

# India

Country M&A team

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## 1. Introduction

### 1.1 General information on M&A in India

The Economic Survey 2008-09 released by the Ministry of Finance, Government of India notes that despite the global financial crises, India has still registered a growth rate of 6.7%. The economy continues to face wide ranging challenges — from improving its social and physical infrastructure to enhancing productivity in agriculture and industry and addressing environmental concerns. At the same time, the Indian economy has shock absorbers that will facilitate early revival of growth.

India has taken the next step towards structural changes in direct taxes by releasing a draft of the proposed new Direct Tax Code (DTC) for public debate. The proposed DTC will replace the existing Income-Tax law upon enactment. The principal aim of the DTC is to moderate tax rates, remove exemptions and simplify tax laws in line with international tax principles. Debate and discussions are expected on the DTC between now and the winter session of Parliament when the Government intends to introduce a Bill in the Parliament. The new Code is proposed to come into force on 1 April 2011.

The Government of India is planning to implement a dual Goods and Service Tax (GST) model during financial year 2010-11. Such implementation will be one of the major reforms in indirect taxation wherein the taxes such as Excise duty, Service tax, Value Added Tax (VAT), Central State Tax (CST) and other local taxes such as Entry Tax are subsumed under GST.

A limited liability partnership (LLP) is a new form of business entity created by enactment of the Limited Liability Partnership Act, 2008. A LLP is a body corporate formed and incorporated under the LLP Act. It is a legal entity, separate from its partners, with perpetual succession. Any change in the partners of the LLP shall not affect the existence, rights or liabilities of the LLP. Under the LLP Act a LLP enjoys the beneficial features of incorporated bodies without having the disadvantages of normal partnerships. A LLP is easy and inexpensive to incorporate.

### 1.2 Direct taxes

#### 1.2.1 Introduction

In India, the tax year is the fiscal year, i.e. from 1 April to 31 March. Income tax is an annual tax on income. Income of the previous year is chargeable in the following assessment year at the rates applicable to that assessment year. This rule is however subject to some exceptions.

The amount of income tax payable is calculated by charging income tax on the taxable income called 'total income' at prescribed rates and applicable surcharge. Income tax and surcharge are further increased by 3% (i.e. 2% education cess and 1% secondary and higher secondary education cess).

Surcharge is payable at 10% (2.5% for non Indian companies) for companies with income over INR 10 million.

Taxable income is computed after adding certain disallowances, such as book loss on sale of assets and miscellaneous expenditure written off, and reducing certain allowances / benefits from book profits.

Provisions of computation of taxable income are governed by the Income-tax Act, 1961 (IT Act). However, tax rates are fixed by the Annual Finance Act and not by the IT Act.

All income accruing or arising in India is taxable in India. A resident of India is liable for tax on their worldwide income subject to double tax relief provided under either the domestic law or a relevant double taxation avoidance agreement. A non-resident Indian (NRI) is only subject to India tax on income sourced or received in India.

#### 1.2.2 Individual tax – residents / not ordinary residents and non residents

Maximum effective rate of tax is 30.9% (30% plus cess of 3%). Surcharge of 10% is abolished for individuals and firms by the Finance (No. 2) Act, 2009.

#### 1.2.3 Firms and LLP tax

Maximum marginal tax rates for firms is reduced from 33.99% to 30.90% on account of removal of surcharge. As per the amendment in the Finance (No. 2) Act, 2009, a firm includes a LLP. Thus, all provisions applicable to a firm apply to an LLP as well. Accordingly a LLP will be taxed at the entity level and income of partners of LLP is exempt from tax.

#### 1.2.4 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%)

### 1.2.5 Minimum alternate tax

With the object of bringing zero tax companies under the tax net, Minimum Alternate Tax (MAT) of 15% (plus the applicable surcharge and education cess) of book profits is levied on companies whose tax payable under normal income tax provisions is less than 15% of book profits. MAT is not applicable to developers of special economic zones and units therein.

The effective MAT rate is as follows:

Company	Where taxable income exceeds INR 10 Million	Other cases
Domestic company	16.995%	15.45%
Foreign company	15.836%	15.45%

A credit of tax paid under MAT provisions by a company with effect from financial year 2005-06 is allowed against the tax liability which arises in the subsequent 7 years (Finance (No. 2) Act, 2009) under the normal provisions of the IT Act.

MAT is payable on the following income, otherwise exempt under the IT Act:

- Long-term capital gains from the sale of listed equities through the stock exchange or units of equity oriented mutual funds;
- Income of undertakings set up in special trade zones and Software Technology Park (STP) units claiming exemption under Section 10A of the IT Act;
- Income of export-oriented undertakings claiming exemption under Section 10B.

### 1.2.6 Dividends

Dividend income is exempt. However, a Dividend Distribution Tax (DDT) is levied on companies declaring dividends. The effective DDT rate is 16.995% (15% plus 10% surcharge and education cess of 3%). An exemption from DDT is granted for profits of Special Economic Zone (SEZ) developers.

Any dividend received by a domestic company (C1) during any financial year from its subsidiary (C2) is allowed to be deducted from the dividend to be declared / distributed / paid by C1 for the purpose of the computation of DDT, provided that the dividend received by C1 had been subjected to DDT by C2. Further, it is provided that C1 should not be a 'subsidiary' of any other company.

### 1.2.7 Capital gains

Any gain on the sale of assets is subject to tax at 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 which are listed shares and units of equity oriented funds which have been charged to Securities Transaction Tax (STT)	15%	15%
(c) Long term capital assets which are 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% (10%**)

*A surcharge and education cess, as applicable, is also levied*

\* *Applicable only for listed shares sold off-market*

\*\* *Various judicial precedents indicate that even non-residents are entitled to a beneficial tax rate of 10% in respect of the sale of listed securities or units or zero coupon bonds not charged to STT*

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

*Indexation of the 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 assets other than shares / debentures in an Indian company acquired in foreign currency.*

### 1.2.8 Fringe Benefit Tax

Fringe Benefit Tax (FBT) has been abolished by the Finance (No. 2) Act of 2009. As a consequence, the fringe benefits shall be taxed in the hands of employees.

### 1.2.9 Banking Cash Transaction Tax

Banking Cash Transaction Tax (BCTT) has been abolished by the Finance Act 2008 with effect from 1 April 2009.

### *1.2.10 Wealth tax*

Wealth tax is charged in respect of the net wealth as at 31 March every year (referred to as the 'valuation date'). Wealth tax is charged both to individuals and companies at the rate of 1% of the amount by which the 'net wealth' exceeds INR 3 million (Finance (No. 2) Act, 2009). The term 'net wealth' broadly represents excess of prescribed assets less debts. Prescribed assets include a guest house or residential house, motor cars, jewellery-bullion-utensils of gold and silver, etc., yachts, boats, aircraft, urban land and cash. A debt is an obligation to pay a certain sum of money incurred in relation to those assets, which are included in the 'net wealth'.

### *1.2.11 Tax losses*

Business losses (other than unabsorbed depreciation) are allowed to be carried forward for set off against future business income for a period of eight years. Unabsorbed depreciation is allowed to be carried forward without any time limit and can be set off against any income (other than salary income).

The change in ownership of a 'widely held' company through a share acquisition does not affect the carry forward and setoff of unabsorbed business losses within the permitted period. However, a change in ownership of a closely held company beyond 49% results in the lapse of unabsorbed business losses.

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 continue as shareholders of the amalgamated or resulting foreign company under a scheme of amalgamation or de-merger.

In case of restructuring by way of amalgamation or de-merger, subject to fulfilment of specified conditions, the accumulated business loss and unabsorbed depreciation of the amalgamating company or the accumulated business loss and unabsorbed depreciation of the de-merged company directly relatable to the undertaking being transferred, as the case may be, is deemed to the business loss or depreciation of the amalgamated company or the resulting company, as the case may be.

### *1.2.12 Securities Transaction Tax*

STT is payable on purchase or sale of equity shares, derivatives and units of an equity-oriented fund on a recognised stock exchange, as well as on the sale of units of an equity-oriented fund or a mutual fund. STT is imposed on the value of taxable securities transactions.

Transaction	Payable by	Rate
Delivery based transactions Purchase / sale of an equity share in a company or unit of an equity oriented fund	Payable both by the purchaser and seller on the transaction value	0.125%
Non-delivery based transactions in equities or units of an equity oriented fund	Seller	0.025%
Sale of an option in securities	Seller	0.017%
Sale of an option in securities, where the option is exercised	Purchaser	0.125%
Sale of futures in securities	Seller	0.017%
Sale of units of an equity oriented fund to the mutual fund	Seller	0.25%

The transaction value is determined as follows:

- Option in securities — option premium
- Option in securities where option is exercised — settlement price
- Futures — traded price
- Other securities — purchase / sale price

STT is collected by the recognised stock exchange and paid to the Government.

### 1.2.13 Commodities Transaction Tax

Commodities Transaction Tax (CTT) was abolished by the Finance (No. 2) Act of 2009.

### 1.2.14 Thin capitalisation

India does not have formal thin capitalisation rules for tax purposes. However, it does have provisions to disallow an interest deduction which relates to exempt income.

### 1.2.15 Tax consolidation

A tax consolidation regime allows wholly-owned groups of companies, together with eligible trusts and partnerships, to consolidate for income tax purposes. As there is no tax consolidation or group relief in India, profits and losses arising in different companies of the same group are dealt with separately and cannot be consolidated so as to minimise profits tax on a group basis.

### *1.2.16 Controlled foreign company*

India does not have specific controlled foreign company legislation; thus there is no difference in the treatment of subsidiaries in low-tax or high-tax jurisdictions.

### *1.2.17 Direct Tax Code*

The Direct Tax Code (DTC) has shifted the basis of taxability to financial year and is likely to come into effect from financial year 2011 – 2012.

#### **Tax rates**

- Tax rates for individuals are proposed to be revised to a maximum of 30%
- Partnership firms including LLPs will be taxed at a maximum marginal rate of 30%, with the partner's share not taxable in their hands
- Tax rate for companies (both domestic and foreign) is proposed to be reduced to 25%
- Domestic companies will continue to be liable to DDT at 15%
- Profits of Indian branches of foreign companies is additionally subject to branch profits tax at 15%

#### **Minimum alternate tax**

- The base for computing MAT is proposed to be shifted from 'book profits' to 'gross assets'
- The rate of MAT is proposed to be 2% on all companies (except for banking companies for which it is proposed to be 0.25%)
- MAT will be a final tax and will not be available as a tax credit in subsequent years

#### **Capital gains**

- All capital gains are taxable at normal rates of tax, removing the benefit of lower tax for long term capital gains
- Gains on the transfer of business capital assets as well as slump sale are taxable as business income
- With the proposed abolition of STT, exemption / lower tax for capital gains tax on the sale of shares on the stock exchange is withdrawn
- Fair market value substitution date is shifted to 1 April 2000

#### **Wealth tax**

- Wealth tax is proposed to be only on individuals, Hindu undivided family and private discretionary trusts
- No wealth tax is applicable to companies

### **Carry forward of losses**

- Loss of a specified business / special source are allowable only against subsequent years' profits of the same business / source
- Capital losses cannot be set off against any other income
- Losses can be carried forward indefinitely
- Losses of unlisted public companies are not to lapse even on change in shareholding of 49% or more

### **International tax**

- General Anti Avoidance Rules (GAAR) are proposed to be introduced in order to discourage tax avoidance
- GAAR empowers the Commissioner of Income-tax (CIT) to declare an arrangement voidable if it has been entered into with the objective of obtaining a tax benefit and lacks commercial substance
- GAAR overrides applicable Double Taxation Avoidance Agreements (DTAAs)
- The arrangements covered by GAAR include round trip financing, lifting of the corporate veil, etc.
- Provisions of treaty or the DTC whichever is later in time shall prevail

### **Transfer pricing**

- The Code seeks to bring about certain far reaching changes within the Indian transfer pricing regime such as, retention of safe harbour provisions, introduction of advance pricing agreement and thin capitalisation measures

### **Amalgamation**

- Amalgamation to include amalgamation of unincorporated bodies with companies
- Amalgamation is restricted to mergers between residents only
- Conditions of owning an industrial undertaking for allowing the carry forward of losses of the transferor company are removed
- In addition to business losses and unabsorbed depreciation, capital losses are allowed to be carried forward

### **De-merger**

- The Code considers de-merger between residents only
- Requirement of business continuity for a period of five years is introduced
- The successor needs to hold at least 3/4ths of the book value of fixed assets acquired for a period of five years

## Slump sale

- Entire sales consideration will be liable to tax under the head business income
- The acquirer of a business may not be able to claim enhanced tax base for the assets acquired on the basis of consideration paid

## Other provisions

- Indirect transfer of capital assets situated in India would also be construed as income “deemed to accrue” in India
- Company to be treated as resident of India if place of control and management situated wholly or partially in India at any time during the year.

## 1.3 Indirect taxes

### 1.3.1 Value Added Tax

State level sales tax was replaced by Value Added Tax (VAT) with effect from 1 April 2005 in the majority of Indian states.

- Under the VAT regime, the VAT paid on goods purchased from within the State is eligible for a VAT credit. The input VAT credit can be utilised against the VAT / Central Sales Tax (CST) payable on the sale of goods. A cascading effect of taxes is thus avoided and only the value addition is taxed.
- CST has been reduced from 4% to 2%. 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 ineligible for an input tax credit. Further, inter-state branch / consignment transfers are exempt from CST provided that a declaration in a specific form is submitted and the transfers are also not eligible for an input tax credit. However, certain states allow an input tax credit in excess of 4% on inter-state stock transfers.
- There is no VAT on imports into India. Exports are zero rated. This means that while output exports will not be chargeable to VAT, inputs purchased and used in the manufacture of export goods are refunded.
- Turnover thresholds have been prescribed so as to keep out small traders from the ambit of VAT. A turnover tax may be levied on such small traders in lieu of the VAT.
- VAT registered dealers need to issue serially numbered invoices with prescribed particulars.
- The periodicity of filing of VAT returns is as per State VAT acts.
- A comprehensive self assessment of VAT has been introduced.
- Turnover taxes, surcharges, additional surcharges and the special additional tax have been abolished.

The Finance Minister has reaffirmed the commitment of the Central Government in accelerating the introduction of the Goods and Services Tax (GST) during the financial year 2010-11 and has commended the work done by the Empowered Committee of State Finance Ministers in preparing the design of the dual GST. GST is a comprehensive Value Added Tax on the supply of goods and services. First discussion paper on GST was made public in the month of November 2009 providing broad contours of proposed GST. The dual GST will comprise the Central GST and the State GST that the centre and state will each legislate, levy and administer the Central GST and the State GST respectively. The implementation of GST is a welcome move which will simplify the current indirect tax regime in India and will help to mitigate, if not eliminate the issue of double taxation on various transactions encompassing both the supply of goods and the provision of services.

### 1.3.2 Stamp duty

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

Stamp duty is not imposed on the 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. Stamp duty is levied on the transfer of immovable property at rates varying from state to state.

Generally, stamp duty is levied by respective states as per the Indian Stamp Act, 1889, whereby each state has modified the Schedule to that Act. Certain states also have their own standalone stamp laws.

## 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

<b>Option 1</b> 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 Act, Foreign Exchange Management Act (FEMA) and Companies Act), despite being 100% foreign owned. At least two members for a private limited company and seven members for a public limited company are mandatory.
<b>Option 2</b> Joint venture with an Indian partner, preferably with majority equity participation	Though a wholly owned subsidiary has been the most preferred, foreign companies have also been formed 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 business.

### 1.4.2 Entry strategy 2: operating as a foreign company

<b>Option 1</b> Liaison office	Setting up a liaison or representative office is 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 the Reserve Bank of India (RBI).
<b>Option 2</b> 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 fulfilment 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.
<b>Option 3</b> Branch office	<p>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 the RBI:</p> <ul style="list-style-type: none"><li>• Export / import of goods</li><li>• Rendering professional or consultancy services</li><li>• Carrying out research work in which the parent company is engaged</li><li>• Promoting technical or financial collaborations between Indian companies and the parent or overseas group company</li><li>• Representing the parent company in India and acting as its buying / selling agent in India</li><li>• Rendering services in information technology and development of software in India</li><li>• Rendering technical support to the products supplied by parent / group companies</li><li>• Foreign airline / shipping company</li></ul> <p>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.</p>

## 1.5 Foreign ownership restrictions

### 1.5.1 Foreign direct investment

During the first half of 2009, India received an estimated USD 13.1 billion in Foreign Direct Investment (FDI) inflows, which is a 40% decrease as compared to the same period in 2008. The amount of FDI inflows from April 2009 to June 2009 was USD 7 billion.

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; and an independent judiciary. This is now recognised by a number of global investors who have either already established a base in India or are in the process of doing so. Ongoing initiatives such as further simplification of rules and regulations improvement of infrastructure are expected to provide the necessary impetus to increase FDI inflows in future.

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 / aquaculture and cultivation of vegetables and mushrooms under controlled conditions and services related to agriculture and allied sectors)
  - Plantations (excluding tea plantation)
  - Retail trading (other than single brand retail)
  - Chit fund businesses
  - Nidhi companies, trading in transferable development rights
  - Activities / sector not opened to private sector investment
  - Real estate business (excluding construction development projects — including housing, commercial premises, resorts, educational institutions, recreational facilities, city and regional level infrastructure and townships)

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 entity has an existing venture / tie-up in India in the same field ('same field' means the same 1987 National Industrial Classification code) as at 12 January 2005, with the exception of the following cases, which do not require prior FIPB approval:

- investment by a venture capital fund registered with the 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 above, prior approval is required from the FIPB.

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

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

#### *1.5.4 Downstream investment*

Downstream investments by foreign owned Indian holding companies are treated the same as FDI guidelines. Prior approval of the 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 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 the public are interested (i.e., a company listed on a 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 are subject to the guidelines of the Securities Exchange Board of India (SEBI). SEBI's takeover regulations require that any person acquiring 15% or more of the voting capital in a public listed company must 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 the takeover provisions under the SEBI's Substantial Acquisition of Shares and Takeover Regulations 1997; and
- The non-resident shareholding complies with sectoral limits under FDI Policy after the transfer.

Press Note 3 (2009) prescribes prior approval from FIPB for the transfer of ownership or control from a resident to a non resident (directly or through an Indian company owned or controlled by non residents) in sectors and activities which either have a FDI cap or require prior FIPB approval.

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

- Prevailing market price, in case of listed companies; and
- Fair Market Value as per Controller of Capital Issues (CCI) valuation guidelines, in the case of unlisted companies.

### *1.5.6 Investment by Foreign Institutional Investors*

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

FIIs are permitted by the RBI to purchase shares / convertible debentures of an Indian company through registered brokers on recognised 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.

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.

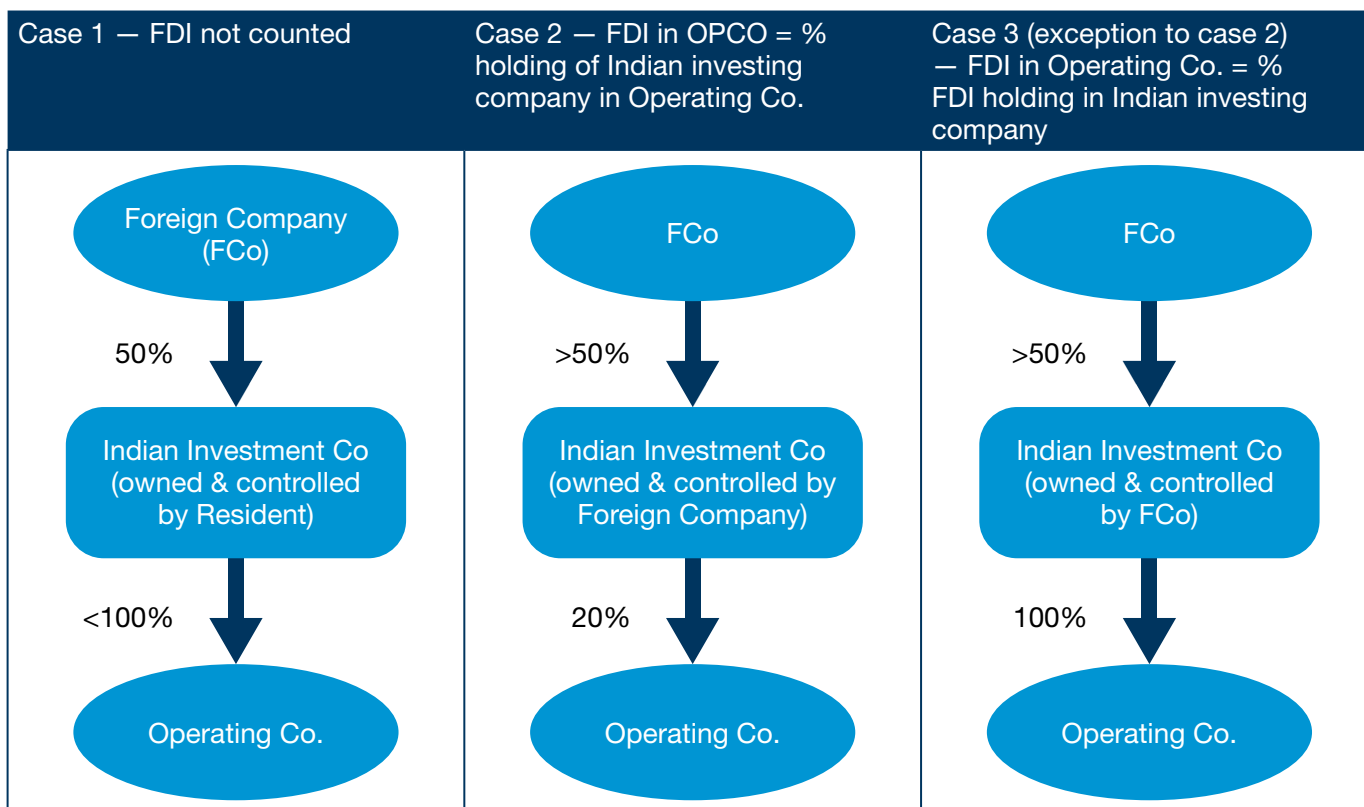
### *1.5.7 Inbound investment*

In an attempt to make FDI norms consistent and transparent, the Department of Industrial Policy and Promotion through Press Notes 2, 3 and 4 of 2009, issued guidelines for the computation of foreign holdings in Indian companies, linking approvals to the concept of control for the first time.

Press Note 2 prescribes the methodology for computing the total foreign investment where:

- All investment directly by a non-resident entity into the Indian operating company will be counted towards foreign investment;
- Indirect foreign investment include all types of foreign investment in the Indian investing company, namely FDI, non-resident Indians (NRIs) and portfolio investment by FII / NRIs, American Depository Receipts / Global Depository Receipts, Foreign Currency Convertible Bonds, Convertible Preference Shares / Convertible Debentures and Foreign Venture Capital Investors. However, NRI investments made on non-repatriation basis will not be counted as FDI for this purpose;

- Calculation of indirect foreign investment in Indian operating companies is illustrated in the following charts:



- For the purposes of the computation, an Indian investing company is deemed to be:
  - owned by a resident, if the resident beneficially owns more than 50% of the equity interest in the Indian investing company, either directly or through Indian companies.
  - controlled by a resident if such resident (either directly or through Indian companies owned and controlled by residents) have the power to appoint the majority of Directors.
- Methodology for computation of foreign investment does not apply to sectors which are governed specifically by a separate statute such as insurance sector;
- The guiding principle of Press Note 4 is that downstream investments by companies ‘owned or controlled’ by non resident entities are required to follow the same norms as direct investment. While prior approval from FIPB is required for FDI in pure investing companies (irrespective of the amount of FDI), FDI in operating cum investing companies will only need to adhere to sectoral FDI norms.

## 2. Structuring a share deal

### 2.1 Seller's perspective

#### 2.1.1 Profit on sale of shares

Gains derived from the transfer of shares in Indian companies are subject to tax in India at the rates prescribed previously as capital gains (see section 1.2.7).

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

However, no capital gains tax is imposed on the transfer of shares in Indian companies by one foreign company to another in a scheme of amalgamation or de-merger, if at least 25% of the shareholders of the amalgamating company (at least 75% of the shareholders in de-merged company) continue to remain as the shareholders of the amalgamated company (resulting company in case of de-merger) and the transfer is exempt from capital gains tax in the country where the amalgamating company / de-merged foreign company is incorporated.

#### 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 a 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 to purchase their holding, if the buyer proposes to acquire 15% or more in the target company.

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

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 financing costs incurred in acquiring 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 a share purchase are allowed to be added to the cost of the shares and are eligible for a tax deduction in determining capital gains on sale.

### *2.2.4 Debt / equity requirements*

There are no prescribed debt-equity ratios, which are generally driven by commercial considerations.

### *2.2.5 Preservation of tax losses*

The benefit of tax concessions, incentives and carry forward of prior years' tax losses is not lost in a share deal involving the acquisition of a company, except in the case of a company in which the public is not substantially interested to the extent indicated under section 1.2.11.

### *2.2.6 Repatriation of profits*

Repatriation of profits in a share deal can only be made by paying a dividend. The tax implications, both for the company distributing the dividend and the shareholders, have been dealt with under sections 1.2.6 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 is 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 at 1 April 1981 if purchased prior to that date) attracts capital gains tax at 20% plus applicable surcharge and cess.

In the case of self-generated intangible assets, the cost of acquisition is generally taken as nil.

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

Non-compete fees payable to the seller for not starting / competing in the business which they have transferred, is deemed to be business income and charged at the full rate of 33.99%.

The seller is liable to VAT / sales tax on movable property at appropriate rates depending on whether it is an inter-state or intra-state 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 long-term capital gain tax where the undertaking is held for more than three years, otherwise it is treated as a short-term capital gain.

The term 'net worth' is the excess of book assets (for depreciable assets, ITWDV is used) over the value of liabilities of the undertaking transferred. The net worth computation requires authentication by a chartered accountant.

#### 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 are dealt with under sections 1.2.6 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 is liable for stamp duty on the 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 are eligible for a tax deduction when the assets are sold.

### *3.2.4 Cost base step up*

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

This may be resisted by the seller due to adverse current income tax implications.

### *3.2.5 Treatment of goodwill*

Goodwill arising from 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. Consideration should therefore be given to identify and allocating proper values to intangible assets.

### 3.2.6 Other matters

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

There are various legal precedents which suggest that no VAT is applicable on a slump sale of an undertaking.

## 4. Concessions relating to M&As

Any transfer, unless specifically exempted, attracts capital gains tax. However, subject to conditions, specified reorganisation schemes, such as amalgamations or de-mergers are exempted from the levy of such tax.

### 4.1 Amalgamations

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

### 4.2 De-mergers

A 'de-merger' refers to the transfer, according to a scheme of arrangement under the Indian Companies Act, by a de-merged 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 de-merged company become the property of the resulting company and appear in the books of the de-merged company and the resulting company issues, in consideration of the de-merger, its shares to the shareholders of the de-merged company on a proportionate basis.

Moreover, the shareholders holding at least 75% in value of the shares in the de-merged 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 / de-merger expenses

In computing taxable income, the reorganisation expenses on account of amalgamation / de-merger 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**

### *4.4.1 Amalgamation*

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

- the amalgamating company that has brought forward tax losses / depreciation has been engaged in that business for at least three years and has continuously held (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:

- the manufacture or processing of goods; or
- the manufacture of computer software; or
- the business of generation or distribution of electricity or any other form of power; or
- the business of providing telecommunications services, whether basic or cellular, including radio paging, domestic satellite services, network of trunking, broadband networks and internet services; or
- mining; or
- the construction of ships, aircrafts or rail systems.

### *4.4.2 De-merger*

In the case of a de-merger, the accumulated losses and unabsorbed depreciation directly relatable to the undertaking being transferred is 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, it shall be apportioned between the de-merged company and the resulting company in the same ratio in which the value of the assets have been transferred. In the case of a de-merger, there are no restrictions of the type of 'industrial undertaking' to be transferred.

## 5. Exit route

The exit route, through a share deal, is the transfer of the shares of the Indian company. The tax implications are detailed in section 2.1.1. As mentioned there, in the case, that shares are held by an entity in Mauritius or Singapore, there is a possibility of availing the capital gains exemption, provided that the conditions stipulated in the respective treaties / circulars of the tax authorities, etc. are complied with. Buy-back of shares, where the funds are drawn from the company, or court approved capital reduction, are also popular routes to provide partial or full exits.

The transfer of shares of an offshore holding company can also be considered, however there is a potential risk of the entire sale consideration being held as taxable in India on account of the controversy triggered by the tax authorities in Vodafone's case, where the indirect transfer of a controlling interest in an Indian company by one non-resident to another non-resident through an overseas transaction was attempted to be brought to tax in India.

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

## 6. Ending remarks: preparation for a deal

The 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 an 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. At the same time, the seller will have to consider the structure from current and future tax perspectives.

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