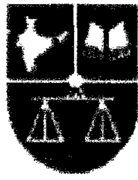


"Taxation Issues in Cross-border Merger and Acquisitions"

DISSERTATION SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF LL.M. (BUSINESS LAWS)

UNDER THE GUIDANCE OF HON'BLE MR. JUSTICE S. RAJENDRA BABU
(FORMER CHIEF JUSTICE OF INDIA AND CHAIRMAN NHRC, NEW DELHI)

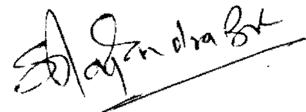
SUBMITTED BY:

SUMIT KUMAR
I.D. No. 341

2010

CERTIFICATE

This is to certify that this dissertation, "**Taxation issues in Cross-border Merger and Acquisition**", submitted by Mr. Sumit Kumar (ID No. 341) in partial fulfillment of the requirements for the degree of Masters of Laws of National Law School of India University, Bangalore is the product of bona-fide research, carried out under my guidance and supervision.



Date: 21/05/2010

Place: Bangalore

Hon'ble Mr. Justice S. Rajendra Babu

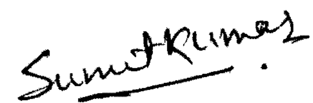
National Law School of India University, Bangalore

DECLARATION

I, Mr. Sumit Kumar, do hereby declare that this dissertation titled "**Taxation issues in Cross-border Merger and Acquisitions**" is the result of the research undertaken by me in the course of my LL.M. (Business Laws) Programme at the National Law School of India University (NLSIU), Bangalore, under the guidance and supervision of **Hon'ble Mr. Justice S. Rajendra Babu.**

This work is my original work, except for such help taken from such authorities as have been referred to at the respective places for which necessary acknowledgements have been made.

I further declare that this work has not been submitted either in part or in whole, for any degree or diploma at any other University or institution.



Sumit Kumar

I.D. No- 341

LL.M (Business Law)

National Law School of India University, Bangalore

May 31, 2010

Bangalore

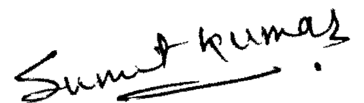
ACKNOWLEDGEMENT

I express my sincere gratitude to my guide **Hon'ble Mr. Justice S. Rajendra Babu** for his guidance during the course of my dissertation. Sometimes, I found it hard to believe how humble and down to earth a person of this stature can be.

Apart from the guidance of my Supervisor, I would like to acknowledge the guidance of our esteemed Vice-Chancellore Prof. Venkata Roa, Prof. T. Ramakrishnan, Prof. A. Jayagovinda, Prof. P. Pillai, Prof. T. Devidas, Prof. V. S. Mallar, Prof. V. Vijayakumar.

This work is an outcome of an unparallel infrastructural support that I have received from the National Law School of India University, Bangalore. I find this opportunity to thank the library staff of the National Law School of India University, Bangalore.

It would never have been possible to complete this study without an untiring support from my family and friends. This study bears testimony to the active encouragement and guidance of a host of friends and well-wishers.



Sumit Kumar

ID No- 341

LL.M (Business Laws)

National Law School of India University, Bangalore

ABBREVIATIONS

AAR- Authority for Advance Rulings

APAs- Advance Pricing Agreements

ASSOCHAM- Associated Chamber of Commerce and Industry of India

CENVAT- Central Value Added Tax

CIT- Commissioner Income Tax

DTAA- Double Taxation

DTC- Direct Taxation Code

ECJ- European Court of Justice

EU- European Union

FII- Foreign Institutional Investor

GAAR- General Anti-Avoidance Rules

GST – Goods and Services Tax

HC- High Court

HTIL- Hutchison Telecommunications International Limited.

I.T- Income Tax

IPCL- Indian Petrochemicals Corporation Limited

IPOs- Initial Public Offerings

ITD - Income Tax Department

ITO- Income Tax Officer

KVAT- Karnataka Value Added Tax

M&A- Merger and Acquisitions

MAPs- Mutual Agreement Procedures

MODVAT- Modified Value Added Tax

NTT- National Tax Tribunal

OECD- Organisation for Economic Co-operation and Development

PE - Permanent Establishment

SC- Supreme Court

UAE- United Arab Emirates

UK- United Kingdom

US- United States

USA- United States of America

VAT- Value Added Tax

VSNL- Videsh Sanchar Nigam Limited

WTO- World Trade Organisation

TABLE OF CASES

1. Achuthan Pillai and Co. v. Commissioner Income Tax
2. Assam Consolidated Tea Estates Ltd. v. ITO 'A' Wards and Ors.
3. Azadi Bachao Andolan's Case
4. CIT v. Bank of China
5. CIT v. Grace Collis
6. CIT v. Nandlal Gandalal
7. Commissioner Income Tax v. P.M. Mathuraman Chettiar
8. Commissioner of Income v. Nirmala Textiles
9. De Beers Consolidated Mines Ltd, v. Howe
10. Egyptiain Hotels Ltd. v. Mitchell
11. Erin Estate Galaph, Ceylon v. Commissioner of Income-Tax
12. In Re: Advance Ruling
13. In re British Gas India Private Limited
14. Integrated Container Feeder Service v. Joint CIT
15. IRC v. Duke of Westminister
16. Maneka Gandhi v. Union of India
17. Narottam & Perira Ltd. V. CIT
18. Neelamai Agro v. CIT
19. Saraswathi Industrial Syndicate Ltd. V. CIT
20. Star Television Entertainment Ltd.
21. Sri Krishna Das v. Town Area Committee, Chirgaon
22. Unit construction Co. Ltd. V. Bullock
23. Universal Cargo Carriers Inc. and ors v. Commissioner of Income Tax

24. V.V.R N.M. Subbayya Chettiar v. CIT

25. Vania Silks Mills v. CIT

26. Vodafone international holdings B.V. v. Union of India and ors

CONTENTS

1. Introduction......1

2. Chapter- 1......7
Meaning and Concept of cross-border Merger and Amalgamation

3. Chapter- 2......19
Residential Status of Company: a battle for Jurisdiction

4. Chapter- 3......34
Capital Gain Taxation

5. Chapter- 4......44
Other provisions under Indian Tax Laws

6. Chapter-5......62
Relief under Double Taxation Avoidance Agreements

7. Chapter-6......74
Impact of proposed tax Reforms over Cross-border Merger and Acquisition

8. Chapter- 7......83
Tax efficient Merger and Acquisition: International Practices

9. Chapter- 8......93
Conclusion and Recommendations

10. Bibliography......98

INTORDUCTION

Over the past decades the integration of world markets has increased dramatically. Product and capital markets are becoming more integrated, new markets are emerging and globalization is an important strategic issue for corporations. Consequently, with the associated increase in investment opportunities for Indian corporations, the market for corporate control is also becoming more *integrated.* This has resulted in both an absolute and relative increase in cross-border takeover activity. India has witnessed a tremendous increase in Mergers and Acquisitions at the domestic as well as international level the insatiable growth appetite of emerging Indian companies fuelled many overseas acquisitions, such as Tata Steel's acquisition of Anglo-Dutch major Corus, Hindalco's acquisition of Novelis, Tata Motors' acquisition of Jaguar Land Rover etc.

Cross-border merger or migration of companies from one tax jurisdiction to another, are the results of free trade and liberalisation. After joining the WTO in the year 1995, India has an obligation to work for border less trade and commerce. Article 51 (c) of Indian Constitution directs India to give respect for international law and treaty obligations. The judiciary has also in numerous times expressed its concern regarding the states obligations towards international community. Former Chief Justice Sikri, in Kesavananda Bharti case observed as follows:

"it seems to be that, in view of Article 51 of the Constitution, this Court must interpret language of the constitution, if not intractable, which is after all a municipal law, in the light of the United Nationals Charter and the solemn declaration subscribed to by India."

India, by becoming a signatory to various international trade and commerce treaties, commits to its adherence and compliance at the national level. Article 51(c) does not deal with the enforcement or implementation of treaties. Unless municipal law is changed, an international covenant does not bind. It is only the municipal law which binds the courts. To fulfill international obligations resulting thereby, Article 253 of the Constitution enables the Indian Parliament to enact laws in this regard.

Above discussion explores the government's power to enter into international treaties and to enforce it in the country. However, there are some provisions in the Indian constitution which give freedom to the individuals to carry out trade and commerce within the territory of India. Article 301 which prescribes freedom[1] of trade, commerce and intercourse throughout the territory of India, can be extended to the cross-border operations as well. If we read Article 301 in the light of various clauses of Article 19, it is aptly clear that the freedom of trade and commerce is allowed not only within the territory of the country but also trans-border. Though article 19 guarantees various freedoms to the citizens only but if we take the progressive approach of Supreme Court in the case of *Maneka Gandhi v. Union of India*[2], we can say that the Supreme Court of India is of the view to expend the ambit of the provisions of fundamental rights and to understand it in broader sense. Article 19(1)(c) and Article 19(1)(g) gives the citizens of India freedom to move freely and to carry out trade and commerce freely throughout the territory of India. Here right to move includes right to move out from India and come inside India.[3] Company as a resident of the country has also right to move and to form unions. International treaties and bilateral agreements allow companies to go for international operations and cross-border mergers.

---

[1] Government can impose restriction on trade and commerce, if in public interest it requires. [Article 302]

[2] AIR 1978 SC 597

[3] Id.

With this constitutional background I am hereby describing my research methodology which is as follows:

RESEARCH METHODOLOGY

SCOPE

In this paper, I have tried to bring forth the finer nuances of globalization and its impact on current trade practices; the research paper is confined only to the analysis of the aspects of "TAXATION ISSUES IN CROSS-BORDER MERGER AND ACQUISITION". A very brief but comprehensive analysis has been done on the Taxation laws of India, US and some countries of EU and its impact on Cross-border mergers. This research also endeavors to analyze various tax treaties and international agreements for example Double Taxation Avoidance Agreements etc. finally in this research, I have tried to check out the impact of proposed tax reforms in India over the cross-border mergers and acquisitions.

OBJECTIVE

Given the time constraint of five month, in the paper, I endeavored to present a brief yet comprehensive analysis of the topic, which otherwise is a vast area of study and covers virtually the whole gamut of analysis.

HYPOTHESIS

i Tax regime in India with respect to cross-border merger is very complex and unfriendly therefore in order to promote acquisition of foreign corporations by Indian corporations, there is a need to ease the present tax regime.

ii The proposed tax reforms in India i.e. "Direct Taxation Code" and "Goods and Services Tax" are unfriendly to the Cross-border mergers and thus to encourage

Indian companies to acquire foreign companies, there is a need to relook certain provisions.

RESEARCH QUESTIONS

1) What is Cross-border Merger and Acquisition?
2) What are the legal implications of cross-border Merger and Acquisitions?
3) What is the importance of Residential status of a company for the purpose of taxation?
4) What is the meaning of Capital Gain Taxation and how is it determined?
5) What are the Jurisdictional issues, associated with Cross-border Merger and Acquisition?
6) What are the other incentives and benefits for Cross-border Merger and Acquisition in various Tax laws?
7) What is the role of International and Bilateral Tax Agreements in Cross-border mergers and Acquisitions?
8) Impact of proposed tax reforms over cross-border Mergers and Acquisitions.
9) What are the international practices for tax efficient Mergers and Acquisitions?

METHOD OF ANALYSIS

A descriptive analysis of the topic and the sub-topics with a comparative study wherever necessary has been presented covering various aspects including the case studies before anticipating possible remedies.

SOURCES

To bring out this dissertation I have confined myself to the empirical research and secondary data collection from books, journals, periodicals, articles (mentioned in the bibliography)

related to the title of the paper accessible from the Library of National Law School of India University, Bangalore and the internet.

CHAPTERISATION

First chapter of the dissertation is to understand the meaning of cross-border merger and acquisition, how they are different from other merger and acquisition. In this chapter I have tried to find out the various legal and taxation issues relating to cross-border merger.

In the second chapter, a comprehensive discussion over the residential status of companies has been done. This is very important part of this dissertation because residential status of companies is always crucial for the tax liability. So there is a general trend that the countries don't allow companies to migrate easily from their jurisdiction to another jurisdiction. In this chapter various aspects of 'residential status' of the company has been analyzed.

In chapter 3, a comprehensive analysis has been done over the Capital Gains Taxation. Capital Gain plays a wide role in tax laws especially for the purposes of Income Tax law. In this chapter Jurisdiction issue has also been discussed.

In Chapter 4, I have tried to find out laws applicable in case of Cross-border merger and acquisition. Not only this, here a critical analysis has also been done on the imposition of various laws over the Cross-border merger and acquisitions.

In chapter 5, an analysis has been made over the Double taxation Avoidance Agreement and its impact over Cross-border Merger activity.

In chapter 6, it has been endeavoured to analyze the proposed Direct Taxation Code and Goods and Services Tax and its provisions affecting the cross-border merger activities.

In Chapter 7, it has been endeavored to find out some very popular tax efficient merger and acquisition practices prevalent in the world.

The last chapter 8, contains the conclusion and recommendations.

MODE OF CITATION

A uniform mode of citation has been followed throughout the course of this thesis.

Chapter-1

Meaning and Concept of Cross-border Merger and Amalgamation

Over the past few years, the mergers and acquisitions market in India has been very active. In particular, the percentage of cross-border transactions has risen significantly. Cross border deals have taken the form of both inbound and outbound transactions. The growth in inbound transactions can be attributed to the growing interest of foreign companies in making acquisitions in India's information-technology and telecom sectors. It has been observed that overseas companies find it far more economical to acquire existing setups rather than opt for organic growth. On the other hand, outbound transactions too have increased significantly, with manufacturing companies acquiring entities overseas.

Mergers and acquisitions are used as a means to achieve crucial growth and are becoming more and more accepted as a tool for implementing business strategy, whether they involve Indian companies waiting to expand or foreign companies wishing to acquire market shares in India. Some of the other motivating factors behind mergers and acquisitions are the desire to acquire a competency or capability, to enter into new markets or product segments, to enter into the Indian market generally, to gain access to funding resources, and to obtain tax benefits.

Merger and Acquisition play a major role in the materialization of globalization, but it is just one of several such serious challenges with similar characteristics, such as transfer pricing, taxation of derivative financial instruments and e-commerce, multiple-residence entities, etc. All of these share two basic tensions that may have been present in the past, but have been significantly exacerbated in importance by globalization: the revenue flight

dilemma and the multinational enterprise tension. The revenue flight dilemma arises from the non-cooperative features of the international tax world.[4]

India is being considered today as one of the most powerful emerging economies of the world. As a result of wide ranging programs of economic reforms, India is moving firmly into the front ranks of the rapidly growing Asia-Pacific Economic Region.

The worldwide takeover activity has been averaging US$ 4 trillion in the recent years.[5] Like IPOs, mergers also come in waves in the US and rest of the world. In Europe, the value of cross-border merger and acquisition is growing at over 100 percent a year. In India also recent years have been the evident of some very high profile cross-border merger and acquisition e.g. Tata Steel-Corus which involved $ 12.2 billion, Vodafone-Hutchison Essar ($ 11.1 Billion), Hindalco - Novelis merger, which involved around $ 6 billion, etc.[6]

As the world economy continues to respond to increasing globalization, the problems that individual businesses have been forced to deal with have grown in number and complexity. Virtually every one of these problems shares a common element: in a truly global economy, businesses that are unable to operate effectively in a multinational environment will not achieve the economies of scale they need in order to remain competitive.

The diverse tax environment that confronts a business that undertakes a multinational merger or acquisition demands that those are managing the tax aspects of the proposed transaction understand global taxation on at least two levels. First, the individuals responsible for tax planning must understand the differences between the basic systems of taxation and how

---

[4] Professor Avi-Yonah has compared this problem, in the context of withholding tax on interest, to a "stag hunt" game, where all the participants avoid initiating cooperative action through unilateral measures to the detriment of them all. See Reuven S. Avi-Yonah, Globalization, tax competition, and the fiscal crisis of the welfare state, 113 Harv. L. Rev. 1573 (2000), 1583

[5] KPMG report on Worldwide announced M&A, 2006

[6] http://business.rediff.com/slide-show/2009/may/29/slide-show-1-indias-11-largest-m-and-a-deals.htm#contentTop

those systems will affect individual transaction. And they must understand the differences between direct and indirect transaction tax systems, global and territorial income tax systems, and entity-level and fully integrated tax systems.

Second, multinational Merger and Amalgamation transaction planners must quickly be able to gain an understanding of how individual tax authorities apply tax systems. It does a planner little good to know that a particular jurisdiction applies a territorial income tax to a post-merger multinational business if the planner does not understand how the jurisdiction measures the amount of income subject to tax in each individual territory.[7]

How domestic merger and amalgamation is different from cross-border merger and amalgamation-

The economic and business literature started to focus on cross-border M&A only recently, since only in the past decade have cross-border M&A become significant in both number and size.[8] The current wave of M&A has, nevertheless, been so significant, that this literature developed rapidly despite its authors' usual conservativeness.[9] At present, the literature finds significant differences between domestic and cross-border M&A from both the investment (stock performance) and operating performance perspectives.[10] In general, the performance of cross-border M&A is found to be inferior, on average, to the

[7] Mergers and Acquisitions: A Global Tax Guide, PricewaterhouseCoopers, John Wiley & Sons, Inc., 2006, Pg-IX

[8] See, Frederick L. Pryor, Dimensions of the worldwide merger boom, working paper (2001), available at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID255412_code010216560.pdf?abstractid=255412.

[9] The lack of which should result, nevertheless, in a word of caution with respect to the current literature.

[10] Sara B. Moeller & Frederik P. Schlingemann, Are cross-border acquisitions different from domestic acquisitions? Evidence on stock and operating performance for U.S. acquirers, Working Paper (2002), see: http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID311543_code020529500.pdf?abstractid=311543

performance of domestic M&A from both perspectives.[11] The announcement period bidder share performance in cross-border M&A has been found to be significantly lower than in domestic M&A,[12] both economically and statistically.[13] These results are more significant for more recent samples[14] and hold when controlled for certain transaction characteristics, such as the method of payment, relative size and hostility.[15] This suggests that engagement in cross-border M&A may not be in the acquiring corporation shareholders' best interest.[16]

The boom in cross-border Mergers and Acquisitions (M&A) has given new urgency to understanding and managing the complex tax consequences of international expansion. There are very little globally accepted norms regarding tax law legislations. With India occupying an increasingly important place on the world stage, there is a need for India to mature in relation to administration of tax laws.

Cross-border Merger and Acquisition: Key Taxation Issues

Cross-border business is increasingly following a global pattern, with a largely common language, consistent accounting treatment and common principles of business regulation. But

[11] Id.

[12] Id. The acquiring corporation's shares' prices either remained basically unchanged or declined in value in these transactions. This interprets to a significant value loss to shareholders in comparison to domestic M&A where they did get normal (but not abnormal) positive returns generally. This loss may even be more significant in comparison to the more beneficial cash domestic transactions. I only indicate here the very rough, general directions of these results and refrain from quantification, since the methodology is still debated and I do not intend, or need to participate in this debate for the purposes of this article. See also B. Espen Eckbo & Karin S. Thorburn, Gains to bidder firms revisitied: Domestic and foreign acquisitions in Canada 35(1) J. Fin & Quant. Analysis 1 (2000) [Comparative advantage (announcement period returns) to Canadian bidders buying Canadian targets over U.S. bidders buying Canadian targets. Largest returns to bidders paying with stock, and relatively small in comparison to target]. This is consistent with Moeller & Schlingemann, but their sample is relatively old – from a period that presented different results in the U.S. context. on McCabe & Yook; and Chatterjee & Aw (2000) [Poor share performance of U.K. bidders in cross-border M&A in comparison to domestic U.K. M&A].

[13] Moeller & Schlingemann, supra, note 4,found an approximately 100 basis points difference.

[14] Id.

[15] Id.

[16] Especially if we remember that even domestically they are not clear winners in M&A See Brauner Reorganizations; Yariv Brauner, A good old habit, or just an old one? Preferential tax treatment for reorganizations , 2004-1 B.Y.U. L. Rev. (forthcoming, Winter 2004).

cross-border acquisitions inevitably involve different cultures, different laws and different business methods.[17] Majority factors contributing to international investments are identified as (1) imperfection in the product and factor markets, (2) imperfections in financial markets[18] and (3) different international tax laws.[19]

Tax rules apply to economic activity, as regulated by the government, retroactively and consecutively to the application of private law and other regulatory rules. Tax law results from the economic policy of the government. It is often a consequence of a compromise between competing policy goals, such as: the size of government preferences, growth, equality, etc. Tax policy designers struggle with the same issues that challenge our economy and society in large. Globalization is one such development, may be the most important of recent times. It has fundamentally altered our markets and societies. To a large extent, many domestic markets for goods and services have converged in the last two decades to a single global market. The primary example is probably the convergence of capital markets; other markets are yet to fully converge, but all have irreversibly changed.

As companies move toward a borderless marketplace with seamless transactions crossing international boundaries, managers seek ways to increase their market share and profitability. Cross-border mergers and acquisitions are one way in which companies extend their reach globally.[20] Though taxation is one of the issues among other issues involved in merger and Acquisitions, it has countless concerns which must be addressed before Merger and amalgamation. International expansion is met with numerous tax considerations at the country, regional and local levels. Understanding the tax factors associated with cross-border

[17] M. whalley and F. J. Semler, International Business Acquisitions, Kluwer Law International, London, 2007, Pg-1

[18] Best example is merger between two Major US company Errunza and Senbet in 1981.

[19] International Acquisition Accounting Method and Corporate Multinationalism: Evidence from Foreign Acquisitions, Kathleen M. Dunne and Gordian A. Ndubizu, Journal of International Business Studies, Vol. 26, No. 2 (2nd Qtr., 1995), pp. 361-377

[20] Chandrashekhar Krishnamurtia and Vishwanath S R, Mergers, Acquisitions and Corporate restructuring, Response (SAGE), 2008, Pg- 170

mergers and acquisitions provides an essential component for successfully executing a restructuring transaction.[21]

The principal taxation goal in all mergers and acquisitions is to minimize (a) any transaction taxes and (b) any ongoing income taxes of the surviving entities. This chapter explores the major tax concepts and issues associated with cross-border restructurings and reviews several transaction structures designed to minimize the related tax consequences.

Asset versus Share Purchases

The decision as to whether an acquiring firm should purchase a target firm's assets or its shares will influence the taxes associated with a transaction, as well as he resulting income taxes following the transaction. As a general rule, transaction taxes are lower for share purchases than for asset purchases.

The major advantage to a buyer acquiring assets rather than shares is that a buyer of assets does not assume the liabilities associated with the acquired company. When the shares of a company are acquired, the buyer acquires the whole company, including the liabilities. This includes both contingent and unknown (or undisclosed) liabilities related to past transactions, which may arise or be discovered after the transfer of shares.

Further, in an acquisition of assets, the due diligence investigation is confined mainly to the details pertaining to the assets and whether the assets are free from liens, mortgages and encumbrances.[22] However some countries do not permit an acquirer to avoid all liabilities. For example, in Germany, the acquirer of a business assumes all liability for existing employment contracts, regardless of whether the acquisition is an asset or share purchase. Another benefit of an asset purchase is the step-up in cost basis that may be associated with

---

[21] Ibid
[22] Model asset purchase agreement by *Ebrahim A.K. Faizullabhoy, Mulla & Mulla & Craigie Blunt & Caroe*

the acquired assets. The cost step-up may be used to reduce future capital gains taxes and increase related depreciation deductions.[23]

The main disadvantage with an asset purchase is that the transaction is , generally, a taxable event for the target corporation and its shareholders. Under an asset purchase, there exists the potential for double taxation, as the target corporation pays taxes on the capital gains of the assets sold and then again as the target's shareholders pay tax on the distributed proceeds if the target is subsequently liquidated.[24]

In many tax jurisdictions, a share purchase can be structured as a tax free exchange of shares, in reality, this 'tax-free exchange' is simply a tax-deferred exchange, with tax deferral lasting until such time the target corporation or the target firm shareholder disposes off the newly acquired shares.

With a share purchase acquisition, the target company's tax attributes are generally retained following the transaction. For example, an acquirer may be able to utilize any pre-acquisition accumulated tax losses and net operating losses of the target company to lower current and future tax obligations of the acquirer or of the consolidated entity. However, the use of net operating losses following a merger may be restricted. Depending on the country, following a merger, a target company is frequently required to continue to operate substantially as the same business in order for the acquiring company to utilize any pre-acquisition net operating losses.[25]

Taxes Associated with Transactions

[23] Chandrashekhar Krishnamurtia and Vishwanath S R, Mergers, Acquisitions and Corporate restructuring, Response (SAGE), 2008, Pg- 171.
[24] Id.
[25] Id.

The taxes typically associated with a restructuring transaction frequently include transfer taxes, capital gains and value-added taxes. Transfer taxes, or stamp duty taxes, refer to taxes associated with transfer to shares or assets from one entity to another. In the UK, the stamp duty tax is as high as 4 per cent on some assets, including land, buildings and goodwill, and as low as 0.5 percent on share purchases. In the US, there is no federal transfer tax, but individual states may impose some limited transfer tax on various assets. Germany has no transfer taxes, but imposes a 3.5 per cent real estate transfer tax on the sale of domestic land and buildings.

Capital gains, defined as the difference between a seller's acquisition cost and the sales price, are the most common and prevailing taxes associated with mergers. In many countries, the capital gains tax can be deferred on share purchases until the exchanged shares are subsequently disposed off. Commonly referred to as a tax-free merger, obtaining capital gains tax relief is particularly difficult when a foreign company is the acquiring firm. For the Netherlands and UK, capital gains tax relief is generally available for share exchanges by a foreign company. But in France and the US, creating a tax-free merger by a foreign corporation is subject to a number of conditions. Additionally, in the US, certain tax law provisions may convert any capital gains into ordinary income, which is generally taxed at higher rates.

A final transactional tax is the value-added tax that may arise with an asset purchase. Generally speaking, the sale of an entire business as a going concern is outside the scope of VAT. However, some countries like France may tax certain assets, such as inventory, even when an entire business is sold.

One overlooked opportunity to minimize transaction taxes is the tax deductibility of the acquisition costs associated with a corporate restructuring. Most acquisition costs are

generally viewed as capital costs and as such are not immediately deductible. However, many jurisdictions provide for all, or at least a portion, of the acquisition costs incurred to be deductible immediately. In many countries, including Germany, Japan, the UK and the US, the determination of which acquisition costs are immediately tax deductible depends on when the final decision is made to acquire a target. Costs incurred prior to a final decision are generally tax deductible, whereas costs incurred after the final decision are capitalized and added to the basis of the shares or the assets.

Tax after the Transaction

In planning an acquisition, the tax structure following a transaction is an important consideration, and if handled properly, can result in significant tax efficiencies. The principal issues include whether the entity can file a consolidated tax return, the tax impact on dividends, the deductibility of interest payments and the amortization of intangible assets, including goodwill.

Many countries, including Mexico and France, the Netherlands and the US, allow corporations to file consolidated tax returns wherein the profits and losses of the various subsidiaries are pooled. That is, a subsidiary with operating losses in the current year can match those losses against the operating profits of another subsidiary. Thus, the impact of consolidation is that the total current tax liability is lower for the consolidated company. Unfortunately, cross-border tax consolidation is not available in all countries.[26]

Merger and acquisition transactions present more complex tax issues when the entities are tax residents of different tax jurisdictions. For example, an acquiring firm is usually unable to offset the interest payments on acquisition debt against a target's profits if the new subsidiary is a tax resident of a foreign country. A common approach to resolving this problem is for the

[26] Australia, Canada and Italy etc.

same country as the target. Under this structure, the interest costs of the holding company may be consolidated with the target's operating profits, thereby making the interest costs on acquisition debt tax-deductible.

Another major issue associated with cross-border restructurings is the double taxation related to income earned and dividends paid by subsidiaries located in tax jurisdictions outside that of the parent company. Double taxation occurs when more than one domain's taxes are levied on the same income and capital gains of a company; countries generally levy taxes on (a) their residents, (b) the operating activity that occurs within its borders and (c) from jurisdictional sources that generate profits. It is reasonable to expect, for instance, that a US resident company which receives Brazilian source income could be taxed on the same income by both the US and Brazil tax authorities, assuming the absence of rules limiting double taxation.

For cross-border dividends, double taxation occurs when a subsidiary in one country distributes a dividend to its parent company in another country. The subsidiary pays taxes on the profits that generated the dividend, and the parent company receiving the foreign dividend incurs taxes on the dividend income. Other tax burden accompanying cross-border dividends are withholding taxes often imposed by local tax authorities when dividends are paid to a foreign parent. These dividends result in 'tax leakage', a reduction of net cash, when the dividends received by a parent company are treated as income by the parent's taxing authority. Thus, a significant portion of a subsidiary's profits may be taxed and withheld when a subsidiary distributes a cross-border dividend. For a parent company, the withholding tax can result in: (a) a tax credit against the subsidiary's income, (b) a refund of the tax or (c) a total loss to the parent company.

Relief from cross-border dividend double taxation can sometimes be obtained by exemption of Credit or deduction. Relief by exemption occurs when a parent's tax jurisdiction exempts a dividend from taxation for which foreign taxes have been paid. And, relief by credit occurs where the parent's tax jurisdiction exempts a dividend from taxation for which foreign taxes have been paid. And, relief by credit occurs where the parent's tax jurisdiction grants a tax credit for foreign taxes paid. Finally, relief by is available where the foreign taxes paid by a subsidiary are allowed as a tax deduction within the parent's tax jurisdiction. Such relief is established either by a tax treaty between two countries or by unilateral relief where a country grants relief to its resident companies receiving dividends from foreign subsidiaries. Depending on the tax jurisdiction, relief may require that the parent company maintain a sufficiently large equity interest in the subsidiary or hold its interest for some minimum length of time.

Interest payments for a borrower are generally tax-deductible against the borrower's operating profits; however, exceptions to this general rule may be enforced where violations of the 'thin capitalization' rules or violation of the 'thin capitalization' rules or violation of the 'debt creation' rules for interest incurred on acquisition debt arise. Thin capitalization rules exist to discourage foreign companies from structuring local subsidiaries with high levels of debt, such that the related interest charges serve to reduce the taxable income of the local subsidiary, thereby reducing local taxes. Violation of an established debt-to-equity ratio often results in the interest payments treated as a de facto dividend payment, such that the local subsidiary's taxable income and taxes increase.

In a cross-border merger transaction, an acquiring firm can push down any related acquisition debt to the local subsidiary or a local holding company, subject to consolidation and the thin capitalization provisions. As a consequence, the deductibility of interest will reduce the cost

of capital associated with the acquisition relative to a share purchase as dividends are not tax deductible.

Chapter-2

Residential Status of a company: a battle over Jurisdiction

A multinational's income is potentially taxed twice. First, it pays corporate income taxes according to the source principle, i.e. it pays income taxes in the countries in which the respective income is generated. Second, a multinational company may have to pay additional income taxes in its home country. Even if the firm's operations are spread over several countries, it remains resident of one country. This country of residence may reserve the right to tax worldwide income instead of exclusively taxing income generated on its own territory. The firm is then subject to double taxation: The multinational has a higher tax load compared to an indigenous firm, because it does not only pay taxes at the source but it is additionally taxed by its country of residence.

Not all of the countries have special tax rules for M&A. Even fewer countries have special tax rules for cross-border M&A. Most of the countries treat their residents and non-residents differently for tax purposes.[27] Thus the question of residence is a crucial aspect of taxation. Common tax concerns in a cross-border merger are loss of revenue due to the resulting company being a foreign company[28], loss of taxing jurisdiction over the global income of the transferor company[29]. For example, section 5(1) of the Indian Income Tax Act uses the term income "accrued or arose" which means the income arose must be somehow related with India.

---

[27] For example under section 6(3) of the Income Tax Act a company is resident in India if (1) it is an Indian company or (2) the control and management of the company is wholly in India.

[28] In India as we have already discussed the resulting company cannot be a foreign company.

[29] Usually every country enjoys power to tax worldwide income of a company resident in the country.

There is a wide range of disparity in the taxing principles itself among different countries. There can be wide range of differences among the countries about the manner in which each country proposes to tax income flows like dividends or interests with substantially different tax consequences.

Despite all the differences the countries maintain a border base to tax the profits of domestic companies as contrasted to the foreign ones. It is a common practice among the nations to have taxing jurisdiction over the income of the resident abroad. India[30], United States[31], and several of OECD[32] are example for the countries that tax the income to the resident abroad. When a company in one country mergers with another company abroad, merging company would become the resident of that country as a result of which the resident country of the transferee company losses jurisdiction over transferor company's foreign income which is known as 'income abroad'. Many multinational corporations involve in 'corporate inversions' for avoiding the tax jurisdiction of the home country.[33] These corporate inversions are effected by altering the corporate structure of company through a trans-border merger wherein the resultant company would be a resident of a low corporate income tax jurisdiction.[34] However in practice the scenario is not as simple as described above. As in the case of application corporate laws there can be two major approach that determine the residential status of a company namely the incorporation theory and the real seat theory. It is noted that the corporate migration through merger to another jurisdiction of lower tax tares is prohibitively costly if the country whose taxing jurisdiction the company is situated follows

[30] Section 5(1) of the Income Tax Act 1961.
[31] See, Kun Orsolya; Corporate Inversions: the interplay of Tax, Corporate and Economic Implications; 29 Del. J. Corp. L. 313; the article is in the context of US corporate tendency to migrate to foreign nations, especially to Bermuda, primary for tax consideration. The article discusses the corporate governance implications of such migrations as well.
[32] Id
[33] Id
[34] Id.

real seat principle.[35] For example in Germany the transfer of real seat is not possible without dissolution of the company with all the unpleasant consequences of liquidation.

The practical effect of different countries using diverse approaches to determine the corporate status that a company may be treated as resident of more than one country. Nevertheless, it is argued that, many jurisdictions claiming taxing jurisdictions over a company creates 'no conceptual or practical barrier.'[36] But argument does not take into account the commercial viability of such a company being taxed as resident in more than one country.

However the real question is how far residence can be changed by the mechanism of the cross-border mergers in the light of the real seat principle followed by most of the nations in respect of taxing jurisdiction.[37] Under the principle it is possible that the resultant company can still be treated as resident of the transferor company if the effective control and management of the company is in the country. There is also possibility that the company would be treated as resident in more than one jurisdiction under the principle. As compared to the domestic mergers countries have a much less enthusiastic approach towards cross-border mergers.[38] This is apparent from the fact that many countries, including India, do not tax on capital gains at the event of domestic merger or on international merger when the amalgamated company is an Indian company, while tax concession is not available when the transferee company is not an Indian company. This tax aspect acts as a major factor in deciding to import or export capital. It is argued that ideally, the investment decision should

---

[35] Kane Mitchell A. et al; Corporate Taxation and International Charter Competition; 106 Mich. L. Rev. 1229
[36] Id.
[37] In India section 6(3) of the Income Tax Act allows a company to be treated as resident if the control and management of the company was wholly in India in the financial year concerned.
[38] Regulation 2 (e); Foreign Exchange Management (Transfer or Issue of any foreign Security) Regulation, 2004: "Direct investment outside India" means investment by way of contribution to the capital or subscription to the Memorandum of Association of a foreign entity or by way of purchase of the existing shares of a foreign entity either by market purchase or private placement or through stock exchange, but does not include portfolio investment.

not be influenced by such tax considerations; but shall be based on economic merit of the investment.[39]

Real Seat approach vis-à-vis Exit Tax

Many corporate merger and acquisition take place in the US, with the motive to reduce tax burden by escaping the tax jurisdictions of the US. This process typically involves incorporating a company in an offshore tax haven and then merging the US Company with such offshore company with the offshore company as he resultant company. It is felt that at least in short term the tax competition may lead to suboptimal level of capital distribution in the world.[40] In a world with disparity in the tax principles it is expected that the countries would take advantage of the differing taxing principles and the corporations to take advantages of such different tax options. This tax competition may also lead to each country collecting less tax than what it would have in the absence of such tax competition.

Tax regimes of different nations have the capability to influence the corporate decision as to the place of business of the company. Many countries adopt tax measure to counter the migration of companies with other jurisdictions through the mechanism of cross-border merger.

One of such measure is exit tax. An exit tax is tax imposed by the nation from whose jurisdiction the company is merging with a company in another jurisdiction, on unrealized gains or deferred taxes of the corporation. Unrealized gains or deferred taxes refer to the tax that was deferred till the actual realisation of the gain.[41] The shares or the assets of the company would have undergone some capital appreciation in the country which would not be

---

[39] This can be called capital export neutrality that is to say that an investment shall not be taxed for it is a cross-border investment.
[40] Supra note 20.
[41] Id.

taxed until such appreciation is not realized. However, when the company decides to leave the jurisdiction exit tax becomes payable. This would deter the company from leaving the jurisdiction if the benefit of merger with the foreign entity is less than the exit tax payable, which may have the effect of trapping the company in an undesirable location.

Real Seat v. Place of Incorporation approach

Issue of jurisdiction is a pivotal issue for tax liabilities. Corporate houses choose tax havens to decrease their tax liabilities. Disincentivisation is a way to stop companies escaping from one jurisdiction to another for tax benefits. One such way to disincentivise the corporate migration, through trans-border merger, for tax purpose would be by making the real seat rule applicable for taxation purpose. As the corporation being a creation of law the existence of it must be with reference to a jurisdiction. Although myriad approaches may be possible to determine this jurisdiction, there are essential two major approaches to it (1) Real Seat and (2) place of Incorporation.

The consequence of not incorporating a company in the real seat of the corporation under the laws of some countries, for example Germany, is that the company would be treated as defectively incorporated resulting in the denial of benefit of incorporations like limited liability,[42] separate legal personality etc. On the other hand corporate migration through trans-border merger is easier in countries that follow the place of incorporation theory as compared to in a company that follow real seat rule. The company by mere merging of the company with a foreign company a company would be able to change the tax law that govern it, even if it's real seat does not change.

[42] Creditors in the jurisdiction of the corporate head office may be able to enforce their claims against the personal property of the investors.

As mentioned before the corporate migration by merging with a foreign company would be easier if the country concerned follow 'place of incorporation rule' and also imposes tax on global income of the company[43] because the company can avoid the tax global income if it is merged into a foreign company. The real seat principle would have prevented this from happening this easily. Further if the tax haven follows Place of incorporation for tax propose then the corporation would have to incorporate there despite the inferior corporate law they might have. Universal application of real seat principle is advisable for the tax purpose.[44] S relocation for the purpose of tax would necessitate relocation for the corporate aspect as well. Since the foreign corporations can also be listed in the US stock exchanges the loss due to the loss of domestic status in the US is not big enough to offset the gain due to the tax advantage abroad.

On the other hand, some countries in the European Union follow the real seat rule to determine the both corporate and tax locations. Some countries follows place of incorporation rule for the purpose of corporate location and real seat for tax purpose.[45] However recent decision of the ECJ in Centros, Uberseering, Inspire Art and Sevic Systems shifted the Europe towards the place of incorporation rule as far as corporate law is concerned. It seems that the approach of the ECJ as reflected in Daily Mail Case[46] is different when tax questions are involved. In the case the company tried to relocate its real seat i.e. control and management of the company, from UK to Netherlands. The UK law prohibited a company which is resident in the UK for tax purpose from ceasing to be so without the permission of the Treasury. The treasury refused permission in this case to cease to be a resident of the UK. ECJ upheld the UK provisions and held that the company is a creation of law and its

---

[43] Supra note 20

[44] Id.

[45] Germany both corporate and Tax location is determined by the real seat rule. On the other hand UK follows place of Incorporation to determine the corporate location while it applies real seat rule for tax purposes.

[46] The Queen v. H.M. Treasury & Comm'rs of Inland Revenue, ex parte Daily Mail & Gen. Trust plc., Case 81/87

incorporation and functioning are determined by the law. It does not have a scope beyond it. This may be taken as an indication that measure the member countries may take to preserve the revenue may not be interfered with by the ECJ. The countries in EC could be free to adopt real seat principle for tax purpose as most of them do now.

Indian Approach

In India the scope of total income for resident and non-resident is different. While income of a resident that is accrued or arises to him outside India is taxable, such income of the non-resident is not taxable in India. In short the global income of resident can be taxed in India but only income that is (1) received or deemed to be received in India and (2) that is accrued or deemed to be accrue or arises in India, to a non-resident, are taxable in India.[47] The concept of residence is of immense importance in determining the scope of total income of the assessee because the exposure of a company which is resident in India to Indian taxation is more than a non-resident company.

Income tax Act lays down a two layer test to determine the residential status of a company. An Indian company or a company, whose control and management is situated wholly in India, is a company resident in India.[48] If company concerned satisfies any of the tests namely, being an Indian company or being company whose management is wholly situated in India, such companies can be taxed as if it were a resident company; that is to say the global income of such company can be taxed. The control and management test thereby allows considering even foreign companies as residents if the control and management is wholly in India. However the control and management shall be wholly in India and a partial control and

[47] Section 5 of Income Tax Act 1961

[48] Section 6(3) of Indian Income Tax Act, 1961- "A company is said to be resident in India in any previous year, if—

(*i*) it is an Indian company ; or

(*ii*) during that year, the control and management of its affairs is situated wholly in India."

management will not qualify the company as a resident. Companies which are not Indian companies and do not have place of control and management completely in India are non residents. This was held in the case "*In Re: Advance Ruling*". In this case the question was whether a French company (ACB) which expected to be awarded a contract by an Indian company, "X", in connection with X's plans to set up a manufacturing plant in India, be treated as resident in India or France. It was ruled that the company would be resident of France however as the company is expected to establish offices in India those would be treated as permanent establishments in India.

The Income Tax Act, 1961 does not define the term 'control and management. Section 4A(c) of the Indian Income-tax Act,1922, which corresponds to section 6(3) of Income tax Act, 1961 formerly provided that a company is resident in the taxable territories in that year if the control and management of its affairs is situated wholly in the taxable territories. The term 'control and management' used in section 6(3)(ii) refers to 'head and brain' which directs the affairs of polity finance, disposal of profit and vital things concerning the management of a company. Usually control and management of a company's affairs is situated at a place where meetings of the board of directors are held. Moreover, the 'control and management' referred to in section 6(1)(iii) means the central control and management and not the carrying on of day-to-day business by employees or agents of the foreign company.[49]

Every Indian company as the expression is defined in section 2(26) is deemed to be resident in India even if its control and management is situated wholly or partly abroad. But a non-Indian company would become resident in India only if its control and management of its affairs is situated wholly in India during the said previous year. Even if a negligible part of the control and management is exercised from outside India, the company would be a non

[49] Taxation of Income from dividends and Capital Gains of an overseas corporate body incorporated in Mauritius : Income-Tax Act, 1961 and the Indo-Mauritius Double Tax Avoidance Convention, M.P. Singh, Taxman, 2002, vol-124, pg- 95

resident for income-tax purposes. The residence of a non-Indian company may have to be determined with reference to each previous year due to the fact that a company which is resident in one year need not necessarily be resident in the next year or years.

In *V.V.R N.M. Subbayya Chettiar v. CIT*[50] the court held that the conception of residence in the case of an artificial person such as a company, and the locality of the residence can only be determined by analogy, asking where is the head and seat and directing power of the affairs of the company. 'control and management' signifies in the present context, the controlling and directing power, the head and the brain as it is sometimes called, and situated implies the functioning of such power at a particular place with some degree of permanence, while 'wholly' would seem to recognize the possibility of the seat of such power being divided between two distinct and separate places. As a general rule, the control and management of a business remains in the hands of a person or a group of persons and the question to be asked is wherefrom the person or group of persons controls or directs the business. Mere activity by the company does not create residence. In *Egyptiain Hotels Ltd. v. Mitchell*[51], Lord Summer said "where the Directors forbore to exercise their powers, the bare possession of these powers was not equivalent to taking part in or controlling the trading."

In the case of *Narottam & Perira Ltd. V. CIT*[52] the company in the question had its meeting of the board of directors held in Bombay and also the meetings of the shareholders. The Court explained the 'control and management' principle referred to in section 4A(c) of the 1922 Income Tax Act which is *pari materia* to the Section 6(3)(II) of the 1961 Act. On the facts the court found that the company has its management in Bombay. The Bombay High Court observed-

[50] [1951] 19 ITR 168 (SC)
[51] 6 T.C. 542
[52] Narottam & Pereira Ltd. V. CIT [1951] 23 ITR 454 (Bom.)

"it is not the servants and agents that constitute the seat of power or the controlling and directing power. It is that authority which controls and manages them, which is the central authority, and it is at the place where the central authority functions that the company resides."

Court further held that it may be in some cases that like in individual a company may have residence in more than one place. It may exercise control and management not only from the fixed abode, but it may have different places. That would again be a question dependent upon the circumstances of each case. Court further opined –

"a company may have a dozen local branches at different places outside India, it may send out agents fully armed with authority to eat with and carry on business at these branches, and yet it may retain the central management and control in Bombay and manage and control all the affairs of these branches from Bombay and at Bombay."

Actually the expression "control and management" means *de facto* control and management and not merely *de jure* right or power to control and manage. This principle was laid down by the Supreme Court in the case of *Erin Estate Galaph, Ceylon v. Commissioner of Income-Tax*[53], accordingly the phrase "control and management" refers to the "head and brain" which directs the affairs of policy, finance, disposal of profits and such other vital things concerning the general and corporate affairs of the Company. In *Narottam and Pereira Ltd.* case it was rightly held that a company can be resident of India even if the substantial business of the company is abroad. In the case of *De Beers Consolidated Mines Ltd, v. Howe*[54] and in *Unit construction Co. Ltd. V. Bullock*[55], the court observed-

---

[53] (1958) 34 ITR 1 (SC)
[54] AC 455 (HL)
[55] [1961] 42 ITR 340 (HL)

"A company cannot eat or sleep, but it can keep house and do business. It is therefore, resident where it really keeps house and does business. The real business is carried on where the central management and control actually abides. In order to hold that a company is resident in India, it must be established that all its affairs are de facto controlled from India."

Similar view was also expressed by Supreme Court in the case of *CIT v. Nandlal Gandalal*[56], where court held that the expression control and management signifies controlling and directive power, "the head and brain" as it is sometimes called. Furthermore, it is settled that the expression 'control and management' means de facto management and not merely the right or power to control and manage.

In the case of *CIT v. Bank of China*[57], the court to made clear the meaning of the expression 'affairs' within the meaning of Section 6(3) of the I.T. Act, 1961. The court held that the affair here means those affairs which have some relation to income. The court in this case held that the assessee company under liquidation is under the control and management of the liquidator. So a foreign bank undergoing liquidation in India is a resident in India. The place of management and control is not the same as controlling shareholding of the company; so the place of residence for majority shareholders cannot be considered as place of management and control for that reason.

---

[56] [1960] 40 ITR 1 (SC)
[57] MANU/WB/0183/1985

Change of residential status of a company

It is very common phenomenon that the company changes its residential status in cross-border merger and acquisition. In fact tax benefit is one of the main reasons company opt for cross-border mergers. Mauritius is very popular residence for Corporate as it gives many tax benefits and holidays to the companies that's why corporate wants to be resident of tax haven countries like Mauritius. A company may change its residential status for purposes of income-tax-in India also by changing the place of control and management of the affairs of the business so as to become resident or non-resident in India depending upon what is beneficial from the tax as well as financial angles. For instance, where a non-Indian company is earning substantial incomes within taxable territories in India but suffering losses without taxable territories outside India, it would not be entitled to set off its losses against Indian incomes but if chooses to become resident, it can set off its losses arising outside taxable territories against the incomes of the taxable territories. This was held in the case of *Commissioner Income Tax v. P.M. Mathuraman Chettiar.*[58] *And the same was reiterated in the case of Wallace v. CIT.*[59]

Indeed the control and management rule would be proved helpful in Cross-border merger situation for every country to protect the revenue and to prevent the resultant company avoiding the taxing jurisdiction of the country. However there is danger of the resultant company to be taxed in both the jurisdictions as resident, since more than one country may treat the place to management and control as situated in their country. This would be highly unfair and the result may not be in the interest of useful business combinations.

---

[58] (1962) 44 ITR 710 (SC)
[59] 13 ITR 39

In India since the control and management should be situated wholly in India, there is less likely hood of situations like double taxation. But in countries like UK, the requirement is that the "substantial control and management should be in UK". So there is more likely hood that the country may treat the company as resident of it and tax accordingly.

But there is one other reason for India to rethink its tax policies is that India follows both place of incorporation theory and real seat theory. Thus there may be a chance that the same company would be treated as resident of India and some other country also. Certainly the possible solution of this problem can be found out through the terms of Double Taxation Avoidance Agreements with various other countries. This aspect shall be dealt in the Chapter- V of this research thesis.

Vodafone Judgment: Expansion of Tax Jurisdiction

In a very recent judgment of Bombay High Court in the case of *Vodafone international holdings B.V. v. Union of India and ors.*[60], the issue of chargeability of global income was discussed in length and court while establishing the jurisdiction of Indian court over global income of incorporations said

"Like most other taxing jurisdictions, the Indian Income Tax Act follows the twin basis for taxation, (i) based on residence or domicile and (ii) based on source of income. While Indian residents are taxed on global income under Section 5(1), non-residents are taxed only on the income, which has its source in India under Section 5(2). The non-residents should have

60 [2009] 311 ITR 46 (Bom)

either received or deemed to have received the income in India or the income should have arisen or accrued in India or should be deemed to have accrued or deemed to have arisen in India. The deeming provision is enumerated in Section 9 of the Income Tax Act. It is the submission of the Revenue that the income or capital gains of HTIL is deemed to have accrued or arisen in India and therefore, it squarely falls within the ambit of Section 9 and is hence chargeable to Income Tax."

Hon'ble Court in this case has taken the view that notwithstanding the fact that the company whose shares were sold is not an Indian resident, the said transfer still amounted to a transfer of an Indian capital asset, as there was a change in the ***indirect controlling interest*** of an Indian company. On this basis, the Hon'ble Court has held that as the person making payment to a seller for a transaction that was taxable in India, Vodafone was liable to have withheld taxes from Hutchison Whampoa.

Court also relied on the judgment of Calcutta High Court in the case of *Assam Consolidated Tea Estates Ltd. v. ITO 'A' Wards and Ors.*[61]. in this case the court held that Section 9(1) of the Act is a complicated provision applying to all income accruing or arising whether directly or indirectly, through or from (a) a business connection in India; (b) and money lent at interest and brought into India in cash or in kind; (c) a transfer of a capital asset situated in India. This being a deeming provision, it is not enough merely to say that the income does not arise directly through or from any of the sources mentioned in the section. The words of the Sections are of the widest amplitude, namely accruing directly, accruing indirectly, arising directly or arising indirectly.

This judgment in my view seeks to establish a legal principle that an "indirect controlling interest" is also a capital asset distinct from the shares of an Indian company. The judgment may have some adverse impact on global merger but it definitely expands the tax jurisdiction

[61] 1981 ITR 699 (Cal)

of Indian Tax authorities. Any global M&A transaction, even if it is a buy-out of one US company by another, for example, would now have to specifically address the tax implications arising on account of the transfer of "indirect controlling interest" of any Indian subsidiaries that the target company might have. This would make the transaction more expensive as a whole. This would also raise questions about how the 'indirect controlling interests" of the Indian subsidiaries of the target company are to be valued. This judgment may have wider tax footprint in cross-border transactions outside the jurisdiction of India.

Chapter- 3

Capital Gain Taxation in M&A

A very prominent way to attract the companies from various other tax jurisdictions is to give them tax concession and incentives. Thus, several countries extend certain tax concessions to the participants in the mergers for it is thought that otherwise certain efficient and beneficial transactions[62] may not happen. Further the 'transfer' of the capital involved in merger does not justified capital gains tax.[63] Although the merger process involve transfer in the capital it does not result in realisation of the capital but the shareholders of the transferor or the transferee company hold the capital on a substituted basis. The capital gains tax would be imposed when the shareholder of the transferee company actually disposes of the shares or the property at future point of time.

However, mainly due to the fear of income of transferor companies escaping the taxing jurisdiction the above benefit is not extended to trans-border mergers in many countries, including India. Assuming that mergers are generally beneficial to the society and involve synergy, the desirability of not extending the benefit of capital gains tax exemption of cross-border merger is to be examined.

Section 368 of the US Internal Revenue Code recognizes seven types tax free acquisitive reorganizations. These tax free acquisitive reorganizations include firstly, the reorganization[64], which is a merger of a target directly into an acquirer with the target's

[62] Mergers are considered beneficial since they are believed to created synergy and increase efficiency.
[63] Supra note 35
[64] Section 368 (a)(1)(A) of US Internal Revenue Code

shareholders receiving stock in the acquirer. Secondly, the reorganization[65] which is a merger of a target into a subsidiary (Acquiring Subsidiary) of the acquiring corporation (acquiring parent). Thirdly, in reorganization[66] an acquiring corporation acquires substantially all of a target's assets in exchange solely for voting stock of the acquirer etc.[67]

Existing regulations under section 368 of the Internal Revenue Code provide rules regarding the necessary conditions for corporate transactions to qualify as tax-free reorganizations. One type of transaction that may qualify as a tax-free reorganization is a "statutory merger." The existing regulations limit the scope of the term "statutory merger" to mergers of domestic corporations. In 2003, temporary and proposed regulations were issued to provide a functional definition of the term "statutory merger," in order to reflect developments in state corporation laws since the term was first defined in 1935.[68]

Indian approach

The income Tax Act does not define the term 'Merger'. The term defined by the Act is 'Amalgamation'.[69] For the purpose of Income Tax Act a merger between companies to be considered as an amalgamation has to meet the following two conditions:

---

[65] Section 368 (a)(2)(D) of US Internal Revenue Code

[66] Section 368 (a)(1)(c) of US Internal Revenue Code

[67] Thompson Samuel C., Impact of Code section 367 and the European Union's 1990 council directive on Tax-free Cross-border Mergers and Acquisitions; 66 U. Cin L. Rev. 1196

[68] Guideline of US Treasury department for Cross-border merger http://www.treas.gov/press/releases/js2179.htm

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

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

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

1. All the property and

2. Liabilities

Of the amalgamating company becomes the property of the amalgamated company by virtue of the amalgamation;

3. Shareholders holding not less than three forth in value of the shares in the amalgamating company become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of the distribution of such property to the other company after the winding up of the first mentioned company.

The requirement that not less than three fourth of the share holders of the target should be shareholders of the amalgamated company is to ensure continuity. Otherwise the scheme can be used as ploy to actually transfer the company to others without paying the tax applicable. The above stipulation can ensure that the shares of the amalgamated company are issued to the shareholders of the amalgamating company on a substituted basis. Nevertheless, such stipulations are not there in the EC directive and US Internal Revenue Code provisions. Further no cash payment is contemplated in India unlike in US and EU. Further the concept of merger under EC directive and US is wider than that in India. Thus it can be said that in these jurisdictions tax exemption is available for a wider variety of merger transactions.

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

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

Under Indian Income Tax Act a capital gain will arise when a capital asset is transferred. The word 'transfer' is defined under the Income Tax Act in Section 2(47)[70]. Primarily, the word 'transfer' means the sale, exchange, or relinquishment of the asset or the extinguishment of any rights therein or the compulsory acquisition thereof under any law.

The learned author Mr. N. A. Palkhivala in his book "The Law and Practice of Income Tax Act", in his own usual style rules out the incidence of capital gains tax.[71]

Illustrating the situation he writes-

"where company A amalgamates with and merges into company B and the shareholders of company A are allotted shares in company B in their own right and not as nominees of company A question arises as to whether those shareholders are liable to tax under the head company A. question arises as to whether those shareholders are liable to tax under the head 'capital Gains'...it is clear that such amalgamation does not involve any transfer or sale of the shares of company A. it does not involve any exchange either within the legal meaning of that term...whereas the allotment of shares by company B to the shareholders of company A does not involve a transfer of property by either of the two parties to the other. There is no

[70] Section 2(47) of IT Act- "transfer", in relation to a capital asset, includes,—

(*i*) the sale, exchange or relinquishment of the asset ; or

(*ii*) the extinguishment of any rights therein ; or

(*iii*) the compulsory acquisition thereof under any law ; or

(*iv*) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment ;] [or]

[(*iva*) the maturity or redemption of a zero coupon bond; or]

[(*v*) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882 (4 of 1882) ; or

(*vi*) any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

Explanation.—For the purposes of sub-clauses (*v*) and (*vi*), "immovable property" shall have the same meaning as in clause (*d*) of section 269UA;

[71] The Law and Practice of Income Tax Act; Palkhivala N. A.; pg-771

transfer of assets by the shareholders of company A to company B; the transfer of assets of company A cannot be regarded as a transfer by its shareholders. Nor is there any transfer by the company cannot be regarded as a transfer of property by that company."

The merger does not involve 'relinquishment of the asset' because relinquishment postulates the continued existence of the asset over which the rights of its holder are relinquished or surrendered, whereas upon amalgamation the shares in company A ceases to exist. The amalgamation does involve extinguishment of the asset, viz. shares in company A; but the better view is that it does not involve 'extinguishment of any rights therein' which expression seems to indicate the continued existence of the capital asset over which the rights of its holder are extinguished.

Those mergers, not meeting the conditions are not amalgamation for the purpose of Income Tax Act. This is important because relief from capital gains tax is available only to amalgamations within the meaning of Income Tax Act.

Capital gain tax is a tax on the profits and gains arising out of transfer of capital asset.[72] Income includes capital gains as well[73] and hence is taxable as any other income. The taxable event in case of capital gains is the transfer of the capital assets absent which there is no question of capital gains tax.[74] In this case a civil suit was filed by the assessee-firm against another company, which was decreed in favour of the assessee. By the decree, the assessee became entitled for *mesne profits*. The question before the court was whether this constitutes transfer of capital assets to attract capital gains tax. Kerala High Court answered this question

[72] Section 45(1) of IT Act:- Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections 54, 54B, 54D, 54E, 54EA, 54EB, 54F, 54G and 54H be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.

[73] Section 2(24)(ii) of IT Act, 1961- Income includes- any capital gains chargeable under section 45.

[74] Achuthan Pillai and Co. v. Commissioner Income Tax; 238 ITR 458

in negative and held that it did not constitute transfer of capital assets [*Achuthan Pillai and Co. v. Commissioner Income Tax*].

In the case of *Commissioner of Income v. Nirmala Textiles*[75] court held that the taxable event occurs on the date of the transfer of the capital assets. In this case the controversy was whether a gain in question was short term capital gain or long term capital gain. The Gujrat High Court held that the taxable event is the date of transfer and the question to the long term and short term has to be calculated on the basis of such date.

With regard to capital assets, Transfer includes-

i. The sale, exchange or relinquishment of the assets; or
ii. The extinguishment of any rights therein.[76]

In a lease the ownership of the property remains with the lessor and he transfers only the right to use the property. An order to give *mesne* profit to the lessor does involve transfer of capital assets to attract capital gains tax since the property was not transferred.[77] Court in the cases of *Vania Silks Mills v. CIT*[78] and *Neelamai Agro v. CIT*[79] held that the Insurance amount

---

[75] 224 ITR 378

[76] See, Section 2(47)- "transfer", in relation to a capital asset, includes,—

(*i*) the sale, exchange or relinquishment of the asset ; or

(*ii*) the extinguishment of any rights therein ; or

(*iii*) the compulsory acquisition thereof under any law ; or

(*iv*) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment ; or

[(*iva*) the maturity or redemption of a zero coupon bond; or]

[(*v*) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882 (4 of 1882) ; or

(*vi*) any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

Explanation.—For the purposes of sub-clauses (*v*) and (*vi*), "immovable property" shall have the same meaning as in clause (*d*) of section 269UA;

[77] Article 4 of European Council Directive on Cross-border Mergers and Acquisitions

[78] 191 ITR 647

[79] 259 ITR 651

received for destruction of the property cannot be considered as capital gains. The property destroyed cannot be considered as property transferred because 'extinguishment of rights' in capital assets presupposes continued of the capital assets.[80] Further in a transfer there shall be a continued existence of asset and of the transferee.[81] However, in the case of *CIT v. Grace Collis*[82] Supreme Court held that the extinguishment of rights can be independent of and otherwise than on account of transfer.

If we leave some of the transactions which other would qualify to be transfer as per the definition of the 'transfer' are excluded from the purview of the term transfer.[83] Many of these are transactions involved in corporate restructuring like mergers and demergers[84] etc. However, these benefits are extended only if the amalgamated company or the resulted company is an Indian company.

As per Section 47 of Indian Income Tax Act, 1961 transfer of capital assets by an amalgamating company to amalgamated company is not a transfer if-

i. The transfer is under a scheme of amalgamation
ii. The amalgamated company is an Indian company.[85]

This section exempts the amalgamating company from any gains that arise from the transfer of the capital assets. However the amalgamating company does not receive any consideration from the amalgamated company; but it is, the shareholders who receive it. So there can possibly be no occasion that the amalgamated company is liable for any capital gains tax. The section is hence criticized for allowing benefit of exemption from capital gains to the

---

[80] Id.
[81] Id.
[82] MANU/SC/1540/2001
[83] Section 47 of the Income Tax Act, 1961
[84] Id.
[85] Section 47(vi) of IT Act, 1961- Nothing contained in section 45 shall apply to the following transfers :—
(*vi*) any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company

amalgamating company only if the amalgamated company is an Indian company when there is no occasion that the amalgamating company can be taxed.[86]

Section 47(vii) exempts any transfer of shares of amalgamating company by shareholders in a scheme of amalgamation if-

i. Such transfer is made in consideration with the shares of the amalgamated company;

ii. The amalgamated company is an Indian Company.

Shares of a shareholder of the amalgamating company are extinguished when the amalgamation is completed and hence it constitutes a transfer[87], but by virtue of Section 47(vii) it is not liable for capital gains tax.

In pursuant to Section 47(via) exemption from the capital gain in transfer of share of an Indian company held by an amalgamating foreign company to amalgamated foreign company in certain qualified situations. In order to be qualified for the exemption the following conditions have to be met-

i. A minimum of 25% of the shareholders of the amalgamating company continue to remain shareholders of the amalgamated foreign company, and

ii. The transfer does not attract capital gains tax in the country of incorporation of the amalgamating company.

But it is very pertinent here to note that the benefit of section 47(vii) and section 47(via) would be available only to the transfer of shares. If there is money involved in the transaction the exemption may not be applicable.

---

[86] Vyas Dinesh; the Law and Practice of Income Tax- Kanga, Paikhivala and Vyas; lexis Nexis, Butterworths; Edn-9th 2004; pg- 1141

[87] Commissioner Income Tax v. Grace Collis, MANU/SC/1540/2001

This section has highly been criticized by some of the scholars. The main criticism of this section is that the section assumes that these transaction are 'transfers' while they do not constitute 'transfer' even in absence of these provisions. This has the effect of making the certain other transaction to look taxable if they have not met the conditions stipulated in the respective sections.[88] However in *Commissioner of Income Tax v. Grace Collis*[89] Supreme Court has held that such transactions are 'transfer' as it involves 'extinguishment of right' of the shareholders.[90] Thus the question can now be considered as settled that if the conditions under section 47 are not met the above described transactions would be treated as transfer and consequently would be liable for capital gains tax.

Thus it is very much clear that the exemption from the capital gains tax would be available when the amalgamated company is an Indian company and not otherwise. So India fall under the kind of countries which exempts mergers from capital gains taxes but when the amalgamated company is a foreign company such exemption are not available.

Further it is also to be noted that that if there is capital appreciation that has happened in the country. It is arguably the right of the country to tax such appreciation that happened within the country because subsequent to the migration the country would not have the opportunity to tax any realisation of the capital appreciation.

Though there is very potent force in the contentions advanced earlier in this chapter regarding the tax exemption of the companies while merging, a blanket denial of the exemption from capital gains tax is not a desirable option. In the first place there is no actual realisation of the capital appreciation in the event of a merger whether domestic or trans-border. Secondly, the reasons for not taxing the domestic merger are equally true for trans-border mergers as well.

---

[88] Supra note 22
[89] Supra note 23
[90] Id. Para 15 and 16

As we have already seen in the case of US, there is no blanket denial of capital gains tax exemption for transferee companies even if they are foreign company. In the United States there are complex tax rules applicable for the purpose of preventing tax evasion. Within the European Union the directive mandates that there shall be no tax if the companies of member state merge. Both the European Council's directive and the United States internal Revenue Code contain provisions to pre vent the tax avoidance or evasion.

Majorly, the capital gain tax in the case of cross-border mergers are in the nature of exit taxes and at least partly meant to dampen the cross-border capital movement and to prevent loss of taxes that might have arisen from the future operations of the company. When it is used for protectionist purposes some beneficial transaction itself would not take place.

Chapter-4

Provisions of Indian Tax Laws applicable in Cross-border M&A

The business and economic environment of the country has thrown up the need for rationalisation of laws relating to business reorganization for restructuring of production system and better utilization of resources which have become necessary with a view to enable the Indian industry to rearrange itself to become globally competitive. Keeping this thing in mind, decades ago the finance Act, 1998 proposed various tax concessions for reorganization of companies. The finance Act, 1999 went one step further and introduced many provisions relating to "demerger of a company" and "sale or transfer of business as a going concern through the slump sale". In addition to these, existing provisions of amalgamation have also been rationalized.

The Income Tax Act now provides for tax concessions in the following cases of business reorganization:[91]

i Amalgamation/merger of companies

ii Conversion of proprietary concern/firm into a company

iii Demerger of a company

iv Slump sale

Nowhere, in the Income Tax Act, 1961 the word 'merger' has been defined. The Act uses the word 'Amalgamation'[92]. A careful study of the definition of 'Amalgamation' enshrined in Section 2(1B)[93] of the IT Act focuses attention on the following areas:

[91] Provisional Approach to Direct Taxes: Law and Practices; Ahuja Girish and Gupta Ravi, Bharat Law House; 16th Edn; 2007-08, Pg- 1362

i. The expression 'amalgamation' used in the IT Act refers only to amalgamation relation to companies and not with reference to any other amalgamation between other forms of legal entities like partnership firms or sole proprietorship.

ii. The following types of combinations are envisaged:

a. Merger of one or more company with another company

b. Merger of two or more companies to form a new company

iii. At the same time, the following are excluded from the definition of amalgamation:

- Acquisition of the property of one company by the other company pursuant to the purchase of such property

- Distribution of property to another company due to winding up of the transferor company.

iv. The transfer of the following is contemplated:

- All the property and liabilities of the transferor companies before the amalgamation becoming the property of the transferee company;

- Shareholders holding not less than nine tenths in value of the shares in the transferor company becoming shareholders of the transferee company by virtue of

---

[92] Section 2(1B)

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

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

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

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

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

amalgamation other than those already held by the transferor company in the transferee company either by itself or through its nominees.

v. The christening of names both for the transferee and the transferor and the transferee:

- The transferor will be known as the amalgamating company
- The transferee will be known as the amalgamated company.

vi. The emphasis of the word 'before amalgamation' used with regard to the transfer of assets and liabilities.[94]

The Supreme Court in *Saraswathi Industrial Syndicate Ltd. V. CIT*[95], further explained the concept of 'amalgamation'. Court observed

"In an amalgamation, two or more companies are fused into one by merger or by one taking over the other. Reconstruction or amalgamation has no precise legal meaning. Amalgamation is a blending of two or more existing undertakings into one undertaking. The shareholders of each blending company become substantially the shareholders in the company which is to carry on the blended undertakings. There may be amalgamation either by transfer of two or more undertakings to a new company or by the transfer of one or more undertakings to an existing company."

Here in the case of cross-border merger there must be an involvement of two or more companies belonging to the different jurisdictions. And in order to get benefit of tax-concession provided in various provisions of Income Tax Act, 1961, the surviving company must be an Indian company.

[94] mergers *et al;* Ramanujam S.; Tata McGraw-Hill Publishing Comp. Ltd.; yr- 2003, Pg- 294
[95] 186 ITR 278

Merger or Amalgamation

For a merger to qualify as 'amalgamation' under the provisions of the IT Act, the definition highlights that the following conditions need to be satisfied:

I. The merger should be pursuant to a scheme of amalgamation.

II. All the assets and liabilities of the amalgamating company should be included in the scheme of amalgamation.

III. No prescribed time limit exists within which the property of the amalgamating company should be transferred to the amalgamated company.

IV. The requirement that the shareholders holding 75 per cent in value of the shares in the amalgamating company to be shareholders in the amalgamated company applies to both preference and equity shareholders. However, it does not prescribe any minimum holding in the amalgamated company, nor does it stipulate for how long they should continue being shareholders in the amalgamated company.

V. The consideration to the shareholders of the amalgamating company can be a combination of cash and the shares in the amalgamated company.

Delhi High Court in the case of Telesound (India) Limited. *In Re.,* held that it is possible to issue even redeemable preference shares as consideration to qualify as amalgamation.[96]

Capital gains tax implication for the amalgamating (transferor) company –

Section 47(vi) of the IT Act specifically exempts the transfer of a capital asset in a scheme of amalgamation by the amalgamating company to the amalgamated company, provided the

[96] [1983] Comp Cases 296

amalgamated company is an Indian company. It is essential that the merger falls within the definition of 'amalgamation' as given under section 2(1B), if the exemption hereunder is to be availed of.

Recently, in January 2010, Authority for Advance Rulings (AAR) has given a very remarkable judgment which may attract the flow of foreign capital investment in India. In a merger deal of *Star Television Entertainment Ltd.*[97], the authority has held that "no capital gains tax liability would arise under the income Tax Act, 1961 in respect of transfer of shares or assets forming part of the terms of an amalgamation". Rejecting the plea of the revenue authorities at the outset, the AAR ruled that a taxpayer is not precluded from minimizing its tax burden while entering into a transaction, as long as such a transaction is not a sham or a contrived device which has the sole objective of avoiding tax. The AAR once again relied on the age-old principle laid down in *IRC v. Duke of Westminister*[98]-

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however, unappreciative the Commissioners of Inland Revenue or his fellow tax payers may be of his ingenuity, he cannot be compelled to pay an increased tax"

The AAR also relied on the landmark decision of the Supreme Court in *Azadi Bachao Andolan's Case*[99], which reiterated the principles laid down in *IRC v. Duke of Westminister* and held that the expression "transaction designed to avoid income tax" cannot be understood to mean that a tax payer is precluded from taking into account the tax implications and to minimize its tax burden. The AAR observed that it is within the legitimate freedom of the contracting parties to enter into a transaction, which has the effect

[97] [2010-TIOL-01-ARA-IT] accessed on http://www.taxguru.in/income-tax-case-laws/advance-ruling-in-the-case-of-star-television-on-taxation-of-cross-border-merger.html
[98] 1936 AC 1 p.754
[99] 263 ITR 706

of extending to the party the benefit of exemption under the taxation statute.

Exemption from capital gains tax to a foreign amalgamating company for transfer of capital asset, being shares in an Indian company -

In a Cross-border scenario, when a foreign holding company transfers its shareholding in an Indian company to another foreign company as a result of a scheme of amalgamation, such a transfer of the capital asset, i.e., shares in the Indian company would also be exempt from capital gains tax in India for the foreign amalgamating company if it satisfies the following two conditions:

I. At least 25 per cent of the shareholders of the amalgamating foreign company continue to be the shareholders of the amalgamated foreign company.

II. Such transfer does not attract capital gains tax in the country where the amalgamating company is incorporated.

It is important to note that the definition of "amalgamation" under section 2(1B) necessities that 75% (in terms of value of shares) of the shareholders of the amalgamating company should be the shareholders in the amalgamated company. However, section 47(via) specifies 25% as the corresponding figure, although with respect to foreign companies alone. This seems to indicate that the general requirement of shareholding in the definition of amalgamation under section 2(1B) could be overridden by the specific requirement under this section. Section 47(vi A) has very wide repercussion in the context of Cross-border mergers.

As it is evident from the clause[100], there could be cases where a capital gains incidence may arise on a foreign company holding shares in Indian company. This situation can be avoided/ minimized by following any one of the methods:[101]

I. By taking advantage of the relevant provisions in the Double Taxation Avoidance Agreement if any entered between the foreign country and India.

II. By not direct holding shares in the Indian company, but instead through another investment company situated in any other foreign country where there will be lesser incidence of capital gains tax.

III. By setting up transactional subsidiaries in typical tax haven countries like Mauritius where there is no capital gains tax on the sale of any movable property of a resident irrespective of the sites of the property.

Capital gains tax liability on the shareholders of the amalgamating company –

In the case of a merger, the shareholders of amalgamating company would be allotted shares in amalgamated company as a result of the amalgamation. This process presupposes the relinquishment of shares in amalgamating company held by shareholders thereof. It is important to determine whether this constitutes a transfer under section 2(47), which would be liable to capital gains tax. According to judicial precedents in this regard, including decisions of the Supreme Court till recently, this transaction did not result in a 'transfer' as envisaged by section 2(47).

---

[100] Section 47(via)- any transfer, in a scheme of amalgamation, of a capital asset being a share or shares held in an Indian company, by the amalgamating foreign company to the amalgamated foreign company, if—

(*a*) at least twenty-five per cent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company, and

(*b*) such transfer does not attract tax on capital gains in the country, in which the amalgamating company is incorporated;

[101] Mergers *et al;* Ramanujam S.; Tata McGraw-Hill Publishing Comp. Ltd.; yr- 2003, Pg- 304

In the case of *CIT v. Mrs. Grace Collis*[102] , the Supreme Court has held that "extinguishment of any rights in any capital asset" under the definition of 'transfer'[103] would include the extinguishment of the right of a holder of shares in an amalgamating company, which would be distinct from and independent of the transfer of the capital asset itself. Hence, the rights of shareholder of the amalgamating company in the capital asset, i.e., the shares stand extinguished upon the amalgamation of the amalgamating company with the amalgamated company and this constitutes a transfer under section 2(47).

However, a transfer by the shareholders of the amalgamating company is specifically exempt from capital gains tax liability, provided the following conditions are satisfied:

I. The transfer is made in consideration of allotment to the shareholder of shares in the amalgamated company.

II. The amalgamated company is an Indian company.

The issue addressed by *Mrs. Grace Collis' case* would arise in situations where the amalgamation does not satisfy all the conditions under section 47(vii) and section 2(1B) and is, therefore, not exempt from the capital gains tax. In view of this decision, the present

[102] 226 ITR 55 Ker

[103] Section 2(*47*) of Income Tax Act- "transfer", in relation to a capital asset, includes,—

(*i*) the sale, exchange or relinquishment of the asset ; or

(*ii*) the extinguishment of any rights therein ; or

(*iii*) the compulsory acquisition thereof under any law ; or

(*iv*) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment ;] [or]

[(*iva*) the maturity or redemption of a zero coupon bond; or]

(*v*) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882 (4 of 1882) ; or

(*vi*) any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

Explanation.—For the purposes of sub-clauses (*v*) and (*vi*), "immovable property" shall have the same meaning as in clause (*d*) of section 269UA

position of law seems to be that such a merger would result in capital gains tax to the shareholders of the amalgamating company.

Computation of capital gains tax on disposal of the shares of amalgamated company - This section contemplates a situation in which shareholders of the amalgamating company, having acquired the shares in the amalgamated company as a result of the amalgamation, now elect to sell off such amalgamated company's shares. Accordingly, when these shareholders sell their shares in the amalgamated company, for computing the capital gains that would accrue to them as a result of the sale, the cost of acquisition would be the cost of their shares in the amalgamating company. Also the period of holding for determining long-term or short-term gains would begin from the date the shares were acquired by the shareholders in the amalgamating company.

Section 49(2) of Income Tax Act, 1961-

This section contemplates a situation in which shareholders of eh amalgamating company, having acquired he shares in the amalgamated company as a result of the amalgamation, now elect to sell off such amalgamated company's shares. According to the provisions of section 49(2) of the IT Act, where a shareholder of amalgamating company acquires a capital asset, being a share or shares in the amalgamated company, which is an Indian company, by virtue of his shareholding in the amalgamating company as referred to in section 47(vii), the cost of acquisition of the shares in B to the shareholder would be deemed to be the cost of acquisition to him of the shares in the amalgamating company. Accordingly, when these shareholders sell their shares in the amalgamated company, for computing the capital gains that would accrue to them as a result of the sale, the cost of acquisition would be the cost of their shares in the amalgamating company. The period of holding for determining long term or short term gains should begin from the date the shares were acquired by the shareholders

in the amalgamating company. Let us understand this situation through an example, 'X' acquires shares in company 'A' at Rs. 100 per share. X receives shares in company B upon merger of A with B (The value of the shares of B is Rs. 125 each.) and relinquishes his right in his y number of shares which are worth Rs. 125each. X now sells his shares in the market for Rs. 150 per shares. Here Capital Gain will be Rs. 150- Rs. 100= Rs. 50 per shares.

Set off of unabsorbed losses and other tax benefits

The amended Section 72A of Indian Income Tax Act, 1961 provide that in case of amalgamation of a company owing an industrial undertaking, the amalgamated company would be able to get the benefit of carry forward of losses and depreciation to set off against its future profits, provided the following conditions are satisfied:

1. The amalgamated company holds three-fourth of the boom value of the fixed assets[104] which it acquired from the amalgamating company continuously for a period of five years,
2. The amalgamated company continues to carry on the business of the amalgamating company for a minimum period of five years from the date of amalgamation. This would imply that if the amalgamating company were engaged in more than one business prior to amalgamation, the amalgamated company would be required to carry on all of those businesses. This may be commercially unviable proposition;
3. Fulfils such other conditions as may be prescribed to ensure the revival of the business of amalgamating company that the amalgamation is for genuine business purpose.

[104] Prior to the change brought about by Finance Act, 2000, the amalgamated company was required to hold ¾ of the value of assets. The type of assets and the value thereof is now clear.

Currently, Rule 9C of the Income Tax Rules, 1962, provides that industrial undertaking of the amalgamated company shall achieve a production level of at least 50% of the installed capacity of he said undertaking before the end of four years from the date of amalgamation and continue to maintain the said minimum level of production till the end of five years from the date of amalgamation. If any of the above conditions is not satisfied, or if the amalgamation is not of a company owing an industrial undertaking, it would not be possible for the amalgamated company to set off brought forward business loss and unabsorbed depreciation o the amalgamating company. In case of a company owing an industrial undertaking, if there is a default in complying with these conditions at any time within the specified period, the set off would not be permitted in and from the year in which such default occurred.[105] Accordingly, the definition does not cover an undertaking providing services either in the information technology sector or in any other service sector. It includes undertakings engaged in the manufacture or processing of goods, manufacture of computer software, business of generation or distribution of electricity or any other form of power or mining or construction of ships, aircrafts or rail systems and engaged in the business of providing telecommunication services.

Availability of carry forward and set off of losses by certain companies: Section 79

Section 79 provides that there is a change in the shareholding of a company in which public are substantially interested, such a company would not be allowed the carry-forward or set-off of accumulated losses if shareholders carrying 51 per cent of voting power of the company on the last day of the year in which the loss is sought to be set off are not the same as the shareholders carrying 51 per cent of voting power on the last day of the year in which

[105] For the purpose of this section an industrial undertaking is defined under section 72A(aa)

the loss was incurred. A new proviso was added by the Finance Act, 1999 to this section. It provides that this restriction in respect of carry forward and set off of losses would not apply in the following circumstances:

When the change in the shareholding of an Indian company which is a subsidiary of a foreign company, takes place as a result of amalgamation of the foreign company and if 51% of the shareholders of the amalgamating foreign company continue to be the shareholders of the amalgamated foreign company. This is a welcome relaxation, though the amalgamated foreign company. This is a welcome relaxation, though the percentage of shareholders to continue in the amalgamated company is fairly high. The proviso does not specify the minimum percentage of shareholding that these 51% shareholders of the amalgamating company should hold in the amalgamated company. It also does not specify for how long they are required to continue holding shares in the amalgamated company. It would be important to evaluate applicability of this section while structuring reorganization of a foreign company, which has an Indian subsidiary.

DEMERGER –

Under a demerger, all the assets and liabilities of the undertaking of the demerging company are transferred to the resulting company and, in consideration for this, the resulting company issues its shares to the shareholders of the demerging company.

The recognition for the need for reorganization and restructuring of businesses for growth and optimization of resource allocation has also resulted in the Government reducing the tax cost of such transactions. In furtherance of this purpose, the IT Act provides certain tax beneficial provisions in the case of a demerger. If the demerger fulfils the conditions listed in the definitions under section 2(19AA) and 2(19AAA), the transfer of assets by the demerged

company to a resulting company has been exempted from capital gains tax. To qualify for the exemption, the resulting company should be an Indian company.

When a demerger of a foreign company occurs, whereby both the demerged and resulting companies are foreign but the assets demerged include or consist of shares in an Indian company, any transfer of these shares is exempt from capital gains tax in the hands of the demerged company. The following conditions need to be complied with for availing of this exemption:

(a) The shareholders holding at least three-fourths in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; and

(b) Such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated.

Since such a demerger would not be in India and, hence, the provisions of the Indian Companies Act would not be applicable in respect thereof, the proviso to this clause has waived the application of sections 391 to 394 of the Companies Act, 1956 to such a demerger.

EXCISE DUTY

There is no change in excise duty liability consequent to the merger as the excise duty as such is payable on goods manufactured and has no correlation whatsoever to the entities merging. Similarly, even the MODVAT credit benefits remain unaffected consequent to the merger. In the situations where an Indian company merges with any foreign country but manufacturing unit of the company continues to be in India, the goods are manufactured in India so the

excise duty on those goods shall be continued to be levied because the excise duty is levied on the manufacture of goods. No matter, from where the company is managed and administered. Similar is the case if the foreign company merged with an Indian company. Section 1 (Short title, extent and commencement) of the Central Excise and Salt Act, 1944[106], limits the enforceability to the Act to Indian Territory only. Therefore, excise duty on goods manufactured out of Indian Territory cannot be levied though the manufacturing unit is a part of Indian company.

SERVICE TAX

In an asset purchase or a slump sale, where the object is to acquire the business of the seller, there may be a covenant in the asset purchase agreement that the seller will procure that its employees accept offers of employment with the acquirer. Part of the consideration payable to the seller may be contingent on the number of employees who join the acquirer. It is possible that such a covenant could amount to the provision of manpower recruitment services by the seller on which service tax may be payable. The other aspect of the Cross-border merger would be that the service rendered by one company to the other would which is otherwise taxable under the Service Tax Act, may not be taxed if these two company get merged with each other as after merger the two company becomes a single entity. And thus service rendered to one another amounts to the service to oneself.

[106] **Short title, extent and commencement**
(1) This Act may be called the Central Excise and Salt Act, 1944;

(2) It extends to the whole of India *[The words "except the State of Jammu and Kashmir" omitted by Act 41 of 1954, s.2 and Sch.]*;

(3) It shall come into force on such *[28th February, 1944, see Notification No.III-D, dated the 26th February, 1944, Gazette of India, Extraordinary, 1944, p.293.]* date as the Central Government may, by notification in the Official Gazette, appoint in this behalf.

VALUE ADDED TAX/SALES TAX

Value added tax ('VAT') or sales tax, as the case may be, may be payable on a purchase of movable assets or goods of the target by the acquirer. Most Indian states have in the last few years replaced their state sales tax laws with laws levying VAT on the sale of goods[107]. Here some relevant provisions of the Karnataka Value Added Tax Act, 2003 ('KVAT'), in connection with the sale of goods in an asset purchase has been analyzed keeping in view of cross-border merger and amalgamation.

Under the Karnataka VAT, VAT is payable on a 'sale' of goods. The term 'sale' is defined to inter alia include a transfer of property in goods by one person to another *in the course of trade or business* for cash, deferred payment or other valuable consideration etc. Therefore, the sale must be in the course of trade or business in order to attract VAT. Since the seller would usually not be in the business of buying or selling the assets proposed to be acquired, and the sale of a business does not amount to a sale of goods, it could be said that a transfer of goods in connection with the sale of the business of the seller, is not a sale attracting VAT under the KVAT. However this argument may be applied only in the case of a slump sale where the business is transferred as whole and not in the case of an itemized sale of assets.

The law pertaining to VAT is state specific and the argument stated above regarding non-applicability of the VAT law to an asset sale, may not be applicable in other Indian States. For example, the Maharashtra Value Added Tax Act, 2002 defines the term 'business' to include any transaction in connection with the commencement or closure of business. Therefore, a slump sale of a business could be a sale in the ordinary course of business and could attract VAT. However an argument can be raised that a slump sale transaction would not attract VAT.

[107] The term 'goods' generally includes all kinds of movable property (other than actionable claims, stocks, shares and securities)

SALES TAX

The most significant advantage one can get through amalgamation is the saving in Sales Tax on the sale of the products between the merging companies. After the completion of amalgamation, the company becomes a division of the amalgamated company and any transaction between the two companies thereafter will be inter-divisional transaction, in the process taking the transaction away from the purview of 'Sale'[108].

STAMP DUTY

Stamp duty is a duty payable on certain specified instruments or documents. Broadly speaking, when there is a conveyance or transfer of any movable or immovable property, the instrument or document effecting the transfer is liable to payment of stamp duty.

Stamp duty on court order for mergers/demergers.

An order sanctioning the scheme of Amalgamation by the High Court under Section 394 of the Companies Act, is an 'instrument' liable for stamp duty. Since the order of the Court merging two or more companies, or approving a demerger, has the effect of transferring property to the surviving /resulting company, the order of the Court may be required to be stamped. The stamp laws of most states require the stamping of such orders. The amount of the stamp duty payable would depend on the state specific stamp law.

Stamp duty on share transfers.

The stamp duty payable on a share transfer form executed in connection with a transfer of shares is 0.25% of the value of, or the consideration paid for, the shares. However, Stamp

[108] Mergers *et al;* Ramanujam S.; Tata McGraw-Hill Publishing Comp. Ltd.; yr- 2003, Pg- 319

duty on shareholders agreements/joint venture agreements will be payable as per the state specific stamp law.

Stamp duty on share purchase agreements.

Stamp duty may be payable on an agreement that records the purchase of shares/debentures of a company. This stamp duty is payable in addition to the stamp duty on the share transfer form.

Transaction costs for asset purchase *vs.* share purchase.

Transaction related costs, are generally higher in the case of an asset purchase as compared to a share purchase. This is primarily because in a share purchase, there would usually be no incidence of sales tax/value added tax/service tax, which may be levied on different aspects of an asset purchase.

Further, the rate stamp duty is also usually higher in an asset purchase, and as discussed above is dependent on the nature of the assets transferred. The stamp duty on a transfer of shares is 0.25% of the consideration payable for the shares, which rate is far less than the stamp duty rates applicable for transfer of movable/immovable assets.

However, in cases where a reorganization or a reconstruction takes place between companies which are more or less under the same ownership, the Indian Stamp Act 1899, contains a notification issued in 1937 whereby the stamp duty payable is remitted and consequently no stamp duty is payable thereon.

However it should be kept in mind that while a share purchase will involve lower transaction costs, the degree of risk with such an acquisition is typically higher, as the acquirer inherits all the liabilities and obligations of the target company. To remit the stamp duty chargeable

under Article 23 and 62 of Schedule 1 to the said Act on instruments evidencing transfer of property between companies limited by share as defined in the Indian Companies Act, in cases,

a) Where at least 90 percent of the issued share capital of the transferee company is in the beneficial ownership of the transferor company, or
b) Where the transfer takes place between a parent company and a subsidiary company one of which is the beneficial owner of not less than 90 per cent of the issued share capital of the other, or
c) Where the transfer takes place between two subsidiary companies in each of which not less than 90 per cent of the share capital is in the beneficial ownership of a common parent company

Chapter-5

Double Taxation Avoidance Agreement

With increasing extension of trade and international transactions beyond frontiers of different countries, inter-dependence in such matters is inevitable. However, tax laws, if not regulated on mutual understanding, can become great deterrence in free flow of trade and commerce *inter se,* hence need of tax treaties.

Any investment or business transaction, which transcends the borders of a particular country gives rise to at least two potential tax claims, namely, of the investors' country of domicile and that of the country in which the investment is made or business transactions take effect. Since the cumulative taxation of the same income by the country of domicile and country of source is likely to be prohibitive and to act as deterrent to foreign investment and business, the systems of the different countries provide in one form or another relief measures designed to eliminate or mitigate the effects of double taxation. This is achieved through Double Taxation Avoidance Agreements.[109]

The constitution of India has conferred the sovereign powers to levy taxes and to enforce collection and recovery thereto on the State under Article 265 by providing that no taxes shall be levied or collected except by authority of law. The power to levy taxes are conferred on the Union of India in respect of matters falling within its domain in list 1, schedule VII of the Constitution. Power to levy taxes, conferred on the State Legislative fall within the scope of

[109] Pandey T. N.; Supremecy of Tax treaties vis-à-vis Tax laws in India; (2004) 3 Comp.LJ; Pg-113

list 2 of schedule VII. Entry (4) of list 1 under schedule VII to the Constitution of India empowers the Union of India to enter into treaties and agreements with foreign countries and implement such treaties, agreements and conventions and entry (10) of list 1, dealing with foreign affairs and entry (9) of list 1 of Schedule VII covers Diplomats, Councils and trade representation and, therefore, the tax treaties including those for Avoidance of Double Taxation fall within the exclusive domain of the Central Government in view of the Constitutional Authority conferred on it.[110]

To remove any doubt and to avoid any confusion, the Income-Tax Act, 1961 contains explicit statutory provisions to confer on the Central Government the power to enter into Agreements with foreign countries for Avoidance of Double Taxation as contained in Chapter IX of the IT Act.[111]

Double taxation means taxation of same income of a person in more than one country. This results due to countries following different rules for income taxation. The main purpose of any DTAA is mitigating the hardship caused by dual taxation on the same source of income. The principle followed in the tax laws in a country are basically two-fold, *viz.* (a) source of income rule (*situs* principle) and (b) fiscal domicile or residence rule.[112]

As per the source of income rule, the income may be subject to tax in the country where the source of such income exists. The source of income is determined on the basis of the place where the business establishment is situated or where the asset or property is located, no matter the income earner is a resident in that country or not.[113]

---

[110] http://www.incometaxindia.gov.in/publications/6_Advance_Rulings/Chapter07.asp
[111] Section 90 and 91 of the Act
[112] http://www.articlesbase.com/regulatory-compliance-articles/double-taxation-avoidance-agreement-indian-point-of-view-1107784.html, accessed on 16/05/2010
[113] Ahuja Girish and Gupta Ravi; Direct Taxes: Law and Practices; Bharat Law House Pvt. Ltd.; 16th Ed.; Yr-2007-08; Pg-1384

On the other hand, the income earner may be taxed on the basis of his residential status in that country. For example is a person is resident of a country, he may have to pay tax on any income earned outside that country as well. Further some countries may follow a mixture of the above two rules. Thus problem of double taxation arises if a person is taxed in respect of any income on the basis of source of income rules in one country and on the basis of residence in another country or on the basis of mixture of above two rules.

There is also a third principle, of nationality, which is applied in few countries like the USA, Mexico and Philippines is combined with the source and residence principle mentioned earlier.[114]

In India, the liability under the Income-Tax Act arises on the basis of the residential status of the assessee during the previous year. In cases the assessee is resident in India, he also has to pay tax on the income which accrues or arises outside India, and also received frequently happens that a person may be found to be a resident in more than one country or that the same item of his income may be treated as accruing, arising or received in more than one country with the result that the same item become liable to tax in more than one country.

Relief against such hardship can be provided mainly in two ways:

1. Bilateral relief- the governments of two countries can enter into double taxation avoidance agreement to provide relief against such Double Taxation, worked out on the basis of mutual agreement between the two concerned sovereign states. This may be called a scheme of bilateral relief as both concerned powers agree as to the basis f the relief t be granted by either of them.
2. Agreement for 'bilateral relief' may be of following two kinds-

[114] Pandey T. N.; Supremecy of Tax treaties vis-à-vis Tax laws in India; (2004) 3 Comp.LJ; Pg-113

a. Exemption method: Agreement, where two countries agree that income from various specified sources which are likely to be taxed in both the countries should either be taxed only in one of them re that each of the two countries should either be taxed only in one of them or that each of the two countries should tax only a particular specified portion of the income so that there is no overleaping. Such an agreement will result in a complete avoidance of double taxation of the same income in the two countries. This is known as exemption method of relief.

b. Tax credit method: the agreement that does not envisage any such scheme of single taxability but merely provides that, if any time of income is taxed in both the countries, the assessee should get relief in a particular manner. Under this type of agreement, the assessee is liable to have his income taxed in both the countries but is given a deduction, from the tax payable by him in India, for a part of the taxes paid by him thereon, usually the lower of the two taxes paid. This is known as tax credit method of relief.

   In practice both types method work in the same manner. Bilateral agreements ensure that either country is to refrain from taxing the whole or part of the income only if the other country has kept to its part of the bargain. The relief under either of these types of agreement depends on an agreement between the countries concerned.

1. Unilateral relief

If the agreement with the foreign country is under clause (b) above for relief against double taxation and not under clause (a) for the avoidance of double taxation, the assessee must show that the identical income has been doubly taxed and that he has paid tax both in India

and in the foreign country, on the same income. Further, relief from Indian income tax is to be granted on the production of proof of assessment in that country.

The above procedure for granting relief will not be sufficient to meet all cases. No country will be in a position to arrive at such agreement as envisaged above with all the countries of the world for all time. The hardship of the taxpayer, however, is a crippling one in all such cases. Some relief can be provided even in such cases by home country irrespective of whether the other country concerned has any agreement with India or has otherwise provided for any relief at all in respect of such double taxation. This relief is known as unilateral relief.

Taxation on the basis of such principles has created numerous problems. For example, taxation merely on source principle leads to flight of capital to other countries leading to paucity of investments in the country of origin. Hence, the countries taxing incomes on source principle have to resort to tax treaties for taxing the income correctly in the source country and avoid double taxation of the same income. Double taxation in the strict legal sense means taxing the same income twice during the same taxing period. The Supreme Court, in the case of *Sri Krishna Das v. Town Area Committee, Chirgaon*[115] has explained that, to constitute double taxation, the two or more taxes must have been-

- i Levied on the same property or subject matter,
- ii By the same Government or authority,
- iii During the same taxing period, and
- iv For the same purpose.

Further in this case Supreme Court was concerned with tax imposed by two authorities in India, in contrast to a situation where the same income becomes taxable by two different Governments of other countries.

International Double Taxation

[115] (1990) 183 ITR 401 (SC)

Double taxation in the international context could be said to arise in the following circumstances, *viz,*

1. Two countries tax a person on his worldwide income because of his personal links like domicile, nationality, residence, place of incorporation and in case of companies, the place of management, *etc.* in the two countries giving concurrent full jurisdiction to each country for taxing such incomes;
2. One State taxes a person on worldwide income or capital gains on residence basis and the other state taxes the same person on source basis, *i.e.*, on the basis of accrual or arousal of income in that State or because of situation of capital in that State;
3. A person becomes liable to limited liability to tax in two stages, *e.g.*, an enterprise of say, State-A having a permanent establishment in State-B also derives income from State-C. In such a situation, there will be concurrent liability for tax in States B and C also.

Tax Treaties to avoid international double taxation

With the growth of international trade, the problems of double taxation have increased in size and complexity. Solutions to such problems have been sought through tax treaties. It was felt that it is in the common interest of all countries to arrive at tax agreements which will not merely ensure that the same income is not taxed twice over in the country of origin of the income, i.e., the source country as well as in country of its destination or the country of residence, but also minimize the scope of tax evasion and facilitate the recovery of tax dues. This is the background, the aim and rational of the bilateral tax treaties into which two countries enter mainly on political and economic considerations.

Indian Scenario:

In India the relief against the double taxation is provided under sections 90 and 91 of the Income-Tax Act.

Bilateral agreements with foreign countries-

Double taxation avoidance agreements also known as 'treaties', are not confined to avoidance of double taxation. These agreements are in fact of wide variety.

Section 90[116] of Income Tax Act empowers the Central Government to enter into an agreement with the Government of any country outside India to provide for the following:

a. Granting of relief in respect of

---

[116] **Agreement with foreign countries or specified territories.**

Section 90. (1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—

(*a*) for the granting of relief in respect of—

(*i*) income on which have been paid both income-tax under this Act and income-tax in that country or specified territory, as the case may be, or

(*ii*) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory, as the case may be, to promote mutual economic relations, trade and investment, or

(*b*) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, as the case may be, or

(*c*) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory, as the case may be, or investigation of cases of such evasion or avoidance, or

(*d*) for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory, as the case may be,

and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

(2) Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.

(3) Any term used but not defined in this Act or in the agreement referred to in sub-section (1) shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Act or the agreement, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.

Explanation 1.—For the removal of doubts, it is hereby declared that the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.

Explanation 2.—For the purposes of this section, "specified territory" means any area outside India which may be notified as such by the Central Government.]

i. Income on which income-tax has been paid both in India and in that country, or

ii. Income-tax chargeable in India and under the corresponding law in force in that country to promote mutual economic relations, trade and investment, or

b. The type of income which shall be chargeable to tax in either country so that there is avoidance of double taxation of income under this Act and under the corresponding law in force in that country.

In addition the Central Government may enter into an agreement to provide:

i. For exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases or such evasion or avoidance, or

ii. For recovery of income-tax under this Act and under the corresponding law in force in that country.

The liability to tax in the source country generally arises out of "business connection" or through what is called "permanent establishment" this is of utmost importance while fixing the tax liability. These agreements also lay down maximum limits of tax that can be levied or withheld and the manner in which it can be levied.

Section 9(1) explanation 2[117], of the Income Tax Act removes the doubts regarding the meaning of business connection. It says business connection include any business activity carried out through a person who, acting on behalf of non-resident,-

[117] Income Tax Act, 1961, Section 9(1) *Explanation 2.*—For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

(*a*) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

a. Has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

b. Has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

c. Habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by or subject ot the same common control, as that non-resident.

However, such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business.

As in the case of Cross-border merger and amalgamation residential status of the company is the key to impose capital gain taxation Indian courts in numerous judgments have ruled that Residential status under Double taxation Avoidance Agreement is decided in the case of company not with reference to the place of incorporation but with reference to the place of "defective management". This was held in the case of *Integrated Container Feeder Service v.*

(*b*) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(*c*) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business :

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.

Joint CIT.[118] In this case the applicant is a company incorporated in the UAE. The applicant company is engaged in offering remittance services for transferring amounts from UAE to India on commission basis. It received the entire commission in UAE. The company was granted license by the RBI for setting up liaison offices in India for undertaking certain approved activities.

In Cross-border merger and acquisition there are some human aspects also as employees of merging company are usually becomes the employees of merged company and there may be shifting of employees from one country to another country. In such a situation taxation on the salary of those employees also attracts the Double Taxation Avoidance Agreement relief. Even if the provisions of Income Tax Act makes the person liable to tax in India, the person in the question may not be taxed if he has already been taxed in another country. The provisions of DTAA has overriding effect on the provisions of Income Tax Act. As in the case of *In re British Gas India Private Limited*[119], the applicant had sought a ruling on the tax liability on salary paid in India to two of its employees who were deputed to group companies in the U.K and had become non-resident in India. While the AAR was of the view that the salary paid in India by the applicant to the concerned employees was taxable in India under the provisions of the domestic law relating to chargeability to tax and ascertainment of total income, it applied the provisions of the DTAA between India and the UK, since the employees had become tax residents of the UK. Under Article 16 on dependent personal services, the AAR held that the salary paid in India to the employees deputed outside India would not be taxable in India, as the same was taxed in the U.K. in pursuance of the DTAA. Accordingly, there was no withholding tax obligations on the applicant either under section 195, regarding payment to non-residents or under 192 regarding payment of salaries. The

[118] (2005) 278 ITR (AT) 182 (Mumbai)
[119] AAR No. 725 of 2006

employees are however required to make the appropriate declaration to the applicant regarding the payment of tax in the UK on this salary.

The respective tax regimes are determined in bilateral tax treaties[120]. The treaties normally resemble the OECD model tax treaty, which recommends the exemption regime or the credit regime for taxing foreign income, explaining the prevalence of these two tax regimes. The contracting countries also regularly agree on lower than standard withholding tax rates. If two countries have not signed a bilateral tax treaty yet, then (higher) standard withholding tax rates apply and it is up to the individual countries if and how they want to provide relief from double taxation unilaterally.

Corporate in all over world are keen to get benefit from the different tax liabilities in different jurisdictions. Tax heavens countries are always attractive destination for corporations to avoid tax liability in that company and to get benefit of the provisions of Double Taxation Avoidance Agreement to evade tax liability in the countries where they actually reside.

A tax haven is generally, a small country in the vicinity of a large country with a high tax rate and it is this large country with a high tax rate and it is this large country or countries which act as the ocean for which the tax haven is a harbour, by affording facilities and tax payers take shelter from the high seas of high taxation in the harbour of tax havens.[121] In simple words tax haven is a place or state where certain taxes are levied at a low rate or not at all. Mauritius, Cyprus, Luxemburg are some of the tax heavens. These Tax Heavens does not impose capital gains tax on its residents, and with India exempting the capital gains under the DTAA, investors could avail of the benefits. The dividend income is also exempt from withholding tax.

[120] The Nordic tax treaties between Denmark, Finland, Iceland, Norway and Sweden are a multilateral exemption. Also the older tax treaty COMECO between several members of the Warsaw pact in 1977 is such an exemption.
[121] Dr. N. V. Lalith Kumar Rao, Tax Havens, Chapter- III, Pg- 25

The long-term capital gains tax, applicable on investments sold after holding them for more than a year, is at the rate of 10 per cent. Short-term rates are applied at the rate of 30 per cent when investments are liquidated.

It is well known that the bulk of the FII investments are routed through Mauritius. Under the current DTAA, companies incorporated in Mauritius are considered "residents" of Mauritius for taxation purposes. The provision has been misused by some, which have formed conduit companies to avoid paying tax in India.

The losses to the exchequer on account of lost capital gains tax in the last decade would amount to a whopping Rs.28,139 crores. The average annual loss to the exchequer amounts to over Rs.2,300 crores. The extent of lost revenues could easily have saved companies such as Balco, VSNL, IPCL and several others from being sold off to private parties. [122]

In order to curb this situation and loss of government revenue this is to be suggested that changes or modification should be made in the DTAAs. Recently there was modification made in the capital gain clause of Indo-Cyprus Double Taxation Avoidance Agreement. The double taxation avoidance agreement (DTAA) between the two countries is all set to lose the capital gains tax exemption benefit. Both the governments are understood to have concluded negotiations on amendments to the tax treaty, following which residents, both individuals and companies of Cyprus, would have to pay capital gains tax at the rate of 10%. A limitation on benefits clause to ensure ineligible entities cannot get a benefit under the tax treaty is also proposed to be inserted.

---

[122] http://www.articlesbase.com/regulatory-compliance-articles/double-taxation-avoidance-agreement-indian-point-of-view-1107784.html

Chapter-6

Cross-border Merger and Amalgamation under proposed Tax Reforms

Cross-Border M&A and DTC

In India, till date The Income Tax Act, 1961 is one and only nodal legislation which governs the direct taxation. The Government recently introduced a draft Direct Tax Code, 2009 (DTC), which aims to simplify the tax provisions in India and bring them at par with the international standards of taxation. The Code signifies a strategic shift in the government's fiscal agenda and seeks to achieve three policy objectives: (i) minimize tax exemptions; (ii) remove ambiguities; and (iii) curb tax evasion. According to the Finance Minister, the Code is designed to provide stability in the tax regime as it is based on well accepted principles of taxation and international best practices. The proposed Direct Taxation Code shall substitute the present Income Tax Act, 1961 and other direct tax laws i.e. dividend distribution tax, fringe benefit tax and wealth-tax so it is obvious that the provision relating to cross-border mergers and acquisitions contained in the existing legislations shall also be changed accordingly. In this Chapter, I tried to find out some of the key aspects of the DTC which may have impact over Cross-border merger and Amalgamation in India.

As of now India has Double Taxation Avoidance Agreement (DTAA) with certain countries. It helps to resolve the problem of Double Taxation for the same income arose in two different countries. In case of cross-border merger and amalgamation this is very much usual as the companies amalgamating and amalgamated belongs to two different countries.

The DTC may override[123] all existing Double Taxation Avoidance Agreements (DTAA) that India has with other countries.[124] These DTAA's were instrumental in avoiding double taxation from offshore transactions. They were also given preferential status over the existing laws on tax. However, the DTC explicitly mentions that it will be treated at par with the existing DTAA's and in case of a conflict, the provisions of DTC being "later in point of time", shall prevail.[125] Therefore, it is speculated that the earlier DTAA's that India has signed with other countries may become redundant.

Another change which the DTC is going to bring with regard cross-border merger and amalgamation is regarding the implementation of General Anti-Avoidance Rules (GAAR)[126]

---

[123] See Para 258(8)(b) of the proposed Direct Taxation Code.

[124] Foreign tax credit; 206. (1) An assessee shall be allowed a credit in respect of income-tax paid by deduction, or otherwise, in any other country under the law in force in that country, in accordance with the provisions of this section.

(2) An assessee shall be allowed a credit against the Indian income-tax payable by him in respect of his income which has accrued during the financial year outside India, of the amount determined in accordance with the Agreement entered into with such other country under section 258.

(3) However, in a case where there is no agreement under section 258 with the other country, the amount referred to in sub-section (2) shall be determined -

(a) at the Indian rate of tax or the rate of tax of the other country, whichever is lower; or

(b) at the Indian rate of tax, if both the rates are equal.

(4) An assessee shall, regardless of anything contained in sub-section (3), not be entitled to credit against the Indian income-tax payable by him in respect of any income referred to therein, if -

(i) the income is also deemed to accrue in India; and

(ii) no Agreement under section 258 has been entered into with the other country in which the income has accrued.

(5) The Central Government may prescribe the method for computing the amount of credit, the manner of claiming credit and such other particulars as are necessary for the relief or avoidance of double taxation.

[125] Supra note 1.

[126] **General anti-avoidance rule**: Para **112.** (1) Any arrangement entered into by a person may be declared as an impermissible avoidance arrangement and the consequences, under this Code, of the arrangement may be determined by,—

(*a*) disregarding, combining or re-characterising any step in, or a part or whole of, the impermissible avoidance arrangement;

(*b*) treating the impermissible avoidance arrangement -

(*i*) as if it had not been entered into or carried out; or

(*ii*) in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

provisions in the DTC. Para 112 of the General Anti-Avoidance Rules give almost unlimited power to income tax authorities (such as the Commissioner of Income Tax) to disregard specific legal entities or individual steps in a series of transactions, that, according to the authorities, have been entered into with the sole purpose to avoid taxation.

The DTC has differentiated between a 'business capital asset'[127] and 'investment asset'[128] holding that only transactions relating to 'investment assets' (property, shares etc) will enjoy

---

(*c*) treating parties who are connected persons in relation to each other as one and the same person; or

(*d*) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;

(*e*) deeming persons who are connected persons in relation to each other to be one and the same person;

(*f*) re-allocating, amongst the parties to the arrangement, -

(*i*) any accrual, or receipt, of a capital or revenue nature; or

(*ii*) any expenditure, deduction, relief or rebate;

(*g*) re-characterising -

(*i*) any equity into debt or *vice versa;*

(*ii*) any accrual, or receipt, of a capital or revenue nature; or

(*iii*) any expenditure, deduction, relief or rebate;

(2) The provisions of this section may be applied in the alternative for, or in addition to, any other basis for making an assessment.

[127] Para 42 of proposed DTC *"business capital asset"* means,-

(*a*) any capital asset self-generated in the course of business;

(*b*) any intangible capital asset in the nature of,—

(*i*) goodwill of a business,

(*ii*) a trade mark or brand name associated with the business,

(*iii*) a right to manufacture or produce any article or thing,

(*iv*) right to carry on any business,

(*v*) tenancy right in respect of premises occupied by the assessee and used by him for the purposes of his business, or

(*vi*) licence, right or permit (by whatever name called) acquired in connection with, or in the course of, any business;

(*c*) any tangible capital asset in the nature of a building, machinery, plant or furniture;or

(*d*) any other capital asset connected with or used for the purposes of any business of the assessee;

[128] Para 151. "investment asset" means any capital asset which is not a business capital asset

capital gains tax exemptions. Therefore, any transfer of a business capital asset (all tangible and intangible capital assets) that take place in corporate re-organisations will not get capital gains tax waiver, unlike the existing system.

Some positive provisions in the DTC are those that propose rationalisation of tax provisions for amalgamations and demergers so that tax remains neutral when businesses re-organise. Also, the DTC proposes to allow business losses to be carried forward indefinitely to allow companies to set off the losses against future business profits. However, in the present Income Tax Act, 1961 only Eight years[129] period has been given to set off the business losses so occurred, against the future business profit.

The DTC also provides that the tax base of the assets in the hands of the buyer would be the tax base in the hands of the seller. Presently the buyer of an undertaking in a slump sale allocates the consideration to the assets (tangible and intangible) at their fair values and claims depreciation accordingly. After the DTC comes into effect, the buyer will not get any tax breaks for the enhanced amount paid for acquisition of the undertaking. The notional written down value of the assets will get reduced for computing the value of the block of assets in the hands of the seller.

While it is true that the Code has introduced a number of constructive measures including a reduction in tax rates, these have been overshadowed by the negative ramifications of certain provisions. Some of these changes will have an adverse effect on both Indian and offshore

[129] Income Tax Act, 1961; Section 72(3) No loss (other than the loss referred to in the proviso to sub-section (1) of this section) shall be carried forward under this section for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed.

M&As involving Indian subsidiaries. The Code has incorporated the much feared general anti-avoidance rules (GAAR) which codify the economic substance doctrine and reject long-settled jurisprudence confirming the validity of form over substance in India. The provisions seem to provide unfettered authority to the Indian tax authorities (Commissioner of Income Tax) to (i) disregard specific legal entities or individual steps in a series of transactions; (ii) re-characterize and re-allocate income between parties: and (iii) re-characterize legal instruments used in transactions.[130]

The DTC, if implemented in its present form, could be pursued as a major stumbling-block for future M&A deals in India, The broad purpose of the GAAR is to restrict innovative transactions made with a view to avoid taxes. All future M&A deals after the coming into force of the DTC will have to contain provisions to avoid a high tax liability. The Code seeks to tax every offshore transaction resulting in an indirect transfer of a capital asset situate in India. It seems that the object behind this provision is to specifically target foreign M&As having underlying Indian subsidiaries or interests.

Moreover, a recent order of the Hon'ble High Court of Bombay may further strengthen the income tax authorities to assess mergers for tax even when both entities to the transaction are situated outside the boundaries of the country. In 2007, the global telecom giant Vodafone acquired Hutchinson Essar Limited (HEL) by acquiring HEL's holding entity situated overseas. However, the Income Tax Department (ITD) sent a show-cause notice to Vodafone for not paying tax on the transaction – a notice which was challenged by Vodafone. The Court gave its decision in the favour of the ITD reasoning that the transaction would significantly affect assets situated in India and is thus liable to be taxed by the Indian tax

[130] http://www.nishithdesai.com/New_Hotline/Tax/TAX%20HOTLINE_PressAug1309.html, accessed on 03/12/2010.

authorities. The judgment is not the final word on the issue as it merely allowed the ITD to proceed with investigations into the nature of the transaction. Moreover the judgment is subject to review by the Hon'ble Supreme Court of India, the apex court. However, the issue is still ambiguous as of now and is pursued to materially affect cross border M&A activities and transactions in the country.

Currently, subject to certain conditions, the transfer of shares of an Indian company pursuant to an offshore merger of two foreign companies is tax exempt. Due to a possible drafting error, such transfer of shares would not qualify for the tax exemption under the Code. Further no provision has been made to cover outbound mergers of Indian companies. Adding to the various woes of investors in general, profits from a slump sale (sale of an undertaking for a lump sum consideration) would be taxed as business profits rather than capital gains.

The Code seems to equate legitimate tax planning with tax evasion. The changes brought about will seriously impact consummation of M&A transactions and many of the current structures will be brought within the tax net. The wide discretion provided to the Indian tax authorities would create complete uncertainty making it a challenge to structure future M&As.

Impact of proposed Goods and Services Tax on Cross-border Merger

Despite the success of VAT, in improving the pre-existing Central excise duty at the national level and the sales tax system at the State level, there are still certain shortcomings in the structure of VAT both at the Central and at the State level. The shortcoming in CENVAT of the Government of India lies in non-inclusion of several Central taxes in the overall

framework of CENVAT, such as additional customs duty, surcharges, etc., and thus keeping the benefits of comprehensive input tax and service tax set-off out of reach for manufacturers/ dealers.

Keeping these shortcomings of present tax system in view, an announcement was made by Shri P. Chidambaram, the then Union Finance Minister in the Central Budget (2007-2008) to the effect that GST would be introduced from April 1, 2010 and accordingly an Empowered Committee of State Finance Ministers, was set up to prepare a road map for the introduction of GST in India. The empowered committee has on November 10, 2009 released a discussion paper on proposed Goods and Services Tax in India. On the basis of the provisions embodied in the discussion paper, herewith it has been endeavored to examine the impact of GST on Cross-border Merger and acquisition in India.

The GST applies to taxable supplies made in any country. In general terms taxable supply is a supply made in the course of a commercial activity and a commercial activity includes the making of a supply by the person of real property of the person, including anything done by the person in the course of or in connection with the making of the supply.

Accordingly, the making of any supply by way of sale of real property, unless the supply is specifically exempted under the Act, is a commercial activity and it is taxable.

Though the Sale of Goods Act nowhere defines the 'Sale' but *Merriam Webster's online dictionary* defines Sale as "An agreement (or contract) in which property is transferred from the seller (vendor) to the buyer (vendee) for a fixed price in money (paid or agreed to be paid by the buyer)[131]" Online dictionary defines the term sale as "the transfer of title to property

[131] http://www.websters-online-dictionary.org/definition/sale

from one party to another for a price"[132] thus on the basis of these dictionary meanings sale can be defined as "in respect of property, any transfer of the ownership of the property and a transfer of the possession of the property under an agreement to transfer ownership of the property". As discussed above and also according to the Para 3.2.ii[133] of 1st discussion paper released by the Empowered committee of State Finance Ministers, any sale of real property such as a transfer of the ownership of commercial real property is taxable unless specifically exempted. However, certain provisions of the proposed Act deem a transfer of the ownership of real property to either not to be a supply or to be a supply made for no consideration. Since under GST is calculated as a percentage of the consideration for the supply, if there is no supply or no consideration for the supply, there is no tax.

The transfer of the ownership of real property pursuant to a merger or amalgamation of corporations can result in a non-taxable sale of real property. Specifically, if two or more corporations (the predecessor corporations) are merged or amalgamated to form one corporation (the new corporation) other than by the purchase of property by one corporation or the wind-up of one corporation, the transfer of property by a predecessor corporation to the new corporation as a result of the merger or amalgamation is deemed not to be a supply. Accordingly, GST will not apply to the transfer.

The new corporation that results from an amalgamation is generally treated for GST purposes as being a person separate from each of the predecessor corporations. However, the new

[132] http://dictionary.lp.findlaw.com/scripts/results.pl?co=dictionary.lp.findlaw.com&topic=2d/2db4bbfc96cd55dd5f074c4368edd361

[133] 1st Discussion Paper on GST, Para 3.2.(ii) The Central GST and the State GST would be applicable to all transactions of goods and services made for a consideration except the exempted goods and services, goods which are outside the purview of GST and the transactions which are below the prescribed threshold limits.

corporation is considered to be the same corporation as, and a continuation of each, of the predecessor corporations with respect to the real property acquired by a predecessor (e.g., the basic tax content of the predecessor's real property immediately prior to the amalgamation becomes the basic tax content of the new corporation's real property immediately after the amalgamation.)

Chapter-7

Tax efficient mergers: International Practices

Tax structuring for a cross-border merger and acquisition is an important decision as the selected structure will surely want to minimize the total tax impact, both at the time of the transaction and subsequently. The transaction structure described under are some general examples that have been successfully used to achieve this objective.

Hive Down[134]

It is possible that some portion of the company's business is viable and if that is the case then the receiver should consider selling off that part of the business by means of what is commonly referred to as a hive down. Part or entire successful or viable portion of the business would be transferred to a new company, which would be controlled by the receiver. A common structure in which an asset purchase is restructured as a share purchase for tax purposes is known as a hive down.[135] Such types of transactions as a tax-free exchange are not allowed in USA. The United States tax authorities consider the substance of a transaction when determining whether it should be a tax free exchange. Most other countries let the form of the transaction determine the taxable status.

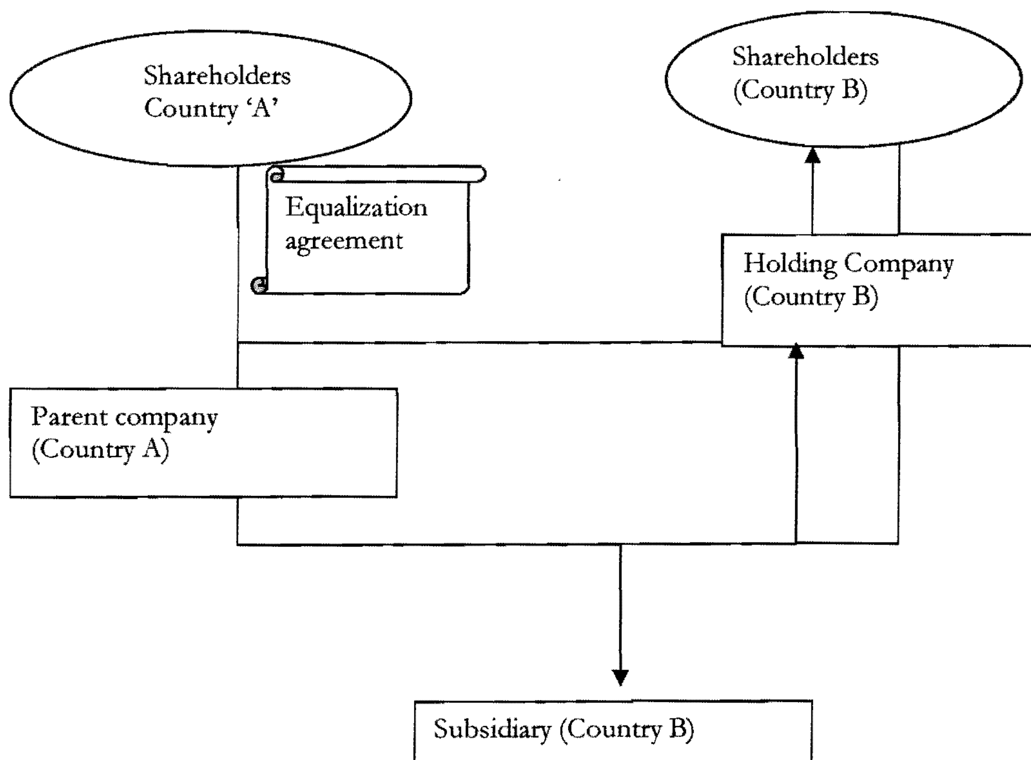
---

[134]Anne-Marie Mooney Cotter, Insolvency Law, Bar Society of Ireland, Pub- Cavendish, pg- 155
http://books.google.co.in/books?id=1_QhhvNU8DYC&pg=PA115&lpg=PA115&dq=hive+down&source=bl&ots=UEy2jyy42r&sig=xD-rt0519AtYm9s60YHN
it6TSc&hl=en&ei=F1j4S8O2JsWzrAfPysXyCg&sa=X&oi=book_result&ct=result&resnum=7&ved=0CDQQ6AEwBg#v=onepage&q=hive%20down&f=false

[135] Krishnamurti Chandrashekhar, Vishwanath S.R; Mergers, Acquisitions and Corporate Restructuring, Response books from Sage publications; Edn.- 2008, Pg.- 175

Income Access

To avoid the difficulties associated with cross-border dividends, income access structures, also known as 'stapled stock', make it possible for shareholders to receive dividends as if from their own tax jurisdictions and thus in a tax advantaged manner. The structure vary in each case, but all share the common aim of ensuring that, so far as possible, shareholders can access profits made in their won jurisdiction.[136] Cross-border mergers using the income access structure include the Waterford (UK) and Wedgewood (Ireland) merger in 1986 and the Wiggins (UK) and Arjomare Prioux (France) merger in 1990.[137]



[136] http://plc.practicallaw.com/2-107-6253?q=income+access+structure&qp=&qo=&qe=
[137] Krishnamurti Chandrashekhar, Vishwanath S.R; Mergers, Acquisitions and Corporate Restructuring, Response books from Sage publications; Edn.- 2008, Pg-176

A simple example (above figure) would be if a company (resident in Country A) purchases a foreign company (resident in Country B) issuing shares as consideration. Rather than routing dividends from the foreign company through the parent in Country A and back to shareholders resident in Country B, the subsidiary could issue income access shares directly to shareholders resident in Country B and pay dividends on those shares out of profits in Country B.

In short, shareholders hold shares in two companies in two different tax jurisdictions. The shareholder, to the extent possible, elects to receive any dividends in a particular jurisdiction, and as such, the dividends on the other 'stapled' stock are reduced accordingly.

Two step Acquisitions

Two step Acquisitions are another example of tax efficient Merger and Acquisitions. In this types of merger and acquisition one company acquires another previously-unrelated one in a two stage transaction.[138] This is a transaction in which an acquirer purchases some (usually a majority) of the target's shares in cash tender offer, then in a subsequent second step eliminates the remaining shareholders by a cash or stock merger.

For example, Big corporations usually want to acquire little corporations, but little corporation's management opposes. Big Corp therefore decides to proceed by a two-step hostile tender offer. At a time when little Corp stock is trading at Rs. 20 per share, Big Corp offers to buy 51 percent of little Corp's stock for Rs. 30 per shares. Big Corp's tender offer documents also say that Big Corp will later merge little Corp into Big Corp with the remaining Little Corp shareholders receiving Rs. 25 per shares.

---

[138]Steven Emanuel & Lazar Emanuel; Corporations; Publ.-Aspen(Wolters Kluwer, US); Edn.- 6th 2009; Pg- 431 http://books.google.co.in/books?id=pAaOysAmCFoC&pg=PA431&lpg=PA431&dq=what+is+"Two-step+Acquisition"+%3F&source=bl&ots=sDqdBTP0j8&sig=ZqGauJWTFeCd-OldQ86VvVcd1cI&hl=en&ei=Am74S4yCJ9SfrAfYmqXLCg&sa=X&oi=book_result&ct=result&resnum=5&ved=0CCYQ6AEwBA#v=onepage&q=what%20is%20%22Two-step%20Acquisition%22%20%3F&f=false

Observe that this offer has a somewhat coercive effect on a little Corp shareholder trying to decide whether to tender his shares. If he tenders, he will get Rs. 30 for about half of his shares, and Rs. 25 for the remaining shares. But if he does not tender, he will be merged out anyway in the second stage, and will receive only Rs. 30 per share in that stage. Therefore, he has an enormous incentive to tender, even though he would really prefer to continue as a shareholder in an independent Little Corp. For this reason, two tier front-loaded offers like this one are often criticized as unfair to the target's shareholders. However, such a practice may always be attacked into court of law as such acquisition always involves unfair and anti-competitive practice.

Advantages and Disadvantages of such practice[139]

The two-step acquisition structure works best where consolidation of tax returns is permitted. Otherwise, the structure may be used to create a tax-free step-up of the target's assets for depreciation and capital gains purposes.

The disadvantage of the two-step approach is that the target company shareholders may pay capital gains tax on the increased value of the assets. Another drawback is that the ability to carry-forward tax operating losses may be restricted or in some cases, not permitted.

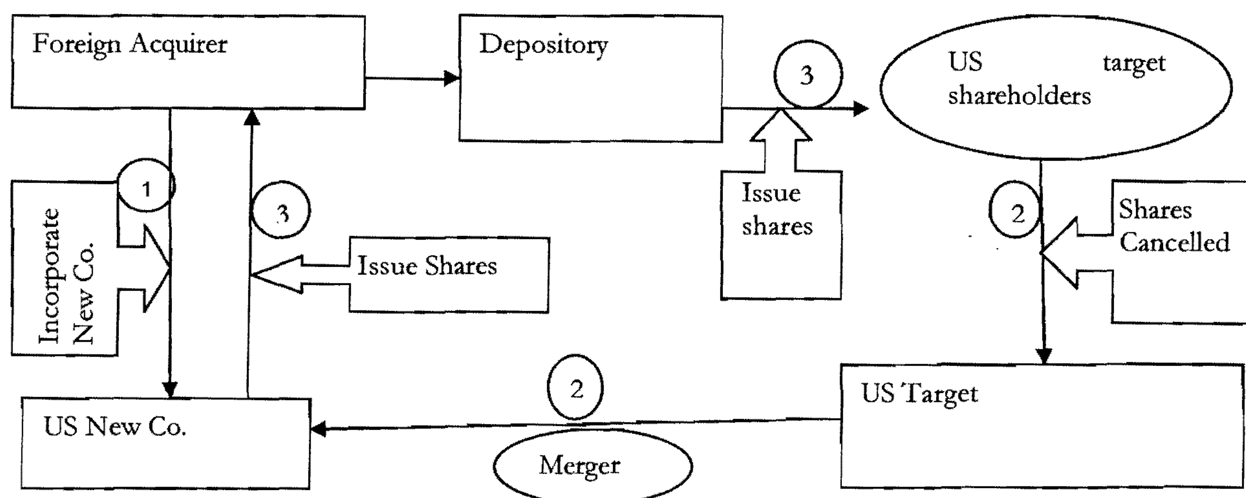
Triangular Mergers

Triangular mergers are so named because they involve three parties rather than the usual two: the acquirer, a subsidiary of the acquirer created especially for the transaction, and the target.

[139] Krishnamurti Chandrashekhar, Vishwanath S.R; Mergers, Acquisitions and Corporate Restructuring, Response books from Sage publications; Edn.- 2008, Pg.- 177

Triangular mergers are of two kind *viz.* "Conventional" or "forward" triangular merger, and the "reverse" triangular merger.[140]

Forward triangular mergers-



Acquisitions of US companies by foreign companies are often effected via a triangular merger, for example, Lucas [UK] and Varity [US]. Such acquisitions are closely corresponds to the two-step acquisition described earlier. A forward triangular merger involves the acquiring company creating a US subsidiary, New Co., which then merges with the target company. New co. remains as the surviving entity and the shares of the target company are cancelled in consideration for shares in the foreign parent acquirer. Shares from the foreign parent are issued to the US target shareholders. For the target company and its shareholders, this structure generally has adverse tax effects as the transfer of assets to the New Co.,

[140] Steven Emanuel & Lazar Emanuel; Corporations; Pub.-Aspen (Wolters Kluwer, US); Edn.- 6th 2009; Pg-376.

subsidiary in exchange for the merger consideration is treated as a liquidation by the US tax authorities, and thus, a taxable event.

A reverse-triangular merger (for example- Daimler [German] and Chrysler [US], Uniliver [Dutch] and Bestfoods [US]), is similar to the forward-triangular merger. The principle difference is that, following the merger between the US New Co. and the target, the surviving corporation is the target company, not the US New Co. subsidiary. The main benefits of a reverse-triangular merger are: (a) the transaction is treated as a share purchase and (b) the acquirer can readily squeeze out target minority shareholders who are unwilling to sell their shares. Triangular mergers are difficult to implement as a hostile takeover, however, because the target shareholders must approve the transaction.

One advantage of this technique, compared with the stock-for-stock exchange to which it is so similar in result, is that this forward merger technique is guaranteed to eliminate all minority interest in Little Corp's asset- every little Corp shareholder is forced to become a Big Corp shareholder, whereas in the stock-for-stock exchange scenario a little Corp shareholder could decline to participate.[141]

Dual-Headed Structures

Recent times have seen more consideration given to dual-headed structures for cross-border mergers involving UK companies. A dual-headed structure allows two companies to combine their operations and yet retain a degree of separation. This is achieved by retaining the merging companies as separate legal entities but putting in place arrangements to ensure that

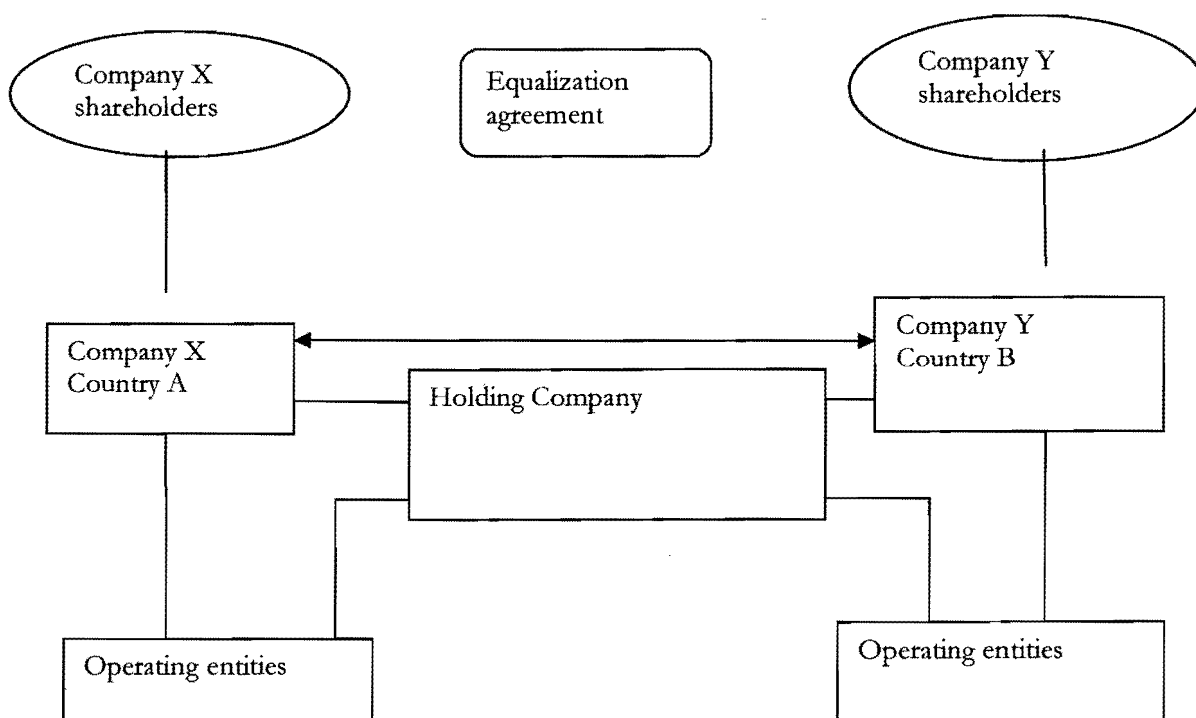
[141] Supra note 29, Pg-377

the group, as a whole, operates as if it were a single enterprise. This achieves certain political, commercial and tax advantages that may not be obtained with a conventional merger.

Well-established dual-headed entities involving the UK include Royal Dutch Shell, Reed Elsevier, and Unilever (all UK and Netherlands), RTZ [UK] and CRA [Australia], Allied Zurich [UK] and Zurich Allied [Switzerland] and Eurotunnel (UK/France).[142]

Not only in UK, this type of merger is prevalent in India also. Merger of Corus with Tata Steel, merger of Zaguar Land Rover [UK] with Tata Motors or Arcelor [Luxembourg] with Mittal steel etc. are also some examples of Dual-Headed Structrues.

In those instances in which the merging companies desire to maintain their pre-merger identities, the dual-headed structure allows the assets to be grouped together through intermediate holding companies. This can be understood through the following structure-



[142] Mergers and Acquisitions in UK; By Bradley Phillips, Derek Hill and Emma Nendick, Herbert Smith, London;International Tax Review; source- http://www.internationaltaxreview.com/includes/magazine/PRINT.asp?SID=488020&ISS=13166&PUBID=35

A dual-headed structure brings two companies together and combines their operations while maintaining their pre-merger corporate identity. This is accomplished by merging the companies as separate legal entities with arrangements that ensure the group operates as a single entity. There are three variations of the dual-beaded structure. The most common is the 'combined group structure' wherein an intermediate holding company owns the operating companies of the group. The top-tier companies are structured under the holding company with voting rights in the holding company. Other forms include a 'separate entities structure' in which the two top-tier companies are not combined but operate as a single entity.

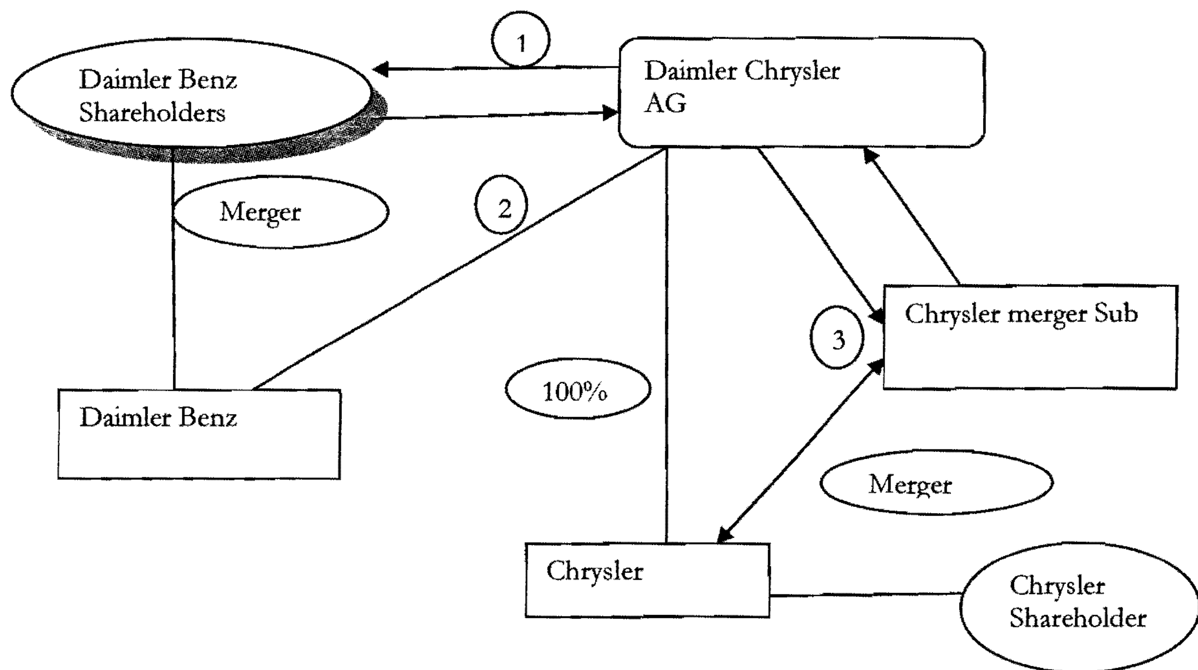
The main advantage of these structures is that they allow for continuity of companies' domicile, continuity of corporate identity, capital gains tax advantages and efficient flow of income across borders. Maintaining a company's domicile can be important where there are strong national interests at stake for example, defense, media, financial etc.

Many countries permit cross-border transactions resulting from share purchases to be tax-free. However, this is not universal. A dual-headed structure avoids the capital gains tax issues associated with a share exchange by allowing the shareholders to maintain their original shares. Dividends received from domestic corporations are more tax efficient than cross-border dividends from foreign companies. By maintaining the top-tier company as a domestic corporation, the dividends paid are from local companies. This avoids concerns with dividend-withholding taxes as well as the availability of foreign dividend credits or deductions. The dark side of Dual-headed structure is that the share prices of companies merging may be different which may arise after the companies merges. This may attract various tax liabilities.

Daimler Chrysler Merger: A tax efficient merger model

A German automobile giant Daimlar-Benz and Chrysler, a US company, executed the first major German-US M&A transaction in the year 1998. This merger set a model framework for tax-free cross-border acquisition.

A significant issue associated with the merger was the location of the surviving parent company- Germany, the US or a third country. With half of Daimler's supervisory board comprised of union employees, it would have been politically difficult to win approval for the new company, DaimlerChrysler, if the parent company was not a German AG. And the tax laws favoured this decision as well.



The figure explains how this tax efficient merger model worked out.

This structure was beneficial because it took advantage of various tax laws in both Germany and the US. First, at the time, German tax law permitted like-for-like (for example- share-for-

share) exchanges on a tax-free basis. Thus, the Daimler-Benz shareholders were able to exchange their Daimler-Benz AG shares for the DaimlerChrysler AG shares tax-free. Second, the Chrysler shareholders could contribute their shares to DaimlerChrysler AG tax-free so long as the Daimler-Benz AG shareholders held the majority of DaimlerChrysler AG immediately following the merger. Third, this structure facilitated access to the German tax law providing that dividends paid by a US firm to a German company to be tax-exempt due to a German/US tax treaty. Finally, the use of a German corporation provided a future opportunity to dispose off the Chrysler Corporation share tax-free.

It is very interesting to note that a slightly different transaction structure would have resulted in significant tax burdens for both corporations and its shareholders. For example, if the newly formed DaimlerChrysler were a US corporation, the German shareholders would not have been able to transfer their shares tax-free. Also, if the US shareholders had received a majority of the shares in the new company, a taxable transfer would have been triggered.

Chapter-8

Conclusion and Recommendations

Taxation is one of the major factors that influence many corporate decisions at the time of merger and acquisitions. It can be more decisive if the proposed merger is a cross-border merger. This happens because such deals involve change of tax jurisdiction and can have adverse effect over the economy of parent country.

Tax laws in many countries tend to be complex, but with India beginning to occupy an increasingly important place on the world stage, the benchmark for comparison has to be changed. There is a need for India to become mature in relation to administration of tax laws. Two important dimensions are the need for laws that are clear and also for a mechanism to provide taxpayers with upfront clarity and dispute resolution. Although the concerns cannot be considered misplaced, these taxing strategies on the part of the nations have the potential to defeat otherwise beneficial trans-border mergers.

There are two major hurdles identifiable in relation to taxation; the first being the inconsistent following of real seat principle and place of incorporation principle for the determination of the residential status by different nations. This lead the corporation to remain resident of the country of the transferor Company even after merger and thus resident of more than one jurisdiction, both taxing the global income of the company. This would put such a company in a very disadvantageous position vis-à-vis other companies by wiping out the benefit of the synergies of the merger. Double taxation avoidance agreements can be of some help but is

not exist between the concerned countries. The second issue is the tax which is imposed in the nature of exit tax.

Significantly, several multinational companies doing business in India, across a broad spectrum of industries, are saddled with ever-increasing number of tax audits and prolonged tax litigation in India on account of failure of our tax authorities to apply tax treaties or follow internationally-accepted standards in treaty interpretation and transfer pricing.

At present, the dispute resolution mechanism in India moves slowly. Assessment proceedings continue for more than two years from the date of filing of the tax return. Thereafter, the two appellate levels take approximately two to seven years to dispose of an appeal. If the dispute still continues, on a question of law, the matter gets referred to the High Court and the Supreme Court which takes very long. This is worrying corporates as it takes a lot of management time and effort.

There is a need to speed up the litigation procedure. There should be a limitation period on disposal of appeals too. Two years ago, the National Tax Tribunal (NTT) was set up to speed up the dispute mechanism. The NTT has, unfortunately, yet not been functional.

The new direct tax code that the Government is planning to introduce, to replace the current Income-tax Act, is expected to emphasize on transparency and taxpayer-friendliness. But the proposed Direct Taxation Code can have severe impact over the cross-border merger and acquisition deal. Many corporate bodies and organisation have expressed their concern over the coming DTC. ASSOCHAM a leading corporate organisation of India has already expressed their worry by saying, "*This can have serious implications in various international transactions like cross-border mergers and transfer of Indian shares in foreign capital markets,*" so there is a dire need to relook the provisions of DTC and to sort out the pit falls of the Bill.

The Indian tax authorities have been aggressively alleging that the Indian subsidiaries are economically dependent on the foreign parent company and, therefore, constitute a Permanent Establishment (PE) of the parent company. In claiming that the parent company has a PE in India, the Indian tax authorities ignore that the rule only applies if the transaction between the foreign company and the agent is not on arm's length terms. The Indian tax authorities have also been aggressive when asserting PE, based on their own interpretation of the rules relating to place of business in India, provision of services in India, etc, rather than relying upon internationally-accepted rules.

Transfer pricing regulations require all international transactions amongst group entities to be priced on an 'arm's length' basis, leading to the often-debated and vexed question of what the best manner of determining the arm's length price is Internationally, too, a majority of tax litigation is due to transfer pricing-related aspects.

In India, we find the litigation on transfer pricing increasing, so the corporates need to manage these risks. Introduction of Advance Pricing Agreements (APAs) and safe harbour provisions; further development of practice around Mutual Agreement Procedures (MAPs) are key steps required to take the Indian transfer pricing regime to the next level.

Amendments brought about by the Finance Act, 2008 would have a major impact on transfer of shares overseas, especially in a case where the seller of the shares is a tax resident of a country with which India does not have a Double Taxation Avoidance Agreement (DTAA). The amendment also brings the investors from countries like the US and UK within the tax net in India, since India's DTAA with such countries provides for taxation of capital gains in accordance with the domestic tax laws of India.

Currently, a large chunk of Foreign Direct Investments into India is coming from favourable offshore jurisdictions. The tax laws shall face the challenge of balancing the interest of the investors and the revenue authorities.

Considering the above, it would seem that there are still a lot of grey areas regarding tax implications of mergers and acquisitions. As can be discerned, there are many issues, which are left open to interpretation and would require a critical analysis of the facts and circumstances to arrive at an appropriate conclusion. Though the law cannot provide regulations for each and every aspect, considering that mergers and acquisitions are truly the flavour of the day, it would be appropriate if the tax laws and double taxation avoidance agreements become better equipped to deal with these issues. Hereunder are some recommendation which must be incorporated in global tax regime for the smooth movement and reorganization of the companies.

a. A cross-border merger, division or exchange of shares should not give rise to any tax liability until such time a capital gain is actually realized. To this effect and to the extent that the assets and liabilities transferred are connected to a permanent establishment of the receiving company located in the country of the transferring company, the tax liability on unrealized capital gains may be shifted to the receiving company to crystallize as income of the receiving company when they are disposed of by the permanent establishment. The same tax neutrality should also be granted when cross-border reorganization entails a transfer of legal seat. The transferring company should however have the option of whether to opt for such a deferral or immediate taxation.
b. Any transfer taxes which may be due on both the transfer of assets and shares should be deferred until actual disposal.

c. On either a cross-border merger, division or exchange of shares the allotment of shares in the receiving company(s) to the shareholders of the transferring company(s) should not give rise to an immediate income tax or capital gains tax. Any taxation of the corresponding gain should be deferred until subsequent transfer of securities received in exchange

d. Any anti-tax evasion or abusive avoidance rules should be reasonable and sufficiently precise in order to avoid uncertainty.

Thus, the above discussion on the topic, proves my first hypothesis partly, and suggest certain areas where the policy makers need to look into. For example, a lot more has to be done in the matters of capital gain tax. Some other provisions of tax laws also give benefit to the acquirer company if it is an Indian company. Such types of biasness is not appreciable for the free trade and commerce. The second hypothesis has been proved correct completely as many scholars academicians and corporate houses has already shown their concern over the proposed tax reforms.

Bibliography

BOOKS

1. Ahuja Girish and Gupta Ravi; Direct Taxes: Law and Practices; Bharat Law House Pvt. Ltd.; 16th Ed.; Yr-2007-08
2. Anne-Marie Mooney Cotter, Insolvency Law, Bar Society of Ireland, Pub- Cavendish,
3. Chandrashekhar Krishnamurtia and Vishwanath S R, Mergers, Acquisitions and Corporate restructuring, Response (SAGE), 2008, Pg- 170
4. Dr. N. V. Lalith Kumar Rao, Tax Havens, Chapter- III
5. M. whalley and F. J. Semler, International Business Acquisitions, Kluwer Law International, London, 2007, Pg-1
6. Mergers and Acquisitions: A Global Tax Guide, PricewaterhouseCoopers, John Wiley & Sons, Inc., 2006, Pg-IX
7. Mergers *et al;* Ramanujam S.; Tata McGraw-Hill Publishing Comp. Ltd.; yr- 2003
8. Provisional Approach to Direct Taxes: Law and Practices; Ahuja Girish and Gupta Ravi, Bharat Law House; 16th Edn; 2007-08
9. Steven Emanuel & Lazar Emanuel; Corporations; Publ.-Aspen(Wolters Kluwer, US); Edn.- 6th 2009
10. The Law and Practice of Income Tax Act; Palkhivala N. A
11. Vyas Dinesh; the Law and Practice of Income Tax- Kanga, Paikhivala and Vyas; lexis Nexis, Butterworths; Edn-9th 2004
12. Joint Ventures & Mergers and Acquisitions in India- Legal and Tax aspect, Seth Dua Associates, Delhi

13. Taxation of Capital Gains; Ahuja Girish and Gupta Ravi; Bharat Law House Pvt. Ltd. New Delhi; 6th Edition, 2009.

14. Rastogi Abhishek A.; Guide to Goods & Services Tax; Taxmann Publication (P) Ltd., 1st Edition; 2010.

ARTICLES

1. Reuven S. Avi-Yonah, Globalization, tax competition, and the fiscal crisis of the welfare state, 113 Harv. L. Rev. 1573 (2000), 1583
2. KPMG report on Worldwide announced M&A, 2006
3. Frederick L. Pryor, Dimensions of the worldwide merger boom, working paper (2001), available at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID255412_code010216560.pdf?abstractid=255412
4. Yariv Brauner, A good old habit, or just an old one? Preferential tax treatment for reorganizations , 2004-1 B.Y.U. L. Rev. (forthcoming, Winter 2004)
5. International Acquisition Accounting Method and Corporate Multinationalism: Evidence from Foreign Acquisitions, Kathleen M. Dunne and Gordian A. Ndubizu, Journal of International Business Studies, Vol. 26, No. 2 (2nd Qtr., 1995), pp. 361-377
6. Model asset purchase agreement by *Ebrahim A.K. Faizullabhoy, Mulla & Mulla & Craigie Blunt & Caroe*
7. Kun Orsolya; Corporate Inversions: the interplay of Tax, Corporate and Economic Implications; 29 Del. J. Corp. L. 313

8. Kane Mitchell A. et al; Corporate Taxation and International Charter Competition; 106 Mich. L. Rev. 1229

9. Taxation of Income from dividends and Capital Gains of an overseas corporate body incorporated in Mauritius : Income-Tax Act, 1961 and the Indo-Mauritius Double Tax Avoidance Convention, M.P. Singh, Taxman, 2002, vol-124

10. Thompson Samuel C., Impact of Code section 367 and the European Union's 1990 council directive on Tax-free Cross-border Mergers and Acquisitions; 66 U. Cin L. Rev. 1196

11. Pandey T. N.; Supremecy of Tax treaties vis-à-vis Tax laws in India; (2004) 3 Comp.LJ; Pg-113

12. Mergers and Acquisitions in UK; By Bradley Phillips, Derek Hill and Emma Nendick, Herbert Smith, London;International Tax Review

WEB SOURCES

1. http://business.rediff.com/slide-show/2009/may/29/slide-show-1-indias-11-largest-m-and-a-deals.htm#contentTop
2. http://www.treas.gov/press/releases/js2179.htm
3. http://www.taxguru.in/income-tax-case-laws/advance-ruling-in-the-case-of-star-television-on-taxation-of-cross-border-merger.html
4. http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID255412_code010216560.pdf?abstractid=255412
5. http://www.incometaxindia.gov.in/publications/6_Advance_Rulings/Chapter07.asp

6. http://www.articlesbase.com/regulatory-compliance-articles/double-taxation-avoidance-agreement-indian-point-of-view-1107784.html

7. http://www.articlesbase.com/regulatory-compliance-articles/double-taxation-avoidance-agreement-indian-point-of-view-1107784.html

8. http://www.nishithdesai.com/New_Hotline/Tax/TAX%20HOTLINE_PressAug1309.html

9. http://www.websters-online-dictionary.org/definition/sale

10. http://dictionary.lp.findlaw.com/scripts/results.pl?co=dictionary.lp.findlaw.com&topic=2d/2db4bbfc96cd55dd5f074c4368edd361

11. http://books.google.co.in/books?id=1_QhhvNU8DYC&pg=PA115&lpg=PA115&dq=hive+down&source=bl&ots=UEy2jyy42r&sig=xD-rt0519AtYm9s60YHN it6TSc&hl=en&ei=F1j4S8O2JsWzrAfPysXyCg&sa=X&oi=book_result&ct=result&resnum=7&ved=0CDQQ6AEwBg#v=onepage&q=hive%20down&f=false

12. http://plc.practicallaw.com/2-107-6253?q=income+access+structure&qp=&qo=&qe=

13. http://books.google.co.in/books?id=pAaOysAmCFoC&pg=PA431&lpg=PA431&dq=what+is+"Two-step+Acquisition"+%3F&source=bl&ots=sDqdBTP0j8&sig=ZqGauJWTFeCd-OldQ86VvVcd1cI&hl=en&ei=Am74S4yCJ9SfrAfYmqXLCg&sa=X&oi=book_result&ct=result&resnum=5&ved=0CCYQ6AEwBA#v=onepage&q=what%20is%20%22Two-step%20Acquisition%22%20%3F&f=false

14. http://www.internationaltaxreview.com/includes/magazine/PRINT.asp?SID=488020&ISS=13166&PUBID=35