrangement arrived at between the two companies. The Delhi High Court in \textit{Delhi Towers},\textsuperscript{22} upheld the levy of stamp duty on a merger order while relying on the aforesaid SC decision. However, the Court exempted the parties ultimately, in light of specific exemptions under certain pre-Constitution era notifications, discussed below.

\begin{itemize}
  \item \textsuperscript{19} Section 2(42A), Explanation 1(b) of the ITA.
  \item \textsuperscript{20} See entries 91 of the Union List, 63 of the State List, and 44 of the Concurrent List, Seventh Schedule, read with Article 246, Constitution of India, 1950.
  \item \textsuperscript{22} \textit{Delhi Towers Ltd. v. G.N.C.T. of Delhi} (2009) 165 DLT 418.
\end{itemize}
1. Introduction

The Bombay High Court\(^{23}\) has held that a scheme of arrangement entails transfer of a going concern, and not of assets and liabilities separately. As a going concern, the value of the property transferred under a scheme of arrangement is reflected from the shares allotted to the shareholders of the transferor company under the scheme. Accordingly, under the Maharashtra Stamp Act, 1958, stamp duty payable on conveyance relating to amalgamation / demerger of companies is 10% of the aggregate market value of the shares issued or allotted in exchange or otherwise and the amount for consideration paid for such amalgamation / demerger, provided that it does not exceed (i) 5% of the total true market value of the immovable property located within the state of Maharashtra of the transferor company / transferred by the demerged company to the resulting company; or (ii) 0.7% of the aggregate of the market value of the shares issued or allotted and the amount of consideration paid for the amalgamation / demerger, whichever is higher, subject to maximum of INR 25 crores.\(^{24}\)

In Haryana, the stamp duty payable on conveyances relating to amalgamation / demerger amounting to sale of immovable property is 1.5% on the market value of the property or the amount of consideration, whichever is higher, subject to a maximum of INR 7.5 crores.\(^{25}\)

Notably, certain notifications issued in 1937, in pre-Constitution India, sought to provide relaxations on payment of stamp duty in case of certain transfers of property. Specifically, Notification No. 1 dated January 16, 1937 exempted stamp duty on transfer of property between companies limited by shares, on production of a certificate attesting to the following conditions being met:

- At least 90% of the issued share capital of the transferee company is beneficially owned by the transferor company;
- Transfer is between a parent and subsidiary company where the parent beneficially owns at least 90% of the issued share capital of the subsidiary; or
- Transfer is between two subsidiaries, at least 90% share capital of each being beneficially held by a common parent.

The aforesaid notification was superseded by Notification No. 13 dated December 25, 1937 which limited the exemption from stamp duty on instruments evidencing transfer of property in the situations enlisted above to the then Province of Delhi.

The Delhi High Court, in Delhi Towers, considered the continuing validity of the 1937 pre-Constitution notifications. It held that in view of Article 372 of the Constitution of India, the notifications continued to remain in force even after the adoption of the Constitution, even without specific laws adopting the said notifications. Resultantly, the Delhi High Court allowed the stamp duty on the amalgamation to be remitted, subject to production of a certificate as required under the 1937 notifications. This decision was not challenged by the Government of Delhi.\(^{26}\) However, post the Delhi High Court decision, the Delhi Government in 2011 has revoked the Notification No. 13 dated December 25, 1937 providing remission from stamp duty on amalgamation in Delhi.

C. Appointed date

Provisions of the CA, 2013 require that every scheme of arrangement under Sections 230 to 232 shall clearly indicate an ‘appointed date’ from which it shall be effective and the scheme shall be deemed to be effective from

---

\(^{23}\) Li Taka Pharmaceuticals Ltd. v. State of Maharashtra and Ors. AIR 1997 Bom 7.

\(^{24}\) Clause 25(da) of Schedule 1, Maharashtra Stamp Act, 1958.

\(^{25}\) The Indian Stamp (Haryana Second Amendment) Act, 2017, dated November 22, 2017.

\(^{26}\) As observed by the Delhi High Court in Delhi High Court Bar Association v. Govt of NCT of Delhi (2013) 203 DLT 129.
1. Introduction

such date and not at a date subsequent to the appointed date. The MCA has clarified that the appointed date may be a specific calendar date or may be tied to the occurrence of an event which is relevant to the scheme. The MCA further clarified that where the ‘appointed date’ is chosen as a specific calendar date, it may precede the date of filing of the application for the scheme of amalgamation in the NCLT. However, if the ‘appointed date’ is significantly ante-dated beyond a year from the date of filing, the justification for the same would have to be specifically brought out in the scheme and it should not be against public interest.

The SC in Marshall Sons & Co India Ltd., recognized that every scheme of amalgamation has to necessarily provide a date with effect from which the amalgamation shall take place. It held that while it is open to the Court (now NCLT) sanctioning the scheme to modify such date, where there is no such modification, but the scheme presented is simply sanctioned, it would follow that the date of amalgamation / transfer is the date specified in the scheme as the transfer date. It further held that pursuant to the scheme of amalgamation, the assessment of the amalgamated / transeree company must take into account the income of both the amalgamating / transferor company and amalgamated / transferee company.

Recently, the SC in Dalmia Power Ltd., upheld the validity of filing revised returns by an amalgamated company beyond the time limit prescribed under the ITA. The SC held that Section 139(5) of the ITA was not applicable to the case at hand since the revised returns were not filed because of an omission or wrong statement contained therein, but on account of the time taken to obtain sanction of the scheme of arrangement from the NCLT.

II. Demerger

A demerger must also be conducted through a scheme of arrangement under the CA, 2013 with the approval of the NCLT.

A demerger is a form of restructuring whereby one or more business ‘undertakings’ of a company are transferred either to a newly formed company or to an existing company and the remainder of the company’s undertaking continues to be vested in the first company. The consideration for such transfer will flow to the shareholders of the demerged undertaking either through issue of shares by the resulting company or other instruments (for it to qualify as a tax neutral demerger) or by way of cash.

The ITA defines a demerger under Section 2(19AA) as a transfer pursuant to a scheme of arrangement under the CA, 2013, by a ‘demerged company’, of one or more of its undertakings to a ‘resulting company’.

The ITA provides that a demerger must satisfy all the following conditions:

i. All the properties and liabilities of the undertaking being transferred by the demerged company, immediately before the demerger, become the property or liability of the resulting company by virtue of the demerger.

27. Section 232(6) of the CA, 2013.
31. The ITA defines an ‘undertaking’ to include any part of an undertaking, or a unit or a division of an undertaking or business activity taken as a whole but does not include individual assets or liabilities or any combination thereof not constituting a business activity.
32. Section 2(19AAA) of the ITA defines demerged company to mean the company whose undertaking is transferred, pursuant to a demerger, to a resulting company.
33. Section 2(41A) of the ITA defines resulting company to mean one or more companies (including 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 and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger.
1. Introduction

ii. The properties and liabilities must be transferred at their book value immediately before the demerger (excluding increase in value due to revaluation). The Finance Act, 2019 relaxed this condition by providing that it would not apply where the resulting company records the assets and liabilities at values different from the values appearing in the books of account of the demerged company, immediately before the demerger, in compliance with the Indian Accounting Standards (“Ind AS”).

iii. In consideration of the demerger, the resulting company must issue its shares to the shareholders of the demerged company on a proportionate basis (except where the resulting company itself is a shareholder of the demerged company).

iv. Shareholders holding at least 3/4th in value of shares in the demerged company become shareholders of the resulting company by virtue of the demerger. Shares in the demerged company already held by the resulting company or its nominee or subsidiary are not considered in calculating 3/4th in value.

v. The transfer of the undertaking must be on a ‘going concern’ basis.

vi. The demerger must be in accordance with additional conditions, if any, as notified by the Central Government under Section 72A (5) of the ITA.

It is only when a demerger satisfies all the above conditions, that it will be considered a ‘demerger’ for purposes of the ITA. Further, subject to fulfilling certain additional conditions, the demerger may be regarded as tax neutral and be exempt from capital gains tax in the hands of the demerged company, shareholders of the demerged company and the resulting company (discussed below). In certain circumstances, the resulting company may also be permitted to carry forward and set off the losses and unabsorbed depreciation of the demerged company against its own profits.

In the context of a demerger, Section 47 of the ITA specifically exempts the following transfers from capital gains tax liability:

i. Transfer of capital assets in a scheme of demerger from the demerged company to the resulting company, if the resulting company is an Indian company. The cost of acquisition of the capital assets for the resulting company will be deemed to be the cost for which the demerged company had acquired such assets, increased by any cost of improvement incurred by the demerged company, and the period of holding of such assets by the resulting company would include the period for which the assets had been held by the demerged company.

ii. Transfer or issue of shares by the resulting company, in a scheme of demerger, to shareholders of the demerged company if the transfer or issue is made in consideration of the demerger.

iii. Transfer of shares in an Indian company by a demerged foreign company to a resulting foreign company if both the conditions below are satisfied:

---

34. Ind AS 103 requires all business combinations within its scope to be accounted at fair value under the purchase method, excluding business combinations under common control, which are to be accounted at book value using pooling of interest method.

35. No conditions have been notified as on date.

36. Please refer to Part 6 for further details on carry forward of losses in the M&A context.

37. Section 47(vib) of the ITA.

38. Section 49(3)(iii)(e) of the ITA.

39. Section 2(42A), Explanation 1(b) of the ITA.

40. Section 47(vid) of the ITA.
1. Introduction

i. Shareholders holding at least 3/4th in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; and

ii. Such transfer does not attract capital gains tax in the country of incorporation of the demerged foreign company.\(^{41}\)

iv. Transfer of a capital asset being shares in a foreign company by the demerged foreign company to the resulting foreign company, where such transfer results in an indirect transfer of Indian shares.\(^{42}\) The conditions to be satisfied to avail exemption from capital gains tax liability are the same as specified in point (iii) above.\(^{43}\)

In both cases (iii) and (iv), the cost of acquisition of the shares for the resulting foreign company will be deemed to be the cost for which the demerged foreign company had acquired such shares,\(^{44}\) and the period of holding of such shares by the resulting foreign company would include the period for which the shares has been held by the demerged foreign company.\(^{45}\)

Since there is no exemption for transfer or issue of shares by resulting foreign companies similar to the exemption in case (ii) above, a question arises as to whether such a transfer or issue would subject the resulting foreign companies to capital gains tax in India.

Other considerations:

i. **Indirect Taxes**: Same as for amalgamation.

ii. **Stamp Duty**: Same as for amalgamation.

iii. **Appointed Date**: Same as for amalgamation.

III. Share Sale

One of the most commonly resorted to methods of acquisition is share acquisition, which involves the acquisition of the shares of the company in which the target business is vested. The entire company is sold - lock, stock and barrel. The major tax implications of share acquisitions are: (i) liability to tax on capital gains, if any, and (ii) liability under Section 56(2)(x) of the ITA, if any.

An existing shareholder may realize a gain or loss on a share transfer. The taxation of gains realized on share transfer would depend on whether such shares are held as capital assets or as stock-in-trade. In case shares are held as stock-in-trade, profits and gains from the transfer of shares will be chargeable to tax under head ‘profits and gains from business and profession’. Where the shares are held as capital assets, profits and gains arising from the transfer of the shares will be chargeable to tax under the head ‘capital gain’ according to section 45 of the ITA. Section 2(14) of the ITA defines the term ‘capital asset’ to include property of any kind held by the taxpayer, whether or not connected with his business or profession, but does not include any stock-in-trade or personal assets subject to certain exceptions. Determination of the character of investment, whether it is a capital asset or stock-in-trade has been the subject of a lot of litigation and uncertainty. The Central Board of Direct Taxes ("CBDT") has, vide circulars and notifications, laid down the following principles in respect of characterization of income arising on sale of securities:

---

41. Section 47(vic) of the ITA.
42. Please refer to Part 4 of this paper for more details on indirect transfer provisions.
43. Section 47(vicc) of the ITA.
44. Section 49(1)(iii)(e) of the ITA.
45. Section 2(42A), Explanation 1(b) of the ITA.
1. Introduction

- In respect of income arising from sale of listed shares and securities which are held for more than 12 months, the taxpayer has a one-time option to treat the income as either business income or capital gains and the option once exercised, is irreversible.\(^{46}\)

- Gains arising from sale of unlisted shares are characterized as capital gains, irrespective of the period of holding of such unlisted shares, except in cases where (i) the genuineness of the transaction is in question, (ii) the transfer is related to an issue pertaining to lifting of the corporate veil, or (iii) the transfer is made along with control and management of the underlying business. In such cases, the CBDT has stated that the Indian tax authorities would take an appropriate view based on the facts of the case.\(^{47}\)

- The CBDT has clarified that the third exception i.e. where the transfer of unlisted shares is made along with control and management of the underlying business, will not be applicable in case of transfer of unlisted shares by Category-I and Category-II Alternative Investment Funds registered with the Securities and Exchange Board of India (“SEBI”).\(^ {48}\)

A. Capital Gains

If the shares qualify as capital assets under Section 2(14) of the ITA, the gains arising upon transfer of the shares would attract capital gains tax liability. As per Section 45, capital gains tax must be assessed at the time of transfer of the capital asset, and not necessarily at the time when consideration is received by the transferor or on the date of the agreement to transfer. In other words, a taxpayer is required to pay capital gains tax with respect to the year his right to receive payment accrues, even if such payment is deferred in whole or in part.

According to Section 48 of the ITA, capital gain is computed by deducting from the consideration received on account of transfer of capital asset:

a. the amount of expenditure incurred wholly and exclusively in connection with such transfer;

b. the cost of acquisition (“COA”) of the asset; and

c. any cost of improvement of the capital asset.

Section 50CA of the ITA provides that where the sales consideration on transfer of unlisted shares is less than their fair market value (“FMV”), computed as per Rule 11UA\(^ {49}\) of the Income-tax Rules, 1962 (“ITR”), the sales consideration is deemed to be the FMV in the hands of the transferor. Section 48 of the ITA also provides that in case of long-term capital gains (“LTCG”), the COA is adjusted for inflation factors\(^ {50}\) as declared by the CBDT (“indexation benefit”). The indexation benefit is not available in certain cases being inter alia LTCG arising to a non-resident on transfer of shares an Indian company. Section 49 of the ITA provides for specific provisions for determination of COA for certain modes of acquisition and Section 55 of the ITA provides the meaning of cost of improvement and COA. Further, the COA includes the entire amount paid for the asset regardless of whether such payment is made in installments over a period of time. However, the SC in B.C. Srinivasa Setty\(^ {51}\) laid down the principle that the COA should be capable of being ascertained in order for the machinery provided in Section 48 of the ITA to apply. If such cost is not ascertainable, no capital gains tax would arise.

---

\(^{46}\) Circular No. 6 of 2016 dated February 29, 2016

\(^{47}\) Order F.No.225/11/2016/ITA.II dated May 2, 2016

\(^{48}\) Order F.No.225/12/2016/ITA.II dated January 24, 2017.

\(^{49}\) Rule 11UA prescribes primarily the net book value, where the value of immovable property is fair valued, and value of investment is computed as per Rule 11UA.

\(^{50}\) The base year for computing the indexation benefit is April 1, 2001. Accordingly, for capital assets that were acquired on or before April 1, 2001, the market value as on April 1, 2001 may be substituted for actual cost while calculating capital gains.

The rate of tax on capital gain in India would depend on (i) whether the capital gains are LTCG or short-term capital gains ("STCG"), (ii) whether the target company is a public listed company, public unlisted company or a private company, (iii) whether the transaction has taken place on the floor of the recognized stock exchange ("RSE") or by way of a private arrangement, and (iv) whether the seller is a resident or a non-resident for tax purposes. Further, in respect of a cross-border share sale, the relevant Double Taxation Avoidance Agreement ("DTAA") would determine whether capital gains are taxable in India or in the other country or both.

The general rule is that STCG arise from the transfer of a capital asset which is held for less than 3 years, while LTCG arise if the capital asset is held for more than 3 years. However, gains arising on transfer of listed shares held for more than 12 months would be classified as LTCG; in any other case, such gains would be classified as STCG. Gains arising on transfer of unlisted securities held for more than 24 months would be classified as LTCG; in any other case, such gains would be classified as STCG.

The table below sets out the rates at which capital gains are taxable under the ITA for different forms of share sales:

<table>
<thead>
<tr>
<th>Sale of listed equity shares on the floor of the RSE (Securities Transaction Tax (&quot;STT&quot;) paid)</th>
<th>Short-Term Capital Gains</th>
<th>Long-Term Capital Gains</th>
<th>Non-resident shareholder or foreign company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate of tax generally applicable to taxpayer</td>
<td>15%§</td>
<td>10% without indexation or foreign exchange fluctuation benefit</td>
<td>10% without foreign exchange fluctuation benefit</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sale of other listed securities</th>
<th>Rate of tax generally applicable to taxpayer</th>
</tr>
</thead>
<tbody>
<tr>
<td>For Individuals, as per prescribed slab rates</td>
<td></td>
</tr>
<tr>
<td>For Domestic Companies, 15% to 30% as applicable</td>
<td></td>
</tr>
<tr>
<td>For Foreign Companies, 40%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sale of unlisted securities</th>
<th>Rate of tax generally applicable to taxpayer</th>
</tr>
</thead>
<tbody>
<tr>
<td>For Individuals, as per prescribed slab rates</td>
<td></td>
</tr>
<tr>
<td>For Domestic Companies, 15% to 30% as applicable</td>
<td></td>
</tr>
<tr>
<td>For Foreign Companies, 40%</td>
<td></td>
</tr>
</tbody>
</table>

Section 115AD of the ITA provides special rates for Foreign Portfolio Investors ("FPIs"), in respect of capital gains arising to FPIs from transfer of securities. While the rate of tax for LTCG remains the same, under Section 115AD of the ITA, LTCG arising from transfer of listed equity shares in a company on or after April 1, 2018 and where such transfers are liable to STT on acquisition and transfer, are taxable at 10%, where such capital gains exceed INR 0.1 million. Taxpayers have been granted the benefit of step up of COA based on fair value of listed equity shares as on January 31, 2018. Further, CBDT has notified certain transactions of acquisition of equity shares (like initial public offer, offer for sale, merger, shares allotted to qualified institutional buyers, bonus issue etc.) on which the condition of payment of STT shall not apply and accordingly, LTCG on transfer of such equity shares shall be taxable at 10%.

---

52. Surcharge, and, a health and education cess at 4% on the aggregate amount of tax and surcharge applies. Rates of surcharge are:

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Foreign Companies</th>
<th>Domestic companies</th>
<th>Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to INR 5 million</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Above INR 5 million up to INR 10 million</td>
<td>Nil</td>
<td>Nil</td>
<td>10%</td>
</tr>
<tr>
<td>Above INR 10 million up to INR 20 million</td>
<td>2%</td>
<td>7%</td>
<td>15%</td>
</tr>
<tr>
<td>Above INR 20 million to INR 50 million</td>
<td>2%</td>
<td>7%</td>
<td>25%</td>
</tr>
<tr>
<td>Above 50 million to INR 100 million</td>
<td>2%</td>
<td>7%</td>
<td>37%</td>
</tr>
<tr>
<td>Above INR 100 million</td>
<td>5%</td>
<td>12%</td>
<td>37%</td>
</tr>
</tbody>
</table>

53. Section 111A of the ITA.

54. Section 112A of the ITA. LTCG arising from transfer of listed equity shares in a company on or after April 1, 2018 and where such transfers are liable to STT on acquisition and transfer, are taxable at 10%, where such capital gains exceed INR 0.1 million. Taxpayers have been granted the benefit of step up of COA based on fair value of listed equity shares as on January 31, 2018. Further, CBDT has notified certain transactions of acquisition of equity shares (like initial public offer, offer for sale, merger, shares allotted to qualified institutional buyers, bonus issue etc.) on which the condition of payment of STT shall not apply and accordingly, LTCG on transfer of such equity shares shall be taxable at 10%.

55. Ibid.

56. Ibid.

57. Ibid.

58. Ibid.

59. Ibid.
STCG is taxable at 30% for FPIs (except STCG from sale of listed equity shares on the floor of the RSE where STT is paid – taxable at 15%).

B. Section 56

Section 56(2)(x) provides that where any person receives any property, other than immovable property, including shares of a company, without consideration, or for a consideration which is less than the FMV (computed as per Rule 11UA of the ITR) of the property by an amount exceeding INR 50,000, the differential between the FMV and the consideration is taxable in the hands of the recipient under head ‘income from other sources’ ("IOS").

The rate at which such income will be taxable depends on the tax status of such person:

- In case of an individual: Taxable at the applicable slab rate for such individual;
- In case of domestic corporates: Corporate tax rate ranging from 15% to 30% as applicable;
- In case of Indian firm: 30%; and
- In case of foreign company: 40%.

Other considerations:

i. Securities Transaction Tax

If the sale of shares takes place on the floor of an RSE in India, STT is levied on the turnover from share sale. In the case of intraday sales, STT at the rate of 0.025% is payable by the seller, while in the case of delivery-based sales, STT at the rate of 0.10% is payable by the seller.

ii. Indirect Taxes

GST is not applicable on sale of shares as ‘securities’ are specifically excluded from the definition of ‘goods’ and ‘services’ under the CGST Act.

iii. Stamp Duty

Transfers of shares in a company are liable to stamp duty at the rate of 0.25% of the value of the shares when held in physical form. However, as per the amendment made by the Finance Act, 2019 with effect from July 1, 2020, transfer of shares is liable to stamp duty at the rate of 0.015% on the value of shares transferred. Earlier, no stamp duty was levied in case the shares were held in an electronic (dematerialized) form with a depository (and not in a physical form). However, the Finance Act, 2019 also amended to limit such exemption to transfer of securities from a person to a depository or from a depository to a beneficial owner.

---

60. Where the total turnover or gross receipt of a domestic company in previous year 2018-19 does not exceed INR 400 crores, corporate tax is applicable at rate of 25%, otherwise 30%. Further, the Taxation Laws (Amendment) Ordinance, 2019 made changes to corporate tax rates under the ITA whereby existing domestic companies and new manufacturing companies have been provided an option to pay tax at concessional rates of 22% / 15% respectively, subject to fulfillment of certain conditions.
IV. Slump Sale

A ‘slump sale’ is defined under the ITA as transfer of one or more undertakings by any means for a lump sum consideration, without assigning values to individual assets or liabilities (definition of slump sale has been amended by Finance Act, 2021 – please refer the discussion below). ‘Undertaking’ has been defined to include an undertaking, or a unit or a division of an undertaking or business activity taken as a whole. However, undertaking does not mean a combination of individual assets which would not constitute a business activity in itself.

The ITA states that gains arising from a slump sale shall be subject to capital gains tax in the hands of the transferor in the year of the transfer. In case the transferor held the undertaking for a period of 36 (thirty-six) months or more, the gains would be taxable as LTCG, otherwise as STCG.

The amount subject to capital gains tax shall be the full value of consideration (“FVC”) for the slump sale less the ‘net worth’ of the undertaking, which has been defined to mean the aggregate value of the assets of the undertaking less the value of liabilities of the undertaking. The value of the assets and liabilities to be considered for the computation is the depreciated book value of such assets or liabilities, with certain exceptions. The Finance Act, 2021 brought about an amendment which provides that the FVC shall be deemed to be the FMV of the undertaking to be determined as per prescribed rules.

What constitutes ‘slump sale’?

In light of the definition of slump sale in the ITA, and judicial interpretation of this definition over the years, the following are considered the fundamental requirements to qualify as a slump sale:

i. **Transfer by any means**: The erstwhile definition of slump sale under the ITA covered a transfer by way of ‘sale’ under the ambit of slump sale and not a transfer by any other mode. In R.R. Ramakrishna Pillai, the SC confirmed that transfer of an asset for consideration other than for monetary consideration is an exchange and not a sale. The Delhi High Court, in SREI Infrastructure Finance Ltd, held that on the transfer of business in exchange of another asset, there is indeed a monetary consideration which is being discharged in the form of shares. The Delhi High Court further held that it would not be appropriate to construe and regard the word ‘slump sale’ to mean that it applies to ‘sale’ in a narrow sense and as an antithesis to the word ‘transfer’ as used in Section 2(47) of ITA. However, a contrary view was taken by the Bombay High Court in Bharat Bijlee Limited where it has held that for any transaction to be considered a ‘slump sale’, an essential element is that the transfer of the undertaking must be for cash consideration.

This position has been clarified post the amendment by the Finance Act, 2021 which replaced the words “undertaking as a result of sale” with “undertaking, by any means” in the definition of slump sale. The amendment broadens the scope of slump sale to include transfer (as defined under section 2(47) of the ITA) of one or more undertakings by any means and effectively overturning the decision of Delhi High Court in case of Bharat Bijlee Limited.

---

61. Section 2(42C) of the ITA.
62. Explanation 1 to Section 2 (19AA).
63. Section 50B of the ITA.
64. Explanation 1 to Section 50B of the ITA.
65. Rule 11UAE of the ITR
66. CIT v. R.R. Ramakrishna Pillai (1967) 66 ITR 725 SC.
1. Transfer of an undertaking: The continuity of business principle also assumes that all assets and liabilities of the concerned undertaking are transferred under the sale. This view has been upheld by the SC, whereby it held that an ‘undertaking’ was a part of an undertaking / unit / business when taken as a whole. Additionally, the ‘net worth’ of the undertaking being transferred considers the book value of the liabilities to be reduced from the aggregate amount of assets of the undertaking, emphasizing the requirement of transferring liabilities.

While an essential element of a ‘slump sale’ is that the assets and liabilities of the undertaking are transferred to ensure continuity of business, for a transaction to be characterized as a ‘slump sale’, it is not essential that all assets are transferred. The Punjab and Haryana High Court has held that it is not essential that all assets are transferred for a transaction to qualify as a slump sale. Even if some assets of the transferor are retained by it, and not transferred to the transferee, the transaction may still retain the characteristic of a slump sale. However, for a transfer to be considered a slump sale, what is crucial is that the assets (along with the liabilities) being transferred forms an ‘undertaking’ in itself, and can function ‘without any interruption’, i.e. as a going concern as discussed below. This understanding of the term ‘undertaking’ is equally applicable to demergers.

iii. Transfer as a going concern: The Bombay High Court while dealing with the concept of ‘slump sale’ generally, clarified that one of the principle tests for determination of whether a transaction would be a ‘slump sale’ is whether there is continuity of business. Thus, the concept of ‘going concern’ is one of the most important conditions to be satisfied when analyzing whether a transaction can be regarded as a slump sale. This view has also been upheld by the Punjab and Haryana High Court.

iv. Lump-sum consideration: The consideration for the slump sale must be a lump-sum figure without attributing individual values to the assets and liabilities forming part of the transferred undertaking.

Another important aspect of a slump sale is that the gains arising from the sale of an undertaking (if any) shall be computed as LTCG, if the undertaking as a whole has been held for a period of 36 months, irrespective of the fact that some of the assets may have been held for a period of less than 36 months. The substance, not the form of a slump sale transaction is to be examined. In cases where the entire undertaking has been transferred under different agreements, the Income Tax Appellate Tribunal (“ITAT”), Mumbai has held that the same would constitute a slump sale.

Valuation rules for computation of FVC for slump sales:

CBDT has prescribed valuation rules for determination of FVC for slump sale under Rule 11UAE of the ITR (“Valuation Rules”). The Valuation Rules provide two methods for determining the FVC as on the date of slump sale and the higher of the two shall be considered to be the FVC.

a. Book value based formula: Broadly under this method, the FVC is a function of the book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) as reduced by the book value of all the liabilities.

---

73. Mahindra Engineering & Chemical Products Ltd. v. ITO [2012] 51 SOT 496 (Mum).
74. For a detailed analysis of the aforementioned decision, please see our hotline here: [https://www.nishithdesai.com/SectionCategory/33/TaxHotline/12/53/TaxHotline/4668/1.html](https://www.nishithdesai.com/SectionCategory/33/TaxHotline/12/53/TaxHotline/4668/1.html)
b. Actual consideration received: This should be a sum of the monetary and non-monetary consideration received or accrued as a result of the slump sale. The Valuation Rules also prescribe the method for computing value of the non-monetary consideration received on account of slump sale.

The Valuation Rules seek to align the rules pertaining to valuation for transfer of shares and immovable property with that of business transfers by way of slump sales, plugging the gap on the tax arbitrage opportunity that slump sales provided.

Other considerations:

**A. Indirect Tax**

There should be no GST on sale of the business as a slump sale. This is because what is being sold is the undertaking or the business on a slump sale basis, and 'business' per se does not qualify under the definition of 'good'.

**B. Stamp Duty**

Please refer to the below section on “Asset Sale”.

### Difference between slump sale and demerger

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Parameter</th>
<th>Demerger</th>
<th>Slump sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Meaning</td>
<td>A form of restructuring whereby one or more business undertakings of a company are transferred either to a newly formed company or to an existing company and the remainder of the company’s undertaking continues to be vested in the first company</td>
<td>Transfer of one or more undertaking(s) by any means undertaking(s) for a lump sum consideration, without assigning values to individual assets or liabilities on a going concern basis</td>
</tr>
<tr>
<td>2.</td>
<td>Transfer of liabilities</td>
<td>All liabilities pertaining to and apportioned to undertaking being transferred, need to be transferred to resulting company</td>
<td>All liabilities pertaining to undertaking need not be transferred, provided what is being transferred qualifies as ‘going concern’</td>
</tr>
<tr>
<td>3.</td>
<td>Sanctioning document</td>
<td>A scheme of arrangement under the CA, 2013 with approval of NCLT</td>
<td>Business transfer agreement</td>
</tr>
<tr>
<td>4.</td>
<td>Form of consideration</td>
<td>Consideration for demerger flows to shareholders of the demerged undertaking either through issuance of shares by the resulting company or other instruments (for it to qualify as a tax neutral demerger) or by way of cash</td>
<td>Cash / non-cash consideration may be received by the seller (to be determined as per the Valuation Rules)</td>
</tr>
<tr>
<td>5.</td>
<td>Capital gains tax implications</td>
<td>No capital gains tax for demerger meeting conditions of ‘tax neutral’ demerger under Section 2 and Section 47 of ITA</td>
<td>Gains arising from slump sale subject to capital gains tax in hands of transferor in year of transfer; Capital gains computed as difference between sale consideration and net-worth of undertaking</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>LTG in case undertaking held for more than 36 months prior to transfer</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>STCG in case undertaking held than less than 36 months prior to transfer</td>
</tr>
<tr>
<td>6.</td>
<td>Carry forward of business losses</td>
<td>Allowed, if conditions under Section 72A(4) satisfied</td>
<td>Not allowed</td>
</tr>
<tr>
<td>7.</td>
<td>Carry forward of Minimum Alternate Tax (“MAT”) Credit</td>
<td>Allowed by Courts on pro rata basis, only qua demerged undertaking</td>
<td>Not allowed</td>
</tr>
</tbody>
</table>
### V. Asset Sale

An asset sale is an itemized sale or piece-meal sale of identified assets of a company. As compared to a slump sale, an asset sale offers the seller/buyer the flexibility to cherry pick assets or liabilities to be transferred depending on commercial considerations. The buyer pays for each asset separately which is accounted for in that manner in the books of the seller.

In an itemized sale of assets, for determining taxability of capital gains, a distinction is drawn between depreciable and non-depreciable assets.

#### A. Non-depreciable Assets

Assets which are not held for the purpose of business use on which depreciation is not available under Section 32 of ITA are considered non-depreciable assets and capital gains on such assets is calculated as per Sections 45 and 48 of the ITA.

Accordingly, on sale of a non-depreciable asset, the COA of the asset should be reduced from the sale consideration received for the asset. Each asset is assigned a value, and the consideration for such asset is also determined. The gains from the sale of each asset is determined and the transferor is liable to capital gains tax on the gains (if any) from the sale of each asset. Further, whether the sale would result in STCG or LTCG would need to be analyzed individually depending on the holding period for each asset by the transferor. Accordingly, it may be possible that certain assets result in STCG, while some result in LTCG, despite being sold as part of the same transaction.

#### B. Depreciable Assets

Section 50 of the ITA provides for computation of capital gains in case of depreciable assets i.e. assets inter-alia being building, plant or machinery etc. on which depreciation is available under Section 32 of the ITA.

The manner of computation based on whether the Block of Asset\(^75\) (“Block”) from which the asset is transferred in an itemized sale ceases to exist post transfer or continues to exist.

- **i. Capital gain where Block continues to exist post-transfer**

  Capital gains from the transfer would be deemed to be STCG and should be taxable in hands of transferor at the applicable tax rate, irrespective of the period of holding of such asset.

  The capital gains will be determined as the difference, if any, between (1) the sale consideration from the transfer of the concerned assets, together with the transfer of any other asset within that block in the same financial year, and (2) the aggregate of:\(^76\)

\(^75\) ‘Block of assets’ is defined in Section 2(11) of the ITA as a group of assets falling within a class of assets in respect of which the same percentage of depreciation is prescribed. Such block of assets may comprise of (a) tangible assets such as buildings, machinery, plant or furniture; (b) intangible assets such as know-how, patents, copyrights etc.

\(^76\) Section 50(1) of the ITA.
1. Introduction

i. Expenditure incurred in connection with such transfers;

ii. Written Down Value ("WDV") of the Block at the beginning of the financial year; and

iii. Actual cost of any asset acquired during that year and forming part of that Block.

If the sale consideration does not exceed the aggregate of the above values, then no capital gain is said to have arisen from the sale of the asset even if the sale consideration exceeds its COA. In such a situation, the sale consideration is adjusted within the block and the value of the block is reduced by the amount of the sale consideration of the asset. Accordingly, due to such an adjustment the transferor should be eligible for reduced depreciation on such Block in the next financial year.

ii. Capital gain where Block ceases to exist post-transfer

Where all assets from a Block are transferred such that the Block ceases to exist, capital gain from such transfer should be deemed to be STCG and should be taxable in hands of transferor at the applicable tax rate, irrespective of the period of holding of such asset.

The capital gain from such transfer should be determined as the difference, if any, between (1) the sale consideration from the transfer of the concerned assets, together with the transfer of any other asset within that Block in the same financial year, and (2) the aggregate of:

i. WDV of the Block at the beginning of the year;

ii. Actual cost of any asset acquired during that year and forming part of that Block.

The main features of an asset sale can be best understood in contrast to the sale of an undertaking under a slump sale:

1. While in a slump sale, each asset is assigned a value for purposes of only stamp duty, etc., in case of an asset sale, each asset is considered as a separate sale and hence values are assigned to each asset. The Hyderabad ITAT, quoting multiple judgments from the SC, has held that what is important for a transaction to be an itemized sale is that each asset be assigned a value for the purpose of the transaction.77 The Hyderabad ITAT went on to state that the mere fact that values had been assigned to individual assets would not necessarily mean that the transaction is an itemized asset sale, but that it could still be regarded as a slump sale. What is essential is that the values have been assigned for the purpose of the sale of the assets.

2. As the name suggests, an asset sale does not include the transfer of liabilities of the transferor company. In some cases, all the assets of a business may be transferred, which may be required to operate the business going forward, without transferring any liabilities. In such cases while the transferred assets operate as a going concern, the transaction is an asset sale, since the liabilities are not transferred.

Other considerations:

a. Indirect Tax

GST could be applicable depending on the nature of asset sold and could be as high as 28%.

77. Section 50(2) of the ITA.
b. Stamp Duty

Stamp duty payable on transfer of assets, whether in case of an itemized sale or a slump sale, is governed by the provisions of the relevant stamp act where the document or instrument of transfer is executed / produced. For instance, in Maharashtra, the stamp duty payable on conveyance of immovable property and movable property is 5% and 3%, respectively, of the consideration paid therefor. However, since the stamp duty is payable on the instrument of transfer, no stamp duty is payable if there is no instrument effecting the transfer. For instance, if the movable tangible assets are delivered by way of physical delivery and the buyer merely acknowledges receipt of such assets by way of a ‘delivery note’, then no stamp duty is payable on such acknowledgement or receipt of assets. As regards movable assets that are intangible in nature, such as goodwill, stamp duty at the rate of 3% will need to be paid on the instrument conveying such intangible assets. If the intangible asset like goodwill is transferred by way of an instrument, such as the business transfer agreement or the asset purchase agreement, then the business transfer agreement or the asset purchase agreement will need to be stamped to the extent of at least 3% of the value of the goodwill. If there are other assets that are being conveyed by way of the business transfer agreement or the asset purchase agreement, then such instruments should be stamped to such appropriate value as may be required under the relevant stamp act. The applicable rates of stamp duty will vary on a state-by-state wise basis.

VI. Comparative Analysis

The table below provides a comparison between the various methods (discussed above) of undertaking M&A transactions.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Slump Sale</th>
<th>Share Sale</th>
<th>Asset Sale</th>
<th>Amalgamation</th>
<th>Demerger</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definition</strong></td>
<td>Transfer of one or more undertakings / businesses by any means for lump-sum consideration on a going concern basis without values being assigned to individual assets and liabilities being transferred</td>
<td>Acquisition in whole or part of the shareholding of a company from existing shareholders. Unless specifically agreed to, the seller has no continuing interest in, or obligation with respect to the assets, liabilities or operations of the business</td>
<td>The sale of the whole or part of the assets of a target to an acquirer with individual values assigned to each asset</td>
<td>Merging of one company into another company, or merging of two or more companies to form a new company under an NCLT-approved process, in compliance with Sections 230 to 232 of the CA, 2013</td>
<td>Transfer of undertaking of company to another company under an NCLT-approved process in compliance with Sections 230 to 232 of the CA, 2013</td>
</tr>
<tr>
<td><strong>Court Approval</strong></td>
<td>Not required</td>
<td>Not required</td>
<td>Not required</td>
<td>Required. Not required in case of FTM</td>
<td>Required</td>
</tr>
<tr>
<td><strong>Transfer</strong></td>
<td>All assets + liabilities pertaining to the undertaking</td>
<td>All assets + liabilities pertaining to the undertaking</td>
<td>Such assets that the parties may determine</td>
<td>All assets + liabilities of the Amalgamating the company</td>
<td>All Assets + Liabilities relatable to the undertaking being transferred</td>
</tr>
<tr>
<td><strong>Particulars</strong></td>
<td>Slump Sale</td>
<td>Share Sale</td>
<td>Asset Sale</td>
<td>Amalgamation</td>
<td>Demerger</td>
</tr>
<tr>
<td><strong>Capital Gains</strong></td>
<td>Capital gains realized on transfer of the undertaking, if held for: more than 36 months, are taxed as LTCG; less than 36 months, are taxed as STCG</td>
<td>Capital gains realized on transfer of listed shares, if held for more than 12 months is taxed as LTCG, otherwise taxed as STCG</td>
<td>For depreciable assets, manner of computation of capital gains depends on whether Block from which asset is transferred ceases or continues to exist post transfer. Nature of capital gain on transfer of depreciable assets deemed to be STCG</td>
<td>No capital gains tax for tax neutral amalgamation, and if transaction is covered under Section 47 of ITA</td>
<td>No capital gains tax for tax neutral demerger, and if transaction is covered under Section 47 of ITA</td>
</tr>
</tbody>
</table>

© Nishith Desai Associates 2022 Provided upon request only
## 1. Introduction

<table>
<thead>
<tr>
<th>Carry forward of losses</th>
<th>Not allowed</th>
<th>Permissible if change in shareholding does not exceed 49%</th>
<th>Not allowed</th>
<th>Allowed if conditions under Section 72A of ITA satisfied</th>
<th>Allowed if conditions under Section 72A of ITA satisfied</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goods and Services Tax</td>
<td>GST not applicable</td>
<td>GST not applicable</td>
<td>GST applicable; ranges between 0 to 28% depending on nature of goods</td>
<td>GST not applicable</td>
<td>GST not applicable</td>
</tr>
<tr>
<td>Stamp Duty</td>
<td>Rate is state specific</td>
<td>0.015% of the sale consideration</td>
<td>Rate is state specific</td>
<td>Rate is state specific</td>
<td>Rate is state specific</td>
</tr>
<tr>
<td>Carry forward of MAT Credit</td>
<td>Not allowed</td>
<td>Credits get transferred as entity, with all assets and liabilities, is transferred</td>
<td>No. Credits remain with transferor entity</td>
<td>Allowed by Courts</td>
<td>Allowed by Courts on pro rata basis, only qua demerged undertaking</td>
</tr>
</tbody>
</table>
2. Tax issues in Domestic M&A

Tax issues arise in domestic M&A transactions when the conditions stipulated under the ITA are not fulfilled or the tax authorities allege that such conditions are not fulfilled. Courts have interpreted the exemptions provided under section 47 of the ITA in relation to amalgamation and demerger in such cases, as discussed below.

I. Allotment of securities or payment of cash consideration to shareholders of amalgamating company

As discussed in Part 1, Section 47 exempts capital gains on transfer by shareholders, in a scheme of amalgamation, of shares of the amalgamating company if the transfer is made in consideration for allotment of shares to the shareholder in the amalgamated company. There may be instances where pursuant to an amalgamation, the shareholder of the amalgamating company may be paid cash consideration or is issued bonds or debentures or other forms of securities by the amalgamated company as consideration for transfer of shares of the amalgamating company.

A question may arise as to whether such issuances by the amalgamated company would be taxable under the ITA. The High Court of Karnataka in Master Raghuveer Trust\textsuperscript{79} inquired into this issue and held that by the process of amalgamation, shares held by the taxpayer in the amalgamating company had become valueless and the amalgamating company was struck off from the register as required under the Companies Act. Further, the taxpayer as a member of the amalgamating company was entitled to some shares, bonds, etc., from the amalgamated company. Per the Karnataka High Court, this was neither in satisfaction of its rights nor as consideration for the transfer, and hence there was no ‘transfer’ for purposes of Section 2(47) of the ITA. It is pertinent to note that the Special Leave Petition filed by the income-tax department against this decision of the Karnataka High Court was dismissed by the SC.\textsuperscript{80} The same view was upheld by the High Court of Madras in case of M. CT. M. Corp.\textsuperscript{81}

The SC in Rasiklal Maneklal,\textsuperscript{82} while considering the taxability of amalgamation held that allotment of shares to the shareholder of the amalgamating company by the amalgamated company did not amount to an exchange. Further, in relation to relinquishment of rights, the SC noted that a relinquishment takes place when the owner withdraws himself from the property and abandons his rights thereto. It presumes that the property continues to exist after the relinquishment. Upon amalgamation, the shares of the amalgamating company lose all value as that company stands dissolved. Accordingly, there can be no relinquishment as well.

However, the SC’s ruling in Grace Collis\textsuperscript{83} watered down the effect of the earlier rulings by holding that the rights of the assessee in the capital asset, being their shares in the amalgamating company, stand extinguished upon the amalgamation. There was, therefore, a ‘transfer’ of shares in the amalgamating company within the meaning of Section 2(47) of the ITA.

\textsuperscript{79}. CIT v. Master Raghuveer Trust (1985) 151 ITR 368 (Kar).
\textsuperscript{80}. CIT v. Master Raghuveer Trust SLP (C) Nos. 4570 and 4571 of 1984, dated November 26, 1990.
\textsuperscript{81}. CIT v. M.C.T.M. Corp. P. Ltd. [1996] 221 ITR 524 (Mad).
\textsuperscript{82}. CIT v. Rasiklal Maneklal [1989] 77 CTR 31 (SC).
2. Tax issues in Domestic M&A

Recently the Delhi High Court in *Nalwa Investment Ltd.*,\(^84\) held that an exchange of shares held as stock-in-trade in case of an amalgamation should be taxable under the head ‘profits and gains from business and profession’. The Delhi High Court specifically stated that the receipt of shares in the amalgamated company in exchange for shares of the amalgamating company constituted a ‘transfer’. The Court distinguished the ratio of *Rasiklal Maneklal* on the basis that it dealt with the erstwhile Income-tax Act, 1922 which did not include ‘extinguishment of shares’ as transfer and hence was not applicable in the scenario under consideration. Instead the ratio of *Grace Collis* was to be applied – where it was held that even when an exchange occurs by operation of law, it should constitute a transfer since the exchange results in ‘extinguishment of shares’ which forms a part of the definition of ‘transfer’ under section 2(47) of the ITA. As seen from the diverging views of Courts, the taxability of capital gains in case of an amalgamation that is not in strict compliance with conditions enumerated under the ITA, is not judicially settled. However, considering the dictate of the SC in *Grace Collis* categorically holding there to be a ‘transfer’ by shareholders of an amalgamating company, it appears that there is presently little room to argue that an amalgamation not in compliance with the provisions of Section 47 would not be taxable under the ITA at all.

II. Part consideration paid directly to shareholders of demerged company

In *Salora International\(^85\)* the Delhi High Court denied the applicability of the ‘income diversion principle’ and held that ‘part consideration’ for transfer of an undertaking received directly by shareholders of the demerged / transferor company under a scheme of arrangement would form part of the total consideration accruing to the demerged / transferor company for purposes of computing capital gains. The Delhi High Court while noting that the shareholders and the company are distinct legal entities, held that since title of the undertaking vested with the demerged / transferor company and not its shareholders, the demerged / transferor company would be entitled to the entire consideration for sale of the undertaking and the fact that part of the consideration was diverted to the shareholders would not absolve the demerged / transferor company from recognizing the entire consideration. It is pertinent to note that the scheme in this ruling explicitly contained a split of consideration between the shareholders of the demerged / transferor company and the demerged / transferor company itself.

Interestingly, since the case pertained to an earlier assessment year, the Delhi High Court did not specifically examine the provisions of Section 47 in the context of the demerger. While an appeal against this ruling is pending before the SC,\(^86\) income tax authorities may apply the ruling in a merger / demerger which does not comply with the tax neutrality provisions under the ITA and contend that consideration issued to shareholders of the demerged / amalgamating company is the full value of consideration receivable and hence recognizable by the demerged / amalgamating company itself.

III. Availability of MAT credit

Section 115JB of the ITA levies MAT on a company if the amount of income-tax payable under general provisions of the ITA is less than 15% of the company’s ‘book profits’. In such case, the ‘book profits’ computed are deemed to be the total income of the company and income-tax is levied thereon at 15%. However, the excess of MAT paid over normal tax liability for the year is permitted to be carried forward under Section 115JAA of the ITA for set-off in future years in which normal tax liability exceeds MAT liability (“MAT Credit”). There is no express provision

---

\(^84\) CIT v. Nalwa Investment Ltd., ITA 822, 833, 935, and 961 of 2005


\(^86\) Salora International Ltd. v. CIT [2016] 242 Taxman 474 (SC)
2. Tax Issues in Domestic M&A

in Section 115JAA which allows an amalgamated / resulting company to carry forward and claim MAT Credit which was available to the amalgamating / demerged company.\(^{87}\)

In relation to amalgamation, several ITAT decisions have allowed the carry forward and set off of MAT Credit of the amalgamating company to amalgamated company.\(^{88}\)

In the context of demerger, the Ahmedabad ITAT analyzed this issue in *Adani Gas*\(^{89}\) and allowed the transfer of MAT Credit to the resulting company on the condition that the benefit of MAT Credit would be confined on a pro rata basis only qua the demerged undertaking. Interestingly, while coming to this conclusion Ahmedabad ITAT relied upon decisions in the context of amalgamation where the amalgamating entity ceased to exist pursuant to the amalgamation, as against the case of a demerger wherein the demerged company continues to exist. Recently, the Mumbai ITAT in *TCS E-Serve International*,\(^{90}\) allowed a demerged company to continue to avail MAT Credit pertaining to its demerged SEZ units even after the demerger. The Mumbai ITAT relied on the Bombay High Court’s order sanctioning the scheme of demerger which provided that the taxes, including income-tax, paid or payable up to the appointed date shall remain only with the demerged company. In doing so, the Mumbai ITAT reiterated the accepted legal position that once a demerger scheme is sanctioned, it gets statutory recognition and would apply as ‘operation of law’ in the absence of any specific provision under the ITA.

**IV. Merger of Limited Liability Partnership into a company**

Recently, the question whether a Limited Liability Partnership (“LLP”) can be merged into a company has become much-debated. In June 2018, the Chennai bench of the NCLT sanctioned a merger of Real Image LLP with Qube Cinema Technologies Private Limited.\(^{91}\) The merger was sanctioned under Sections 230 to 232 of the CA, 2013 read with relevant rules. The Chennai NCLT invoked the casus omissus principle and sanctioned the merger on the basis that all the conditions under CA, 2013 had been fulfilled and the erstwhile Companies Act, 1956 allowed a merger of an LLP into a company. However, the Regional Director and the Registrar of Companies filed an appeal with the National Company Law Appellate Tribunal (“NCLAT”) against the order of NCLT.\(^{92}\) The NCLAT denied the application of the casus omissus principle and clarified that the only way to merge an LLP into a company is by first converting the LLP into a company under Section 366 of the CA, 2013.

While the NCLAT decision brings clarity on this issue, given that Section 47 of the ITA does not exempt the merger of an LLP into a company, capital gains arising pursuant to such a transfer should be taxable under the ITA. Having said this, the manner of computation of capital gains in such cases remains untested presently.

---

87. The ITA contains specific provisions in certain other sections (like Sections 35AB(3), 35D(5), 72A(1) etc.) to entitle an amalgamated / resulting company to claim deductions which the amalgamating / demerged company was entitled to.
89. Adani Gas Ltd. v. ACIT, ITA Nos. 2241 & 2516/ Ahd/ 2011.
90. DCIT v. TCS E-Serve International Limited, decision dated August 28, 2019, ITA No. 2779/Mum/2018.
91. In Re: Real Image LLP and Others, decision dated June 11, 2018, CF/123/CAA/2018 with TCA/157/CAA/2017;
3. Tax Issues in Cross Border M&A

I. Introduction

Tax issues arise in cross border deals when two jurisdictions seek to tax the same income or the same legal person, causing double-taxation of that income. Most countries acknowledge that double taxation acts as a disincentive for cross-border trade and activity, and therefore, with the primary objective to encourage cooperation, trade and investment, countries enter bilateral DTAA to limit their taxing rights voluntarily through self-restraint, thereby avoiding overlapping tax claims.

The availability of DTAA benefits and the ultimate tax liability often either drives or hinders the conclusion of cross border transactions. Particularly in the Indian context, where the tax administration is perceived to be aggressive and the laws are uncertain, any protection offered by a country with which India has a DTAA is important. For a buyer, it becomes important in determining whether there would be any tax withholding obligation while making a remittance to a seller.

India has been going through an overhaul of its existing investment climate. Foreign Direct Investments (“FDI”) into India from Mauritius, Singapore and Cyprus collectively amounted to more than 50% of the FDI in India. With amendments made to the DTAA with each of these countries, India appears to be changing the status quo and restricting tax benefits available to investors investing through these jurisdictions. Further, global concern on treaty abuse is also increasing as evidenced by the Base Erosion and Profit Shifting (“BEPS”) Action Plan 6 on prevention of tax treaty abuse. The Organization for Economic Co-operation and Development (“OECD”) in its final report on Action Plan 6 has recommended the adoption of the following minimum standards:

i. The inclusion of a clear statement of intent in DTAA that the countries intend to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping; and

ii. The inclusion in DTAA of any one of the following:
   a. A combined approach consisting of a Limitation of Benefits (“LoB”) rule and a principal purpose test (“PPT”);
   b. Only a PPT; or
   c. The LoB rule supplemented by specific rules targeting conduit financing arrangements.

As a result of Action Plan 15 of the BEPS project, the Multilateral Instrument (“MLI”) was brought into force on July 1, 2018 and entered into force for India on October 1, 2019. The MLI is intended to apply alongside DTAA that each country notifies as a Covered Tax Agreement (“CTA”). Article 7 of the MLI corresponds to the recommendations in Action Plan 6 mentioned above. In situations where both parties to a CTA do not choose to
apply the LoB rule (detailed or simplified), the PPT applies by default. Since few states have chosen the LoB rule, it is anticipated that the PPT will be incorporated in more than 1100 treaties.\textsuperscript{97} The PPT essentially states that if it can be reasonably concluded that obtaining benefits under DTAAAs was one of the principal purposes of any arrangement or transaction, benefits under the DTAA would be denied unless it is established that granting of such benefits is in accordance with the object and purpose of the provisions of such DTAA. Accordingly, going forward, demonstration of commercial rationale and substance will play an integral role in obtaining benefits under DTAAAs.

Additionally, the introduction of the General Anti-Avoidance Rules ("GAAR") in Indian domestic law has brought in a shift toward a ‘substance over form’ approach in India, an approach that is also reflected in other actions of the Indian government – in actively participating in the OECD’s BEPS project, recent policy changes, etc. The GAAR provisions\textsuperscript{98} enable Indian tax authorities to declare an arrangement to be an Impermissible Avoidance Arrangement ("IAA") and to determine the tax consequences by disregarding any structure, reallocating or recharacterizing income, denying treaty relief, etc. Thus clearly, the Indian GAAR permits Indian tax authorities to deny relief under DTAAAs. Having said this, it will be important to examine the interplay of the provisions of GAAR and the PPT rule under the DTAA with respect to the facts of each transaction.\textsuperscript{99}

II. Claiming Treaty Benefits: Requirements and Procedure

Under Section 90(2) of the ITA, if a non-resident is resident in a country with which India has a DTAA, they would be taxable according to the provisions of the DTAA or the ITA, whichever is more beneficial to them.

Relief under a DTAA should normally be available as long as the non-resident is a resident and a separate legal person under the laws of its country of residence and is liable to tax under its laws. Sections 90(4) and 90(5) require a non-resident claiming treaty relief to:

i. Furnish a valid Tax Residency Certificate ("TRC") issued by the government of its home country; and

ii. Provide certain additional information, as may be prescribed from time to time, in Form 10F.

At present, the following details are required to be provided by a non-resident claiming relief under a DTAA:

i. Status of the claimant i.e., individual, company, firm etc.;

ii. Nationality or country of incorporation;

iii. Claimant’s tax identification number in the country of residence and in case there is no such number, a unique number on the basis of which the claimant is identified by the Government of the country of which he claims to be a resident;

iv. Period for which the residential status, as mentioned in the TRC, is applicable; and

v. Claimant’s address outside India, during the period for which the TRC is applicable.

Typically, subject to certain exceptions, a non-resident claiming relief under a DTAA is required to furnish an income-tax return to the Indian tax authorities, where they would be required to quote their Permanent Account Number ("PAN"), which is a tax identification number issued by Indian tax authorities.

---

\textsuperscript{97} Vikram Chand (2018), The Principal Purpose Test in the Multilateral Convention: An in depth Analysis, Intertax Volume 46 Issue 1, Kluwer Law International BV.

\textsuperscript{98} Chapter X-A read with Section 144BA of the ITA; read with Rules 10U to 10UC of the ITR.

\textsuperscript{99} Please refer Part 12 of this paper for further details on GAAR.
III. Withholding Tax Obligations

Under Section 195 of the ITA, any person paying a sum to a non-resident that is chargeable to tax under the ITA (read with the applicable DTAA) would be required to withhold taxes on such sum at the appropriate rate. Such withholding is required to be made either at the time of payment or at the time of credit of income to the account of the non-resident, whichever is earlier. If the amount paid is not taxable in India, there is no requirement to withhold tax on such payments. However, if the amount paid has an element of income that is taxable in India, then even a non-resident who makes such remittance is obligated to withhold tax as per the ITA.

Further, section 194E of the ITA provides for withholding tax obligations when payments are being made to non-resident sportsmen or sports associations. In a recent SC ruling in the case of Pilcom, the court held that the obligation to withhold tax under Section 194E is not affected by the DTAA. The benefit of DTAA can be pleaded and if the case is made out, the amount in question will be refunded with interest, but this does not absolve the liability under Section 194E.

India levies withholding tax on certain types of passive income (e.g. interest, royalties, dividends etc.):

- **Dividends**: In respect of dividends paid by Indian companies till March 31, 2020, India did not levy a withholding tax and instead levied a Dividend Distribution Tax ("DDT") on the Indian company. In a landmark move, vide the Finance Act, 2020 India has abolished the DDT and reverted to the classical system of taxation of dividends in the hands of shareholders, at the applicable tax rate with a corresponding withholding liability on the Indian payer company. The regular withholding rate on dividends is 20% for non-resident shareholders, and lower rates may apply if provided for in an applicable DTAA.

- **Royalties and Fees for technical services**: The withholding tax rate on royalties and fees for technical services is 10% under the ITA, and lower rates may apply if provided for in a DTAA.

- **Interest**: The regular withholding tax rate on interest is 40% where the recipient is a foreign company. However, more beneficial rates (ranging from 0% – 20%) of withholding are available to non-resident creditors depending on the nature of the security involved, the status of the non-resident creditor etc.

India also levies a tax on capital gains arising from the transfer of an asset located in India. Historically, such capital gains tax was eliminated typically through the use of structures involving a Mauritian or Singaporean holding company, since the Indian DTAs with the aforementioned countries allocated the capital gains taxing rights exclusively to the residence country, subject to certain criteria being fulfilled (e.g., absence of a permanent establishment in India).

However, with the amendments in these DTAs, this benefit has been restricted to shares acquired prior to April 1, 2017. With the revision of the DTAs, and introduction of anti-abuse rules, courts and tribunals in India have also been challenging the availability of treaty benefits for investments dating prior to April 1,

---

100. GE India Technology Centre Ltd. v. CIT, [2010] 327 ITR 456; Vodafone International Holdings BV v. Union of India, [2012] 341 ITR 1 (SC).
102. India also levies a tax on the gains arising on the transfer of shares or an interest in a foreign company, if the share or interest derives its value substantially from assets (tangible or intangible) located in India. Please refer to Part 4 of this paper for more details on indirect transfer provisions.
103. India also levies a tax on capital gains arising from the transfer of an asset located in India. Historically, such capital gains tax was eliminated typically through the use of structures involving a Mauritian or Singaporean holding company, since the Indian DTAs with the aforementioned countries allocated the capital gains taxing rights exclusively to the residence country, subject to certain criteria being fulfilled (e.g., absence of a permanent establishment in India). However, with the amendments in these DTAs, this benefit has been restricted to shares acquired prior to April 1, 2017. With the revision of the DTAs, and introduction of anti-abuse rules, courts and tribunals in India have also been challenging the availability of treaty benefits for investments dating prior to April 1,
3. Tax Issues in Cross Border M&A

2017. Recently, the Mumbai bench of the Authority for Advance Rulings (“AAR”) in 

Bidvest104 rejected capital gains tax benefit under Article 13(4) of the India–Mauritius DTAA to a Mauritian entity, on sale of shares of an Indian joint venture company. The benefit was denied on the basis that the Mauritian entity, on the basis of facts, was shown to be a mere conduit / shell entity and hence was held to not be the beneficial owner of the shares transferred. It is pertinent to note that the AAR gave an adverse order irrespective of the fact that the investment of the Mauritian entity was grandfathered under the India-Mauritius DTAA (i.e. the investment pre-dated April 1, 2017).

In the context of the India-Mauritius DTAA, the CBDT had issued Circular No. 682 of 1994 which stated that “any resident of Mauritius deriving income from alienation of shares of Indian companies will be liable to capital gains tax only in Mauritius as per Mauritius tax law and will not have and capital gains liability in India”. The CBDT also issued Circular No. 789 of 2000 which stated that: “Wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAA accordingly”. These Circulars continue to remain in force and on this basis, the SC in Azadi Bachao Andolan105 and Vodafone International Holdings B.V 106 has held that a TRC is ample evidence of residence of an entity, for it to avail benefits of the India-Mauritius DTAA.

Despite this route, the Mauritius route has been the subject of much litigation, and more so recently. Several Indian Courts have in the past allowed taxpayers to claim benefits under the India-Mauritius DTAA basis certain principles, for example, availability of valid TRC,107 period of holding of the Indian investment,108 taxpayer not being a shell or fly-by-night company,109 etc. However, certain Courts have also taken contrary views specifically challenging the beneficial ownership of shares of the Indian company by the Mauritian taxpayer and alleging that the transaction of acquisition of shares of Indian company was a colourable device and an impermissible tax avoidance arrangement for deriving DTAA benefit.110 The Bombay High Court in Aditya Birla Nuvo,111 denied benefit under the India-Mauritius DTAA and held that the holding of shares of the Indian company by the Mauritian company was only in the capacity of a permitted transferee of its U.S. parent and the beneficial ownership of the shares vested with the parent.

In the event relief under the relevant DTAA is not available, a non-resident would be taxed on capital gains at the rate of 15% for STCG on sale of listed shares on an RSE (subject to STT) or 40% for other STCG (assuming the non-resident is a foreign company). LTCG arising from sale of listed shares on an RSE are subject to a 10% rate where the amount of gains exceeds INR 100,000 or taxed at 10% if sold outside the RSE.

LTCGs arising to non-residents on transfer of unlisted securities is taxable at 10% without indexation benefit, while LTCG arising from the transfer of any other asset are taxed at the rate of 20%. The STCG on transfer of unlisted securities is taxed at the prevailing corporate tax rates i.e. 40% in the case of foreign companies.

104. In Re: Bid Services Division (Mauritius) Ltd. [2020 (2) TML 1183]. For a detailed analysis of the aforementioned decision, please see our hotline here https://www.nishithdesai.com/information/research-and-articles/nda热线文章/aar-applies-the-look-through-approach-denies-treaty-relief-to-a-mauritian-entity-on-trans-fi.html?no_cache=1&cHash=232a09831f6ccf77b27b384c36b6af


3. Tax Issues in Cross Border M&A

**Tax Identification Number for Non-residents:** Section 206AA of the ITA, provides that where any person fails to provide his PAN to the person responsible for deducting tax at source, the latter shall be required to deduct tax at the rate of 20%, or the maximum applicable rate chargeable under the ITA, whichever is higher. Whether this provision would be applicable to a non-resident claiming treaty benefit has been the subject of much litigation, with courts holding both for and against the proposition.\(^\text{112}\) However, with effect from June 1, 2016, non-residents are permitted to furnish alternative documents and information such as a tax identification number issued by their country of residence. This benefit is applicable in respect of certain payments which include payments in the nature of interest, royalty, fees for technical services, dividends and payments on transfer of any capital asset.\(^\text{113}\) This measure ensures that needless incremental compliance burden borne by non-residents who are doing business with India is avoided.

### IV. Most favoured nation (“MFN”) clause

Several Indian tax treaties (like France, Netherlands, Switzerland etc.) have the MFN clause. The effect of an MFN clause is that one state obligates itself to its treaty partner with respect to offering it a ‘more favourable’ tax treatment (than what is set out in their own tax treaty), if such ‘more favourable’ tax treatment is offered by the first state in its tax treaty provisions with a different third state. Both, the second and the third states will need to be OECD members for the MFN to apply.

The applicability of MFN clause in Indian tax treaties has been subject to debate in recent past. The CBDT has also recently released a circular dated February 3, 2022 ("MFN Circular"), clarifying the applicability of MFN clause present in Indian tax treaties.\(^\text{114}\)

The MFN Circular was released in response to the unilateral directives issued by France, Netherlands and Switzerland, notifying that the MFN clause in the protocols to India’s tax treaties with these countries would have the effect of modifying and reducing India’s withholding rate of tax on dividends as per these treaties to 5% (if the beneficial owner of the dividend is a resident of the other state); on account of the lower 5% rate in India’s tax treaties with Slovenia, Lithuania, and Colombia (all of whom have become members of the OECD on subsequent dates after India’s treaties with France, Netherlands, and Switzerland came into effect). The MFN Circular also seemed to be a clarification from the CBDT on account of certain judgments of the Delhi High Court\(^\text{115}\) on the issue, which had ruled in favour of the taxpayer; thereby granting the reduced withholding rate (on account of the MFN clause).

The MFN Circular has clarified that the ‘more favorable’ rates on dividend taxation within India’s tax treaties with Colombia, Slovenia, or Lithuania will not be applicable to India’s treaties with France, Netherlands, and Switzerland. Concisely, the CBDT has set out the following mandatory conditions to be fulfilled for an MFN clause to apply:

\begin{align*}
a. \ & \text{The second treaty (with the third state) is entered into after the signature/entry into force (depending upon the language of the treaty) of the treaty between India and the first OECD state;}
\end{align*}

\begin{align*}
b. \ & \text{The second treaty is entered into between India and a third state which is a member of the OECD at the time of signing the treaty with it;}
\end{align*}

\begin{align*}
c. \ & \text{India limits its taxing rights in the second treaty in relation to rate or scope of taxation only in respect of relevant items of income (i.e., those items of income as set out in the MFN clause to the relevant protocol);}
\end{align*}


\(^{113}\) Rule 37BC of the ITR.

\(^{114}\) For a detailed analysis of the aforementioned decision, please see our hotline here [https://www.nishithdesai.com/SectionCategory/33/Tax-Hotline/12/53/TaxHotline/5290/1.html](https://www.nishithdesai.com/SectionCategory/33/Tax-Hotline/12/53/TaxHotline/5290/1.html)

\(^{115}\) Concentrix Services Netherlands B.V. vs. Income Tax Officer TDS & Anr W.P.(C) 9051/2020 and W.P.(C) 882/2021; Please note that a special leave petition has been admitted by the SC against this decision.
d. A separate notification is issued by India, importing the benefits of the second treaty with the first state, as required by the provisions of Section 90(1) of the ITA.

However, recently, the Pune ITAT while ruling in favour of the taxpayer allowed the benefit of the MFN clause under the India-Spain tax treaty and held that no separate notification was required to be issued to extend benefit of MFN clause in India – Spain tax treaty. The Pune ITAT while citing several judgements from the SC also held that the circulars issued by CBDT are binding only upon the tax authorities; and not binding upon the taxpayer or the judiciary. It also held that the MFN Circular can have only prospective application.

V. Structuring Investments into India – Suitable Holding Company Jurisdictions

In light of a non-resident’s ability to claim benefits under an applicable DTAA, we have highlighted some of the more beneficial jurisdictions though which investments into India are often structured. Of course, the requirement to demonstrate commercial substance is ever present, and the table below assumes eligibility to avail DTAA benefits.

<table>
<thead>
<tr>
<th>S No.</th>
<th>Parameters</th>
<th>Mauritius</th>
<th>Cyprus</th>
<th>Singapore</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Capital gains tax on sale of Indian securities</td>
<td>No local tax in Mauritius on capital gains. Till April 1, 2017, Mauritius residents were not taxed in India on gains resulting from the transfer of shares in an Indian company. After April 1, 2017 post amendment of India-Mauritius DTAA:</td>
<td>No local tax in Cyprus on capital gains derived from sale of shares. No tax on capital gains in India on alienation of shares acquired by Cypriot residents before April 1, 2017. Capital gains arising on alienation of shares acquired by Cypriot resident on or after April 1, 2017 taxable in India.</td>
<td>No local tax in Singapore on capital gains (unless characterized as business income). Till April 1, 2017, Singapore residents were not taxed in India on gains resulting from the transfer of shares in an Indian company. After April 1, 2017 post amendment of India-Singapore DTAA:</td>
<td>Generally taxable in Netherlands. No tax if Participation exemption available; else taxed as business income. May be taxable in India if – Capital gains arise on alienation of shares forming part of substantial interest (25% or more) of an Indian company, which derive value from immovable property in India.</td>
</tr>
</tbody>
</table>
### 3. Tax Issues in Cross Border M&A

<table>
<thead>
<tr>
<th>S No.</th>
<th>Parameters</th>
<th>Mauritius</th>
<th>Cyprus</th>
<th>Singapore</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>The LoB rule states that a shell / conduit company shall not be entitled</td>
<td>i. 50% of applicable Indian tax rate on capital gains arising to Singapore</td>
<td>ii. Capital gains arising on alienation of shares wherein Dutch resident holds more than 10% shares of</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>to the concessional tax rate under Article 13(3B).</td>
<td>residents from alienation of shares between April 1, 2017 to April 1, 2019, subject</td>
<td>Indian company and sale is made to Indian resident. Such capital gains would not be taxable in India if they arise</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>iii. Capital gains arising on alienation of shares acquired by Mauritian</td>
<td>to PPT and LoB rule.</td>
<td>in course of a corporate organization, reorganization, amalgamation, division</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>residents after April 1, 2019 taxable in India.</td>
<td></td>
<td>or similar transaction and the buyer or seller owns at least 10% of capital</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>of the other company.</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Withholding tax on</td>
<td>5%, if Mauritian shareholder is beneficial owner holding directly at least 10% share capital of</td>
<td>10%, if Cypriot shareholder is beneficial owner of dividends.</td>
<td>10%, if the Singaporean shareholder is a company being beneficial owner of</td>
<td>10%, if the Dutch shareholder is beneficial owner of dividends.</td>
</tr>
<tr>
<td></td>
<td>dividends</td>
<td>Indian company; otherwise 15%.</td>
<td></td>
<td>at least 25% share capital of Indian company; otherwise 15%</td>
<td></td>
</tr>
</tbody>
</table>

---

123. A shell/conduit company is defined to mean any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. Article 27A of India-Mauritius DTAA also elaborates cases wherein an entity will be deemed or will not be deemed to be a shell / conduit company.

124. Article 13(4) of India-Mauritius DTAA.

125. Article 13(4C) read with Article 24A of India-Singapore DTAA.

126. Article 24A of India-Singapore DTAA elaborates cases wherein an entity will be deemed or will not be deemed to be a shell / conduit company.

127. Article 13(5) of India-Netherlands DTAA.

128. Article 13(5) of India-Netherlands DTAA.

129. Article 10(2) of India-Mauritius DTAA.

130. Article 10(2) of India-Cyprus DTAA.

131. Article 10(2) of India-Singapore DTAA.

132. Article 10(2) of India-Netherlands DTAA.
## 3. Tax Issues in Cross Border M&A

<table>
<thead>
<tr>
<th>S No.</th>
<th>Parameters</th>
<th>Mauritius</th>
<th>Cyprus</th>
<th>Singapore</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.</td>
<td>Withholding tax on outbound interest</td>
<td>7.5%, subject to satisfaction of beneficial ownership test.133</td>
<td>10%, subject to satisfaction of beneficial ownership test.134</td>
<td>15%, subject to satisfaction of beneficial ownership test.135</td>
<td>10%, subject to satisfaction of beneficial ownership test.136</td>
</tr>
<tr>
<td>4.</td>
<td>Withholding tax on outbound royalties and fees for technical services</td>
<td>15% for royalties under DTAA.137 10% under ITA.138 10% for FTS.139 subject to satisfaction of beneficial ownership test.</td>
<td>10%, subject to satisfaction of beneficial ownership test.134</td>
<td>10%, subject to satisfaction of beneficial ownership test.135</td>
<td>10%, subject to satisfaction of beneficial ownership test.136</td>
</tr>
<tr>
<td>5.</td>
<td>MLI</td>
<td>Mauritius has not included India in its definitive notification, accordingly, India-Mauritius DTAA is not considered a CTA. In case Mauritius notifies India-Mauritius DTAA as CTA, there would be a significant change in tax positions from investments made through the Mauritius route.143</td>
<td>India-Cyprus DTAA notified as CTA. Preamble of India-Cyprus DTAA modified to include clear statement of intent. PPT to be satisfied to avail benefits.</td>
<td>India-Singapore DTAA notified as CTA. Preamble of India-Singapore DTAA modified to include clear statement of intent.</td>
<td>India-Netherlands DTAA notified as CTA. Preamble of India-Netherlands DTAA modified to include clear statement of intent. PPT to be satisfied to avail benefits.</td>
</tr>
</tbody>
</table>

---

133. Article 11(2) of India-Mauritius DTAA.
134. Article 11(2) of India-Cyprus DTAA.
135. Article 11(2)(b) of India-Singapore DTAA.
136. Article 11(2) of India-Netherlands DTAA.
137. Article 12(2) of India-Mauritius DTAA.
138. Section 115A read with 195 of the ITA.
139. Article 12A(2) of India-Mauritius DTAA.
140. Article 12(2) of India-Cyprus DTAA.
141. Article 12(2) of India-Singapore DTAA.
142. Article 12(2) of India-Netherlands DTAA.
143. From news reports, it appears that India and Mauritius may bilaterally re-negotiate the India-Mauritius DTAA to adopt the minimum standards emanating from the MLI; https://www.business-standard.com/article/markets/talks-on-to-adopt-beps-minimum-standards-in-tax-treaty-mauritius-minister-120051800772_1.html
144. The other specific tests under the LoB in Article 24A of the India-Singapore DTAA relating to shell / conduit companies not being entitled to benefits, minimum expenditure requirements etc. will continue to be applicable as they are not incompatible with the PPT.
The India-Mauritius DTAA and the India-Singapore DTAA were amended significantly in 2016. Prior to the amendments, both DTAAs exempted from Indian tax the capital gains arising to a Mauritius or Singapore tax resident, from alienation of shares of a company resident in India. Pursuant to the amendment, these capital gains were made taxable in India – doing away with a major benefit to foreign investors investing from these jurisdictions. However, the amendments ‘grandfathered’ from this revised provision investments that were made prior to April 1, 2017.

This grandfathering however would not be available in respect of equity shares issued to non-resident investors pursuant to a merger / demerger of an Indian company i.e. issue of shares of the amalgamated / resulting company. Transfer thereafter of such shares would be subject to tax in India, even if they were issued prior to April 1, 2017 pursuant to a merger or demerger. Having said this, while grandfathering benefit may not be available, the cost base and period of holding with respect to the shares of the amalgamated / resulting company would include the cost and period of holding of shares of the amalgamating / demerging company.

VI. Representative Taxpayer / Assessee

In a cross-border M&A where capital gains arise, although the person who ultimately bears the tax burden on such capital gains is the seller, the person responsible for making the payment may also be treated as a

---

145. Article 26 of India-Mauritius DTAA.
146. Article 26A of India-Mauritius DTAA.
147. Article 26 of India-Cyprus DTAA.
148. Article 27 of India-Cyprus DTAA.
149. Article 28 of India-Singapore DTAA.
150. Article 26 of India-Netherlands DTAA.
representative assessee of the seller. This requirement is independent of the requirement of the buyer to deduct tax at source ("TDS"), or the withholding tax obligations of the buyer.

Where any final tax liability falls on a non-resident, particularly a foreign company, and Indian tax authorities believe it may be difficult to recover tax from such non-resident during assessment proceedings, they may, even at the stage of deduction of TDS, proceed to recover such amounts from an agent of the non-resident by treating the agent as a representative taxpayer / assessee.

The power to treat an agent of the non-resident as a representative taxpayer and recover amounts due from the non-resident from the representative taxpayer is not limited only to TDS proceedings, and recoveries can be made even for liabilities due after the final assessment is completed. It is also legal for tax authorities to proceed against both the non-resident and their agent simultaneously so long as the recovery is made only from either one of them. The representative assessee has in turn the right to recover such amounts paid by it on behalf of the non-resident from the non-resident.

A representative assessee has been defined, inter alia, to include the "agent" of a non-resident in respect of such income of the non-resident which is deemed to accrue or arise in India.\textsuperscript{151} A representative assessee is subject to the same duties, responsibilities and liabilities as if the income were received by or accruing in favour of the representative assessee beneficially. Further, the tax can be levied upon and recovered from the representative assessee in a like manner and to the same extent as it would be leviable upon and recoverable from the person represented by the representative assessee.\textsuperscript{152} The following persons may be held to be agents of a non-resident:

a. A person employed by or on behalf of the non-resident;
b. A person that has any business connection with the non-resident;
c. A person from or through whom the non-resident receives income directly or indirectly; or
d. A trustee of the non-resident.

The above also includes any other person who, whether a resident or non-resident, has acquired by means of a transfer, a capital asset in India.\textsuperscript{153}

In this context, the term ‘business connection’ means a continuing business relationship carried on by the non-resident with a person that yields profits or gains through some activity in India.

In the landmark decision by the SC in Vodafone International Holdings,\textsuperscript{154} the Court noted that the representative assessee provisions cannot be invoked to tax the buyer entity when there is no transfer of a capital asset. Therefore, the representative assessee provisions may only be used if there is income chargeable to tax in India. Further, Courts have also held that the liability of a representative assessee under Section 161(1) of the ITA is a vicarious liability and it is co-extensive with the liability of a person represented by them.\textsuperscript{155}

\textsuperscript{151} Section 160 of the ITA.
\textsuperscript{152} Section 161 of the ITA.
\textsuperscript{153} Section 163 of the ITA.
\textsuperscript{154} Vodafone International Holdings BV v. Union of India (2012) 6 SCC 613.
\textsuperscript{155} CIT v. Duduwala & Co (1986) 53 CTR 327 (Rajasthan).
VII. Provisions for Cross-Border Mergers

The Ministry of Corporate Affairs ("MCA") has notified provisions (i.e. Section 234 of CA, 2013) for enabling cross-border mergers which are expected to operationalize corporate law provisions and processes facilitating merger/amalgamation of an Indian company with a foreign company and vice versa. The MCA has also notified Rule 25A of the Companies (Compromises, Arrangement and Amalgamation) Rules, 2016 ("Rules") to operationalize the provisions under Section 234 of the CA, 2013. In this regard, below are few relevant points in relation to cross-border mergers:

- Section 234 of the CA, 2013 read with the Rules permit the merger of a foreign company with an Indian company and the merger of an Indian company with a foreign company incorporated in specified jurisdictions after obtaining prior approval of the Reserve Bank of India ("RBI") and in compliance with the provisions of Sections 230 to 232 of the CA, 2013. Accordingly, any cross-border merger under Section 234 will have to comply with the requirements as laid down in Sections 230 to 232 (requirements applicable to domestic transactions). This will include procedural requirements such as filing an application before the jurisdictional NCLT, conducting meetings of shareholders/creditors, notification to income-tax authorities, other sectoral regulators etc., publication of advertisement in respect of the merger, etc.

- Section 234 of the CA, 2013 provides the terms and conditions of the scheme of merger. It may provide, among other things, for the payment of consideration to the shareholders of the merging company in cash, or in Depository Receipts, or partly in cash and partly in Depository Receipts.

- The transferee company/surviving entity is required to ensure valuation by a valuer who is a member of a recognized professional body in its jurisdiction and in accordance with internationally accepted principles on accounting and valuation. In this regard, a declaration is required to be submitted by the transferee company along with the application to the RBI for obtaining its approval for the merger.

Pursuant to the notification of provisions under the CA, 2013 and the Rules, the RBI has notified the Foreign Exchange Management (Cross Border Merger) Regulation, 2018 ("CBM Regulations") dealing with cross border mergers and laying down conditions for cross-border mergers from an exchange control law perspective.

The key provisions of the CBM Regulations include the following:

- Cross-border merger has been defined to mean any merger, amalgamation or arrangement between an Indian company and foreign company in accordance with the Rules notified under the CA, 2013. Cross-border merger includes inbound and outbound merger. Inbound merger means a cross-border merger where the resultant company is an Indian company. Outbound merger means a cross-border merger where the resultant company is a foreign company.

- The CBM Regulations have introduced the concept of ‘deemed approval’ wherein any cross-border merger undertaken in accordance with the conditions specified in the CBM Regulations shall be deemed to have been approved by the RBI and no separate approval will be required under the CA, 2013.

- The following conditions inter-alia must be adhered to qualify for deemed approval under the CBM Regulations:

---

3. Tax Issues in Cross Border M&A

i. In case of Inbound Mergers, the issuance or transfer of Indian / resultant company’s securities to a person resident outside India must be in consonance with the conditions in the FDI Regulations;

ii. In case of Outbound Mergers, the acquisition / holding of securities in foreign / resultant company by an Indian resident must be in consonance with the Foreign Exchange Management (Transfer or issue of Foreign Security) Regulations, 2000 or the provisions of the Liberalized Remittance Scheme, as applicable;

iii. In case of Inbound Mergers, the guarantees or borrowings from outside sources inherited by a resultant Indian company must conform to the external commercial borrowing norms or trade credit norms, as the case may be, laid down under regulations under the Foreign Exchange Management Act, 2000, (“FEMA”) within two years of such merger;

iv. In case of Outbound Mergers, the guarantees or borrowings of the Indian company which become the liabilities of the resultant company foreign shall be repaid as per the scheme sanctioned by the NCLT in terms of the Rules;

v. Impermissible assets i.e. assets that are not permitted to be held by the resultant company (Indian or foreign) under India’s foreign exchange regulations, held by the resultant company (Indian or foreign) as a consequence of the merger, must be disposed of within two years of the sanction of the scheme of amalgamation by the NCLT and the proceeds must be repatriated to India or outside India, as applicable, immediately;

vi. An office in India of the Indian / transferor company, in the case of an Outbound Merger, and an office outside India of the foreign / transferor company, in case of an Inbound Merger, shall be deemed to be a branch office (i) of a foreign company, inside India, and (ii) of an Indian company, outside India, respectively and must satisfy applicable respective regulations under FEMA.

Currently, the ITA provides for tax neutral treatment of inbound mergers only. The merger of two foreign companies involving the transfer of shares of an Indian company, is tax exempt provided that the merger satisfies the criteria for an amalgamation set out in Part 1 above, i.e. (i) at least 25% of the shareholders of the amalgamating foreign company remain shareholders in the amalgamated foreign company, and (ii) such transfer does not attract capital gains tax in the country in which the amalgamating foreign company is incorporated.159

While the operational provisions in relation to outbound merger seek to enable Indian companies to restructure / externalize their shareholdings and obtain access to foreign markets, absence of corresponding tax neutrality provisions under the ITA places outbound mergers in a disadvantageous position vis-à-vis inbound mergers. Further, risks in relation to constitution of permanent establishment of the resultant foreign company may also arise in case of outbound mergers.

While Section 234 of the CA, 2013 permits only cross-border mergers without any express mention of cross-border demergers, the ITA contains tax neutrality provisions for transfer of shares of an Indian company due to demerger between two foreign companies. As mentioned in Part 1 above, demergers involving the transfer of shares of an Indian company by a demerged foreign company to the resulting foreign company are also tax exempt provided that (i) the shareholders holding not less than 3/4th of the shares in the demerged foreign company remain shareholders in the resulting foreign company, and (ii) such transfer does not attract capital gains in the country in which the demerged foreign company is located.160

159. Section 47(via) of the ITA.
160. Section 47(vic) of the ITA.
VIII. Tax Indemnities on Transfer

Tax indemnities are a critical aspect of negotiating M&A deals. This has been discussed in greater detail in the Part 8 of this paper.

Given the adversarial nature of India's tax regime, from a commercial standpoint it becomes essential to negotiate suitable tax indemnity agreements to cover not only the actual tax that may become payable but provide for costs associated with prolonged litigation such as interests, penalties, advisory and litigation costs.

Traditionally, tax indemnities were negotiated for a period of 7 years, in line with the erstwhile statute of limitations under the ITA. Pertinent to note that the Finance Act, 2021 has revised the timeline for issuance of notice for income escaping assessment to 4 years from the end of the financial year in which the transfer takes place. Despite the reduction in the timeline, considering that the order for default on complying with withholding tax on payments made to residents can be made upto 7 years from the end of financial year in which payment was made, it may be possible that tax indemnities may still be negotiated for 7 years. Investors may opt for tax insurance to reduce the risk involved if ultimately any tax is liable to be paid.
4. Indirect Transfer Provisions

I. Introduction

The indirect transfer provisions were introduced in the ITA as a knee-jerk reaction to the SC’s decision in the Vodafone International Holdings.\(^{161}\) The retrospective amendments introduced by the Finance Act, 2012 effectively negated the decision of the SC wherein the Court had held that offshore transfer of shares was not liable to tax in India.

The Finance Act, 2012 retrospectively amended Section 9(1)(i) of ITA by adding Explanation 5 clarifying that an offshore capital asset would be considered to have situs in India if it substantially derived its value (directly or indirectly) from assets situated in India. However, the Finance Act, 2012 did not define the word ‘substantially’. Subsequently, Finance Act, 2015 (‘FA 2015’) introduced Explanations 6 and 7 to Section 9(1)(i) to specify the situations to which Explanation 5 would apply.

II. 2015 Amendments

The FA, 2015 amendments clarified the following in relation to indirect transfer provisions:

A. Threshold for Substantiality and Valuation

Explanation 6 to Section 9(1)(i) introduced by FA, 2015 provides that a share or interest of a foreign company or entity shall be deemed to derive its value substantially from assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds INR 100 million (‘de minimis threshold’); and (ii) represents at least 50% of the value of all the assets owned by the foreign company or entity. The value of the assets shall be the FMV of such asset, without reduction of liabilities, if any, in respect of the asset.

The CBDT notified rules prescribing the method of computation of FMV of assets (Rule 11UB), computation of income attributable to such assets in India (Rule 11UC) and reporting requirements under the indirect transfer provisions (Rule 114DB).\(^{162}\) Broadly, Rule 11UB in relation to computation of FMV of assets prescribes the adding back of liabilities that were deducted while calculating the FMV through internationally accepted methods of valuation. As stated above, the indirect transfer tax should apply if the total asset value of the Indian assets is above the aforementioned thresholds without taking into account any deduction on the basis of existing liabilities. Rule 11UB prescribes separate rules and methods with respect to each asset class such as listed shares, unlisted shares, interests in a partnership and other capital assets in India and slightly different valuation rules for similar assets held abroad.

The FMV of shares of unlisted Indian companies\(^{163}\) will be as determined by a merchant banker or an accountant in accordance with any internationally accepted valuation methodology for valuation of shares on an arm’s length basis as increased by the liability, if any, considered in such determination.

---

163. Rule 11UB(3) of the ITR.
4. Indirect Transfer Provisions

The methodologies for computing the value of all the assets of a foreign entity are also prescribed in Rule 11UB.\textsuperscript{164}

Further, Rule 114DB lays responsibility on every Indian concern (whose shares are being indirectly transferred), referred to under Section 285A of the ITA to electronically furnish relevant information in Form 49D within 90 days from the end of the financial year in which any indirect transfer of asset has taken place. However, when such indirect transfer has the effect of transferring the right of management or control in relation to the Indian concern, Form 49D has to be furnished within 90 days from the date of the transaction. Rule 114DB also states that the Indian concern shall maintain details inter alia of its immediate / intermediate holding company and ultimate holding company, the holding structure of the shares of, or the interest in, the foreign company or entity before and after the transfer, information relating to the decision or implementation process of the overall arrangement of the transfer, the details of payment of tax outside India, which relates to the transfer of the share or interest etc.

B. Date for Determining Valuation

The amendments made by FA, 2015 state that typically, the end of the accounting period of the foreign entity preceding the date of transfer shall be the 'specified date' i.e. the relevant date of valuation. However, in a situation when the book value of the assets on the date of transfer exceeds by at least 15%, the book value of the assets as on the last balance sheet date preceding the date of transfer, then the specified date shall be the date of transfer.

C. Apportionment of Gains

Explanation 7 to Section 9(1)(i) introduced by FA, 2015 provides inter alia that the gains arising on transfer of a share or interest deriving, directly or indirectly, its value substantially from assets located in India will be taxed on a proportional basis based on the assets located in India vis-à-vis global assets. Rule 11UC provides for the determination of income attributable to assets in India. Essentially, Rule 11UC provides for apportionment of income from indirect transfer basis the ratio between the FMV of the assets located in India and FMV of all assets of the foreign entity as computed according to Rule 11UB of the ITR.

D. Exemptions

The amendments made by FA, 2015 also state that the indirect transfer provisions shall not be applicable in the following circumstances:

1. Where the transferor of shares of or interest in a foreign entity, along with its related parties does not hold (i) the right of control or management; and (ii) the voting power or share capital or interest exceeding 5% of the total voting power or total share capital in the foreign company or entity directly holding the Indian assets ("Holding Co").

2. Where the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly, then the exemption shall be available to the transferor if it, along with related parties, does not hold (i) the right of management or control in relation to such company or entity; and (ii) any rights in such company which would entitle it to either exercise control or management of the Holding Co or entitle it to voting power exceeding 5% in the Holding Co.

3. In case of business reorganization in the form of demergers and amalgamations, exemptions have been provided under Section 47 of the ITA as elaborated in Part 1 above.

\textsuperscript{164} Rule 11UB(6) of the ITR.
Between 2012 to 2016, in the absence of a statutory definition of 'substantially' under the ITA, the indirect transfer provisions were subject matter of scrutiny in several cases. Prior to the amendments by FA, 2015, these cases such as Copal Research Limited, GEA Refrigeration Technologies Gmbh, Banca Sella S.p.A., have uniformly held that 'substantially' appearing in Explanation 5 to Section 9(1)(i) of the ITA means at least 50% interest in Indian assets. Further, recently, the AAR has held that amendments made to the indirect transfer provisions by FA, 2015 are retroactive in nature. This AAR ruling provides some measure of certainty in respect of transactions consummated prior to the amendments undertaken by FA, 2015.

III. Prevailing Issues

A. Concerns for Multi-layered Structures

The indirect transfer tax provisions raise critical concerns for an organization which seeks to take exposure to an Indian entity through an intermediary holding vehicle. Not only at the time of exit, but there is also a risk of taxation when cash is up-streamed by way of redemption of shares of the holding company that are held by the parent company.

The CBDT has released a circular clarifying that a distribution of dividends by an offshore company with underlying Indian assets would not result in a tax liability under Section 9(1)(i) read with Explanation 5. The operative portion of the 2015 Circular states as follows:

“Declaration of dividend by such a foreign company outside India does not have the effect of transfer of any underlying assets located in India. It is therefore, clarified that the dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets in India would not be deemed to be income accruing or arising in India by virtue of provisions of Explanation 5 to Section 9(1)(i) of the Act.”

However, there is lack of certainty over distributions that arise out of redemption of shares made from accumulated profits of the holding vehicle to the parent company. A view may be taken that redemptions should not be scrutinized under Explanation 5 of Section 9(1)(i) of the ITA since Section 2(22) of the ITA (which defines the term "dividend") includes distributions by way of any “capital reduction” and provides that “dividend” includes any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits, whether the such accumulated profits have been capitalized or not. However, this position suffers from ambiguity since Section 46A of the ITA treats purchase of its own shares by an Indian company to be a transaction that is subject to capital gains and does not consider such purchases to be a form of dividend distribution.

The CBDT issued another circular in 2017 exempting the application of indirect transfer provisions on income derived from redemption of shares or interests outside India by foreign investment funds including private equity funds and venture capital funds. The clarification resulted from concerns raised by investment funds.

---

set up as multi-tier investment structures, that the income derived in India on redemption of shares or interests could be subjected to multiple taxation on every level of the investment structure outside India. As a result of the circular, non-residents investing in multi-layered investment structures would be exempted from indirect transfer provisions on account of redemption of shares or interests outside India. However, such exemption is only available to Category I and II Alternate Investment Funds (“AIFs”) and not to Category III AIFs at present. Further, such exemption is only available if capital gains tax has been paid at the Indian level at the time when the AIF divests shares of the Indian company.

Lastly, another issue that arises in such a scenario is that the existence of indirect transfer provisions may lead to multiple incidences of taxation i.e. every instance of indirect transfer shall create a taxable transaction in India. Therefore, in a situation where there are multiple levels of transactions, the indirect transfer provisions may lead to an absurd consequence of the liability being imposed each time by the Indian revenue authorities.

B. Availability of Tax Credits

In respect of taxes paid due to the indirect transfer provisions, credit for such payment may not be available if the jurisdiction of the assessee does not recognize such payment for credit against a capital gains liability that arises out of a direct transfer of assets.

IV. Current Situation

Despite several clarifications issued by the CBDT, the indirect transfer provisions continue to remain one of the most litigated issues in India. One heavily litigated issue is the availability of DTAA benefits for indirect transfers. Recently, the AAR rejected applications made by Tiger Global International seeking a ruling on the taxability of capital gains arising on sale of shares of a Singapore entity (which derived substantial value from an Indian company) on the ground that the arrangement was a pre-ordained transaction created for the purpose of tax avoidance in India. While rejecting the applications at the admission stage, the AAR interestingly, with respect to the India-Mauritius DTAA, observed that exemption from capital gains tax on sale of shares of a company not resident in India was never intended to be provided under the original as well as the revised India-Mauritius DTAA. This case once again opens a plethora of questions with respect to availability of DTAA benefits for indirect transfer provisions.

Another landmark decision with respect to indirect transfers was issued by the Delhi ITAT in Cairn U.K. Holdings Limited. The Delhi ITAT upheld a capital gains tax levy of INR 103 billion (approximately USD 1.56 billion) against Cairn U.K Holdings Limited (“CUHL”), a wholly owned subsidiary of UK-based Cairn Energy PLC in relation to a group restructuring of Indian operating assets. Cairn India Holdings Limited (“CIHL”) was incorporated in Jersey in August 2006 as a wholly owned subsidiary of CUHL. CUHL transferred its shareholding in 9 Indian subsidiaries to CIHL in exchange for the issuance of shares of CIHL. Thereafter, Cairn India Limited (“CIL”) was incorporated in India in August 2006 as a wholly owned subsidiary of CUHL. By way of a subscription and share purchase agreement and a share purchase deed, shares constituting the entire issued share capital of CIHL were transferred to CIL, the consideration for which was paid partly in cash and partly in the form of shares of CIL. CIL then divested 30.5% of its shareholding by way of an Initial Public Offering. As a result of divesting approximately 30% of its stake in the subsidiaries and part of IPO proceeds, CUHL received approx. INR 61 billion (approximately USD 931 million). The ITAT upheld the taxability of capital gains arising due to the transaction and concluded that any income arising ‘through or from’ transfer of any property in India shall be chargeable to

4. Indirect Transfer Provisions

tax as income deemed to accrue or arise in India in terms of Section 9(1)(i) of the ITA. The Delhi ITAT considered whether the retrospective amendment to the ITA introduced by the Finance Act, 2012 was bad in law and ultra vires, but rejected this contention on the ground that the ITAT was not the appropriate forum for challenging the validity of the provisions of the ITA.

With respect to whether an amendment under the ITA can override tax treaties, the Andhra Pradesh High Court in *Sanofi Pasteur Holding SA*\(^{173}\) held that retrospective amendments to the ITA (vide the Finance Act, 2012) have no impact on the interpretation of the DTAA. The Court held that since the transaction in question fell within the purview of Article 14(5) of the India-France tax treaty, the taxing rights with respect to capital gains lay exclusively with France. Appeal by Indian tax authorities in Sanofi is presently pending adjudication before the SC.\(^{174}\)

Recently, the Mumbai ITAT in *Sofina SA*\(^{175}\) noted that while the indirect transfer provisions contained in Explanation 5 to Section 9(1)(i) of the ITA may contemplate a ‘see-through’ approach, Article 13(5) of the India-Belgium tax treaty does not permit a ‘see-through’ approach. The Mumbai ITAT noted that in the absence of a deeming fiction in the India-Belgium DTAA like the deeming fiction in Explanation 5, the said deeming fiction cannot be read into the provisions of the DTAA. Accordingly, it was held that a transfer of shares of a Singapore company which derived value from India was not taxable in India under India-Belgium tax treaty. The Mumbai ITAT placed reliance on the ruling of the Andhra Pradesh High Court in *Sanofi*. While in these rulings the courts have taken a view that indirect transfer may be protected under the relevant DTAA, the recent decision of the AAR in *Tiger Global* is contrary and does not address these decisions.

V. Revocation of retroactivity of indirect transfer provisions

The demands raised by the Indian Government under the indirect transfer tax provisions spurred investment treaty arbitration cases against India – among which are Vodafone International Holdings BV v. The Republic of India (“*Vodafone arbitration*”) and Cairn Energy Plc and CUHL v the Republic of India (“*Cairn arbitration*”). The arbitral tribunals have ruled in favour of the foreign investors against India in the Vodafone and Cairn arbitrations.

In this backdrop, the Taxation Laws (Amendment) Act, 2021 (“*Amendment Act*”) dated August 13, 2021 amended the indirect transfer provisions contained in section 9 and section 119 of the ITA.\(^{176}\) The following changes have been made pursuant to the Amendment Act:\(^{177}\)

a. **An embargo on future tax demands:** The Amendment Act provides that the indirect transfer provisions would not apply to income accruing or arising as a result of an indirect transfer undertaken prior to May 28, 2012.

The Amendment Act has added a proviso to Explanation 5 to section 9(1)(i) of the ITA for non-application of indirect transfer provisions on (i) assessments or reassessments initiated under specified sections, (ii) orders passed enhancing a tax assessment or reducing a refund and (iii) orders passed deeming a person to be an assessee-in-default for not withholding taxes in respect of indirect transfers prior to May 28, 2012.

---

175. Sofina SA v. ACIT, decision dated March 5, 2020, ITA No.7244/Mum/2018.
176. For a detailed analysis of the Amendment Act, please see our hotline here: https://www.nishithdesai.com/SectionCategory/33/Tax-Hotline/12/53/TaxHotline/4770/1.html
177. CBDT has notified the rules for implementing the amendment made by the Amendment Act through press release dated October 02, 2021.
4. Indirect Transfer Provisions

b. **Nullification of tax demands raised:** The Amendment Act also provides that demands raised for indirect transfers of Indian assets made prior to May 28, 2012 shall be nullified, subject to fulfilment of the following conditions by the person in whose case such demand has been raised:

   i. withdrawal or an undertaking for withdrawal of appeal filed before an appellate forum or a writ petition filed before a High Court or the Supreme Court of India;

   ii. withdrawal or an undertaking for withdrawal of any proceedings for arbitration, conciliation or mediation initiated by such person such as under a bilateral investment treaty; and

   iii. furnishing of an undertaking waiving their rights to seek or pursue any remedy or any claim in relation to such income whether in India or outside India

c. **Refund of amounts paid:** The Amendment Act also provides that the Government shall refund the taxes paid in cases where the application of indirect transfer provisions is being withdrawn due to fulfilment of the conditions mentioned above. However, no interest, cost or damage shall be paid by the Government on such refund of taxes.

The Amendment Act saw moves towards settlement of quite a few cases including the Revenue withdrawing its petition before the SC over taxability in the Sanofi case (as indicated in the case status on SC website).
5. Taxation of Earn-out Arrangements

I. Introduction

It is increasingly common for M&A transactions to contemplate deferred contingent payments to sellers as part of the consideration when the buyer and seller cannot agree on the value of a target company. This type of payment, or ‘earn-out’ is contingent upon the happening of certain events or the achieving of pre-set targets such as meeting a post-transaction earnings goal. Earn-out arrangements are particularly helpful when the target company is an early-stage or high-growth company where value would be better represented by future performance as against historic performance. With the Government's encouragement of start-ups in India, and the steady rise in M&A activity in the country, it is important to understand the tax treatment of such earn-out arrangements.

Business and valuation models containing earn-out arrangements are prevalent practice in international M&A with investors seeking recourse to the same where promoter involvement is sought to be retained throughout the transition period or even to motivate the seller to retain customers and increase productivity even after the acquisition. However, in India, such arrangements are largely used in domestic deals since acquisition of shares by a foreign acquirer from a resident seller for a deferred consideration requires prior approval from the RBI, which in practice is not granted very often. Although there are various methods of structuring such arrangements, this restriction has made deferred consideration and earn-out covenants difficult to negotiate and implement in cross-border M&A.

II. Issues in the Tax Treatment

The tax treatment of earn-outs requires in-depth analysis using basic principles of income tax law. Various fundamental questions need to be answered, such as:

- Is the earn-out contingent upon the promoter's continued employment by the buyer or only the achievement of business targets?
- In case of the former, is an earn-out only an incentive compensation making it salary income for the purposes of Section 17 of the ITA?
- In case of the latter, is an earn-out an additional purchase price, i.e. a part of the full consideration making it taxable as capital gain in accordance with Section 45 of the ITA?
- Considering that in case of an earn-out arrangement the amount payable is unascertainable at the time of transfer, when should it be taxed?

III. Earn-outs in Employment Agreements

Earn-out arrangements are often contained in employment agreements between the company and the promoter. The AAR in Anurag Jain178 was examining one such arrangement and found that the contingent payments contemplated in a business transfer agreement had a real nexus with the employment agreement and were in

---

5. Taxation of Earn-out Arrangements

the nature of incentive remuneration for achieving a prescribed target. The AAR found that such contingent payments fell squarely under Section 17(3)(ii) of the ITA and would therefore be categorized as salary income. This decision of the AAR was subsequently affirmed by the Madras High Court.\(^\text{179}\)

IV. Earn-outs as Purchase Consideration

On the other hand, when an earn-out arrangement is not disguised as remuneration, it is to be considered as part of the full value of consideration receivable. The AAR in \textit{Moody's Analytics Inc.}\(^\text{180}\) found that since an earn-out consideration was a part of the sale consideration, it was to form part of the capital gains and the rules of taxing capital gains would be applicable.

At the same time, if consideration structured as an earn-out is not determinable at the time of transfer, the FMV of the shares on the date of transfer shall be considered the full value consideration for the purposes of the ITA.

V. When will an Earn-out be Taxed?

Besides issues arising out of ambiguity in the characterization of income, the taxation of earn-outs also sees challenges such as the year of taxability of the income or even the quantification of the deferred payment and consequent revisions to the purchase price. In other words, in case earn-out payments are not made in the future due to underperformance of the company, the capital loss so generated creates no tax benefit for the seller since the capital gain is deemed to accrue in the year of transfer of shareholding.

The question whether the entire sale proceeds including the contingent consideration receivable in three succeeding years was to be considered for the purpose of levy of capital gains was placed before the Delhi High Court in \textit{Ajay Guliya}.\(^\text{181}\) The Court, citing the SC's decision in \textit{Ashokbhai Chimanbhai},\(^\text{182}\) found that a conjoint reading of Section 45 and Section 48 of the ITA indicates that the FVC received or accruing in any year as a result of transfer of the capital asset shall be taxed in the year in which the transfer takes place irrespective of the year of accrual or receipt. The Delhi High Court also took into account the fact that there was no material on record to suggest that title to the shares would revert to the seller if the entire consideration or part was not paid. Therefore, the true nature of the transaction was determinable at the point of transfer and the adoption of a deferred payment mechanism would not detract from the chargeability of the shares when sold. Consequently, the income would accrue at the time of transfer of the shares, and the whole sale consideration would be subject to capital gains tax.

A contrary position has been adopted by the Bombay High Court in \textit{Hemal Raju Shete}.\(^\text{183}\) In this case, deferred consideration was payable to the taxpayer over a period of four years and the agreement was clear in providing that the deferred consideration would be dependent upon the profits made by the company concerned in each of the years. The Bombay High Court, relying on the SC decisions in \textit{Morvi Industries}\(^\text{184}\) and \textit{E.D. Sassoon}\(^\text{185}\) found that the amount sought to be taxed was the maximum amount receivable by the taxpayer and not an assured consideration to be received. Therefore, the amount sought to be taxed did not meet the test of accrual i.e. whether

\(^{180}\) In Re: Moody’s Analytics Inc, USA (2012) 24 taxmann.com 41 (AAR).
\(^{181}\) Ajay Guliya v. ACIT [2012] 209 Taxman 295 (Delhi).
\(^{184}\) Morvi Industries Ltd. v. CIT [1971] 82 ITR 835 (SC).
there was a right to receive the amount, though later, and whether such right was legally enforceable. The Bombay High Court held that the whole amount could not be said to have accrued to the taxpayer as it was not certain if she would be entitled to the maximum amount and therefore could not be taxed in the assessment year of transfer.

Another common practice in M&A transactions is the usage of escrow accounts to provision for contingent liabilities of the target company or the seller. Taxability of amounts deposited in escrow account (including timing of taxation) has been frequently litigated.

Recently, the High Court of Madras in case of held that the amount parked in the escrow account will be treated as accrued income and hence will be taxed under section 45 of the ITA. The High Court of Madras while arriving at this conclusion noted that the taxpayer actually received the full consideration (including the amount deposited in the escrow account) without any deduction of liabilities envisaged under the agreement. In relation to the timing, the Madras High Court held that the entire amount had accrued to the taxpayer upon execution and thus was subject to tax in the same year itself. In a slightly different scenario, the Bombay High Court held amount of consideration for sale of shares deposited by the seller in an escrow account, but subsequently withdrawn by buyer from such account towards payment of contingent liabilities will be allowed to be deducted from the FVC paid to the seller for computing tax on capital gains under section 45 of the ITA. In both cases, the Courts relied on the language and intent of the share purchase agreement.

VI. Conclusion

As it currently stands, the Indian tax regime places potential liability to pay tax for the entire consideration on the sellers. This often leads to a tax outflow for the seller which is disproportionate to cash inflow. Furthermore, the tax regime provides no mechanism for recovery of tax paid in the event of reduced consideration linked to the underperformance of the business. It is important for taxpayers to carefully draft the earn-out / escrow related provisions in the relevant agreement to reduce the chances of litigation in future.

---

186. Caborandum Universal Ltd. v. ACIT [2021] 130 taxmann.com 133 (Madras)
187. Dinesh Vazirani vs PCIT & Union of India Writ Petition No. 2475 of 2015
6. Carry Forward of Losses in M&A Transactions

I. Introduction

A taxpayer may generally carry forward business losses for a period of up to eight assessment years succeeding the assessment year in which the loss was first computed.\(^{188}\) Such accumulated business losses may only be set off against the taxpayer’s business income.\(^{189}\) On the other hand, a taxpayer may generally carry forward unabsorbed depreciation indefinitely which may be set off against the taxpayer’s income arising under any head.\(^{190}\) While setting off accumulated business losses and unabsorbed depreciation, priority must be accorded to accumulated business losses.\(^{191}\)

In the context of a slump sale, accumulated losses and unabsorbed depreciation of the transferor are generally not available to the transferee (being a distinct taxpayer). In the context of an amalgamation or a demerger, as a general rule, the accumulated losses\(^{192}\) and unabsorbed depreciation\(^{193}\) of the amalgamating / demerging company may not be carried forward and set-off by the amalgamated / resulting company. However, certain provisions of the ITA provide exceptions to this rule under certain circumstances, discussed below.

Additionally, since the definition of “accumulates losses” only covers business losses, the benefits of the aforesaid provisions do not apply to capital losses of the amalgamating or demerging company, which cannot be carried forward or set off by the amalgamated or resulting company.

II. Mergers (Amalgamations)

Section 72A of the ITA provides that in case of amalgamation of a company owning an “industrial undertaking”\(^{194}\) or a hotel or a ship, with another company, the amalgamated company will be allowed to carry forward and set-off the accumulated loss and unabsorbed depreciation of the amalgamating company against its profits, if the following conditions\(^{195}\) are fulfilled:

i. The amalgamated company shall continuously hold at least 3/4th in book value of the assets acquired of the amalgamating company for a minimum period of 5 years from the date of amalgamation;

ii. The amalgamated company shall continue the business of the amalgamating company for at least 5 years from the date of amalgamation;

---

188. Section 72 of the ITA.
189. Ibid.
190. Section 32 of the ITA.
191. Section 72(2) of the ITA.
192. “Accumulated loss” means so much of the loss of the amalgamating company or the demerged company, as the case may be, under the head “Profits and gains of business or profession” (not being a loss sustained in a speculation business) which such company would have been entitled to carry forward and set off under the provisions of Section 72 of the ITA if the amalgamation or demerger had not taken place.
193. “Unabsorbed depreciation” means so much of the allowance for depreciation of the amalgamating company or demerged company which remains to be allowed and which would have been allowed to such company under the provisions of the ITA, if the amalgamation or demerger had not taken place.
194. An “industrial undertaking” has been defined under Section 72A(7)(aa) as “any undertaking which is engaged in the manufacture or processing of goods, manufacture of computer software, business of generation or distribution of electricity or any other form of power, business of providing telecommunication services, mining, and the construction of ships, aircraft or rail systems”.
195. Section 72A(2) of the ITA.
6. Carry Forward of Losses in M&A Transactions

iii. The amalgamating company should have been engaged in the business for at least 3 years during which the loss / depreciation was accumulated;

iv. The amalgamating company should have continuously held on the date of amalgamation, at least 3/4th of the book value of the fixed assets, which it had held 2 years prior to the date of amalgamation; and

v. Any other conditions which may be prescribed by the Central Government to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose. The Central Government has at present prescribed the following additional conditions:

   a. The amalgamated company shall achieve the level of production of at least 50% of the installed capacity of the industrial undertaking of the amalgamating company before the end of 4 years from the date of amalgamation and shall continue to maintain this minimum level of production till the end of 5 years from the date of amalgamation. However, it is open to the amalgamated company to make an application to the Central Government for relaxation of the above conditions having regard to genuine efforts by the amalgamated company to attain the prescribed levels of production and the attendant circumstances preventing the same.

   b. The amalgamated company is required to furnish to the Assessing Officer a certificate in the prescribed form, duly verified by an accountant, with reference to the books of account and other documents showing particulars of production, along with the return of income for the assessment year relevant to the previous year during which the prescribed level of production is achieved and for subsequent assessment years relevant to the previous year's falling within 5 years from the date of amalgamation.

In case any of the aforesaid conditions are not met, any set-off of loss or allowance of depreciation availed by the amalgamated company in any previous year will be treated as the income of the amalgamated company for the year in which the non-compliance occurs.

III. Demergers

Section 72A(4) of the ITA provides that in case of a demerger, the accumulated losses and unabsorbed depreciation directly relatable to the undertaking that is being transferred under the demerger, shall be allowed to be carried forward in the hands of the resulting company.

If the loss or unabsorbed depreciation cannot be directly attributed to the said undertaking, the same shall be apportioned between the demerged and resulting company in the same ratio in which the assets of the undertaking have been retained by the demerging company and transferred to the resulting company and shall be allowed to be carried forward and set off in the hands of the demerged company and the resulting company, as the case may be.

There is no requirement to comply with the conditions prescribed with regard to amalgamations to avail of the benefit provided under Section 72A(4). Also, the accumulated losses and unabsorbed depreciation in case of demerger are available irrespective of whether an industrial undertaking is owned by the demerging company or not.

196. Rule 9C of the ITR.
197. In Bayer Material Science P. Ltd. v. ACIT (2013) 142 ITD 22 (Mum - Trib), it was held that it was not open to the Assessing officer to raise an objection as to the non-compliance of Rule 9C(a) before completion of the fourth year from the date of amalgamation.
198. Section 72A(3) of the ITA.
IV. Changes in Shareholding Pattern

While the general rule is that a company may continue to carry forward and set off accumulated losses and unabsorbed depreciation despite a change in its shareholding pattern, in case the company is not a ‘company in which the public are substantially interested’, Section 79 of the ITA provides that the business losses of the company accumulated in any year prior to the previous year may not be carried forward and set off against income in the previous year, if on the last day of the previous year, pursuant to a change in shareholding, shares representing at least 51% of the voting power of the company are no longer beneficially held by persons who beneficially held shares representing 51% of the voting power of the company on the last day of the year in which the losses were incurred.

The basic intent of the section is to suppress the mischief of taxpayers acquiring control over a company which has incurred losses only to reduce their tax liability. The application of this section is irrespective of the mode through which the change in shareholding is affected. Hence, in addition to share purchases, Section 79 may also apply in the context of amalgamations or demergers. However, in case of eligible start-ups referred to in Section 80IAC of the ITA, the carry forward and set off provisions would be available where the existing shareholders sell their holding (but maintain 51% of voting power) or continue to hold all the shares which they were holding in the year in which the loss occurred, without satisfying the 51% condition.

However, there are certain exceptions to Section 79 i.e. situations where a company may continue to carry forward and set off accumulated losses and unabsorbed depreciation despite a change in its shareholding pattern:

- Where a change in the voting power and shareholding takes place as a result of:
  - the death of a shareholder; or
  - a gift of shares by a shareholder to a relative.

- Where there is a change in the shareholding of an Indian subsidiary of a foreign company due to the amalgamation or demerger of the foreign company, provided that 51% shareholders of the amalgamating or demerged foreign company continue to be the shareholders of the amalgamated or resulting foreign company.

- Where a change in shareholding of a company takes place pursuant to a resolution plan approved under the Insolvency and Bankruptcy Code, 2016 (“IBC”).

- Where change in shareholding of a company, its subsidiary and the subsidiary of such subsidiary has taken place pursuant to a resolution plan approved by the NCLT under the CA, 2013, in an application for relief in case of oppression or mismanagement under Section 241 of the CA, 2013.

The concept of beneficial ownership dealt with in this section has been the subject matter of disputes before Indian courts. Some decisions have allowed a company to carry forward and set off losses despite shareholders who held shares representing 51% of the voting power of the company in the year in which losses were incurred, not holding shares representing 51% of the voting power of the company in the previous year in which the losses were sought.

---

199. Defined in Section 2(18) of the ITA.
201. Section 80IAC defines ‘eligible start-up’ as a company or LLP engaged in eligible business which fulfills the following conditions, namely –
   a) it is incorporated between April 1, 2016 and April 1, 2022;
   b) the total turnover of its business does not exceed INR 1 billion in the relevant year for which the deduction is claimed; and
   c) it holds a certificate of eligible business from the Inter-Ministerial Board of Certification.
6. Carry Forward of Losses in M&A Transactions

to be set-off, since the ultimate shareholder of the company remained the same. However, other decisions have applied the bar under Section 79 despite the ultimate shareholding of the company remaining the same.

In a significant recent decision, the Bombay High Court allowed the taxpayers, three sub-funds of Aberdeen Institutional Commingled Funds, LLC ("AICFL"), a Delaware (USA) based limited liability company, to carry forward losses following a change in the legal identity of AICFL, from a trust to a limited liability company ("LLC"). While allowing the carry forward of losses, the Bombay High Court applied the *lex domicilli* principle to hold that the LLC in its trust avatar is the same entity post conversion. The Court recognized that, under conflict of laws principles, matters relating to the legal status of an entity will be determined by the law of the state of incorporation i.e. *lex domicilli* and not Indian law. The Court placed reliance on the SC's decision in *Technip SA*, which dealt with the status of a French company, and the applicability of the Indian Takeover Code to it.

Further, carrying forward and setting off of losses under Section 72A is fraught with practical difficulties such as obtaining sanction of the competent court for the proposed scheme of amalgamation. This can be a time-consuming process, especially if the amalgamated and amalgamating companies are in different states, in which case the application for grant of approval will be required to be filed in the competent courts of both states. The above conditions pertaining to continuation of business and holding of assets post the amalgamation (including the conditions prescribed by the Central Government under Rule 9C of the ITR) also add to challenges faced by the amalgamated company which faces the risk of having to pay tax on the amount of loss or depreciation already set-off or allowed, in addition to the disallowance of the carry forward of the balance of the loss or depreciation in case of any non-compliance.

---

204. Aberdeen Asia Pacific Including Japan Equity Fund v. DCIT, decision dated June 12, 2020, WP No. 2796 of 2019 (Bombay High Court).

© Nishith Desai Associates 2022 Provided upon request only
7. ESOPs and Employee Taxation in M&A

I. Introductions

M&A often involves transfer of employees. When employees are transferred, there are several considerations involved: (a) whether the transfer of employees is to be effected as part of the acquisition or whether it should be by way of resignation and re-hire; (b) whether stock / similar incentives granted to employees are proposed to be continued and if not, how are the employees proposed to be compensated for termination of such incentives; (c) how to incentivize employees to continue their employment post acquisition; (d) what are the withholding tax obligations of the transferor and transferee entities; etc. These aspects need to be analyzed on a case-to-case basis in light of commercial, strategic, legal, regulatory and tax implications involved. This section focusses on some of the key implications from a tax perspective, particularly, withholding tax obligations of the transferor and transferee entity.

Tax implications could differ depending on the manner in which M&A is structured. In case of M&A by way of merger, demerger, slump sale, asset sale, etc., employees are transferred from one corporate entity to another. In case of transfer of shares, there is no change in the corporate entity by whom the employees are engaged. However, there is a change in control / management governing the corporate entity.

II. Taxation of Employees

Before delving into taxation in case of M&A, we outline below some basic principles relating to taxation of employees.

Generally, employment income, including salary and perquisites (both monetary and non-monetary) of resident employees are subject to tax in the hands of the employee as salary income at the rate of tax applicable according to the prevalent slab rate (maximum marginal rate of 30%). Such taxes are required to be withheld by the employer. If there are any non-monetary incentives / perquisites, taxes with respect to such incentives / perquisites are also required to be withheld. Such taxes could be withheld from the monetary payments (if sufficient) or the employee could be asked to pay the equivalent amount to the employer. Alternatively, at the option of the employer, they could be borne by the employer wholly / partially.

Having said that, taxation of perquisites like employee stock option plan (“ESOPs”) are not triggered while they are contingent in nature. ESOPs are an option given to employees to purchase the stock of the employer / parent company of the employer for no consideration or for a consideration which is significantly less than the FMV of such stock. The ability to exercise such option is subject to satisfaction of conditions prescribed by the entity issuing ESOPs. Generally, one of the conditions include continuation in employment for a certain number of years, which is called the vesting period. When the option is exercised (after completion of the vesting period), the issue of stock is subject to tax (as salary income) on the difference between the FMV of the stock and the exercise price (if any) payable by the employee at the time of exercise of ESOPs.\(^\text{206}\) The employer is required to withhold the tax so payable. Therefore, liquidity may become a matter of concern as salary and other monetary incentives relating to the employee (which are generally payable on a month-on-month basis) may not be sufficient for withholding taxes.

\(^{206}\) Section 17(2)(vi) of the ITA.
It may be noted that non-fulfilment of withholding tax obligations by the employer could lead to liability for the withholding tax amount, interest at 12% per annum and penalty up to 100% of the tax amount.

### III. Transfer of Employees between Corporate Entities in M&A

In M&A transactions where employees are transferred between corporate entities, taxation of the employee and withholding tax obligations of the employer would depend on how various employee incentives, including ESOPs are proposed to be transitioned and/or changed.

In case of employee incentives not connected with stock or in case of cash incentives which are connected with stock merely for quantification purposes (for example, stock appreciation rights, where employees may be paid a certain multiple of the appreciation in the value of certain stock on a periodic basis), the incentives may be modified/terminated as part of the terms of the M&A. Such modification/termination may or may not involve payment to employees in lieu of the modification/termination. If any payments are involved, the transferor or transferee entity, whichever is responsible for making such payments would have to withhold tax from such payments.

In case of ESOPs, depending on the terms of the M&A agreed between the transferor and the transferee entities, ESOPs granted to employees by the transferor entity may either be terminated with or without a cash payout; and ESOPs may be granted by the transferee entity on similar/different terms and with or without recognition for the period of service rendered as an employee of the transferor entity.

### IV. Extinguishment of ESOPs in Transferor Entity

Gains arising from the transfer of a ‘capital asset’ are taxable as capital gains. ‘Transfer’ of capital assets includes exchange or relinquishment of the capital assets and extinguishment of rights therein.

However, in the context of M&A, termination/forfeiture of ESOPs granted by the transferor entity without a cash payout/in lieu of receiving ESOPs of the transferee entity may not be taxable as capital gains for the following reasons: (a) unvested stock options merely confer contingent rights to acquire an asset and therefore, there should be no ‘capital asset’ being transferred; (b) the monetary value of stock options may not be determinable and therefore, as per the SC in B.C. Srinivasa Setty207 capital gains should not be levied when the computation mechanism fails; (c) relinquishment and extinguishment can be said to apply only to circumstances where the rights of the person holding the ‘capital asset’ come to an end without extinguishment of the ‘capital asset’ itself. These issues, however, are untested at present and have not been judicially settled.

However, if the termination/forfeiture of ESOPs granted by the transferor entity is made for a cash payout, such payout can be taxable as income in the hands of the employee and consequently, may be subject to withholding tax in the hands of the transferor entity.

### V. Grant of ESOP in Transferee Entity

There should be no tax liability at the time of grant of ESOPs as stock options merely confer contingent rights. It is only upon the exercise of stock options by the employees (after the completion of the vesting period) that tax liability should arise in India. At the time of such exercise, the transferee entity shall be required to withhold applicable tax.

---

VI. Transition Payments

If any payments are due and payable to employees by the transferor entity, but are paid by the transferee entity post acquisition, the payment should normally not be liable to withholding tax in the hands of the transferee entity, particularly if: (i) there are no agreements between the transferor entity, the transferee entity and the employees or other evidence reflecting an understanding that the transferee entity is making such payment to the employees on behalf of the transferor entity; and (ii) the transferee entity makes such payment without being under an obligation contractually / otherwise to do so. As held by the High Court of Andhra Pradesh in V.R. Ganti,\textsuperscript{208} “the answer to such questions would depend upon whether the amount was paid by the employer or the former employer to the employee qua employee for something done as employee or in his capacity other than that of an employee”. However, if there is some contractual / other obligation on account of which such payment is made by the transferee entity on behalf of the transferor entity, the payment would be liable to withholding tax in the hands of the transferee entity at the time of payment.

VII. M&A not involving Transfer of Employees

Acquisition by way of transfer of shares do not involve any change in the corporate entity which engages employees. However, there is change in control / management governing the corporate entity involved. In these cases, there are generally no extinction / change in employee incentives, including ESOPs. However, if ESOPs are granted by the parent entity and if the share transfer involves change in the parent entity of the target company, the considerations outlined above in case of transfers of employees from one corporate entity to another would become relevant vis-à-vis such ESOPs.

VIII. ESOPs granted to employees of start-ups

The quality of human resource of a start-up can determine the success or failure of the start-up. ESOPs have been a significant component of the compensation for employees of start-ups, as it allows the founders and start-ups to employ highly talented employees at a relatively low salary with higher incentive being offered up via ESOPs. ESOPs are generally an important component to most start-up employees’ compensation packages as start-ups do not generally have the initial capital or cash inflow required to adequately compensate high level employees required to conduct business.

However, as mentioned above, as ESOPs are taxed as perquisites, ESOP holders are required to pay tax upon exercise of the ESOPs as income from salary on the difference between the FMV of the shares on the date on which the ESOP is exercised and the amount paid by the employee, if any. The fact that upon exercise, the employee only receives shares of the start-up and no cash results in a significant tax burden on the employee. A similar burden is also faced by the start-up, which is required to withhold tax on the benefit accruing to its employee.

The Finance Act, 2020 made certain changes to the ITA to address cash-flow problems faced by start-ups referred to in Section 80IAC of the ITA and their employees holding ESOPs. It amended inter alia the withholding tax provisions to ease both the employees’ and the start-up’s tax burdens by allowing them to defer payment / deduction (as the case may be) of tax on the ESOP to within 14 days:

- after expiry of 4 years from the end of the relevant assessment year;

\textsuperscript{208}. V.R. Ganti v. CIT [1995] 82 Taxman 37 (AP).
7. ESOPs and Employee Taxation in M&A

- from the date of sale of shares by the employee; or
- from the date on which the employee ceases to be employed by the start-up,
- whichever is earliest.

However, the amount of tax payable / deductible will be calculated as per the rates in force at the time the shares were first allotted or transferred to the employee.

IX. Conclusion

In light of potential consequences of non-fulfilment of withholding tax obligations, it becomes important to carefully evaluate all monetary and non-monetary incentives of employees both before and after the acquisition, along with modifications pursuant to the acquisition. Further, acquisition documentation should be robust, with possible non-compliances by the transferor / transferee factored in, along with indemnities / other clauses to address potential future risks.
8. Drafting Tax Representations and Taxation of Indemnity Payments

I. Introduction

Is the key to any document just getting all that the client wants? It’s not. While having all the commercials that have been agreed to between the parties in place is important, it is equally important that the client’s rights and obligations are safeguarded. Foreseeing the future and analyzing various permutations and combinations that could arise and then providing adequate protection to clients in such situations is not only important but necessary.

In case of an international M&A transaction, tax representations and indemnity payments are of key importance. Let’s take the example of a share sale of an Indian company which is taking place between two non-residents. In such a case, from an Indian tax perspective, there is a capital gains tax implication for the non-resident seller in India. However, if the seller is resident in a favorable DTAA jurisdiction with India, it should be possible for it to avail the benefit of the DTAA with India and end up paying no taxes at all on the share sale. Thus, there should be no withholding tax obligation on the buyer by virtue of no tax being payable on the transaction. However, on what basis can the buyer decide to not withhold any taxes from the payment consideration for the share purchase. This is where tax representations become important – it is based on those representations that the buyer decides not to withhold any taxes. However, this does not preclude the tax department in India from issuing notices to the buyer for not withholding taxes, and that is when a tax indemnity assumes importance as the payment that the buyer may be required to make to the Indian tax authorities should be indemnified by the seller as the seller is the one who has the primary liability to pay tax in India.

II. Tax and Business Representations

As discussed above, in offshore M&A deals where the underlying assets are Indian shares, tax representations become crucial. Only based on these representations will the buyer be able to ascertain whether it should withhold any taxes while paying the consideration to the seller.

Usually, in offshore M&A deals, the seller will avail benefit (if any) of the DTAA such that there is no withholding requirement and the buyer can make payment of the consideration amount in full to the seller. In such a situation, some representations that become non-negotiable are:

- **Residency:** The seller should represent that it is a taxable person under laws of the foreign country in which it is a resident and is eligible to claim benefits of the relevant DTAA. It is not a resident of India and will not become a resident of India in the year the sale of shares takes place, it does not have a permanent establishment in India, its place of effective management is not in India and it does not have a business connection in India as defined under the ITA. If the seller is a resident of India or has a permanent establishment in India or has its place of effective management in India, the benefit of the DTAA may not be available to the seller and hence there would be a requirement to withhold taxes by the buyer as per the ITA while paying the consideration to the seller. Hence, all the above representations are must-haves for the buyer to not withhold any taxes or to withhold taxes as per provisions of the applicable DTAA.
TRC and Form 10F: The seller should represent that it is holding a valid TRC and will continue to hold a valid TRC at the time of sale of the shares. Having a TRC is a mandatory requirement for availing benefit of a DTAA, without which the benefit may be denied. Practically, this factor becomes very important from a timeline perspective, as authorities in respective countries may take a certain period of time (which could be anywhere between a few days to a few months) to issue a TRC. Another relevant factor is the period for which the TRC sought is applicable – it is important that the date of closing is covered within this period. The TRC should contain all the information that has been prescribed under the ITR. To the extent certain details are not present in the TRC, the seller should then issue a Form 10F specifying those details to the buyer, which should also form a part of the representations.

Board meetings and Board of Directors: The seller should provide representations stating that it is controlled and managed by its board of directors, and that all meetings of the board of directors of the seller are held and chaired outside of India. Further, the key management decisions that are necessary for the conduct of business of the seller are taken by its board of directors. This representation is an extension of the residency representation. This is because if the board of the company is taking decisions sitting in India, it could result in the seller company being regarded as having its place of effective management, and hence tax residence in India and consequently DTAA benefits may not be available.

Tax proceedings: The seller should represent that all its tax liabilities in India have been discharged and no tax proceedings are pending against it in India.

Tax Returns: All non-residents claiming DTAA benefits should file tax returns in India and the seller should provide a representation to that extent.

Capital asset: The seller should represent that the shares are held by it as investments / capital assets and not as stock-in-trade. This is because if they are held as capital assets, the gains should be taxed as capital gains whereas in case they are held as stock, the income would be taxed as business income for the seller and accordingly be subject to different tax consequences (and correspondingly different withholding consequences) in India.

Certain other representations such as the seller having complete title to the shares, that shares are free from all encumbrances, the shares were acquired by the seller in compliance with all applicable laws in India should also be taken from the seller. Further, the seller should also provide for representation in respect of organization and authority such as it is duly organized and validly existing in the jurisdiction of incorporation and, that the seller was a non-resident at the time of acquisition of the shares which are being sold. Another standard representation (in light of certain AAR rulings) is on the fact that the payments for purchase of the Indian shares were received by the seller in a bank account located in its country of residence.

III. Tax Indemnity

Typically, indemnities are provided for a breach of any of the representations and warranties that the parties make in an agreement. The affected party (commonly referred to as the “Indemnified Party”) in such a case claims indemnity for losses that it had to incur due to such a breach which then becomes payable by the other party (commonly referred to as the “Indemnifying Party”). The process for claiming indemnity which need to be followed is laid out under the indemnity provisions in the agreement. However, when it comes to tax indemnities, one needs to go a step further. This is because of the risk of a demand being raised by tax authorities on buyers for not withholding taxes from the consideration that was paid to the seller. In such situations, it is important that the buyer is well protected as
8. Drafting Tax Representations and Taxation of Indemnity Payments

it was because of the representations that were made by the seller that the buyer did not withhold any taxes. In such circumstances, it is usually the buyer who will receive the demand notice from tax authorities for non-payment of taxes. While it is common for parties to negotiate tax indemnities, some other practices in deal negotiations include obtaining tax insurance by the seller, entering into escrow / holdback arrangements, application to income tax authorities for obtaining an a lower withholding certificate under Section 197 of the ITA.

While the buyer will always want to get the most from the indemnity provisions, it is important from the seller’s side that the liability is limited to the extent necessary. While we all agree that if taxes are payable, it is the liability of the seller but that does not mean that the seller provides for unlimited liability to the buyer in the indemnity provisions. What needs to be understood is that the tax is applicable only on the capital gains amount and not on the consideration amount that is paid. Therefore, the seller should limit its indemnity payment to such amount. For both parties to understand the impact in terms of absolute numbers, it is important for the seller to provide a tax computation for the scenario where DTAA benefits are not granted, and capital gains are taxable under the ITA. Further, for assessment proceedings to begin in India, it may take up to 2 years after a return of income is filed and if at that time a demand is raised, there may be interest and penalty that may be applied on the tax demand by the income tax authorities. While there cannot be an absolute estimation of this, what can be taken into account is the total tax payable plus interest at the rate of 12% per annum along with penalties which can be capped at up to 100% of the tax amount. Another way of limiting the liability is by providing for liability up to the amount of the sales consideration paid. This limit may subsume the interest and penalty amount also.

The next important aspect to be considered is the time limit for which the indemnity provisions will remain applicable. While there is no timeline prescribed under law for default in complying with withholding tax obligations for payments made to non-residents, indemnity provisions are usually negotiated to remain in force for a period of 7 years from the date on which the transaction takes place. The 7-year period is provided keeping in mind that the tax department in India has the power under the ITA to re-open assessment proceedings up to a maximum period of 6 years (from the year in which assessment is made). The additional year is because the return of income in which the transaction will be disclosed is the financial year following the year in which the transaction has taken place i.e. for a transaction that takes place in December 2015, the return of income will be filed in the next financial year i.e. 2016-17 (i.e. the transactions undertaken in financial year 2015-16 will be assessed in assessment year 2016-17). Therefore, the additional one year is added to the 6-year period. The Finance Act, 2021 has reduced the timeline to re-open assessment proceedings up to a maximum period of 3 years (from the year in which assessment is made). Despite the reduction in the timeline, considering that the order for default on complying with withholding tax on payments made to residents can be made up to 7 years from the end of financial year in which payment was made, tax indemnities may still be negotiated for 7 years.

A 3-year period can also be commercially agreed between the parties on the assumption that if tax proceedings are commenced, it will be in the course of regular assessment proceedings, and not on account of reopening of assessment. Further, in relation to defaults on withholding tax, the provisions of the ITA provide that an order deeming a person to be an assessee in default or for failure to deduct the whole or any part of the tax from a person resident in India cannot be made after expiry of 7 years from the end of financial year in which payment was made or 2 years from the end of financial year in which the withholding tax return was filed. The time limit applies in case of deduction of tax on payments made to Indian tax residents only, and there is no corresponding provision for deduction of tax on payments made to non-residents. While there is no statutory limitation for withholding tax proceedings against buyers vis-a-vis non-resident sellers, judicial precedents have held that the limitation applicable in respect of resident payees should apply for non-resident payees as well.

210. Section 201(1A) of the ITA provides that in case of delay in deduction of tax at source, the person responsible for deduction of tax shall be liable to interest at rate of 1% per month from the date on which such tax was deductible to the date on which the tax has been deducted.

211. The High Court of Delhi in case of Bharti Airtel v. Union of India [2017] 291 CTR 254 (Delhi) has held that the limitation period prescribed under section 201(3) of the ITA would be equally applicable in respect of non-residents
From a buyer's perspective, in case a demand notice is received, and assessment proceedings are initiated, the indemnity provisions should provide that the indemnity will continue to remain in force till such time that a final non-appealable order has been received or indemnity amount has been paid by the seller, and the 7-year limitation should not apply. However, from a seller's perspective, it is important that a carve out is made in the clause stating that in the event of a favorable decision being obtained and no appeal being filed in respect of such decision or a non-appealable order has been received the indemnity provisions will automatically fall away.

The next point for consideration is how the indemnity payment should be treated in the books of the buyer once the seller pays such amount. While there is limited jurisprudence on this point, the AAR in In Re: Aberdeen Claims Administration Inc. held that payments received out of a contractual settlement should be considered to be capital receipts and should not be taxable in the hands of the receiver. Applying the same principle, in case of an indemnity payment under a contract, there should be no tax in the hands of the receiver of such payment considering that the indemnity amounts should not be regarded as payments in lieu of loss of business or revenue.

In addition to the above, a few other important considerations to be kept in mind while negotiating the indemnity provisions include the manner of conduct of proceedings between the buyer and seller i.e. manner of communication on receipt of a tax notice, the manner of communication with tax authorities, consequences in case of delay in communication between parties, the manner of bearing costs of proceedings etc.

---

213. Also see Bharat Forge Co. Ltd. v. CIT [1994] 205 ITR 339 (Bombay).
9. Taxation of Non-Compete Payments in M&A

I. Introduction

In M&A transactions, parties frequently enter into non-compete agreements or insert non-compete clauses in transaction documentation. A non-compete right encompasses a right under which one person can prohibit the other from competing in business with the first person for a stipulated period. It would be the right of the latter to carry on a business in competition, but for such non-compete agreement. Therefore, the right acquired under a non-compete agreement is a right for which a valuable consideration is paid. Generally, non-compete fee is paid for a definite period. The idea is to see to it that the business of the acquirer of the non-compete right is put on a firm footing, by avoiding competition, thus enabling such business to sustain later.

In order to determine the taxability of transactions involving non-compete provisions, there are several considerations involved: (a) what would be the tax treatment in the hands of the person receiving a sum, in cash or in kind, to refrain from competing in business; (b) what would be the treatment of expenditure incurred in the acquisition of a non-compete right; (c) what would be the tax implications in case the expenditure incurred on a non-compete right is characterized as revenue expenditure; (d) what would be the implications in case the expenditure incurred on a non-compete right is characterized as capital expenditure; etc. These aspects need to be analyzed on a case-to-case basis in light of commercial, strategic, legal, regulatory and tax implications involved. This section focuses on some of the key implications from a tax perspective.

II. Taxation of Non-Compete Receipts

The ITA provides that sums received, or receivable, under an agreement for not carrying out any activity in relation to any business or profession; or for not sharing any know-how, patent, copyright, trade-mark, license, franchise or any other business or commercial right of a similar nature or information or technique likely to assist in the manufacture or processing of goods or provision of services shall be income chargeable to income tax under the head “Profits and gains of business or profession”. The ITA provides for exceptions for receipts on account of transfer of the right to manufacture, produce or process any article or thing or right to carry on business or profession chargeable under the head “Capital gains” as well as for sums received as compensation from the multilateral fund of the Montreal Protocol on Substances that Deplete the Ozone Layer. Save for these limited exceptions, receipts under non-compete agreements / clauses, including under most M&A transaction documents, would be chargeable to income tax under the head of “Profits and gains of business or profession”.

III. Taxation of Non-Compete Expenditure

The more contentious issues regarding non-compete fees revolve around their treatment when a person incurs expenditure in acquiring non-compete rights. The first stage of analysis would involve ascertainment as to whether such expenditure is to be regarded as expenditure on the capital account or expenditure on the revenue account.
A. Non-compete Expenditure – Revenue or Capital?

There is no single criterion or test to determine whether an item of expenditure is to be characterized as having been made on the revenue account or on the capital account. Such a determination would be dependent on the nature of the transaction, looking at the aim and object of expenditure and the commercial necessities of making such expenditure. Another important aspect noted by various high courts is whether the advantage derived by the taxpayer was enduring in nature (based on the length of time the non-compete agreement would be in effect). However, courts have been careful to note that the length of time of the advantage may not be decisive in all cases, and that the determination of whether the expenditure is of a revenue or capital nature depends on the facts of each case.\textsuperscript{215}

If the advantage accruing pursuant to the expenditure consists merely in enabling the management and conduct of the business, while leaving the fixed capital untouched, it would be regarded as having been made on the revenue account. For example, in the context of an amalgamation, non-compete fees paid to a high-ranking official of the amalgamating companies, who had full knowledge of the entire operations, have been held to be a commercial decision in respect of performance of the business of the amalgamated company, and therefore held to be expenditure made on revenue account.\textsuperscript{216} In a more recent decision, a similar finding was made where expenditure was incurred for the payment of non-compete fees to an employee to safeguard the business interests of the taxpayer which was a strategic investor, and had obligations towards its joint venture companies to not enter into (or allow its employees to enter into) competing business.\textsuperscript{217}

Conversely, courts have commonly held non-compete expenditure as having been made on capital account when the advantage that accrues is akin to that provided by a capital asset. For example, a non-compete arrangement for a substantial period of time, especially with a person who could otherwise have provided substantial competition to the acquirer of the non-compete right, has been held to be capital expenditure.\textsuperscript{218}

Therefore, the determination of whether an item of non-compete expenditure is to be treated as revenue or capital is a fact-specific determination dependent on the commercials of the transaction, with focus on the advantage that accrues pursuant to the non-compete right.

B. Non-compete Expenditure as Revenue Expenditure

In case expenditure incurred on the acquisition of a non-compete right is characterized as revenue expenditure, then as per Section 37 of the ITA, such expenditure which is wholly and exclusively used for the purposes of the business or profession shall be allowed in computing the income chargeable under the head of “Profits and gains of business or profession”. Therefore, the taxable income will be reduced by the amount of such expenditure.

C. Non-compete Expenditure as Capital Expenditure

In case expenditure incurred on the acquisition of a non-compete right is characterized as capital expenditure, the main question that arises is whether such non-compete right can be regarded as a capital asset on which depreciation can be claimed under Section 32 of the ITA.

Section 32 provides for depreciation in respect of tangible assets, as well as intangible assets. In respect of intangible assets, Section 32(1)(ii) applies to \textit{“know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired

\textsuperscript{216} Carborundum Universal Ltd. v. [CIT (2012) 26 taxmann.com 268 (Madras).
\textsuperscript{217} CIT v. Max India Limited, decision dated August 6, 2018 (Punjab & Haryana High Court).
\textsuperscript{218} Sharp Business System v. CIT [2012] 211 Taxman 576 (Delhi).
9. Taxation of Non-Compete Payments in M&A

on or after the 1st day of April, 1998, owned, wholly or partly, by the assessee and used for the purposes of the business or profession”. Currently, for intangible assets, the rate of depreciation prescribed under the ITR is 25% on the WDV of the assets.

The most controversial aspect with regard to a non-compete right which has been characterized as a capital asset is whether it can be regarded as a “business or commercial right of a similar nature” as know-how, patents, copyrights etc. such that it is eligible for depreciation in terms of Section 32(1)(ii) of the ITA.

In Sharp Business System, the Delhi High Court, while looking at a standalone non-compete arrangement held that a non-compete right cannot be said to be of the same nature as know-how, patent, copyright etc. The High Court explained that the nature of these rights (i.e. know-how, patent, copyrights, etc.) consists of an element of exclusivity whereby only the owner of such rights has an advantage which can be exercised against the world at large (a right in rem). However, by the very nature of the right obtained pursuant to non-compete arrangements, the advantage is more restricted and only for a period of time. Having arrived at the conclusion that the right of non-compete is not similar in nature to rights associated with know-how, patent, copyright, trademark, licenses, franchises, the Delhi High Court held that no depreciation under Section 32 could be claimed on the amount incurred in acquisition of such a right.

In contrast, in Pentasoft Technologies, the Madras High Court, while considering a composite agreement for the transfer of software and training divisions of a business to the assessee, including copyrights, trademarks, and non-compete rights, observed that the non-compete clause in the agreement must be read as a supporting clause to the transfer of copyrights and patents. Therefore, the Madras High Court herein, while taking the non-compete right to be a commercial right similar in nature to patents, copyrights etc., held that such non-compete right is eligible for depreciation in terms of Section 32(1)(ii) of the ITA.

Thereafter, in Ingersoll Rand International, the Karnataka High Court, while contemplating a business transfer agreement keeping in mind the decisions in Sharp and Pentasoft, took forward the logic employed by the Madras High Court in Pentasoft, held a non-compete right to be eligible for depreciation in terms of Section 32(1)(ii) of the ITA by virtue of it being a commercial right similar in nature to patents, copyrights etc. However, while the Madras High Court in Pentasoft made the determination of the non-compete right as an intangible asset of a similar nature as know-how, patents etc. dependent on it being a part of a composite agreement involving the transfer of such intangible assets as well, the Karnataka High Court did not make such a distinction. Following the logic of the Karnataka High Court, it would appear that a non-compete right, once determined to be a capital asset, would be eligible for depreciation in terms of Section 32(1)(ii) of the ITA even if it were to be transferred as a standalone right.

This view has been supported by both the Delhi and Mumbai benches of the ITAT. In both instances, the ITAT relied on the Karnataka High Court to find that like rights associated with know-how, patent, copyright, etc., even a non-compete right affords the taxpayer the ability to carry on a business more efficiently by utilizing available knowledge to the exclusion of other competing businesses. Accordingly, fees paid for such non-compete rights should be eligible for depreciation under Section 32(1)(ii) of the ITA.

In most M&A transactions, non-compete rights would form part of a gamut of rights being transferred, which would typically involve intangible assets such as know-how, patents etc. Therefore, employing the reasoning applied by

---

221. CIT v. Ingersoll Rand International Ind. Ltd. [2014] 227 Taxman 176 (Karnataka).
the Madras High Court in *Pentasoft* and the Karnataka High Court in *Ingersoll Rand*, it seems reasonable that such non-compete rights acquired under the M&A transaction documents, should be treated as capital assets eligible for depreciation in terms of Section 32 of the ITA (assuming other requirements of the provision are met).

However, as elucidated hereinabove, there is a dichotomy in the approach of different High Courts to the treatment of non-compete rights with respect to eligibility for depreciation in terms of Section 32 of the ITA, with the Madras High Court position in *Pentasoft* being towards the middle end of the spectrum, the ends of which are occupied by the positions taken by the Delhi High Court in *Sharp* and by the Karnataka High Court in *Ingersoll Rand*.224

**IV. Conclusion**

The taxation of receipts in pursuance of non-compete agreements / clauses is covered under Section 28(va) of the ITA, save for certain exceptions mentioned therein.

However, the situation is not as clear with respect to expenditure incurred on the acquisition of a non-compete right. The first step to be taken is to ascertain whether such expenditure needs to be characterized as revenue expenditure or capital expenditure. If treated as revenue expenditure, then such expenditure is allowable as a deduction in the computation of total income under the ITA. If treated as capital expenditure, there remains a grey area as to whether non-compete rights can be treated as capital assets eligible for depreciation (thereby reducing the taxable income) or as capital assets not eligible for depreciation. As elucidated above, there is a variance of opinion on this issue among the different High Courts in India.

For non-compete rights to be treated as capital assets eligible for depreciation, it would be preferable to structure M&A transaction documents such that the non-compete rights are transferred as part of a composite agreement wherein other assets, especially intangible assets such as know-how, patents etc. are also transferred. Such structuring would strengthen the case for the non-compete right to be treated as a capital asset eligible to depreciation in terms of Section 32 of the ITA, considering the judicial decisions discussed above.

224. Another point to be noted is that Section 28(va)(a) specifically provides for non-compete receipts and Section 28(va)(b) specifically provides for receipts on account of non-sharing of intangible assets such as know-how, patents etc. However, such wording as found in Section 28(va)(a) is not found in Section 32(1)(i), although it contains wording similar to Section 28(va)(b) with respect to intangible assets. However, the Madras and Karnataka High Courts have read in the concept of non-compete rights as intangible assets of a similar nature such as know-how, patents etc. in the cases cited.
10. Depreciation on Goodwill

I. Introduction

Often in M&A transactions, depending on the mode in which the transaction is undertaken, it is not unusual for a buyer to pay consideration that is in excess of the net value of the assets being acquired. This excess can be regarded as payment for acquiring the ‘goodwill’ of the business being acquired, an intangible asset that is generated on account of the practices and reputation of the business. The SC in B.C. Srinivasa Setty, has stated that goodwill denotes the benefit arising from connection and reputation and is imperceptible at its birth. However, whether such goodwill can be regarded as an asset on which the buyer can claim depreciation under the ITA, is a question that is complicated and not free from doubt.

II. Treatment under the ITA

Section 55(2)(a) of the ITA provides that the COA of goodwill, for purposes of computing capital gains under Sections 48 and 49, means the purchase price in case the goodwill has been purchased by the assessee from the previous owner. In any other case, the COA of goodwill is Nil. Since goodwill is a ‘self-generated’ asset, it does not have a COA and is not recorded on the books of the entity that has created it (unless the goodwill has been purchased), and neither can such entity claim depreciation on it. In case of self-generated goodwill, goodwill acquires a COA on its transfer, as a value can then be accorded to it and it is then recorded on the books of the acquirer at such value.

On the issue of allowability of depreciation on goodwill, as mentioned earlier Section 32 provides for depreciation in respect of tangible assets, as well as intangible assets. In respect of intangible assets, Section 32(1)(ii) applies to “know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets acquired on or after the 1st day of April, 1998, owned, wholly or partly, by the assessee and used for the purposes of the business or profession”. Currently, for intangible assets, the rate of depreciation prescribed under the ITR is 25% on the WDV of the assets.

The SC of India, in Smifs Securities Limited\(^{225}\) has unequivocally held that goodwill falls in the category of ‘any other business or commercial rights of similar nature’ and should hence be eligible for depreciation as per the provisions of section 32 of the ITA, making it a depreciable asset. However, the Court in Smifs Securities did not adjudicate on the amount of goodwill that would be eligible for depreciation, or on the applicability of certain provisions of the ITA that limit the quantum of depreciation that can be availed by the amalgamated entity in case of an amalgamation.

For example, Explanations 7 and 7A to Section 43(1), provided that where, pursuant to a merger, a capital asset is transferred by the merging company to the merged company, the actual cost of the transferred capital asset to the merged company will be the same as it would have been if the merging company had continued to hold the capital asset for purposes of its own business.

10. Depreciation on Goodwill

These provisions are interpreted by Indian tax authorities to imply that the amalgamated company would only be eligible to claim depreciation on assets in respect of which the amalgamating company claimed depreciation. Since goodwill is a self-generated asset and does not exist as an asset on the books of the amalgamating company, the amalgamating company would not have claimed depreciation on goodwill. On this basis, the claim of depreciation by the amalgamated company can be sought to be denied as well.

Although courts\(^{226}\) have relied on the SC’s ruling in Smifs Securities and allowed depreciation on goodwill arising on amalgamation, the issue has not been laid to rest completely and remained contentious on account of these provisions which had not been addressed by the SC.

However, the Finance Act, 2021 lay the debate to rest by simply excluding goodwill from the ambit of depreciable assets. The changes will be applicable to M&A transactions across the board.

### III. Changes by Finance Act, 2021

The Finance Act, 2021, through a series of amendments to the relevant provisions has clarified that goodwill is not a depreciable asset. The Memorandum to the Finance Act noted that goodwill of a business or a profession has not been specifically provided as an asset either in the definition under section 2(11) (defined the term ‘block of assets’) or in section 32 of the ITA. It also noted the decision rendered by the SC in case of Smiff Securities and other provisions relevant for calculation of depreciation under the ITA. In this regard, the Memorandum noted as under:

> “It is seen that Goodwill, in general, is not a depreciable asset and in fact depending upon how the business runs; goodwill may see appreciation or in the alternative no depreciation to its value. Therefore, there may not be a justification of depreciation on goodwill in the manner there is a need to provide for depreciation in case of other intangible assets or plant & machinery. Hence there appears to be little justification for depreciation on goodwill even in the category of cases referred to in the immediately preceding paragraph”

These amendments inter-alia provide that (i) goodwill will be excluded from part of Block and list of intangible assets, (ii) adjustments in Block to offset the impact of depreciation claimed in past, (iii) manner of computing cost of goodwill in different scenarios etc.

Though the amendment is said applicable prospectively, it will also impact any transactions undertaken in the recent past wherein goodwill was recorded in the books and on which depreciation was claimed for tax purposes (in cases where the entire Block of intangible asset comprising of goodwill has not been substantially depreciated).

The CBDT has notified a new rule which provides for the manner in which the opening WDV of the Block of intangible assets comprising of any goodwill is to be recomputed.\(^{227}\) Apart from the loss of potential depreciation claim on goodwill going forward, the rule requires the taxpayers to pay taxes on excess depreciation claimed in the past on such goodwill by deeming the same as STCG in certain circumstances.

These amendments are likely to have a huge impact on M&A transactions as potential savings from claim of depreciation on goodwill has been one of the important factors affecting valuation. The changes made by the Finance Act, 2021 has put to rest all debates with respect of availability of depreciation on self-generated / purchased goodwill, goodwill generated in tax-neutral / non-tax neutral transactions etc.

---


227. Rule 8AC of ITR
11. Tax issues under Insolvency and Bankruptcy Code

Historically, insolvency resolution processes for Indian corporates involved simultaneous operation of several statutory regimes viz. the Sick Industrial Companies Act, 1985, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, the Recovery of Debt Due to Banks and Financial Institutions Act, 1993, and the CA, 2013. This led to immense confusion making the system unworkable and led to an increase in non-performing assets and creditors who had to wait for years to recover their money.

The Indian Government introduced the IBC in 2016 with a view to streamline the corporate insolvency resolution / liquidation process and improve India’s ease of doing business competence. The IBC consolidates existing laws relating to insolvency of corporate entities and individuals into a single legislation. It has unified the law relating to enforcement of statutory rights of creditors and streamlined the manner in which a debtor company can be revived to sustain its debt without extinguishing the rights of creditors.

Under the IBC, the corporate insolvency resolution process falls under the purview of the NCLT. Appeals from orders of the NCLT lie before the NCLAT. All appeals from orders of the NCLAT lie to the SC of India. The IBC envisages a two-stage process, first, revival and second, liquidation. Corporate insolvency resolution process and fast track corporate insolvency resolution process are measures to help revive a company. The IBC attempts to first examine possibilities of a revival of a corporate debtor, failing which the entity will be liquidated. It is important to note that the SC in Monnet Ispat and Energy Ltd., has upheld the overriding nature and supremacy of the provisions of the IBC over any other enactment in case of conflicting provisions, by virtue of a non-obstante clause contained in section 238 of the IBC.

Please see our research paper titled ‘A Primer on the Insolvency and Bankruptcy Code, 2016’ here.

The following amendments were introduced in the ITA to support the corporate insolvency resolution process:

a. Section 115JB of the ITA was amended to provide that for determining the ‘book profits’ (for levy of MAT) of a company against whom an application for corporate insolvency resolution was admitted by the NCLT, deduction of the aggregate amount of brought forward losses and unabsorbed depreciation would be allowed. In this regard, it is pertinent to note that in case of regular corporate taxpayers, a deduction of lower of (i) the brought forward losses or (ii) unabsorbed depreciation is allowed for the purpose of determining the ‘book profits’.

b. Section 79 of the ITA (as discussed in Part 6 of this paper) was amended to not apply to cases where the shareholding of a corporate taxpayer changes pursuant to a resolution plan approved under the IBC, after allowing the tax authorities a reasonable opportunity of being heard in this regard.

In Leo Edibles & Fats Limited, the High Court of Andhra Pradesh and Telangana dealt with the issue of settling the dues of the income-tax authority during the liquidation of a company. The Court held that in the event that the assessee company is undergoing the liquidation process under the IBC, the income-tax authority can no longer claim priority in respect of clearance of tax dues under the ITA. It was further held that assets that"

---

228. Section 61 of the IBC.
229. Section 182 of the IBC.
11. Tax issues under Insolvency and Bankruptcy Code

are under attachment (though encumbered) will not create any interest in favour of the income-tax authority as a secured creditor under the IBC. Additionally, it was further set out that the moratorium in terms of proceedings as set out under the IBC ensures that any pending litigation initiated prior to commencement of the insolvency proceeding are suspended.

Further, recently, the Delhi ITAT in Shamken Multifab Limited,233 held that where an application filed under section 7 of the IBC has been admitted and moratorium under section 14 of the IBC has been declared, appeal filed by income-tax authorities against the assessee company under provisions of ITA could not be allowed to be continued during the course of moratorium period. The Delhi ITAT relied on the ruling of SC in Alchemist Asset Reconstruction.234 wherein the SC held that even arbitration proceedings cannot be initiated after imposition of the moratorium under section 14 of the IBC.

In light of the economic distress caused by COVID-19, recently the Government of India has announced the suspension of initiation of corporate insolvency resolution process of a corporate debtor, for any default arising on or after March 25, 2020, for a period of 6 months (expandable to 1 year).235 This change was made after the threshold for initiation of corporate resolution insolvency process was increased to INR 10 million from INR 0.1 million.236

12. Anti-Abuse Rules to be Considered in an M&A Transaction

I. Introduction

Several specific and general anti-abuse rules have been enacted by India to check tax avoidance in domestic as well as cross-border transactions. The effect of these measures may vary from re-characterization of income earned in a transaction to having the transaction rendered void against a claim by the income-tax authorities. Therefore, the following key anti-abuse rules may need to be borne in mind by companies looking to engage in M&A transactions in India.

II. Successor Liability

As a general rule, when a business is succeeded by any other entity (whether by slump sale or itemized sale), which subsequently continues to carry on that business, the predecessor is assessed for the income of financial years prior to the date of succession and the successor is assessed on the income of the financial years after the date of succession. Section 170 of the ITA provides the manner of taxation (i.e. who is assessable) in cases of succession of a business (or profession) to a person who succeeds and carries on the business (from its predecessor). It envisages separate assessments on both, the predecessor and the successor (for which they both separately compute their taxes, apply deductions, and pay taxes as per their applicable rates). The issue regarding the validity of assessment / re-assessment proceedings initiated on predecessor entities during the pendency of reorganization proceedings before the adjudicating authorities have been subject to litigation in the past. The SC in case of PCIT vs Maruti Suzuki India Limited held that pursuant to amalgamation of one company with another company, amalgamating company loses its existence and assessment order passed, post amalgamation, in the name of amalgamating company (non-existent entity) will be invalid. However, on basis of specific facts of the case, the SC in another recent decision held that an assessment order cannot be quashed solely on the ground that it is passed in the name of the amalgamating entity, which ceased to exist post the effective date mentioned in the scheme of merger. This controversy has now been settled by the amendment made by Finance Act, 2022.

In order to clarify this issue, the Finance Act, 2022, amended section 170 of the ITA (with effect from April 1, 2022) to provide that where assessment / re-assessment proceedings are initiated on predecessor entity during the pendency of reorganization proceedings, such proceedings shall be deemed to have been made on the successor entity.

In the case of a ‘slump sale’ or the transfer of a business undertaking (comprising such combination of assets and liabilities that is capable of being run independently for a foreseeable future), the successor may also be liable for the historical indirect tax liabilities (customs, excise and service tax) in respect of the financial year in which the succession took place up to the date of such succession as well as the financial year immediately preceding that year in the event that the predecessor cannot be found or where the predecessor has been assessed but the tax cannot be recovered from him.

237. Section 170 of the ITA.
238. 2019 SCCOnline SC 928.
239. Refer footnote 9
240. Refer footnote 239
As a measure to check the possibility of assets and/or liabilities of a business being transferred by a taxpayer with the intention to defraud revenue authorities, Section 281 of the ITA states that any transfer of assets during the pendency of income tax assessment proceedings shall be void as against any claim on such assets in respect of any income tax/interest/penalties payable by the transferor. Therefore, if any tax litigation is pending against the business or any portion thereof, the requirement to obtain a no-objection certificate ("NoC") from the income-tax authorities may need to be evaluated by the parties to the transaction keeping in mind the timelines involved and the consequences of Section 281 of the ITA being invoked against the transaction.

Mergers, on the other hand, are currently court-driven procedures in India. At present, companies are required to approach the jurisdictional NCLT in order to seek approval for a merger. Considering that NCLT seeks the approval of the income tax authorities and other regulatory authorities before approving the merger, a specific NoC need not be sought by the parties to the transaction in the case of a merger. However, being a court-driven process, it may take anywhere between 6 months to a year to obtain approval from the NCLT in respect of a merger.

III. Transfer Pricing Regulations and Section 56

The ITA includes certain anti-abuse provisions which are designed to capture within the tax net, those transactions which have been undertaken at a price below the FMV. Provisions in Chapter X of the ITA provide for transfer pricing regulations in respect of international transactions between related parties, and also in respect of certain Specified Domestic Transactions. These provisions read along with allied rules, circulars and notifications—collectively called the Transfer Pricing Regulations—notionally tax income of a taxpayer when the actual transaction has not been undertaken at an arm’s length price.

Separate anti-abuse provisions are also present in Section 56 of the ITA. These anti-abuse provisions were earlier limited to receipt of assets below FMV by individuals, Hindu Undivided Families, unlisted companies and LLPs. However, the Finance Act, 2017 expanded the scope of these provisions to now include all recipients such as listed companies, trusts etc., with only a few exceptions.

Section 56(2)(x) of the ITA provides that where any person receives any property inter-alia being shares of a company:

1. Without consideration, where the aggregate FMV of such shares exceeds INR 50,000 (USD 748.5); or
2. For a consideration that is less than the aggregate FMV of such shares by INR 50,000 (USD 748.5).

The difference between the FMV of the shares and the consideration for the receipt of such shares shall be taxed as ‘other income’ in the hands of the recipient. However, certain transfers like transfer on account of amalgamation, demerger etc. are exempt from these provisions. There is, however, ambiguity on applicability of Section 56(2)(x) to a slump sale. The term ‘property’ has been defined to mean a capital asset of the assessee namely inter-alia immovable property being land or building or both, share and securities, jewelry, paintings and any work of art. While, the definition of property does not explicitly include an undertaking, in case any of the specified assets mentioned in the definition of property are transferred as a part of the undertaking in slump sale, the possibility of income-tax authorities arguing applicability of Section 56(2)(x) basis the purchase price allocation cannot be ruled out. It may be argued that this approach may go against the whole concept of taxation of slump sale, where a lump sum consideration is paid for the entire business as compared to assigning of values to individual assets acquired as part of the business. Recently, the CBDT has notified certain transactions on which the anti-abuse rules do not apply.
provisions of section 56(2)(x) shall not apply **inter alia** including any movable property, being shares of a reconstructed bank, received by the investor or the investor bank, as the case may be, where the shares have been allotted by the reconstructed bank under the scheme at a price specified in such scheme etc.\(^\text{241}\)

The applicability of the erstwhile section 56(2)(vii) on issuance of shares has been a subject matter of controversy. In December 2018, the CBDT had issued a circular clarifying that the provisions of section 56(2)(viia) shall not be applicable in case of receipt of shares as a result of fresh issuance by way of bonus issue, rights shares etc.\(^\text{242}\)

However, soon after the clarification, the CBDT withdrew the aforesaid circular stating that the matter was **sub judice** in certain higher judicial forums.\(^\text{243}\) While the CBDT was doing a flip-flop on its position, the Mumbai ITAT in **Subhodh Menon**\(^\text{244}\) held that the provisions of section 56(2)(viia) do not apply to proportionate issue of rights shares and bona fide business transactions. The Mumbai ITAT took note of the fact that the shares were being issued to comply with a covenant in a loan agreement with the bank to fund the acquisition of business and consideration for the shares was received through banking channels. The Mumbai ITAT upheld the ruling of its co-ordinate bench in case of **Sudhir Menon**.\(^\text{245}\)

### IV. General Anti-Avoidance Rules

As discussed in section 3, given that global concern over tax treaty abuse is increasing, demonstration of commercial rationale and substance in a transaction is assuming greater importance. Therefore, in cases where parties to a transaction are relying on benefits under a DTAA, such parties should consider whether benefits under the DTAA may be denied on the ground of substance requirements.

India introduced the domestic General Anti-Avoidance Rule ("**GAAR**") under the ITA in 2012, although it is applicable with effect from April 1, 2017. While introducing the GAAR under the ITA through the Finance Act, 2012, the then Finance Minister had highlighted that a GAAR was being introduced to curb aggressive tax avoidance schemes while ensuring that it is used only in appropriate cases, by requiring a tax officer to submit a request for invoking the GAAR for review before a panel constituted according to prescriptions under the ITA.

The GAAR provisions, contained in Chapter X-A of the ITA authorizes income-tax authorities to declare an arrangement as an IAA and determine the tax consequences in case of an IAA.\(^\text{246}\) The ITA defines an IAA to mean an arrangement, the main purpose of which is to obtain a tax benefit\(^\text{247}\) ("**Tax Benefit Test**"); and it:

1. creates rights or obligations which are not ordinarily created between persons dealing at arm's length,
2. results directly or indirectly in the misuse or abuse of the provisions of the ITA,
3. lacks commercial substance or are deemed to lack commercial substance, in whole or in part, **or**
4. is entered into or carried out by means or in a manner that is not ordinarily employed for **bona fide** purposes.\(^\text{248}\)

The abovementioned tests are hereinafter to as the "**Tainted Elements**".

---

\(^\text{241}\) Rule 11UAC of the ITR.
\(^\text{244}\) ACIT v. Subhodh Menon [2019] 175 ITD 449 (Mumbai).
\(^\text{245}\) Sudhir Menon HUF v. ACIT [2014] 148 ITD 260 (Mum.-Trib)
\(^\text{246}\) Section 95 of the ITA.
\(^\text{247}\) **Tax benefit** includes a reduction or avoidance or deferral of tax or other amount that would be payable under the ITA, as a result of a tax treaty; or an increase in refund of tax or other amount under the ITA, as a result of a tax treaty.
\(^\text{248}\) Section 96 of the ITA.
The ITA further provides that where the main purpose of a step or part of an arrangement is to obtain a tax benefit, the main purpose of the entire arrangement is presumed to be to obtain a tax benefit, unless the taxpayer proves to the contrary.

While applying the GAAR, tax authorities may disregard entities in a structure, deny benefits available under the DTAA, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, treat debt as equity and vice versa.249

The necessary procedures for application of the GAAR and conditions under which it shall not apply, have been enumerated in Rules 10U to 10UC of the ITR. In this regard, Rule 10U of the ITR enumerates certain special cases on which provisions of the GAAR would not apply, these cases include:

1. An arrangement where the tax benefit arising to all parties to the arrangement does not exceed a sum of INR 30 million (approximately USD 450,000) in the relevant financial year;
2. Any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made prior to April 1, 2017;
3. Non-residents directly or indirectly investing in offshore derivative instruments (such as participatory notes issued by FPIs / Foreign Institutional Investors (“FIIs”)); and
4. An FII / FPI who is an assessee under the Act, has not obtained benefit under a DTAA and who has invested in listed securities or unlisted securities in accordance with regulations issued by the SEBI.

It is important to note that even if certain prior investments are grandfathered, any corporate arrangement may become subject to scrutiny under the GAAR on its implementation starting April 1, 2017. Therefore, in light of the GAAR, it would be advisable that the commercial rationale behind each step in the corporate arrangement should also be adequately documented.

In the context of implementation of the GAAR, the CBDT has issued Circular No. 7 of 2017 dated January 27, 2017 providing certain clarifications which inter-alia includes the following:

1. Special Anti-Avoidance Rules (“SAAR”) provisions may not address all situations of abuse, thus there is a need for general anti-abusive provisions in ITA. The provisions of SAARs and the GAAR can coexist and are applicable in parallel.
2. Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-abuse rules. If a case of avoidance is sufficiently addressed by LoB in a DTAA, GAAR cannot be invoked.
3. The GAAR will not interplay with the right of the taxpayer to select or choose a method of implementing a transaction.
4. GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction. If a jurisdiction is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply.
5. The proposal to declare an arrangement as an IAA under the GAAR will be vetted first by the Principal Commissioner / Commissioner and at a second stage by an Approving Panel, headed by a retired judge of a High Court.

249. Section 98 of the ITA.
12. Anti-Abuse Rules to be Considered in an M&A Transaction

6. The GAAR provisions will not apply to an arrangement sanctioned by a Court and in respect of an arrangement on which advance ruling has been obtained, where tax implications of the arrangement have been explicitly and adequately considered.

7. The CBDT has refused to allow corresponding adjustments in the hands of other participant(s) in an arrangement / transaction which is declared as an IAA and a participant is made the subject matter of GAAR provisions.

Interestingly, the Mumbai bench of the NCLT had rejected a scheme of amalgamation between Ajanta Pharma Limited and Gabs Investment Private Limited on the ground that the scheme was designed purely for the avoidance of tax and was not in public interest – an order seen as an indirect invocation of the GAAR.250 Contrary to the aforesaid ruling, the Delhi bench of the NCLT sanctioned a scheme of amalgamation between investment holding companies (PIPL Business Advisors and Investment Private Limited and GSPL Advisory Services and Investment Private Limited) with a listed entity, NIIT Technologies Limited while rejecting the objections raised by tax authorities and holding that every transaction or arrangement which is permissible under law and has the effect of reducing the tax burden cannot be looked upon with disfavour.251 The NCLAT vide a December 2019 order upheld the NCLT’s order approving a scheme of demerger among Reliance group companies, rejecting the Revenue’s plea that the scheme had been devised as a tool to evade taxes.252 Recently, the Kolkata ITAT upheld the sanctity of a scheme of amalgamation approved by the Punjab & Haryana High Court and the Delhi High Court and categorically rejected the revenue’s attempt at invoking the GAAR provisions retrospectively on the contention that the amalgamation was a colourable device, being illegal and without any factual base.253

Aside from the GAAR, as discussed above, a general anti-avoidance rule has also been incorporated in several of India’s DTAs by operation of the MLI. The default anti-avoidance standard under the MLI is the PPT, which is expected to apply to most DTAs notified as CTAs going forward. While the scope of the GAAR and PPT are similar, there are several significant differences as well.

Section 90 of the ITA has been amended to state that the GAAR is intended to override DTAs, however it is unclear how it would interact with the PPT under the MLI. Certain Indian DTAs (such as DTAs with Luxembourg and Malaysia) has been revised to specifically allow the operation of domestic GAAR over and above the DTAA – meaning that the GAAR would also need to be satisfied where a taxpayer has met the PPT standard and qualified for DTAA benefits. However, this supremacy of the domestic GAAR is not clear in case of other DTAs.

The table below examines the interplay of the provisions of the GAAR and the PPT:

<table>
<thead>
<tr>
<th>S No</th>
<th>Parameter</th>
<th>GAAR</th>
<th>PPT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Application</td>
<td>GAAR is wider in application as it seeks to curb abuse of domestic law provisions, including cases where benefit under a DTAA is sought by the taxpayer.</td>
<td>The PPT being a treaty abuse test, by definition, would apply only to cases where the benefit sought is under a DTAA.</td>
</tr>
<tr>
<td>2.</td>
<td>Scope</td>
<td>Provisions of GAAR can be invoked only if ‘the main purpose’ is to obtain tax benefit.</td>
<td>PPT can be invoked even if ‘one of the principle purposes’ is to avail tax benefit.</td>
</tr>
</tbody>
</table>

---


© Nishith Desai Associates 2022 Provided upon request only
### 3. Additional tests or carve outs
- The GAAR has the Tainted Elements Test that characterizes the tax benefit further in light of the nature of the transaction.
- For a transaction to be characterized as an IAA under the GAAR, it would be imperative that both the Tax Benefit Test and the Tainted Elements Test are satisfied.
- The PPT does not have the requirement to characterize the nature of the transaction. However, it does have a carve-out for tax benefits in line with the ‘object and purpose’ of relevant provisions of the tax treaty.

### 4. Safeguards
- Procedural safeguards for invocation of GAAR in place.
- No safeguards prescribed.

### 5. Exclusions
- Exclusions provided under Rule 10U of the ITR.
- No exclusions provided

### 6. Grandfathering of investments
- Income from transfer of investments made prior to April 1, 2017 grandfathered from application of GAAR.
- No grandfathering provided under the PPT.
- This results in a situation where the GAAR will not apply to investments made before April 1, 2017, but the same transaction will need to pass muster under the PPT, even though the investments may date back to a time when the PPT was not in contemplation.

### 7. Burden and standard of proof
- The burden of proof is on the taxpayer in the event income-tax authorities prove that one step of an arrangement has as its main purpose to obtain a tax benefit.
- The PPT, while it places the burden of proof on the revenue, requires it to meet a standard of ‘reasonableness’ in finding a principal purpose of an arrangement to be to obtain a tax benefit.

Therefore, as is evident from the above, the provisions of the PPT are wider in scope than the GAAR. The OECD states that where the main aspects of the domestic GAAR are in line with the ‘guiding principle’ enunciated by the OECD and the PPT that incorporates the guiding principle, there is no possibility of conflict between the domestic GAAR and DTAA provisions. Given that limited guidance is available on the interaction between a domestic GAAR and anti-abuse standards under DTAA, in the context of the GAAR and the PPT, where the consequences of adverse findings can be drastic, it is important for the Indian government to clarify how the provisions of the PPT will be interpreted alongside the GAAR. Such clarifications would go a long way in providing policy certainty and comfort to taxpayers investing in the country, who are under a sea of uncertainty on how their benefits would be interpreted under these anti-avoidance principles.
The following research papers and much more are available on our Knowledge Site: www.nishithdesai.com

<table>
<thead>
<tr>
<th>Title</th>
<th>Type</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supreme Court Clears The Air on The Pledge of Dematerialised Shares</td>
<td>Dispute Resolution</td>
<td>May 2022</td>
</tr>
<tr>
<td>Singapore Court of Appeal Allows a Non-Party to Enforce an Award</td>
<td>Dispute Resolution</td>
<td>May 2022</td>
</tr>
<tr>
<td>Delhi High Court’s Guidance on Conversion Rate For Foreign Currency Denominated Arbitral Awards</td>
<td>Dispute Resolution</td>
<td>May 2022</td>
</tr>
<tr>
<td>NCLT Approves Scheme of Amalgamation and Rejects Tax Department’s Objection on Loss of Tax Revenue and Invocation of Gaar</td>
<td>Tax</td>
<td>May 2022</td>
</tr>
<tr>
<td>Beneficial Ownership Test Cannot Be Read Into Article 13 (Capital Gains) Of The India-Mauritius Tax Treaty, Without Specific Language To Such Effect</td>
<td>Tax</td>
<td>May 2022</td>
</tr>
<tr>
<td>Withdrawal of Amount Deposited in Escrow Account by Buyer Deductible From Sale Consideration</td>
<td>Tax</td>
<td>May 2022</td>
</tr>
<tr>
<td>CERT-In Releases FAQs Explaining the Direction on Cybersecurity</td>
<td>Technology Law</td>
<td>May 2022</td>
</tr>
<tr>
<td>Cyber Security: India Revamps Rules on Mandatory Incident Reporting &amp; Allied Compliances</td>
<td>Technology Law</td>
<td>May 2022</td>
</tr>
<tr>
<td>Employment Generation in India: Prioritise Service Sector - If Speed is the Essence</td>
<td>HR Law</td>
<td>April 2022</td>
</tr>
<tr>
<td>India’s New Labor Codes - Reduced Direct Liability of Directors?</td>
<td>HR Law</td>
<td>April 2022</td>
</tr>
<tr>
<td>New Labour Codes In India Delayed</td>
<td>HR Law</td>
<td>April 2022</td>
</tr>
<tr>
<td>What Does Liberalisation Of Drone Laws Mean For The Pharmaceutical Industry?</td>
<td>Technology Law</td>
<td>March 2022</td>
</tr>
<tr>
<td>The Rbi Stand On Crypto Lacks Balance</td>
<td>Technology Law</td>
<td>March 2022</td>
</tr>
<tr>
<td>The Data Protection Bill: In Search Of A Balanced Horizontal Data Protection Framework</td>
<td>Technology Law</td>
<td>March 2022</td>
</tr>
</tbody>
</table>
Research @ NDA

Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm’s culture.

Our dedication to research has been instrumental in creating thought leadership in various areas of law and public policy. Through research, we develop intellectual capital and leverage it actively for both our clients and the development of our associates. We use research to discover new thinking, approaches, skills and reflections on jurisprudence, and ultimately deliver superior value to our clients. Over time, we have embedded a culture and built processes of learning through research that give us a robust edge in providing best quality advices and services to our clients, to our fraternity and to the community at large.

Every member of the firm is required to participate in research activities. The seeds of research are typically sown in hour-long continuing education sessions conducted every day as the first thing in the morning. Free interactions in these sessions help associates identify new legal, regulatory, technological and business trends that require intellectual investigation from the legal and tax perspectives. Then, one or few associates take up an emerging trend or issue under the guidance of seniors and put it through our “Anticipate-Prepare-Deliver” research model.

As the first step, they would conduct a capsule research, which involves a quick analysis of readily available secondary data. Often such basic research provides valuable insights and creates broader understanding of the issue for the involved associates, who in turn would disseminate it to other associates through tacit and explicit knowledge exchange processes. For us, knowledge sharing is as important an attribute as knowledge acquisition.

When the issue requires further investigation, we develop an extensive research paper. Often we collect our own primary data when we feel the issue demands going deep to the root or when we find gaps in secondary data. In some cases, we have even taken up multi-year research projects to investigate every aspect of the topic and build unparallel mastery. Our TMT practice, IP practice, Pharma & Healthcare/Med-Tech and Medical Device, practice and energy sector practice have emerged from such projects. Research in essence graduates to Knowledge, and finally to Intellectual Property.

Over the years, we have produced some outstanding research papers, articles, webinars and talks. Almost on daily basis, we analyze and offer our perspective on latest legal developments through our regular “Hotlines”, which go out to our clients and fraternity. Our Lab Reports dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research articles and disseminate them through our website. Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with much needed comparative research for rule making. Our discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged. Although we invest heavily in terms of time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

As we continue to grow through our research-based approach, we now have established an exclusive four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of exclusive Alibaug-Raigadh district. Imaginarium AliGunjan is a platform for creative thinking; an apolitical eco-system that connects multi-disciplinary threads of ideas, innovation and imagination. Designed to inspire ‘blue sky’ thinking, research, exploration and synthesis, reflections and communication, it aims to bring in wholeness—that leads to answers to the biggest challenges of our time and beyond. It seeks to be a bridge that connects the futuristic advancements of diverse disciplines. It offers a space, both virtually and literally, for integration and synthesis of knowhow and innovation from various streams and serves as a dais to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear your suggestions on our research reports. Please feel free to contact us at research@nishithdesai.com
Tax Issues in M&A Transactions