

Changes in Transnational and Domestic Tax Regulations affecting Cross-border Mergers and Acquisitions in India

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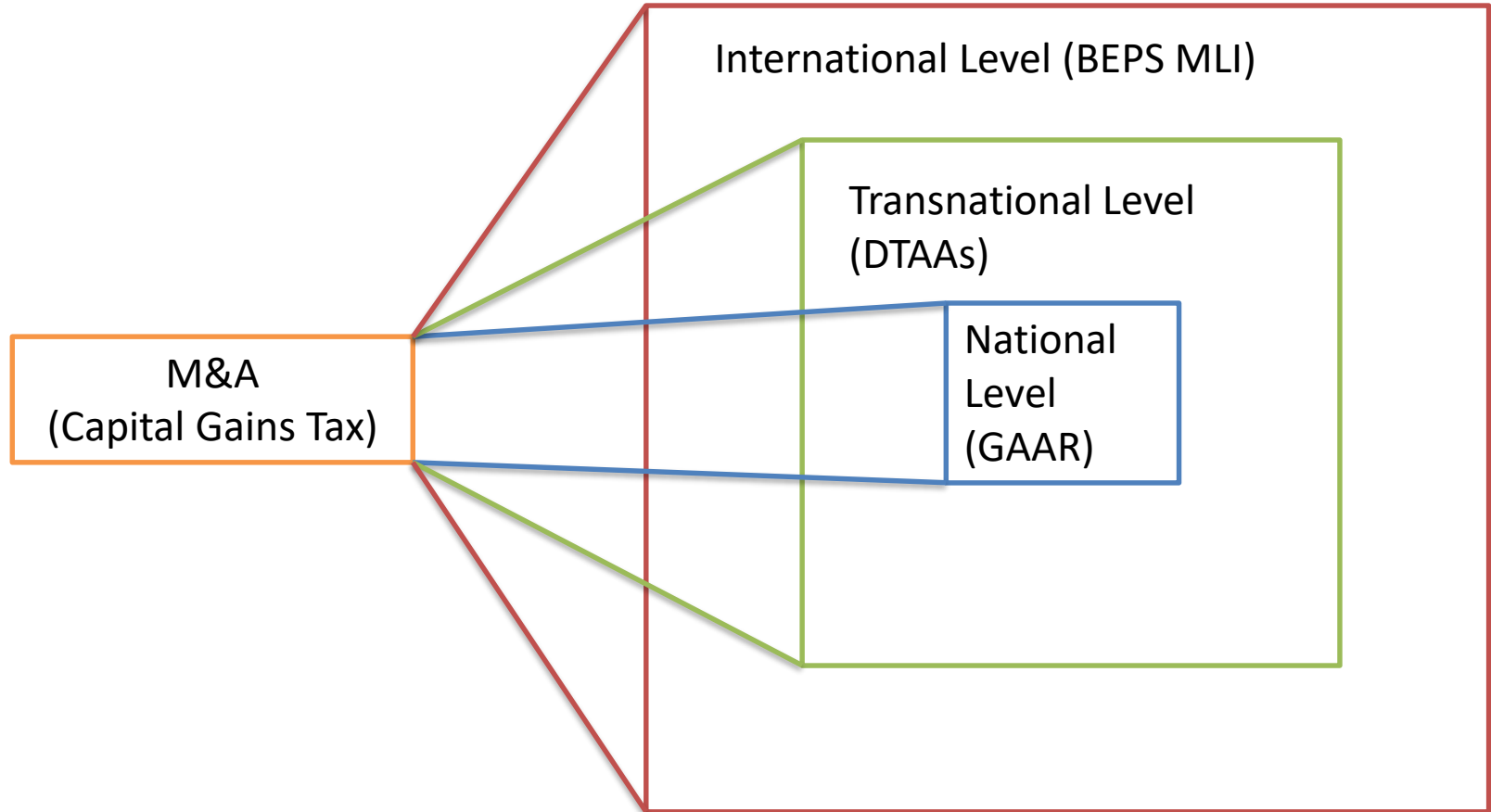
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Tax Regulations affecting M&A



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Defining M&A

Income Tax Act 1961 (IT Act 1961) Section 2(1B) “**amalgamation**”, in relation to companies, means the **merger of one or more companies with another company** or the **merger of two or more companies to form one company** (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that—

(i) all the **property of the amalgamating company or companies** immediately before the amalgamation **becomes the property of the amalgamated company** by virtue of the amalgamation ;

(ii) all the **liabilities of the amalgamating company or companies** immediately before the amalgamation **become the liabilities of the amalgamated company by virtue of the amalgamation** ;

(iii) **shareholders holding not less than [three-fourths] in value of the shares in the amalgamating company or companies** (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) **become shareholders of the amalgamated company** by virtue of the amalgamation;

otherwise than as a result of **the acquisition of the property** of one company by another company pursuant to the **purchase of such property** by the other company or as a result of the **distribution of such property** to the other company after the **winding up** of the first- mentioned company ;]

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Related Definitions

| | |
|---|----------------------------|
| Capital Assets | IT Act 1961 Section 2 (14) |
| The parameters for the transfer of Capital Assets | IT Act 1961 Section 2 (47) |
| The taxation of Capital Gains | IT Act 1961 Section 45 (1) |
| Regulation and computation of Capital Gains Tax | IT Act 1961 Section 49 |
| Exemption of Capital Gains Tax | IT Act 1961 Section 47 |

M&As which do not trigger the exceptions of the provisions would then be susceptible to capital gains tax.

The issue that then arises in cross border M&As is that of transactions being taxed by both jurisdictions, amounting to double taxation – which may prove to be a disincentive for FDI.

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Double Taxation Avoidance Agreements

Tax authorities in India may enter into a Double Taxation Avoidance Agreement (DTAA) in order to “grant relief” from income tax being levied simultaneously in India and any other jurisdiction, and in order to **“promote mutual economic relations, trade and investment”** (IT Act 1961 Section 90(1)(a) and (b))

Tools of information exchange between jurisdictions, in order to prevent or identify instances of tax evasion and the eventual recovery of such tax

Capital gains tax regulations can be made redundant through the use of innovative structures involving holding companies in favourable jurisdictions, which don't impose a capital gains tax and have a DTAA with India - **‘treaty shopping’**

The IT Act allows a tax assessee to choose the most beneficial tax regime from the jurisdictions involved in a DTAA, under which the assessee is taxed (IT Act 1961 Section 90(2))

Multinational corporations (MNCs) were able to establish a presence in third party countries that have tax treaties with India and a more beneficial tax regime

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Double Taxation Avoidance Agreements (contd.)

Example – Mauritius

Often been a preferred route for FDI due to tax benefits accruing from the India-Mauritius treaty

1994 - Central Board of Direct Taxes (CBDT) passed a circular stating that Mauritian residents deriving income from the alienation of Indian shares, would be liable for capital gains tax in Mauritius and not in India (Income Tax Department Circular No. 682, 30th March 1994 Para 3)

Several Foreign Institutional Investors (FIIs) not to be genuine establishments but rather 'shell companies' looking to take advantage of the DTAA and as a result avoiding taxes – 'Show cause' for their status of residence.

2000 circular by the CBDT stated that a 'Certificate of Residence' issued by Mauritian Authorities was sufficient evidence for accepting the status of residence (Income Tax Department Circular No. 789, 13th April 2000 Para 2)

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Double Taxation Avoidance Agreements (contd.)

Azadi Bachao Andolan case

(Union Of India (Uoi) And Anr. vs Azadi Bachao Andolan And Anr (2004) 1 CompLJ 50 SC)

Allegation that the CBDT had exceeded its authority

The SC decided that they could not agree with the argument that

“an act which is otherwise valid in law can be treated as non-est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests”.

As a result, treaty shopping leading to significant avoidance of Indian income tax, was deemed not to be illegal. Several subsequent cases also relied upon the *Azadi Bachao Andolan* judgement.

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Double Taxation Avoidance Agreements (contd.)

Vodafone case

Vodafone International Holdings BV v. Union of India, [2012] 341 ITR 1 (SC)

The SC passed a judgement that denied Indian tax administrators any jurisdiction over the transaction.

“no court [would] recognise a sham transaction or a colourable device or adoption of a dubious method to evade tax, but to say that the Indo-Mauritian Treaty [would] recognise FDI and FII only if it originates from Mauritius, not the investors from third countries, is pitching it too high, especially when statistics reveals that for the last decade the FDI in India was US\$ 178 billion and, of this, 42% i.e. US\$ 74.56 billion was through Mauritian route. [...] Facts, therefore, clearly show that almost the entire FDI and FII made in India from Mauritius under DTAA does not originate from that country, but has been made by Mauritius Companies/SPV, which are owned by companies/individuals of third countries providing funds for making FDI by such companies/individuals not from Mauritius, but from third countries.”

(Separate Judgement of Radhakrishnan J.)

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Consequences – Retrospective regulations

Finance Act 2012:

Modified the definition of 'capital assets' by including an explanation that

“‘property’ includes and ***shall be deemed to have always included*** any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever”

Similarly, the definition of 'a transfer of capital assets' and 'income deemed to accrue or arise in India' was modified to include a retroactive effect.

Thereby circumventing the SC judgement

A ramification of the above-described situation has been the negotiations and recent modifications of existing DTAAs

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DTAA modifications

India-Mauritius DTAA was amended and notified in August 2016, and the amendments came into effect from the 19th of July 2016 for shares acquired on or after the 1st of April 2017

India will be able to tax capital gains arising from the alienation of shares of an Indian resident company acquired on or after 1st April 2017 – No retroactive effect

Furthermore, capital gains arising between the 1st of April 2017 and the 31st of March 2019 will be subject to a limited tax of 50% of the domestic tax rate of India

Similar amendments for the India – Cyprus DTAA and India – Singapore DTAA, with a starting date of 1st April 2017, whereby source based taxation has been instituted, replacing the previous residence based taxation

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Limitation of Benefits (LoB)

DTAAs included a 'Limitation of Benefits' (LoB) clause

(In the Vodafone case, one of the reasons given by the Supreme Court, for the judgement was the absence of an LoB clause)

LoB clause disentitles an entity to the benefits from certain provisions if its affairs are arranged with the primary purpose to take advantage of those provisions, thereby effectively disallowing shell or conduit companies.

Provisions such as LoB clauses are often termed Special Anti-Avoidance Regulations (SAAR).

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Limitation of Benefits (LOB): DTAA Provisions

Amended India – Mauritius DTAA:

LoB clause disallows a shell/conduit company from being eligible for the benefits of the DTAA

Defines a shell/conduit company:

“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”.

“deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less than Mauritian Rs.1,500,000 or Indian Rs. 2,700,000 in the respective Contracting State”.

An entity may prove itself not to be a shell/conduit company if it is listed in a recognized stock exchange of a Contracting State.

The India – Singapore DTAA has identical LoB conditions excepting their limit of expenditure on operations, which in this case is Singapore \$200,000 or Indian Rs. 5,000,000.

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General Anti Avoidance Rules

Inclusion of the General Anti Avoidance Rules (GAAR) into the IT Act, 1961

GAAR are found under Chapter XA of the IT Act (Sections 95 – 102)

The provisions define certain commercial arrangements to be ‘impermissible avoidance arrangements’ if the main purpose of such arrangements is to accrue a tax benefit.

‘Commercial Substance’:

- it is deemed to be an impermissible avoidance agreement and attract the punitive and consequential provisions of GAAR
- “the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part
- it involves “round trip financing”, “an accommodating party”, elements within the arrangement that “have the effect of offsetting or cancelling each other”, or if it is a “transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction”

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General Anti Avoidance Rules(contd.)

Regulatory Grey Area

Shome Committee Report – The report differentiates between tax mitigation, evasion and avoidance

Mitigation - Right of the taxpayer to compute taxes in a way allowed by tax legislation, that would allow him to pay the 'least tax possible', and thereby minimise tax liabilities – extends to the arrangement of company structures, including the use of commercial arrangements M&As, as long as the 'main purpose' behind such arrangement is not reducing taxes

Evasion - use of illegal means, such as the falsification of records and suppression of facts to reduce tax liabilities. It is, of course, illegal in the eyes of the law, and subject to punitive regulatory repercussions

Avoidance – falls within an ethical grey area – concerns commercial arrangements that have legal form but lack 'commercial substance' - the substance of a commercial arrangement is analysed in conjunction with the legal form of such arrangements

The Shome Committee Report recognizes it to be “a business arrangement to avoid tax [that] may not reflect its embedded legislative intent”

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General Anti Avoidance Rules (contd.)

Applicability of GAAR to cross-border transactions

M&A arrangements have to be carefully implemented in order not to fall foul of the IT Act.

Compared to other jurisdictions, the Indian GAAR is much broader in scope

Cross border transactions, which may have a step or part designed to avoid taxation or where one of the purposes is to avoid taxes, may be judged in its entirety to be an impermissible avoidance arrangement (Section 96 (2) of the IT Act 1961)

However, the IT Act also provides safeguards to limit its applicability

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General Anti Avoidance Rules (contd.)

Safeguards to limit applicability of GAAR

Threshold limit for GAAR

Shome Committee Panel – recommended that GAAR be applied to very selective cases, above a high threshold of INR 3 Crores – GAAR would be anti-deterrent rather than a revenue-generating

Although Chapter X A of the IT Act does not specifically mention a threshold, a clarifying notification by the Central Board of Direct Taxes (CBDT notification) put the threshold at INR 3 Crores (Circular No. 7 of 2017)

Grandfather clause (Section 95(2))

All transactions and arrangements made before the 1st of April 2017 may not be assessed under Chapter X-A

This is further asserted by Section 10U(1)(d) of the Income Tax Rules, 1965

Gives an assurance to foreign investors against any retrospective application

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