India

Country M&A Team

Country Leader ~ Hiten Kotak

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1. Introduction

1.1 General Information on M&A in India

With GDP growth at 8.7% during financial year 2007-08 and prospects of maintaining the growth rate, the Indian economy is one of the fastest growing in the world. Its rapidly increasing consuming class provides the world with a huge market potential. Given its strategic strengths and rapidly paced economy, India serves as an ideal catalyst for investors to launch into the Asian market.

India witnessed heightened deal activity in the first half of 2007 with the value of M&A transactions crossing US$ 55 billion, spread over 550 deals, far exceeding the total deal value recorded for all of 2006. Notable amongst deals during the period were the sharp acceleration in outbound activity by Indian corporates, and significant growth in private equity investments in the country. Outbound investments, which included Tata Steel's US$ 13.6 billion acquisition of Corus and Hindalco's US$ 6 billion acquisition of Novelis, exceeded US$ 28 billion. In a way these two large deals have brought Indian M&A to the global forefront – India's outbound M&A during the first six months of 2007 was second only to Australia. It has also broken the myth that Indian businesses are all about IT and outsourcing, as most of the outbound M&A were by companies belonging to the "traditional old economy sectors". Sectors such as energy, oil & gas, steel, cement, aluminium and other metals accounted for over 50 percent of the total deal value compared to just 20-25 percent of deal value a couple of years back.

While outbound deals were clearly the flavour of the season, domestic and inbound investments too scaled new peaks for any first half on record. The most significant of these being Vodafone's acquisition of a 52 percent stake in India's fourth largest mobile service operator Hutchison Essar for a consideration of US$ 10.9 billion.

Private equity investments have also been rising steadily, with over 200 deals during the first half of 2007 – in value terms the private equity deal activity crossed US$ 6 billion, compared to the US$ 7.9 billion for the whole of 2006. There has also been a shift in sector focus by private equity with industries such as real estate, banking and financial services, media & entertainment witnessing tremendous growth in investment vis-à-vis traditional sectors such as IT & ITeS, pharmaceuticals & healthcare and telecom.

1.2 Direct Taxes

1.2.1 Individual Tax – Residents / Not Ordinary Residents and Non Residents

Maximum effective rate of tax is 33.99% (30% plus surcharge of 10% and education cess of 3%), where taxable income exceeds Rs.1 million. Otherwise Maximum effective rate of tax is 30.9% (30% plus education cess of 3%).

1.2.2 Corporate Tax

The corporate income tax rates for a domestic company and a foreign company are as follows:

Company	Where taxable income exceeds INR 10 Million*	Other cases
Domestic Company	33.99% (30% plus surcharge of 10% plus education cess of 3%)	30.9% (30% plus education cess of 3%)
Foreign Company	42.23% (40% plus surcharge of 2.5% and education cess of 3%)	41.2% (40% plus education cess of 3%)

**Marginal relief is provided in cases where incremental tax liability exceeds incremental income.*

All incomes accruing or arising in India are taxable in India. A resident of India is liable for tax on its worldwide income subject to double tax relief provided under either the domestic law or a relevant double tax agreement. A non-resident is only subject to India tax on income sourced or received in India.

Taxable income is computed for uniform accounting year, i.e. the fiscal year from 1 April to 31 March.

The taxable income, called "Total Income", is computed after adding certain disallowances, such as book loss on sale of asset and miscellaneous expenditure written off, and reducing certain allowances / benefits from the book profits.

1.2.3 Minimum Alternate Tax

With an object to bring zero tax companies under tax net, MAT @ 10% (plus applicable surcharge, and education cess) of book profits is levied on companies whose tax payable under normal Income Tax provisions is less than 10% of book profits. Further, MAT is not applicable to SEZ developers / Units in respect of income arising on or after 1 April 2005.

The effective MAT rate is as follows:

Company	Where taxable income exceeds INR 10 Million	Other cases
Domestic Company	11.33%	10.3%
Foreign Company	10.557%	10.3%

A credit of such tax paid under MAT provisions by a company w.e.f. financial year 2005-06 shall be allowed against the tax liability which arises in subsequent seven years under the normal provisions of the IT Act.

MAT is payable on the following incomes, otherwise exempt under the Income-tax Act, 1961 ('the IT Act'):

- long-term capital gains from the sale of listed equities through stock exchange or units of equity oriented mutual funds;
- income of undertakings set up in special trade zones claiming exemption under Section 10A of the IT Act;
- income of export-oriented undertakings claiming exemption under Section 10B.

1.2.4 Dividends

Dividend income is exempt in the hands of the shareholders. However, a Dividend Distribution Tax (DDT) is levied on Companies declaring dividend. The effective DDT rate is 16.995% (15% plus 10% surcharge, and education cess of 3%). An exemption from DDT has been granted in case of profits of SEZ developers.

1.2.5 Capital Gains

Gains on sale of assets are subject to tax at the rates depending on the duration of ownership. The rates are as follows:

Particulars	Resident	Non-residents
(a). Short term capital assets (other than (b) below) (Note 1)	Normal corporate / individual tax rates	Normal corporate / individual tax rates
(b). Short term capital assets being listed shares and units of equity oriented fund which have been charged to Securities Transaction Tax (STT) (Note 2)	10%	10%
(c). Long term capital assets being listed shares in a company or units of an equity oriented fund, which have been charged to STT	Exempt	Exempt
(d). Other long term capital assets	20% (10% without indexation)	20%

Surcharge and education cess as applicable, would also be levied.

Note:

1. Short-term capital asset is one which is held for not more than 36 months (12 months in case of shares, listed securities, units of mutual funds and zero coupon bonds).

   Indexation of cost of acquisition and improvement of a long-term capital asset of any nature (other than debentures) is available to Residents. However, the benefit of indexation is available to Non-residents only on long-term capital asset other than shares / debentures of an Indian Company acquired in foreign currency.

2. The Finance Bill 2008 proposes to increase this rate to 15% w.e.f. 1 April 2008.

1.2.6 Fringe Benefit Tax (FBT)

An additional tax termed as "Fringe Benefit Tax" has been introduced with effect from Financial Year 2005-06. It provides for levy of an additional tax @ 30% (plus applicable surcharge and education cess) in the hands of the employer on the value of fringe benefits (including Employee Stock Option Plans) provided to the employees other than perquisites on which tax is paid / payable by the employee.

1.2.7 Banking cash transaction tax

Banking cash transaction tax is leviable @ 0.1% on the following:

- Amount of cash withdrawn from a schedule bank (by whatever mode) on a single day from an account (except savings account) exceeding:
  - INR 50,000 in case of individual (w.e.f. 1 June 2007)
  - INR 100,000 in other cases
- Amount of cash received on encashment of term deposit(s) on a single day from a scheduled bank exceeding:
  - INR 50,000 in case of individual (w.e.f. 1 June 2007)
  - INR 100,000 in other cases
- The Finance Bill 2008 proposes to abolish this tax w.e.f. 1 April 2009.

1.2.8 Wealth Tax

Wealth tax is charged in respect of the net wealth as on 31 March every year (referred to as 'valuation date'). Wealth tax is charged both on individuals and companies at the rate of 1% of the amount by which the 'net wealth' exceeds Rs. 1.5 million. The term 'net wealth' broadly represents excess of prescribed assets over the concerned debts. Prescribed Assets include guest house & residential house, motor cars, jewellery-bullion-utensils of gold & silver, etc, yachts, boats, aircraft, urban land and cash in hand. A debt is an obligation to pay liquidated or certain sum of money incurred in relation to those assets, which are included in the 'net wealth'.

1.2.9 Tax Losses

Change in ownership of a “widely held” company through share acquisition does not affect the carry forward and setoff of unabsorbed business loss within the permitted period.

However, where the acquired company is a company in which the public is not substantially interested (i.e. a closely held company whose shares are not listed in any recognised Indian stock exchange), the benefit of unabsorbed business loss is lost if on the last day of the fiscal year in which the acquisition takes place, shares carrying at least 51% of the voting rights are not beneficially held by the same shareholders who beneficially held shares of the acquired company carrying not less than 51% of the voting power as on the last day of the fiscal year in which the loss was incurred.

The above restriction is not applicable where the acquired company is a subsidiary of a foreign company and at least 51% of the shareholders of the parent foreign company pursuant to a scheme of amalgamation or demerger continue to remain shareholders of the amalgamated or resulting foreign company.

In case of restructuring by way of amalgamation or demerger, subject to fulfillment of specified conditions, the accumulated business loss and unabsorbed depreciation of the amalgamating company or the accumulated business loss and unabsorbed depreciation of the demerged company directly relatable to the undertaking being transferred, as the case may be, shall be deemed to the business loss or depreciation of the amalgamated company or the resulting company, as the case may be.

1.2.10 Thin Capitalisation

India does not have formal thin capitalisation rules for tax purposes. But for the prescribed debt-equity ratio under the exchange control regulations, debt-equity mix is generally driven by commercial considerations.

1.3 Indirect Taxes

1.3.1 Value Added Tax (VAT)

State level sales tax was replaced by VAT w.e.f. 1 April 2005 in a majority of Indian states. The sales tax regime is only applicable in the State of Uttar Pradesh.

- Under the VAT regime the VAT paid on goods purchased from within the State is eligible for VAT credit. The input VAT credit can be utilized against the VAT / Central Sales Tax (CST) payable on the sale of goods. It is thus ensured that cascading effect of taxes is avoided and only the value addition is taxed.
- The Central Sales Tax is sought to be phased out. CST has been reduced from 4% to 2% w.e.f 1 April 2008. However, CST continues to co-exist with the State VAT. Inter State procurement, on which central sales tax is charged by the originating State is eligible for input tax credit. Further, inter State branch / consignment transfers are exempt from VAT and hence not eligible for input tax credit. However, certain states are allowing input tax credit in excess of 4% on inter state stock transfers.

- There would be no VAT on imports into India for the present. Exports will be zero rated. This would mean that while output exports will not be charged to VAT, inputs purchased and used in the manufacture of export goods will be refunded.
- Turnover thresholds have been prescribed so as to keep out small traders from the ambit of the VAT. A turnover tax may be levied on such small traders in lieu of the VAT.
- VAT registered dealers will need to issue serially numbered invoices with prescribed particulars.
- The periodicity of filing of VAT returns will remain the same as prescribed in the erstwhile sales tax regime.
- A comprehensive self assessment of VAT has been introduced.
- Turnover taxes, surcharges, additional surcharges and the special additional tax have been abolished.
- Entry taxes will continue, if vatable, except where they are in lieu of octroi.

The Empowered Committee is currently considering introduction of coding in terms of the Harmonised System of Nomenclature for commodities under the VAT.

Budget 2006 had taken a major step by indicating the date of 1 April 2010 for the introduction of a national, integrated Goods and Services Tax (GST). Budget 2008 has reiterated the commitment towards introduction of a national level Goods & Services Tax (GST) by the said date. The Central Government has indicated that the Empowered Committee of State Finance Ministers would work with the Central Government in setting out a specific road map for the introduction of GST by the above date.

1.3.2 Stamp Duty

Stamp duty is levied at various rates on documents such as bills of exchange, promissory notes, insurance policies, contracts effecting transfer of shares, debenture, and conveyances for transfer of immovable property.

Stamp duty is not imposed on transfer of shares held in the dematerialised mode. However, transfer of shares held in physical form attracts stamp duty generally at 0.25% of market value, statutorily payable by the buyer. Stamp duty is levied on transfer of immovable property at rates varying from state to state.

1.4 Entity Options in India

A foreign company looking at setting up operations in India has the following options for formulating its entry strategy:

1.4.1 Entry Strategy 1: Operating as an Indian Company, through:

Option 1 Wholly owned subsidiary	A foreign company can set up a wholly owned subsidiary company in India for carrying out its activities. Such subsidiary is treated as an Indian resident and an Indian Company for all Indian regulations (incl. Income Tax, FEMA and Companies Act), despite being 100% foreign owned. At least two and seven shareholders are mandatory for a private limited and public limited company respectively.
Option 2 Joint Venture with an Indian Partner preferably with majority equity participation	Though a wholly owned subsidiary has been the most preferred option, foreign companies have also been setting up shop in India by forging strategic alliances with Indian partners. The trend in this respect is to choose a partner who is in the same field / area of activity and has sufficient experience and expertise in the relevant line of activity.

1.4.2 Entry Strategy 2: Operating as a Foreign Company, through:

Option 1 Liaison Office	Setting up a Liaison or Representative Office is a common practice for foreign companies seeking to enter the Indian market. The role of such offices is limited to collecting information about the possible market and providing information about the company and its products to prospective Indian customers. Such offices act as "listening and transmission posts" and provide a two-way information flow between the foreign company and the Indian customers. A Liaison Office is not allowed to undertake any business activity other than liaison activities in India and cannot, therefore, earn any income in India, in terms of the approval granted by RBI.
Option 2 Project Office	Foreign Companies planning to execute specific projects in India can set up temporary project / site offices in India for this purpose. RBI has granted general permission to a foreign entity for setting up a project office in India, subject to fulfillment of certain conditions. The foreign entity only has to furnish a report to the jurisdictional Regional Office of RBI giving the particulars of the project / contract.
Option 3 Branch Office	Foreign companies engaged in manufacturing and trading activities abroad can set up Branch Offices in India for the following purposes, with the prior approval of RBI: • Export / Import of goods • Rendering professional or consultancy services • Carrying out research work, in which the parent company is engaged • Promoting technical or financial collaborations between Indian companies and parent or overseas group company • Representing the parent company in India and acting as buying / selling agent in India • Rendering services in Information Technology and development of software in India • Rendering technical support to the products supplied by parent / group companies • Foreign airline / shipping company. In general, manufacturing activity cannot be undertaken through a branch office. However, foreign companies can establish branch office / unit for manufacturing in a SEZ subject to fulfillment of certain conditions.

1.5 Foreign Ownership Restrictions

1.5.1 Foreign Direct Investment (FDI)

During FY 2006-07, India received an estimated USD 16 billion in FDI inflows, growing three-folds over the previous year. Amount of FDI inflows from April 2007 to August 2007 was USD 6.45 billion. For FDI during 2007-2008 (till August 2007), Service sector accounted for 20.63% of the total FDI inflows followed by Computer Software & Hardware (15.97%), Telecommunication (8.74%), Automobile Industry (8.74%) and Construction activities (5.23%). The balance of inflows (40.69%) was accounted for by other sectors.

The advantage of India as an investment destination rest on strong fundamentals which include a large and growing market; world-class scientific, technical and managerial manpower; cost effective and highly skilled labour; abundant natural resources; a large English speaking population; independent judiciary, etc. This is now recognised by a number of global investors who have either already established a base in India or is in the process of doing so. On going initiatives such as further simplification of rules and regulations, improvement in infrastructure is expected to provide necessary impetus to increase FDI inflows in future.

The inflows of FDI would depend on domestic economic conditions, world economic trends, and strategies of global investors. Government, on its part is fully committed to creating strong economic fundamentals and an increasingly proactive FDI policy regime. The positive efforts of the Government to improve the investment climate, including sustained improvement on infrastructure front, have led to renewed optimism about India as an emerging investment destination.

The Indian Government embarked on liberalizing the Indian regulatory framework with specific reference to foreign investment, through the Statement on Industrial Policy of 1991. Since then the Indian regulatory environment for foreign investment has been eased consistently to make it increasingly investor-friendly.

Under the current FDI framework, foreign investment is permitted from all categories of investors and in all sectors except –

- Citizens / entities of Pakistan and Bangladesh
- Certain sectors, namely:
  - Atomic Energy
  - Lottery Business / Gambling & Betting
  - Agriculture (excluding floriculture, horticulture, seed development, animal husbandry, pisciculture and cultivation of vegetables, mushrooms, etc.)
  - Plantations (excluding Tea plantation)
  - Retail Trading (other than Single Brand retail)

For other sectors, there are two approval routes for foreign investment in India:

- Automatic route under delegated powers exercised by the Reserve Bank of India (RBI);
- Approval by the Government through the Foreign Investment Promotion Board (FIPB) under the Ministry of Finance.

These are discussed in brief below.

1.5.2 Automatic Route:

- FDI is permitted under the automatic route (i.e. without requiring prior approval) for all items / activities except the following:
- where the foreign collaborator has an existing venture / tie-up in India in the same field ('same field' means the same 1987 NIC code) as on 12 January 2005, with the exception of following cases which would not require prior FIPB approval:
  - investment by a Venture Capital Fund registered with Securities and Exchange Board of India (SEBI);
  - existing joint venture has less than 3% investment by either party;
  - existing joint venture is defunct or sick.
- proposals falling outside notified sectoral policy / caps or sectors in which FDI is not permitted.

1.5.3 FIPB Route:

In all other cases of foreign investment, where the project does not qualify for automatic approval, as given above, prior approval is required from FIPB.

Decision of the FIPB is normally conveyed within 30 days of submitting the application. The proposal for foreign investment is decided on a case-to-case basis depending upon the merits of the case and in accordance with the prescribed sectoral policy.

- Generally, preference is given to projects in high priority industries, infrastructure sector, those having export potential, large-scale employment opportunities, linkages with agro sector, social relevance or relating to infusion of capital and induction of technology.

1.5.4 Downstream investment

Downstream investments by foreign owned Indian holding companies are treated at par with FDI guidelines. Prior approval of FIPB is required to act as a holding company.

Domestic funds cannot be leveraged by the foreign owned Indian holding company for downstream investments.

1.5.5 Investment by Non Resident Indians (NRIs)

NRIs are also permitted to purchase and sell shares / convertible debentures under the portfolio investment scheme on repatriation and / or non repatriation basis through a branch designated by an authorised dealer for the purpose and duly approved by the RBI, subject to fulfillment of certain conditions. Under the non-repatriation scheme (i.e. capital is not repatriable outside India), NRIs are permitted to invest in all activities except in a company which is a Chit-Fund or a Nidhi Company or is engaged in agricultural / plantation activities, or real estate business[1], or construction of farmhouses or dealing in transfer of development rights.

Under the Portfolio Investment Scheme, the total holding by each NRI cannot exceed 5% of the total paid up equity capital or 5% of the paid up value of each series of convertible debentures issued by an Indian company. Further, the total holdings of all NRIs put together cannot exceed 10% of paid up equity capital or paid up value of each series of convertible debentures. This limit of 10% may be increased to 24% by the concerned Indian company by sanction of the shareholders through a special resolution.

1.5.6 Investment by Way of Acquisition of Shares

Acquisitions may be made from an existing Indian company which is either a privately held company or a company in which public are interested (i.e., a company listed on stock exchange), provided a resolution to this effect has been passed by the Board of Directors of the Indian Company.

Acquisition of shares of a public listed company is subject to the guidelines of the Securities Exchange Board of India (SEBI). SEBI's Take-Over Code Regulations require that any person acquiring 15% or more of the voting capital in a public listed company should make a public offer to acquire a minimum 20% stake from the public.

Foreign investors looking at acquiring equity in an existing Indian company through stock acquisitions can do so without obtaining approvals except in the financial services sector, provided:

- such investments do not trigger off the takeover provisions under the SEBI's Substantial Acquisition of Shares and Takeovers Regulations 1997; and
- the non-resident shareholding after transfer complies with sectoral limits under FDI Policy.

As per RBI valuation norms, acquisition price should not be lower than:

- Prevailing market price, in case of listed companies; and
- Fair Market Value as per CCI valuation guidelines, in case of unlisted companies.

[1] *For this purpose, Real estate business does not include development of township, construction of residential / commercial pre-mises, roads, bridges, etc.*

1.5.7 Investment by Foreign Institutional Investors

A registered Foreign Institutional Investor (FII) may, through SEBI, apply to RBI for permission to purchase the shares and convertible debentures of an Indian company under Portfolio Investment Scheme.

FIIs are permitted by RBI to purchase shares / convertible debentures of an Indian company through registered brokers on recognized stock exchanges in India. They are also permitted to purchase shares / convertible debentures of an Indian company through private placement / arrangement.

The total holding by each FII / SEBI approved sub-account of FII cannot exceed 10% of the total paid-up equity capital or 10% of the paid-up value of each series of convertible debentures issued by an Indian company. Further, the total holdings of all FIIs / sub-accounts of FIIs put together cannot exceed 24% of paid-up equity capital or paid-up value of each series of convertible debentures. This limit of 24% may be increased to the specified sectoral cap / statutory ceiling, as applicable, by the Indian company concerned by passing a Board of Directors' resolution followed by sanction of the shareholders through a special resolution to that effect.

1.5.8 Technology Transfer

For promoting an industrial environment, which accords priority to the acquisition of technological capability, foreign technology induction is encouraged both through FDI and through foreign technology collaboration agreements. Foreign collaboration agreements are permitted either through the automatic approval route or with prior approval from the Government.

Automatic Approval

No approvals are required in respect to all those foreign technology agreements, which involve:

- a lump-sum payment of up to USD 2 million;
- royalty[2] payable up to 5 per cent on net domestic sales and 8 per cent on exports.

Government Approval

Approval from the Government of India is necessary for the following categories of foreign technical collaboration agreements:

- Proposals attracting compulsory licensing;
- Items of manufacture reserved for the small-scale sector;
- Proposals involving any existing joint venture, or technology transfer / trademark agreement in the 'same field' in India;
- Proposals not meeting any or all of the parameters for automatic approval.

[2] *Royalty is to be calculated on the basis of the net ex-factory sale price of the product, exclusive to excise duties minus the cost of standard bought-out components and the landed cost of imported components, irrespective of the source of procurement, including ocean freight, insurance, customs duties, etc.*

It is permissible for an Indian Company to issue equity shares against lump-sum fee and royalty in convertible foreign currency already due for payment / repayment, subject to meeting all applicable tax liabilities and procedures.

2. Structuring a Share Deal

2.1 Seller's Perspective

2.1.1 Profit on Sale of Shares

Gains derived from transfer of shares in Indian companies are subject to tax in India at the rates prescribed previously as Capital Gains (see section 1.2.5).

For the purpose of computing the capital gains tax liability, the cost of acquisition, expenses incurred in connection with the transfer and the consideration receivable for the transfer are required to be converted in the same foreign currency as that utilised for the purchase of such capital asset and the resultant capital gain reconverted into INR.

However, no capital gains tax is imposed on transfers of shares in Indian companies by one foreign company to another in a scheme of amalgamation, if at least 25% of the shareholders of the amalgamating company continue to remain as the shareholders of the amalgamated company and the transfer is exempt from capital gains tax in the country where the amalgamating company is located.

2.1.2 Distribution of Profits

Distribution of profits will depend on the form of the business entity of the Target Company. In a corporate entity, Indian Company Law regulations require a maximum retention up to 10% of the profits prior to distribution of dividends except in the case of liquidation. Under the existing laws, the company distributing dividend of the balance of the profits after the retention of the amount required under the Indian Company Law regulations has to pay dividend distribution tax at an effective rate of 16.995%.

The balance may be distributed to the shareholders by way of dividend without any withholding tax because dividends under the existing laws are not taxed in the hands of the shareholders.

2.2 Buyer's Perspective

2.2.1 Acquisition Structure

In a share deal, the cost of the assets may not be revalued. Further, in the case of the acquisition of a listed company, the acquirer has to comply with the Takeover Code regulations which, inter alia, make it mandatory for the acquirer to make an open offer to the public shareholders of the acquired company for purchasing their holding, if the buyer proposes to acquire 15% or more in Target Company.

Acquisition through an overseas intermediate company (having substance) located in Mauritius or Singapore can be considered because of preferential tax treatment with regard capital gains tax under the respective treaties.

This remains the most preferred method of acquisition and it is also cost effective as compared to an asset deal because of stamp duty implications.

2.2.2 Funding Costs

Under the existing tax regime, it is preferable to treat the financing costs incurred in acquiring the shares as a part of the cost of acquisition because such costs are not tax deductible against the dividend income which is exempt from tax in the hands of the shareholders.

2.2.3 Acquisition Expenses

The acquisition expenses directly related to the share purchase are allowed to be added to the cost of the shares and are eligible for tax deduction in determining capital gains on sale.

2.2.4 Debt / Equity Requirements

There are no prescribed debt-equity ratios (except under the exchange control regulations), which are generally driven by commercial considerations.

2.2.5 Preservation of Tax Losses

The benefit of tax concessions, incentives, carry forward of prior years' tax losses is not lost in a share deal involving the acquisition of a company except in case of a company in which the public is not substantially interested to the extent indicated under section 1.2.9.

2.2.6 Repatriation of Profits

Repatriation of profits in a share deal can only be through the dividend route. The tax implications, both for the company distributing the dividend and the shareholders, have been dealt with under sections 1.2.4 and 2.1.2.

Stock dividends (on equity shares) in the form of bonus shares are not taxable in the hands of the recipient. However, the entire consideration received on any subsequent sale of such shares would be subject to capital gains as the cost of acquisition of such shares is considered to be nil.

3. Structuring an Asset Deal

3.1 Seller's Perspective

3.1.1 Profit on Sale of Assets

In the case of depreciable assets, the income tax written down value of the block of assets (ITWDV) is reduced by the consideration received from the sale and consequently depreciation at the rate applicable to the block of assets is allowed on the reduced ITWDV. If the consideration receivable for the transfer of the assets exceeds the ITWDV, the excess is considered to be a short-term capital gain and subjected to tax at the corporate tax rate applicable to the entity. In the case of non-depreciable assets, the short-term capital gain is taxed at the corporate tax rate applicable to the entity whereas the long-term capital gains computed (after allowing indexation benefits and substitution of the cost price as on 1 April 1981 if purchased prior to that date) attracts capital gains tax at 20% (10% without indexation) plus applicable surcharge and cess.

For the purpose of computing the capital gains tax liability, the valuation adopted by the registration authorities for levy of stamp duty in connection with the transfer of immovable property shall be adopted if it is more than the consideration receivable for the transfer of the said immovable property.

The seller would be liable to VAT / sales tax on movable property at appropriate rates depending on whether it is an inter-state or intra-state sale.

3.1.2 Distribution of Profits

Distribution of profits will depend on the form of the business entity of the Target Company. In a corporate structure, it can be distributed by way of dividends. The tax implications for both the company distributing the dividend and the shareholders have been dealt with under sections 1.2.4 and 2.1.2.

3.2 Buyer's Perspective

3.2.1 Acquisition Structure

In an asset deal, the acquirer may opt to buy the assets of the company for a slump price and, based on a valuation report, allocate the purchase price properly to the respective assets to ensure the maximum benefit on account of depreciation and amortisation allowed under the tax laws.

It should be kept in mind that the buyer would be liable for stamp duty on transfer of immovable property at a rate which varies from state to state.

The purchase of assets of an Indian company by a foreign company requires the permission of the regulatory authorities unless the purchase is routed through an Indian subsidiary of the foreign company.

3.2.2 Funding Costs

If the assets are acquired through an existing Indian subsidiary engaged in business, the interest on loan taken for the acquisition of the assets is considered as a tax-deductible expenditure to the Indian company.

3.2.3 Acquisition Expenses

The acquisition expenses directly related to the purchase of the assets will be added to the cost of the assets and be eligible for depreciation allowance in the case of depreciable assets. For non-depreciable assets, such costs will be eligible for tax deduction when the assets are sold.

3.2.4 Cost Base Step Up

In an asset deal, the acquirer may opt for buying the assets of the company for a slump price and based on a valuation report allocate the purchase price properly to the respective assets to reap maximum benefit on account of depreciation allowance and amortisation allowed under the tax laws.

This may be resisted by the seller for adverse income tax as well as VAT implications.

3.2.5 Treatment of Goodwill

The goodwill arising out of an asset deal cannot be amortised by the buyer to claim tax benefits. However, the benefit of the cost of acquisition is available on subsequent disposal. Currently, the cost of intangible assets (such as know-how, patents, copyrights, trademarks, franchises or any other business / commercial rights of a similar nature) can be depreciated at the prescribed rates. Due regard should therefore be given for identifying and allocating proper values to such intangible assets.

3.2.6 Other Matters

An asset deal normally attracts heavy incidence of stamp duty at rates varying from state to state on transfer of immovable property which the acquirer has to bear.

4. Concessions Relating to M&As

Any “transfer”, unless specifically exempted, attracts capital gain tax. However, subject to conditions, specified reorganisation schemes, such as amalgamations or demergers are exempted from the levy of such tax.

4.1 Amalgamations

Specified conditions in case of an amalgamation of one or more companies into one includes all assets and liabilities of the amalgamating companies become assets / liabilities of the amalgamated company and the shareholders holding 75% of the share value in the amalgamating companies become shareholders of the amalgamated company.

4.2 Demergers

A “demerger” refers to the transfer, pursuant to a scheme of arrangement under the Indian Companies Act, by a demerged company of one or more of its undertakings to any resulting company in such a manner that all the assets and liabilities being transferred by the demerged company becomes the property of the resulting company and appear at it book values as appearing in the books of the demerged company and the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis.

Moreover, the shareholders holding at least 75% in value of the shares in the demerged company become shareholders of the resulting company and the transfer of the undertaking is on a going concern basis.

4.3 Amortisation of the Amalgamation / Demerger Expenses

In computing taxable income, the reorganisation expenses on account of amalgamation / demerger is amortised at 20% per annum over a five year period.

4.4 Provisions Relating to Carry Forward and Set off of Accumulated Loss and Unabsorbed Depreciation Allowance in Amalgamation or Demerger

(a) Amalgamation

Subject to certain conditions, the accumulated tax loss / unabsorbed depreciation of an amalgamating company engaged in industrial undertaking / ship / hotel / banking / operation of an aircraft business shall be considered as deemed tax loss / depreciation of the amalgamated company provided:

- the amalgamating company having brought forward tax loss / depreciation has been engaged in that business for at least three years, and it has held continuously (as on the date of the amalgamation) at least 75% of the book value of fixed assets for two years prior to the date of amalgamation; and
- the amalgamated company holds at least 75% of the book value of fixed assets of the amalgamating company as well as continuing with the business for five years, besides adhering to certain other prescribed conditions.

For this purpose, “industrial undertaking” means any undertaking which is engaged in:

i. the manufacture or processing of goods; or

ii. the manufacture of computer software; or

iii. the business of generation or distribution of electricity or any other form of power; or

iv. the business of providing telecommunication services, whether basic or cellular, including radio paging, domestic satellite service, network of trunking, broadband network and internet service; or

v. mining; or

vi. the construction of ships, aircrafts or rail systems.

(b) Demerger

In case of a demerger, the accumulated loss and unabsorbed depreciation directly relatable to the undertaking being transferred shall be allowed to be carried forward and set off in the hands of the resulting company. If the accumulated loss or unabsorbed depreciation is not directly relatable to the undertaking, the same shall be apportioned between the demerged company and the resulting company in the same ratio in which the value of the assets have been transferred. In case of demerger, there are no restrictions of "industrial undertaking" to be transferred.

4.5 Slump Sale

"Slump sale" refers to the transfer, where an undertaking is transferred at a lump-sum consideration without values being assigned to the individual assets and liabilities in such sales. Any consideration in excess over the "net worth" arising from the slump sale is chargeable to capital gain tax.

The term "net worth" is the excess of book assets over the value of liabilities of the undertaking transferred. The net worth computation requires authentication by a Chartered Accountant.

5. Exit Route

The exit route, in the case of a share deal, is the transfer of the shares of the Indian company. The tax implications are indicated under section 2.1.1. Transfer of shares of offshore holding company can also be considered.

The exit route, in the case of an asset deal, is the transfer of the assets. The tax implications are indicated under section 3.1.1.

6. Ending Remarks: Preparation for a Deal

The relative considerations of the buyer and seller will depend on the facts of each case. The buyer should weigh the possibility of increasing the asset base through asset acquisition against high stamp duty, loss of unabsorbed losses and depreciation, and recapture of past capital allowances. The buyer should ensure that the acquisition is structured in a manner which will result in improving shareholder value and optimising return on investments.