

M&A Hotline

April 26, 2012

INDIA BUDGET 2012: IMPACT ON CROSS BORDER M&AS

Further to our [analysis of Budget 2012](#) (India Budget Insights (2012 - 13) circulated earlier, this M&A Hotline discusses the key changes introduced by Budget 2012 relevant to cross-border M&A transactions involving India.

Some of the critical changes proposed in Budget 2012 which could have far reaching impact on cross border M&As in India include taxation of offshore indirect transfers; withholding of tax on payments made by a non-resident (irrespective of their presence in India) to another non-resident, introduction of the draconian General Anti Avoidance Rules ("GAAR") provisions, taxation of earn-outs and non-compete payments, etc.

Since the proposed changes have extensive implications on doing any M&A deal in India, and considering the aggressive stance taken by the Indian tax authorities lately, it is important to analyze some of the key changes proposed to understand their implications on cross border M&As going forward.

INDIRECT SHARE TRANSFERS TAXABLE

Proposed Amendments

Budget 2012 has proposed certain provisions which will bring transactions consummated at offshore level under the Indian tax net subject to satisfaction of certain conditions.

Scope of income of non-resident: Section 9 of the Income Tax Act, 1961 ("**Act**") currently provides that in respect of a non-resident, 'income accruing or arising, whether directly or indirectly, ...] through transfer of a capital asset situate in India shall be deemed to accrue or arise in India'. It has been proposed to clarify that a capital asset being any share or interest in an offshore company shall be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

Definition of a 'capital asset': The current definition of 'capital asset' under the Act includes property of any kind held by a taxpayer (with certain exceptions). Budget 2012 has proposed to expand the definition of 'capital asset' (with effect from April 1, 1961) to include any rights whatsoever in (or in relation to) an Indian company, including the rights to manage and control it.

Definition of a 'transfer': The current definition of 'transfer' under the Act includes any sale, exchange, extinguishment or relinquishment of rights. Budget 2012 has proposed to clarify that 'transfer' shall include creation or disposing of any interest in any asset in any manner whatsoever (i.e. directly, indirectly, absolutely, conditionally, voluntarily, involuntarily by way of an agreement entered into in India or outside India or otherwise) even if such transfer of rights has been characterized as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India.

Analysis

- Offshore transactions taxed: The Supreme Court had pronounced early this year in Vodafone case¹ that the Indian tax authorities did not have jurisdiction for taxing offshore transfers. The changes proposed in Budget 2012 seem to be a knee jerk reaction of the Government of India to override Supreme Court's ruling in the Vodafone case. Any transfer of share or interest in an offshore company, where such share or interest derives its value (directly or indirectly) substantially from Indian assets, has now been proposed to be brought under the Indian tax net. While the intent seems to be to capture M&A transaction structures overseas which relate to Indian assets, there are currently no exemptions even for shares of overseas listed companies or in relation to sale of portfolio holdings, if the value of such company is substantially derived from Indian assets. Further, these changes have been proposed as clarifications rather than new changes in the Act and are applicable retrospectively from April 1, 1961 which means that even the past transactions will get captured through these clarifications.
- Substantial interest not defined: In the draft Direct Taxes Code that is proposed to supersede the existing Act next year, a threshold of 50% of the voting power or economic interest in a company or a concern was specified as trigger for taxation of indirect transfers. However, Budget 2012 does not define the phrase 'derives value substantially from the assets located in India'. Absence of clear guidance on such a term which forms the basis of the charging provision for taxing indirect transfers would lead to ambiguity and indiscriminate interpretation, and transfer of genuine holding companies abroad with subsidiaries across the globe could also be taxed under these provisions.
- Definitions of 'transfer' and 'capital asset' broadened: Budget 2012 proposes to broaden the definition of 'capital asset' to include a right to control and manage in an Indian company. Further, the definition of 'transfer' proposes to tax even transfer of such rights irrespective of whether such transfer of rights is flowing from the transfer of a share of the Indian company. This change has been proposed to overturn Supreme Court's judgment in Vodafone case wherein it was held that transfer of rights flow together with transfer of shares and the same cannot be segregated.

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This proposed change could create serious ambiguities on attribution of consideration between shares and other rights and may result in prolonged litigation with the Indian tax authorities.

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GAAR INTRODUCED

Proposed Amendments

From a tax perspective, India has traditionally followed 'form over substance' principle. Budget 2012 proposes to change this principle to 'substance over form' by introducing comprehensive GAAR provisions providing wide powers to the Indian tax authorities for taxing 'impermissible avoidance arrangements'. An arrangement will be considered 'impermissible avoidance arrangement' if (i) a tax benefit has been availed and (ii) (a) there has been misuse or abuse of provisions of the Act or (b) the transaction or arrangement is non-arms length or (c) the transaction or arrangement is not bonafide or (d) the transaction or arrangement lacks commercial substance. Once any arrangement is considered 'impermissible avoidance arrangement', the Indian tax authorities have the power to override the tax treaty, disregard entities in a structure, 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, etc. Under the GAAR provisions, no definition of 'commercial substance' has been provided which gives discretionary powers to the Indian tax authorities to interpret the term 'commercial substance'. Further, the GAAR provisions can be triggered by Commissioner of Income-tax whose decision can be ultimately revalidated by GAAR panel comprising of 3 Commissioners of Income-tax. GAAR provisions proposed in Budget 2012 are not applicable retrospectively. However, it is not yet clear as to whether the structures set up before March 31, 2012 will be grandfathered from the applicability of GAAR provisions.

Analysis

- Indian tax authorities may deny tax benefits even if conferred under a tax treaty by disregarding the tax treaty if the GAAR provisions are triggered resulting in double taxation.
- Wide discretionary powers provided to the Indian tax authorities give much room for misuse of GAAR provisions and will increase litigation with respect to M&As.
- The structuring of cross border M&As will become extremely complex going forward.
- Documenting commercial rationale for each and every step in the transaction will become critical when the transaction documents are drafted.
- The composition of GAAR panel gives absolute powers to the Indian tax authorities to trigger GAAR. Internationally, in addition to members from tax authorities, GAAR panel also has members from judiciary, academicians, industry representatives, etc which can take a broader perspective of any case rather than only considering the benefit/loss to the tax exchequer.

WITHHOLDING OF TAX

Proposed Amendment

The Supreme Court in the Vodafone case had held that under section 195 of the Act, a non-resident who does not have a presence in India could not be subject to withholding tax obligations when payment is made to another non-resident. Though, withholding taxes are administratively easier to collect from the acquirer, this ratio was thought to be a rational move considering that a burdensome obligation should not be imposed on a non-resident who does not have presence in India. However, Budget 2012 has sought to make the Supreme Court ruling redundant by seeking to introduce an explanation to extend the application of withholding tax on payments by all persons, resident or non-resident, whether or not the non-resident has a residence or place of business or business connection in India, or any other presence in any manner whatsoever in India. The changes with respect to withholding tax have been proposed as clarifications rather than new changes in the Act and are applicable retrospectively from April 1, 1961.

Analysis

- Administrative hassle: The above amendments have been proposed as a clarification and not a new change and are applicable retrospectively from April 1, 1961. This means that the acquirer was always obligated to withhold tax for the past direct and indirect transfer transactions that got consummated post April 1, 1961. Further, for withholding tax related provisions, there is no limitation period which has been prescribed which means that the Indian tax authorities can target past transactions without any restriction on the period of time for which they can go back.
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ELIGIBILITY TO CLAIM TREATY BENEFITS

Budget 2012 proposals give rise to onerous compliance challenges for foreign investors. For claiming treaty benefits, non-resident taxpayers will be required to obtain a tax residency certificate from their home jurisdiction containing specific particulars as may be prescribed by the Revenue in absence of which treaty benefits will not be available. Further, the concern is that not every country may issue a tax residency certificate in the form in which Indian tax authorities want and this may result in denial of treaty benefits due to procedural issues. Further, even if a tax residency certificate is obtained from the home jurisdiction in the form required by the Indian tax authorities, there is no certainty that the treaty benefits will be available since the Indian tax authorities may deny benefits under the treaty by triggering GAAR provisions.

REOPENING PAST CASES

Budget 2012 also increases the time period for taxing prior transactions from 6 years to 16 years (in relation to offshore transfers), making it extremely difficult for taxpayers to maintain necessary documentation and manage litigation risks. Further, the provision contains a carve out which does not make the limitation period applicable to income which has escaped assessment including income in relation to any asset (including financial interest) in any entity located outside India.

TAXATION OF EARN-OUTS

Proposed Amendment

Budget 2012 has proposed a new provision for taxation of earn outs wherein if the consideration to be paid for any asset is not determinable at the time of transfer of such asset, the fair market value of such asset on the date of such transfer shall be considered as the consideration for the purpose of the Act.

Analysis

It's very common in M&A deals in India that the acquirer pays certain upfront consideration to the seller and the balance consideration is paid to the seller depending on the profits of the target company in subsequent years. The proposed amendment will impact all the earn out transactions since the seller will have to pay tax in the year of transfer not only on the upfront consideration but also on the fair market value of balance consideration in spite of the fact that there is no certainty of receipt of such balance consideration from the acquirer in subsequent years.

TAXATION OF NON-COMPETE PAYMENTS

Proposed Amendment

With the intention of gradually transitioning towards the Goods and Service Tax ("GST") regime, Budget 2012 has proposed that the service tax law will henceforth follow the 'Negative List approach'. Under this approach, all services, except those specified in the negative list and those specifically exempted, would be chargeable to service tax. The base rate of service tax too has been increased from 10% to 12% uniformly on all services.

Analysis

Since, 'service' has been widely defined as "any activity carried out by a person for another for consideration ...", an activity even if not perceived to be a service, could be held as one by the Indian tax authorities, thus leading to increased litigation. As per Budget 2012, 'services' will also include 'declared services'. Specifically, one of the 'declared services' being included is agreeing to the obligation to refrain from an act which means that non-compete payments will also be caught in the service tax net. This change will make the M&A deals costlier for the parties to the extent of service tax component on non-compete fees.

CONCLUSION

Post the announcement of Budget 2012, there have been a lot of representations to the Finance Minister from the FII's, various industry bodies and foreign governments on the uncertainty which Budget 2012 has created. The press reports indicate that before the Budget 2012 is passed by the Parliament sometime next month, the Finance Minister may relook at the GAAR provisions to provide some safe harbors for certain types of investors / situations. It remains to be seen as to how the Finance Minister balances the need of an emerging economy like India to get more foreign investment vis-à-vis to collect more taxes to curtail the mounting fiscal deficit.

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You can direct your queries or comments to the authors

¹ Please refer to the hotline on the judgment of the Supreme Court in the Vodafone case at http://www.nishithdesai.com/New_Hotline/Tax/Tax%20Hotline_Jan2312.htm

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