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TOPIC:

"The Aspect of Taxation in Cross-border Mergers and Acquisitions"

Under the guidance of: The Hon'ble Justice S. RAJENDRA BABU

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ID No. – 360

LL.M

CERTIFICATE

This is to certify that, this Dissertation on the topic titled as **"THE ASPECT OF TAXATION IN CROSS-BORDER MERGERS AND ACQUISITIONS"** submitted by **ZOEB SHABBIR CUTLERYWALA**, I.D. No. 360 in partial fulfilment of the requirement for the degree of **Masters of Laws (LL.M)** for the academic year 2008/10, of the **National Law School of India University, Bangalore** is the product of the bona fide research, carried out under my guidance and supervision.

Date: 28-05-2010

Place: Bangalore

Hon'ble Justice S. Rajendra Babu

National Law School of India University

DECLARATION

I, **ZOEB SHABBIR CUTLERYWALA** do hereby declare that this Dissertation titled ***"The Aspect of Taxation in Cross-border Mergers and Acquisitions"*** is the result of *bonafide* research undertaken by me in partial fulfilment of the LL.M programme at NATIONAL LAW SCHOOL OF INDIA UNIVERSITY [NLSIU], BANGALORE, INDIA. This Dissertation has been prepared by me under the guidance and supervision of the **Hon'ble Justice Mr. S. RAJENDRA BABU**.

I further declare that this Dissertation is my original work and relevant materials taken from the other sources have been cited properly at appropriate places and which are duly acknowledged. I declare that this work has not been submitted either in part or whole for any other degree or any other course at any other University or like institution.

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DEDICATION

This work is dedicated to my Parents

Table of Contents

CHAPTER 1 - INTRODUCTION

INDIA IS A LAND of great variety in terrain, race, language, religion and culture. In the eyes of most foreigners, the country has an image which does not reflect its reality, even those who arrive here for the first time with as much preparation as possible find it difficult to cope with the experience they encounter. The sweltering crowd dressed in varied fashion, chaotic traffic, animal driven carts, man-pulled rickshaws to latest model Mercedes, filthy slums to skyscrapers, shouting hawkers to modern shopping arcades create a sudden impact for which the foreigners are not ready. Those who imagine India as a mystic land inhabited by jungle-tribes, snake charmers, saints and astrologers are as much bewildered as those who compare it with the western world. In fact India is a country living simultaneously in 19th and 21st century. Once this peculiar and unique feature is identified, living in India is an experience a foreigner will cherish for a long time.

Cross-border Mergers and Acquisitions (M&As) have gained in popularity over the last decade. Now, more than ever, companies are seeking and making acquisitions abroad. As multinational companies expand around the world, the firms that do business with then may be required to think globally as well. While the benefits of making foreign investment through merger and acquisition transactions can be sizable, there are risks in doing business in locations that are unfamiliar to the rules and regulations can all interfere and frustrate the acquisition approach of foreign buyers.

Globalisation of business over the past decade has generated a search for cutting edge competitive advantage that is worldwide in scale. Companies have followed their customers, who are going global themselves, as they respond to the pressures of obtaining scale in rapidly consolidating global economy. In combination with other trends, such as increased deregulation, privatization, and corporate restructuring, globalization has spurred an unprecedented surge in cross border merger and acquisition activity. **Mergers & Acquisitions (M&A)** are now the favoured route the world over to effect business consolidation, restructuring and growth. It has become part of strategic architecture of corporate bodies to exploit existing core competencies as well as to build new ones for future.[1]

Global corporate world is currently witnessing booming activity in mergers and acquisitions. Globally, the number and size of deals is heading towards newer levels, with cross-border deals taking centre stage, as companies take advantage of readily available low-cost financing to pursue their expansive M&A strategies. M&A worldwide rose to a record $3.1 trillion, in 2006, as leveraged buyouts (LBOs) almost tripled, surpassing the previous high set in 2000 during the peek of the dot com boom.

Are the mergers tax induced? Need not be always, but it can play a significant role in merger decisions. My study here is on the tax aspects of Cross-border Mergers and Acquisitions. In economic transactions, there involves incidences of taxation in most of the circumstances. All business and economic transactions are attempted to perform in such a way that it is the most tax efficient manner of doing it. Mergers and acquisitions of companies are also such business activities which have some tax implications.

Over the last decade, 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

[1] See http://www.taxmann.com/TaxmannFlashes/flashart9-2-10_12.htm last visited on 16-05-2010.

companies fuelled many overseas acquisitions, such as Tata Steel's acquisition of Anglo-Dutch major Corus and Hindalco's acquisition of Novelis.[2]

There are ample reasons for believing that there are always firms whose owners can be induced to sell out on terms favourable both to them and to the acquiring firms. Among these reasons are differences in expectations of future profits or the discount rates applies to them, special tax incentives to mergers, and possibly opportunities to exploit economies to size of firm or opportunities to gain or enhance positions of market power.[3] Thus the factors that induce and affect a Merger decision are many. The various aspects / issues that may induce and affect a Merger can be Company Law issues, Contractual issues, IPR issues, Exchange Control issues, Labour and employment issues, Anti-trust, Competition & Consumer issues, Taxation issues, etc. Here my discussion is concentrated only on the Taxation Aspect of Cross-border Mergers and Acquisitions.

The post independence era witnessed some radical changes towards a welfare state at the policy level. The policy of controlled economy which derived from the ideas of the Soviet Union was part of the welfare measures adopted by Nehru government. But it took more years to bring out a new Income Tax Act in place for the out dated Colonial legislation of 1922. The present Act of 1961 came into force w.e.f. 1st April 1962.

It was always a cautious and careful business of the draftsmen to avoid ambiguities in the matter of taxation of combined entities. But the Income Tax Act 1961 has been mutilated by

[2] Girish Vanvari, Boosting M&As: Laws need to change, Business Standard, February 20, 2008.
[3] John J. Mc Gowan, International Comparisons of Merger Activity, Journal of Law and Economics, Vol. 14, No. 1 (Apr., 1971), p. 20.

thousands of amendments, which made the legislation a cause for flooding litigation. In the words of N A Palkhivala:

> "Today Income tax Act 1961 is a national disgrace…the tragedy of India is the tragedy of waste- waste national time, energy and manpower. Tens of millions man-hours, crammed with intelligence and knowledge of tax gatherers tax payers and tax advisors- are squandered every year in grappling with the torrential spate of mindless amendments."[4]

Company is a legal entity distinct from the shareholders. There are various provisions under the income tax act which are dealing with the taxing of a corporate entity. For income tax purposes also a company is a separate legal person and an assessee by itself. The income tax is levied on 'person' and the term 'person' is defined under the Income Tax Act which includes a company.[5]

The term Merger has not been defined under the Income Tax Act 1961. However, in common parlance, merger means combination of two or more commercial organisations into one. But the Act uses Amalgamation to merger and is defined.

"The study is aimed at understanding and analyzing the tax structure and regime globally and also under the Income Tax Act 1961 with regard to Cross-border Mergers and Acquisitions. The researcher has tried his level best in tackling a very abstruse and a very specialised subject which is seldom read and rarely understood, in a very exhaustive and competent manner."

[4] Kanga, Palkhivala and Vyas, The Law and Practise of Income Tax, vol. 1, ninth Edn, Lexis Nexis, New Delhi, 2004, p vii.
[5] Sec 2(31) of the Income Tax Act 1961.

Research Methodology

Research Objective

The primary objective of this paper is to determine and analyse the implications of Taxation laws in Cross-border M&A deals, because tax planning of any kind necessarily pre supposes comprehensive knowledge of tax liability and the circumstances in which it arises. One of the other objects of the present paper is to "assist the tax payers in India and abroad to know in advance, to the extent practicable, the tax implications of various transactions arising from the implementation of the agreement for foreign collaboration between any person in India and another outside India." Another subsidiary objective of this paper is "to help the vast majority of tax-payers and tax practitioners as well as assessing and appellate authorities in India and abroad to be guided by the judicial precedents in matters of Cross-border M&A deals." The researcher has fulfilled this purpose admirably by discussing few relevant case laws on the subject in the present paper.

Hypothesis

Cross-border mergers although growing on a large scale for the purposes of expansion of the business globally among the companies, but have major Tax hurdles amongst others in achieving the Trans-border mergers in India.

The Chapterisation

The dissertation starts with a general introduction (chapter one), to the increasing trends in Cross-border M&A activities. The second chapter discusses the reasons for the growth of the Cross-border Mergers and Acquisitions. The chapter discusses the various motives which are the triggering factor for the increase in the number for M&As. The third chapter discusses the various aspects on which a Cross-border M&A depends. The aspects which actually decide whether a particular M&A deal is and/or would be fruitful to both the transferor and the transferee. The fourth chapter lays down, in the form of charts and tables, various Acquisitions made by Indian companies abroad and the largest M&A deals worldwide. The fifth chapter which is the most important chapter of this paper discusses in detail about the various tax law issues pertaining to Cross-border Mergers and Acquisitions with relevant case laws cited. Since the paper is about "Cross-border" mergers it becomes important to discuss about the treaties entered into between India and other countries in this regard which is extensively discussed in chapter six. The seventh and the last chapter concludes by summarising the whole paper.

Research Questions

Q1. What are the triggering factors for a particular M&A deal and the different aspects on which that particular M&A deal will depend?

Q2. Do taxation issues amongst others actually need consideration while executing a particular M&A deal?

Q3. How important it is to keep the tax implications in mind before or during deciding for a particular M&A deal?

Mode of Citation

A uniform mode of citation has been followed throughout the paper.

Method

The method is purely descriptive and analytical in nature.

Sources of Data

To accomplish the aforesaid objective the researcher has heavily relied upon the secondary sources of data in the form of books, articles, journals, websites, reports, etc. All these sources have been duly cited.

CHAPTER 2 – REASONS FOR THE GROWTH OF CROSS-BORDER MERGERS AND ACQUISITIONS

This chapter seeks to identify the benefits of Cross-border Mergers and Acquisitions over other modes of expansion and growth. One important aspect of understanding Cross-border Mergers and Acquisitions is to examine the motives driving the ever increasing deals. The discussion below examines three distinct but some what related motives; strategic, market and economic.

2.1 Strategic motives

Strategic motives involve acquisitions that improve the strength of a firm's business strategy. Examples would include mergers intended to create synergy, capitalize on a firm's core competence, increase market power, provide the firm with complimentary resources/products/strengths, or finally to take benefits of a parenting advantage. Ford's acquisition of Volvo could be called strategic. Ford has announced the acquisition of a firm whose products fill a gap in its product line both in term of price, image and geography. Ford included Volvo as a part of its newly formed Premier Automotive Group that will focus on the product segment, which, except for sport utility vehicles, has the greatest potential for profit.[6]

Merging to create synergy is probably the most often cited justification for an acquirer to pay a premium for a target firm. The still cited classic case of this is acquisition of Miller Beer by Phillip Morris. Phillip Morris applied their strengths in marketing cigarettes to the

[6] Economic integration and the profitability of cross-border mergers and acquisitions, by, Kjetil Bjorvatn, Department of Economics, Norwegian School of Economics and Business Administration, Helleveien 30, 5045 Bergen Norway, European Economic Review 48 (2004) 1211 – 1226.

brewing industry, an industry that had previously emphasized production as its core activity. They were very successful in improving Miller's position by using their already developed abilities in advertising, packaging, product development and positioning of branded consumer products. In the process, they were able to improve Miller's market position from number seven to number two.

2.2 Market motives

The most important market motive of a cross-border acquisition is to use it as a market access tool in new countries. Increasingly, companies are acquiring already established companies as the fastest way to enter a new country. Often a market may become the target of acquirers because it has changed its texture from a protected to an open market. Companies from other countries may see acquisition of the formerly regulated or state-owned operation as the fastest way to gain a strong position in the new market. In addition to being fast in acquiring a position in a particular market, it is a way to gain entry without adding additional capacity to a market that already may have excess capacity. It may make much more sense in a target market with established brand names to acquire a brand name and the company behind it instead of trying to grow a new brand name in a market where customer loyalty is hard to change.

To protect, maintain, defend or grow a market position, companies may find it necessary to acquire instead of starting from scratch. In this regard best example can be of Firestone by Bridgestone. In thinking about acquisition as a mode of entry into a new market, it is useful to compare it with other modes of entry which include exporting, licensing, franchising, joint ventures or wholly owned subsidiaries, Exporting, licensing and franchising all have in common that they offer a low degree of control over distribution line and market risk, low need for resource commitment, and fast implementation. Joint ventures, M&As and wholly owned subsidiaries have in common a higher degree of end line control and risks associated and higher need for resource commitment. But M&As offer more control than a joint venture and are efficient to implement than a wholly owned subsidiary. Furthermore, research shows that foreign buyers are more likely to use acquisition rather than establish a wholly owned subsidiary when they do not have clear advantages over their rivals and when they plan to manufacture a product that they do not manufacture at home.[7] Thus, firms apparently are acquiring competitive advantage and experience.

2.3 Economic motives

Economic motives for acquiring include many important reasons to merge. One is to establish economies of scale. A second closely related reason is to be able to reduce costs due to redundant resources of two firms in the same or closely related industry. Thus, if we are acquiring a firm in the same or a closely related industry and there is substantial overlap between the two businesses, there may be ample opportunities to reduce costs. A third reason is the stock of the firms from a particular country may be undervalued.

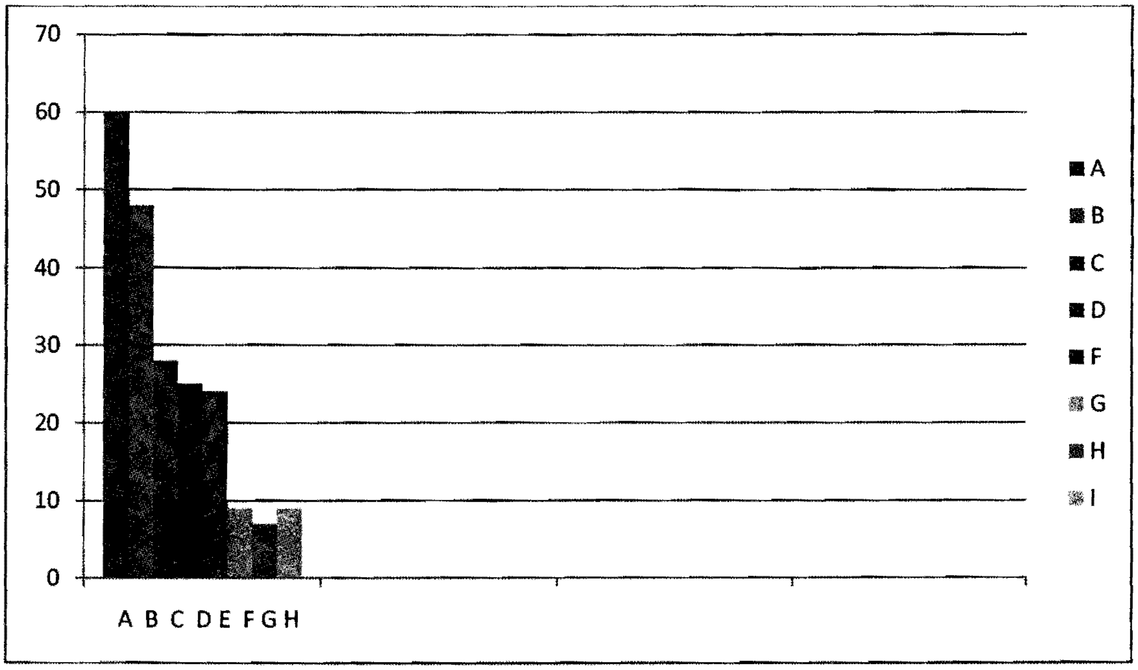
Finally, a driver of Cross-border mergers might ne differences in the macroeconomic conditions in the two countries. That, is one country might have a higher growth rate and more opportunity than some other country. Thus, it would seem reasonable to expect the slower growth country to be more often home to acquirers whereas the faster growth country is likely to more often be home to target firms.

[7] See http://faculty. business.utsa.edu/kshimizu/Publication/Cross-border%20M&A%20(JIM).pdf

Recently, there was a global survey on 'Cross Border Mergers and Acquisition' by Accenture[8], in this 420 senior executives responded from companies headquartered in US, UK, Germany, Sweden, Norway and Finland. Key findings from that survey are mentioned in this paper with analysis:

What are the main drivers for companies to make cross-border acquisitions (% of respondents)

Figure 1.



[8] Accenture / Economist Intelligence Unit 2006 Global M&A Survey Executive Summary, 'cited in', http://www.accenture.com/Global/Services/By_Subject/Corporate_Strategy/R_and_I/RiseCrossBorderM&A, last visited on 20/04/2010.

2.4 Motives of Overseas Investment

Many Western companies acknowledge the unyielding pressure to look overseas, within their own region or beyond in search of growth and profits.[9] More than half of the respondents in this survey said companies in their industry would be driven to acquire overseas interests in the next five years to guarantee the profitability of the business, and 49% said cross-border M&A would be required to meet all the targets of the stated corporate strategy.[10] Twenty-six percent of respondents said overseas acquisitions were necessary simply to survive.[11] To pursue these goals, companies in different industries, however, are likely to target different markets (as shown in Table 1).[12] For example, financial services companies remain keen on the US and UK, as consolidation in those markets continue. Many, however, are looking to exploit new opportunity in markets like China and India. China and US, meanwhile top the list of likely acquisition locales for manufacturers, while energy and natural resource companies are most often looking to the US, Russia and the UK. IT and telecommunications companies are eying the US, above all, but are also actively considering India and China.[13]

Table I

Most popular M&A markets in coming three years, by industry
% of respondents (of respondents citing) given country in response to question: "Which countries do you think will be of greatest interest to your company for M&A activity in the next three years?'

[9] ibid
[10] Table 1
[11] Supra 10
[12] Supra 10
[13] Supra 10

Financial Services		Manufacturing		Energy & natural resources		IT / Telecoms	
US	47%	China	67%	US	53%	US	67%
China	33%	US	54%	Russia	30%	**India**	**38%**
UK	30%	**India**	**40%**	UK	30%	China	34%
Germany	27%	Brazil	25%	Germany	27%	UK	26%
India	**29%**	Germany	25%	**India**	**23%**	Russia	21%
Spain	24%	UK	25%	Nordic/Scandinavian countries	23%	Brazil	17%
France	19%	Russia	21%	China	20%	Germany	17%
						Japan	17%

Nevertheless, different countries lure would-be buyers (domestic or foreign) for different reasons, some strategic, and some more practical (Table 2).

For example, the survey shows US to be the most frequently cited destination for would-be M&A overall. Fifty-five percent of respondents said that US is likely to feature in their corporate M&A strategy in the next three years not surprising given the global economic importance of the country, and its reputation for being one of the liberal countries in which to make an acquisition.

China, by contrast, remains the market with lots of potential, but is seen as one of the hardest markets to access, because of its perceived lack of transparency, inconsistent policies, and politico-cultural rigidity. Nevertheless, many companies hope to expand there, with 44% of all Western respondents saying China will be of great M&A interest in the coming years.

India, another of Asia's major growth markets, is generally far friendlier to foreign investors, making it a seemingly more accessible destination. Not surprisingly, 37% of

Western survey respondents have said that India would be of great interest to their company in the coming years.

Countries	% of Respondents	Reputation
US	55%	Open to foreign investors, transparent financial/accounting/regulatory regime, few language problems, accessible culture
China	44%	Excessive government oversight/bureaucracy, opaque financial/regulatory/legal systems, infrastructure issues, language/culture problems
India	**37%**	Law may favour foreign investment but much red tape in practice
UK	26%	Few regulatory hurdles, strong corporate law, pro competition, accessible culture, few language problems
Germany	25%	Compatible corporate and cultural mindset, similar business practices, ample legal protection, few language problems
Brazil	19%	Some incompatible business practices, integrity concerns, cultural barriers
France	14%	Ambivalent to foreign ownership, strong labour law/lobby creates organizational cost (e.g. layoffs prohibited)

1 - % of respondents citing given country in response to question: "Which countries do you think will be of greatest interest to your company for M&A activity in the next three years?"
Based on responses to question, "In your opinion, for companies in your country, which is the easiest/most difficult country region in which to make an acquisition, and why?

2.5 Cross Border M&A and FDI

Earlier there have been talks that FDI from India is getting lower; this would be primarily because of the mega deals in which Indian companies are the acquirers, such as the, "Tata Corus Deal". Table below shows FDI in particular countries because of Cross Border M&As.

Foreign Direct Investment (FDI) Inflows and Cross-Border Merger and Acquisition (M&A) Sales, by Host Economy, 2004 and 2005.[14]

Table- III

Economy	FDI US$ million (2004)	M&A Sales US$ million (2004)	FDI US$ million (2005)	M&A Sales US$ (2005)
Australia	42,594	15,128	35547	12,051
Japan	7,816	8,875	2,775	2,512
China	60,630	6,768	72,406	8,253
Korea	7,687	5,638	7,198	6,542
New Zealand	2,441	4,292	1,603	4,033
Hong Kong SAR	34,035	3,936	35,897	9,472
India	5,335	1,760	6,598	4,210
Indonesia	1,023	1,269	5,260	6,763
Thailand	1,064	1,236	3,687	338
Singapore	16,060	1,190	20,083	5,802
Philippines	469	733	1,132	328
Malaysia	4,264	638	3,967	1,454
Taiwan	1,898	398	1,625	756

Crossborder mergers and acquisitions (M&As) make up the overwhelming part of FDI flows. However, there is no one-to one correspondence between data on FDI flows and crossborder M&As. The latter may be financed by local or international capital market funds that are not reported as FDI, as recorded in balance-of-payments statistics. Data on M&As refer to amounts recorded at the time of closure of deals, and values are not necessarily paid out in a single year. In addition, FDI.the change in inward and outward direct investment assets and liabilities.is reported on a .net. basis: for example, FDI inflows equal inward investment flows minus repatriated capital. M&A data are on a gross basis, and, furthermore, associated payments can be phased over several years. Finally, M&A statistics often record the total amount of capital,

[14] See http://www.business.nsw.gov.au/aboutnsw/Trade+and+Investment/B7_foreign_dir_inv_inflow.htm last visited 20-04-2010

whereas FDI refers only to transactions involving more than 10% of the equity capital of firms (if less than10%, the flows are classified as portfolio investments).

The legal and financial reforms by the government of India since the early 1990's have resulted in substantial growth of the Indian economy. The sea change in trade and investment policies and the regulatory environment in the past decade, including, easing of restrictions on foreign investment and acquisition, and the deregulation and privatization of many industries, has probably been the most significant catalyst for the growth of cross border M&A transactions involving India.

Recently, the press has reported of a decision by RBI that Indian companies merging with overseas firms will continue to be treated as entities resident in the country under FEMA and FEMA will be accordingly amended.[15] It has also clarified that payment by the foreign company to shareholders of listed Indian companies being merged can be made in the form of cash, shares or Indian Depository Receipts ("**IDRs**") issued by the overseas companies. Further since IDRs in their existing form do not have voting rights, the law has to be changed to incorporate this change. This will be important if the merger involves allotting voting rights to Indian shareholders or some sort of management control.

Indian economy is proving itself highly conducive to foreign investment.[16] While the government policies supporting foreign investment have led to a renewed interest by foreign

[15] Anindita Dey, FEMA TO APPLY TO REVERSE OVERSEAS M&AS, SAYS RBI, Business Standard, 9 October 2009, also see http://www.business-standard.com/india/news/fema-to-apply-to-reverse-overseas-mas-says-rbi/372711/ last visited 21-02-2010.

[16] Anjali Agarwal, INBOUND INVESTMENTS INTO INDIA - STRUCTURING THE DEAL!, (2009) 24 (7) JIBLR 375.

investors and the consequent flow of overseas funds into India, the consequential domestic economic growth has enabled the Indian entrepreneurs to come out and explore business avenues on a global level. We believe that India will keep signing on the screen of cross border M&As and would regain its status of the "**Golden Bird**"

CHAPTER 3 – VARIOUS ASPECTS ON WHICH CROSS-BORDER MERGER AND ACQUISITION DEPENDS

3.1 Introduction

With increasing globalization and dispersion of technology, product life-cycles are shortening and competition is becoming intense, where there is little room for organizations to meet their growth aspirations through internal development or organic growth. In order to achieve speedy growth with limited market access, technology, finance and time, corporates worldwide have preferred to grow inorganically through the route of mergers and acquisitions (M&A)

From the beginning of the 21st century, India has witnessed a tremendous growth in M&A activities, both inbound & outbound. However, the recent economic downturn has eclipsed the M&A landscape almost halving the deals in both number and value.

Cross border M&A deal values have fallen from USD 42 billion in H1 2007 and USD 12 billion in H1 2008 to just USD 1.4 billion in H1 2009. This marks an 85% decrease from last year highlighting the lack of overseas deals.

Domestic deals have registered USD 3.5 billion in H1 2009 compared to USD 4.3 billion in H1 2008. The buoyancy in the domestic market could be attributed in part to Indian companies looking for group consolidation, cash repatriation strategies and avenues for balance sheet restructuring all in an attempt to tide over the current crisis.

With reports of green shoots showing in some European economies there is some optimism that the economic crisis may pass by the third or fourth quarter of 2009. However the M&A space is still being treaded upon cautiously and there is not enough clarity on when volumes would get back to the highs of 2008.

However, there remains a huge potential for M&A as in spite of the economic crisis, the advantages of inorganic growth still fit in the modern corporate rationale.

This chapter attempts to provide a broad overview of various aspects of M&A activities. Before discussing these aspects it would be indeed better to discuss certain important concepts involved in Mergers and acquisitions.

3.2 CERTAIN IMPORTANT CONCEPTS IN M&A

3.2.1 Merger and Amalgamation

A merger may be regarded as the fusion or absorption of one thing or right into another. A merger has been defined as an arrangement whereby the assets, liabilities and businesses of two (or more) companies become vested in, or under the control of one company (which may or may not be the original two companies), which has as its shareholders, all or substantially all the shareholders of the two companies. In merger, one of the two existing companies merges its identity into another existing company or one or more existing companies may form a new company and merge their identities into the new company by transferring their business and undertakings including all other assets and liabilities to the new company (herein after known as the merged company).

The process of merger is also alternatively referred to as "amalgamation". The amalgamating companies loose their identity and the shareholders of the amalgamating companies become shareholders of the amalgamated company.

The term amalgamation has not been defined in the Companies Act, 1956. However, the Income-tax Act, 1961 ('Act') defines amalgamation as follows:

"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—

- 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;
- 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;
- 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, and not 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;

Thus, the above three conditions should be satisfied for a merger to qualify as an amalgamation within the meaning of the Income-tax Act 1961.

Mergers are generally classified as follows:

1. Cogeneric mergers or mergers within same industries
2. Conglomerate mergers or mergers within different industries

3.2.2 Cogeneric mergers

These mergers take place between companies within the same industries. On the basis of merger motives, cogeneric mergers may further classified as:

i. Horizontal Mergers
ii. Vertical Mergers

Horizontal mergers takes place between companies engaged in the same business activities for profit; i.e., manufacturing or distribution of same types of products or rendition of similar services. A classic instance of horizontal merger is the acquisition of Mobil by Exxon. Typically, horizontal mergers take place between business competitors within an industry, thereby leading to reduction in competition and increase in the scope for economies of scale and elimination of duplicate facilities. The main rationale behind horizontal mergers is achievement of economies of scale. However, horizontal mergers promote monopolistic trend in an industry by inhibiting competition.

Vertical mergers take place between two or more companies which are functionally complementary to each other. For instance if one company specializes in manufacturing a particular product, and another company specializes in marketing or distribution of this product, a merger of these two companies will be regarded as a vertical merger. The acquiring company may expand through backward integration in the direction of production processes or forward integration in the direction of the ultimate consumer. The merger of Tea Estate Ltd. with Brooke Bond India Ltd. was a case of vertical merger. Vertical mergers too discourage competition in the industry.

3.2.3 Conglomerate mergers

Conglomerate mergers take place between companies from different industries. The businesses of the merging companies obviously lack commonality in their end products or services and functional economic relationships. A company may achieve inorganic growth through diversification by acquiring companies from different industries. A conglomerate merger is a complex process that requires adequate understanding of industry dynamics across diverse businesses vis-à-vis the merger motives of the merging entities. Besides the above, mergers may be classified as:

- Up stream merger, in which a subsidiary company is merged with its parent company;
- Down stream merger, in which a parent company is merged with its subsidiary company;

- Reverse merger, in which a company with a sound financial track record amalgamates with a loss making or less profitable company.

3.2.4 Takeover

Takeover is a strategy of acquiring control over the management of another company – either directly by acquiring shares carrying voting rights or by participating in the management. Where the shares of the company are closely held by a small number of persons a takeover may be effected by agreement within the shareholders. However, where the shares of a company are widely held by the general public, relevant regulatory aspects, including provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997 need to be borne in minds.

Takeovers may be broadly classified as follows:

- Friendly takeover: It is a takeover effected with the consent of the taken over company. In this case there is an agreement between the managements of the two companies through negotiations and the takeover bid may be with the consent of majority shareholders of the target company. It is also known as negotiated takeover.
- Hostile takeover: When an acquirer company does not offer the target company the proposal to acquire its undertaking but silently and unilaterally pursues efforts to gain control against the wishes of the existing management, such acts are considered hostile on the management and thus called hostile takeovers. The recently consummated Arcelor Mittal deal is an example of hostile takeover,

where the LN Mittal group acquired management control of Arcelor against the wishes of the Arcelor management.

- Bail out takeover: Takeover of a financially weak or a sick company by a profit earning company to bail out the former is known as bail out takeover. Such takeovers normally take place in pursuance to a scheme of rehabilitation approved by the financial institution or the scheduled bank, who have lent money to the sick company. In bail out takeovers, the financial institution appraises the financially weak company, which is a sick industrial company, taking into account its financial viability, the requirement of funds for revival and draws up a rehabilitation package on the principle of protection of interests of minority shareholders, good management, effective revival and transparency. The rehabilitation scheme should provide the details of any change in the management and may provide for the acquisition of shares in the financially weak company as follows:

1. An outright purchase of shares or
2. An exchange of shares or
3. A combination of both

3.2.5 Joint Venture

Joint venture is a strategic business policy whereby a business enterprise for profit is formed in which two or more parties share responsibilities in an agreed manner, by providing risk capital, technology, patent/trademark/ brand names and access to the market. Joint ventures with multinational companies contribute to the expansion of production capacity, transfer of technology and penetration into the global market. In joint ventures the assets are managed jointly. Skills and knowledge flow from both the parties.

3.2.6 Leveraged/Management Buyout

Leveraged buyout (LBO) is defined as the acquisition of stock or assets by a small group of investors, financed largely by borrowing. The acquisition may be either of all stock or assets of a hitherto public company. The buying group forms a shell company to act as a legal entity for making the acquisition.

The LBOs differ from the ordinary acquisitions in two main ways: firstly a large fraction of the purchase price is debt financed and secondly the shares are not traded on open markets. In a typical LBO programme, the acquiring group consists of number of persons or organizations sponsored by buyout specialists.

The buyout group may not include the current management of the target company. If the group does so, the buyout may be regarded as Management Buyout (MBO). A MBO is a transaction in which the management buys out all or most of the other shareholders. The management may tie up with financial partners and organizes the entire restructuring on its own.

An MBO begins with an arrangement of finance. Thereafter an offer to purchase all or nearly all of the shares of a company (not presently held by the management) has to be made which necessitates a public offer and even delisting. Consequent upon this restructuring of the company may be affected and once targets have been achieved, the company can list its share on stock exchange again.

3.2.7 Demerger

Demerger is a common form of corporate restructuring. In the past we have seen a number of companies following a demerger route to unlock value in their businesses. Demerger has several advantages including the following:

- Creating a better value for shareholders by both improving profitability of businesses and changing perception of the investors as to what are the businesses of the Company and what is the future direction;
- Improving the resource raising ability of the businesses;
- Providing better focus to businesses and thereby improve overall profitability;
- Hedging risk by inviting participation from investors.

Demerger is a court approved process and requires compliance with the provisions of sections 391-394 of the Companies Act, 1956. It requires approval from the High Courts of the States in which the registered offices of the demerged and resulting companies are located. Under the Income-tax Act, 1961, "demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement, by a demerged company of its one or more undertakings to any resulting company in such a manner that:

- all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;
- all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;
- the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;
- the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;
- the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;
- the transfer of the undertaking is on a going concern basis;
- the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A by the Central Government in this behalf.

As evident from the above definition, demerger entails transfer of one or more undertakings of the demerged company to the resulting company and the resultant issue of shares by the resulting company to the shareholders of the demerged company. The satisfaction of the above conditions is necessary to ensure tax neutrality of the demerger.

In case of demerger of a listed company of its undertaking, the shares of the resulting company are listed on the stock exchange where the demerged company's shares are traded. For instance, the largest demerger in India was in the case of Reliance Industries wherein its 4 businesses where demerged into separate companies and the resulting companies were listed on the stock exchanges.

The shareholders of Reliance Industries were allotted shares in the resulting companies based on a predetermined share swap ratio.

3.2.8 Slump — Sale/Hive off

The Income-tax Act, 1961 defines "slump sale" as follows:

"Slump sale" means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.

In a slump sale, a company sells or disposes of the whole or substantially the whole of its undertaking for a lump sum predetermined consideration. In a slump sale, an acquiring company may not be interested in buying the whole company, but only one of its divisions or a running undertaking on a going concern basis. The sale is made for a lump sum price without values being assigned to individual assets and liabilities transferred. The business to be hived off is transferred from the transferor company to an exiting or a new company. A Business Transfer Agreement is drafted containing the terms and conditions of business transfer.

3.3 Various aspects on which M&A depends:

1. Legal Aspects;
2. Economic Aspects;
3. Valuation Aspects;
4. Taxation Aspect;
5. Stamp Duty Aspects;
6. Competition Act 2002 and as amended by Act of 2007;
7. Limited Liability Partnetships;
8. Human Aspects.

3.3.1 Legal aspects of M&A

Merger/Demerger is a court approved process which requires compliance of provisions under sections 391-394 of the Companies Act, 1956. Accordingly, a merger/demerger scheme is presented to the courts in which, the registered office of the transferor and transferee companies are situated for their approval. However in the case of listed companies such scheme before filing with the State High Court, need to the submitted to Stock Exchange where its shares are listed.

The Courts then require the transferor and transferee companies to comply with the provisions of the Companies Act relating to calling for shareholders and creditors meeting for passing a resolution of merger/ demerger and the resultant issue of shares by the transferee company. The Courts accord their approval to the scheme provided the scheme is not prejudicial to public interest and the interests of the creditors and stakeholders are not jeopardized.

The Companies Bill 2008, was introduced in the Parliament on 23rd October, 2008 based on J.J. Irani Committee's recommendation and on detailed consultations with various Ministries, Departments and Government Regulators. The Bill proposes certain changes to existing provisions with respect to M&A.[17]

The key features of the bill as regards M&A are as follows:

- Cross border mergers (both ways) seem to be possible under the proposed Bill, with countries as may be notified by Central Government form time to time. (Clause 205 of Companies Bill, 2008) unlike prohibition in case of a "foreign transferee company" under existing provisions.
- Currently merger of a listed transferor company into an unlisted transferee company typically results in listing of shares of the unlisted company. The Bill proposes to give an option to the transferee company to continue as an unlisted

[17] See http://www.mca.gov.in/Ministry/pdf/RevisionofCompaniesAct.pdf last visited on 11-05-2010.

company with payment of cash to shareholders of listed transferor company who decide to opt out of the unlisted company.

- The Bill proposes a valuation report to be given alongwith notice of meeting and also at the time of filing of application with the National Company Law Tribunal ("NCLT") to the shareholders and the creditors which is not required as per the current provisions.
- The Bill proposes that in case of merger or hive off, in addition to the notice requirements for shareholders and creditors meetings, confirmation of filing of the scheme with Registrar and supplementary accounting statement where the last audited accounting statement is more than six months old before the first meeting of the Company will be required.
- In order to enable fast track and cost efficient merger of small companies, the Bill proposes a separate process for a merger and amalgamation of holding and wholly owned subsidiary companies or between two or more small companies.
- The Bill provides that fees paid by the transferor company on authorized share capital shall be available for setoff against the fees payable by the transferee company on its authorized share capital subsequent to the merger. This may enable clubbing of authorized share capital.

3.3.2 Economic aspects of M&A

Some of the key economic considerations in an M&A process are as follows

Shareholders wealth

An M&A transaction may enhance shareholders value in two ways — value creation and value capture.

Value creation is a long term phenomenon which results from the synergy generated from a transaction. Value creation may be achieved by way of functional skill or management skill transfers. Value capture is a one time phenomenon, wherein the shareholders of the acquiring company gain the value of the existing shareholders of the acquired company.

Synergy

Synergy from mergers and acquisitions has been characteristically connoted by 2+2=5. It signifies improvement of the performance of the acquired company by the strength of the acquiring company or vice versa. There may be operational synergies through improved economies of scale or financial synergies through reduction in cost of capital.

Realisation of synergies through consolidation — domestic and global have been one of the main aims of the worldwide M&A activities today

Market share

The co-relation between increased market share and improved profitability underlies the motive of constant increase of market share by companies. The focus on new markets and increase in product offerings, leads to higher level of production and lower unit costs. Thus this motive is closely aligned with the motive to achieve economies of scale.

Core competence

Cogeneric mergers often augment a firm's competitiveness in an existing business domain. This urge for core competence is closely aligned with the motive of defending or fortifying a company's business domain and warding off competition.

Diversification

The M&A route serves as an effective tool to diversify into new businesses. Increasing returns with set customer base and lower risks of operation form the rationale of such conglomerate mergers.

Increased debt capacity

Typically a merged entity would enjoy higher debt capacity because benefits of combination of two or more firms provide greater stability to the earnings level. This is an important consideration for the lenders. Moreover, a higher debt capacity if utilized, would mean greater tax advantage for the merged firm leading to higher value of the firm.

Customer pull

Increased customer consciousness about established brands have made it imperative for companies to exploit their customer pull to negotiate better deals fulfilling the twin needs of customer satisfaction and enhancement of shareholder value

3.3.3 Valuation aspects of M&A

Valuation is the central focus in fundamental analysis, wherein the underlying theme is that the true value of the firm can be related to its financial characteristics, viz. its growth prospects, risk profile and cash flows. In a business valuation exercise, the worth of an enterprise, which is subject to merger or acquisition or demerger (the target), is assessed for quantification of the purchase consideration or the transaction price.

Generally, the value of the target from the bidder's point of view is the pre-bid standalone value of the target. On the other hand, the target companies may be unduly optimistic in estimating value, especially in case of hostile takeovers, as their objective is to convince the shareholders that the offer price is too low. Since valuation of the target depends on expectations of the timing of realization as well as the magnitude of anticipated benefits, the bidder is exposed to valuation risk. The degree of risk depends upon whether the target is a private or public company, whether the bid is hostile or friendly and the due-diligence performed on the target.

The main value concepts viz.

• Owner value

• Market value and

• Fair value

The owner value determines the price in negotiated deals and is often led by a promoter's view of the value if he was deprived from the property. The basis of market value is the assumption that if comparable property has fetched a certain price, then the subject property will realize a price something near to it. The fair value concept in essence, ensures that the value is equitable to both parties to the transaction.

METHODS OF VALUATION OF TARGET

Valuation based on assets

The valuation method is based on the simple assumption that adding the value of all the assets of the company and sub-contracting the liabilities leaving a net asset valuation, can best determine the value of a business. Although the balance sheet of a company usually gives an accurate indication of the short-term assets and liabilities, this is not the case of long term ones as they may be hidden by techniques such as "off balance sheet financing". Moreover, valuation being a forward looking exercise may not bear much relationship with the historical records of assets and liabilities in the published balance sheet.

Valuations of listed companies have to be done on a different footing as compared to an unlisted company. In case of listed companies, the real value of the assets may or may not be reflected by the market price of the shares. However, in case of unlisted companies, only the information relating to the profitability of the company as reflected in the accounts is available and there is no indication of market price.

Valuation based on earnings

The normal purpose of the contemplated purchase is to provide for the buyer the annuity for his investment outlay. The buyer would certainly expect yearly income, returns stable or fluctuating but nevertheless some return which commensurate with the price paid therefore. Valuation based on earnings, based on the rate of return on the capital employed, is a more modern method being adopted.

An alternate to this method is the use of the price earning (P/E) ratio instead of the rate of return. The P/E ratio of a listed company can be calculated by dividing the current price of the share by the earning per share (EPS). Therefore the reciprocal of the P/E ratio is called earnings-price ratio or earning yield.

Thus P/E = P/ EPS, where P is the current price of the shares. The share price can therefore be determined as P=EPS × P/E ratio.

Similarly, several other valuation methodologies (including valuation based on sales, profit after tax, earning before interest, tax, depreciation and amortization etc.) are commonly used.

3.3.4 TAXATION ASPECTS OF M&A

Carry forward and set off of accumulated loss and unabsorbed depreciation

Under the Income-tax Act 1961, a special provision is made which governs the provisions relating to carry forward and set off of accumulated business loss and unabsorbed depreciation allowance in certain cases of amalgamations and demergers.

It is to be noted that as unabsorbed losses of the amalgamating company are deemed to be the losses for the previous year in which the amalgamation was effected, the amalgamated company (subject to fulfillment of certain conditions) will have the right to carry forward the loss for a period of eight assessment years immediately succeeding the assessment year relevant to the previous year in which the amalgamation was effected.

If any of the conditions for allowability of right to carry forward of loss, is violated in any year, the set off of loss or allowance of depreciation made in any previous year in the hands of the amalgamated company shall be deemed to be the income of the amalgamated company chargeable to tax for the year in which the conditions are violated.

Capital gains

Capital gains tax is leviable if there arises capital gain due to transfer of capital assets. The term "transfer" is defined in the Income-tax Act in an inclusive manner.

Under the Income-tax Act, "transfer" does not include any transfer in a scheme of amalgamation of a capital asset by the amalgamating company to the amalgamated company, if the later is an Indian company.

From assessment year 1993-94, any transfer of shares of an Indian company held by a foreign company to another foreign company in a scheme of amalgamation between the two foreign companies will not be regarded as "transfer" for the purpose of levying capital gains tax, subject to fulfilment of certain conditions.

Further, the term transfer also does not include any transfer by a shareholder in a scheme of amalgamation of a capital asset being a share or the shares held by him in the amalgamating company if the transfer is made in consideration of the allotment to him of any share or the shares in the amalgamated company and the amalgamated company is an Indian company.

Similar exemptions have been provided to a 'demerger' under the Income-tax Act, 1961.

Expenditure of amalgamation or demerger

The Income-tax Act, 1961 provides that where an assessee being an Indian company incurs any expenditure on or after the 1st day of April, 1999, wholly and exclusively for the purposes of amalgamation or demerger of an undertaking, the assessee shall be allowed a deduction u/s of an amount equal to of one-fifth of such expenditure for each of the successive previous years beginning with the previous year in which the amalgamation or demerger takes place.

Deductibility of certain expenditure incurred by amalgamating or demerged companies

The Income-tax Act, 1961 provides for continuance of deduction of certain expenditure incurred by the amalgamating company or demerged company as the case may be in the hands of the amalgamated company or resulting company, post amalgamation or demerger viz. capital expenditure on scientific research (only in case of amalgamation), expenditure on acquisition of patents or copyrights, expenditure on know how, expenditure for obtaining license to operate telecommunication services.

Tax characterisation of sale of business/slump sale

For a sale of business to be considered as a 'slump sale' the following conditions need to fulfilled:

- There is a sale of an undertaking;
- The sale is for a lump sum consideration; and
- No separate values being assigned to individual assets and liabilities.

If separate values are assigned to assets, the sale will be regarded as an 'itemised sale'.

Indian tax laws have specifically clarified that the determination of the value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities

In a slump sale, the profits arising from a sale of an undertaking would be treated as a capital gain arising from a single transaction. Where the undertaking being transferred was held for at least 36 months prior to the date of the slump sale, the income from such a sale would qualify as long-term capital gains at rate of 20% (plus surcharge and cess). If the undertaking has been held for less than 36 months prior to the date of slump sale, then the income would be taxable as short-term capital gains at the rate of 30% (plus surcharge and cess).

Whereas an itemized sale of individual assets takes place, profit arising from the sale of each asset is taxed separately. Accordingly, income from the sale of assets in the form of "stock-in-trade" will be taxed as business income, and the sale of capital assets is taxable as capital gains.

Significantly, the tax rates on such capital gains would depend on the period that each asset (and not the business as a whole) has been held by the seller entity prior to such sale.

Proposed tax treatment under Direct Tax Code (' the Code')

It is to be noted that recently, the Finance Minister has released the new Direct Tax Code which seeks to bring about a structural change in the tax system currently governed by the Income-tax Act, 1961.

Summarized below are the key proposed provisions that are likely to have an impact on the mergers and acquisitions in India:

- Currently, the definition of 'amalgamation' covers only amalgamation between companies. It is now proposed to include, subject to fulfillment of certain conditions, even amalgamation amongst co-operative societies and amalgamation of sole proprietary concern and unincorporated bodies (firm, association of persons and body of individuals) into a company in this definition.
- For amalgamation of companies to be tax neutral, in addition to existing conditions the Code proposes that amalgamation should be in accordance with the provisions of the Companies Act, 1956.
- In case of demerger, resulting company can issue only equity shares (as against both equity and preference shares as per existing provisions) as consideration to

the shareholders of demerged company, for the demerger to qualify as tax neutral demerger.

- Irrespective of sectors (ie manufacturing or service), the benefit of carry forward and set off of losses of predecessor in the hands of successor Company is proposed to be available to all the companies. As per existing provisions in view of definition of "industrial undertaking" certain companies were not able to utilize the benefit of losses as a result of amalgamation. Further, the Code provides for indefinite carry forward of business losses as against restrictive limit of 8 years under existing provisions.
- Profit from the slump sale of any undertaking is proposed to be taxed as a business income as against capital gains income.
- Code seeks to eliminate the distinction between long term and short term capital asset.
- Introduction of General Anti Avoidance Rule ('GAAR') which empowers the Commissioner of Income-tax ('CIT') to declare an arrangement as impermissible if the same has been entered into with the objective of obtaining tax benefit and which lacks commercial substance.

3.3.5 Stamp duty aspects of M&A

Stamp duty is payable on the value of immovable property transferred by the demerged/ amalgamating/ transferor company or value of shares issued/consideration paid by the resulting/ amalgamated/ transferee company. In certain States there are specific provisions for levy of stamp duty on amalgamation/ demerger order viz. Maharashtra, Gujarat, Rajasthan etc. However in other States these provisions are still to be introduced.

Thus in respect of States where there is no specific provision, there exists an ambiguity as to whether the stamp duty is payable as per the conveyance entry or the market value of immovable property. The High Court order is regarded as a conveyance deed for mutation of ownership of the transferred property. Stamp duty is payable in the States where the registered office of the transferor and transferred companies is situated. In addition to the same, stamp duty may also be payable in the States in which the immovable properties of the transferred business are situated. Normally, set off for stamp duty paid in a particular State is available against stamp duty payable in the other State. However, the same depends upon the stamp laws under the various States. In addition to the stamp duty on transfer of business, additional stamp duty on issue of shares is also payable based on the rates prevailing in the State in which shares are issued.

3.3.6 COMPETITION ACT, 2002

Competition Act, 2002 has been enacted to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other markets participants in India.

Competition Act, 2002 regulates the specified combination of acquisition or merger or amalgamation based on the turnover or gross turnover. The amended provision is applicable to entities

a. in India, if the acquiring and the acquired entities jointly have assets more than Rs 1,000 crore or turnover more than Rs. 3,000 crore or the group has assets more than Rs. 4,000 crore or the turnover more than Rs. 12,000 crore, or
b. in India or outside India if the acquiring and the acquired entities jointly have assets more than $500 million assets (including > Rs. 500 crore in India) or turn over more than $ 1500 million turnover (including >1,500 crore in India) or the group has assets more than $ 2000 million (including > Rs. 500 crore in India) or turnover more than $ 6000 million (including > Rs. 1,500 crore in India).

The above-mentioned entities is required to give notice to Competition Commission of India (CCI), within 30 days of the approval of the proposal relating to the merger by board of directors of the companies or execution of any agreement/document for acquisition and no combination shall come in effect unless 210 days have passed from serving such notice to the CCI or grant of approval by CCI, whichever is earlier.

3.3.7 LIMITED LIABILITY PARTNERSHIPS

With a view to provide an alternative to the traditional partnership, with an unlimited liability and a statute based governance structure of limited liability company, a new corporate form namely a Limited Liability Partnership (LLP) has been established under LLP Act, 2008. ("LLP Act")

It is felt that the new business form will not only enable professional expertise and entrepreneurial initiative to combine, organize and operate in flexible, innovative and efficient manner but will also provide a further impetus to India's economic growth.

LLP allows its members the flexibility of organizing their internal structure as a partnership based on a mutually arrived agreement with a limited liability of its members. Accordingly enterprises are now free to form commercially efficient vehicles suited to their requirements.

An LLP can either be incorporated as such or a partnership firm, private company or an unlisted public company can be converted into a LLP. Further the LLP Act provides for compromise, arrangement or reconstruction of LLPs amongst LLPs.

On the taxation front, the income tax Act considers LLP at par with a partnership firm.

Also currently there is no clarity on the stamp duty implications or the position of FDI in case of LLP.

The recently released Code also treats a LLP as firm for taxation purposes. Further, the Code proposes to allow amalgamation of LLP with company subject to satisfaction of certain conditions.

3.3.8 HUMAN ASPECTS OF M&A

The period of merger is a period of great uncertainty for the employees at all levels of the merging organizations. The uncertainty relates to job security and status within the company leading to fear and hence low morale among the employees and quite naturally so. The influx of new employees into an organization also creates a sense of invasion at times and ultimately leads to resentment. Moreover, the general chaos which follows any merger results in disorientation due to ill defined roles and responsibilities. This leads to frustrations resulting into poor performance and low productivity since strategic and financial advantage is generally a motive for any merger.

The top executives involved in implementation of merger often overlook the human aspect of mergers by neglecting the culture shocks facing the merger. Understanding different cultures and where and how to integrate them properly is vital to the success of an acquisition or a merger.

Important factors to be taken note of would include the mechanism of corporate control particularly encompassing delegation of power and power of control, responsibility towards management information system, interdivisional and intra-divisional harmony and achieving optimum results through changes and motivation.

The key to a successful M&A transaction is an effective integration that is capable of achieving the benefits intended. It is at the integration stage immediately following the closing of the transaction that many well-conceived transactions fail. Although often overlooked in the rush of events that typically precede the closing of the transaction, it is at the integration stage with careful planning and execution that plays an important role which, in the end, is essential to a successful transaction.

Integration issues, to the extent possible, should be identified during the due diligence phase, which should comprise both financial and HR exercises, to help to mitigate transaction risk and increase likelihood of integration success.

In conclusion, to achieve a flawless M&A transaction lies in being able to start right, well before the combination, plan with precision, and ensure a relentless clarity of purpose and concerted action in the actual integration and post-integration stage.

CHAPTER 4 – INDIAN ACQUISITIONS ABROAD

4.1 Introduction

A look at the India's corporate development will show that Indian companies are still in relation to the size of major international companies. Thus, with the opening of trade and foreign direct investment, Indian companies need to go through a period of consolidation in order to be globally competitive and to survive amongst competition.[18] However there has been an unprecedented increase in the amount of mergers and acquisitions involving Indian companies. In 2007, in the first quarter, the total value of M&A in involving Indian Companies was about $37 billion, compared to $20.3 billion during the whole 2006, that's nearly doubling of value in one fourth the time.[19] Outbound deals, where Indian companies are venturing out for foreign buyouts, are much larger in number and value that inbound deals (where foreign companies are buying into domestic entities). This jump is mainly because of two deals: Tata group's acquisition of European steel major Corus (valued at $13 billion) and Hindalco's buyout of Novelis (valued at $6 billion). Among the inbound deals, the most significant was Vodafone's acquisition of Hutch's 67% stake in Hutch Essar for $12.6 billion and Mittal Investments $711 million buyouts of 49% stake in Guru Gobind Singh Refineries.[20]

"Indian companies are spreading their wings beyond borders and acquiring foreign assets to serve global markets. The total value of M&A deals in India grew at a compounded annual growth rate of around 28% between 2002 to 2006"[21]. Most of this growth has come between

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[18] Economis Times, dated 23/12/2007

[19] Economic Times, dated 14/04/2007

[20] ibid

[21] Says Dr. Sarita Nagpal, Head Manufacturing Services Division, Confederation of Indian Industry, 'cited in Economis Times, dated, 06/04/2007

2004 to 2006, with the value of M&A deals increasing from US $7.5 billion in 2004 to US $21.4 billion in 2006.[22]

There was a report by Grant Thornton who revealed that the number of cross-border deals from India in 2006 grew much faster than domestic deals. In 2006 the M&A deals in India stood at 480 with a total value of about $20.3bn. Of these, more than half (266), were cross-border deals (value $15.3bn). Of the 480 M&A deals, only 40 had a deal value of over US $100mn. According to the report, the domestic, inbound and outbound deals increased in the range from 36%-42%. The share of domestic, inbound and outbound deals were more or less stable, with domestic deals having a share of 44%, inbound deals 16% and outbound deals 40%.[23]

4.2.1 <u>Table 1.1 Largest M&A deals worldwide since 2000</u>[24]:

Rank	Year	Acquirer	Target	Transaction Value (in Mil. USD)	%
1	2000	*Merger* : America Online Inc. (AOL)	Time Warner	164,747	21.83
2	2000	Glaxo Wellcome Plc.	SmithKline Beecham Plc.	75,961	10.06
3	2004	Royal Dutch Petroleum Co.	Shell Transport & Trading Co	74,559	9.87
4	2006	AT&T Inc.	BellSouth Corporation	72,671	9.62
5	2001	Comcast Corporation	AT&T Broadband & Internet Svcs	72,041	9.54
6	2004	Sanofi-Synthelabo SA	Aventis SA	60,243	7.98
7	2000	*Spin-off* : Nortel Networks Corporation		59,974	7.95
8	2002	Pfizer Inc.	Pharmacia Corporation	59,515	7.89
9	2004	*Merger* : JP Morgan Chase & Co.	Bank One Corporation	58,761	7.79

[22] Economic Times, dated 06/04/2007
[23] M&A in India Growing Rapidly
[24] Source: Institute of Mergers, Acquisitions and Alliances Research, Thomson Financial

10	2006	*Pending*: E.on AG	Endesa SA	56,266	7.45
		Total		754,738	100

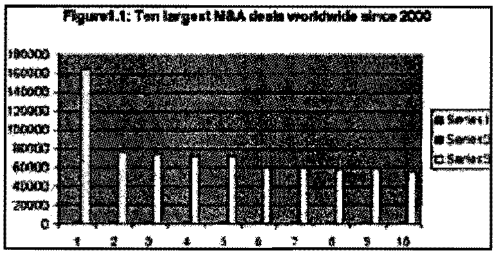


Table: 1.1 and fig.1.1 above shows the ten largest M&A deals worldwide since 2000. Table and figure reflects that the largest M & A deal from 2000 till 2006 was between American Online Inc and. Time Warner of worth $ 164,747 million during 2000, which account 21.83% of total transaction value of top ten worldwide merger and acquisition deals. While second largest deal was between Glaxo Wellcome Plc. & SmithKline Beecham Plc. Of US $ 75,961 million which was also occurred during 2000, which was 10.06 % of total transaction value of top ten worldwide M & a deals & third largest deal was between Royal Dutch Petroleum Co. Shell Transport & Trading Co of worth US $ 74,559 million, it is 9.87 % of total transaction value of top ten worldwide M & a deals.

4.2.2 <u>Cross-border Merger and acquisition: India</u>

Until upto a early 2000, the news that Indian companies having acquired American-European entities was very rare. However, this scenario took sudden U turn from 2006 onwards. Nowadays, news of Indian Companies acquiring foreign businesses is more common than other way round.

Buoyant Indian Economy, extra cash with Indian Corporates, Government policies and newly found dynamism in Indian businessmen have all contributed to this new acquisition trend. Indian companies are now aggressively looking at North American and European markets to spread their wings and become the global players.

The Indian IT and ITES companies already have a strong presence in foreign markets, however, other sectors are also now growing rapidly. The increasing engagement of the Indian companies in the world markets, and particularly in the US, is not only an indication of the maturity reached by Indian Industry but also the extent of their participation in the overall globalization process.[25]

4.2.3 Table1.2: The top 10 acquisitions made by Indian companies worldwide[26]:

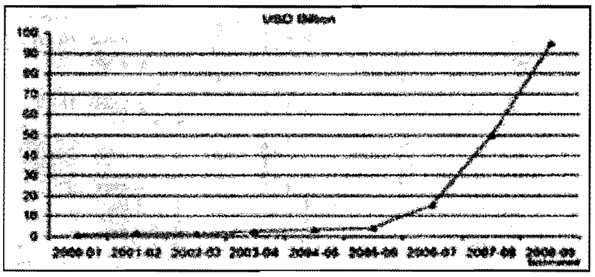
Acquirer	Target Company	Country targeted	Deal value ($ ml)	Industry
Tata Steel	Corus Group plc	UK	12,000	Steel
Hindalco	Novelis	Canada	5,982	Steel
Videocon	Daewoo Electronics Corp.	Korea	729	Electronics
Dr. Reddy's Labs	Betapharm	Germany	597	Pharmaceutical
Suzlon Energy	Hansen Group	Belgium	565	Energy
HPCL	Kenya Petroleum Refinery Ltd.	Kenya	500	Oil and Gas
Ranbaxy Labs	Terapia SA	Romania	324	Pharmaceutical
Tata Steel	Natsteel	Singapore	293	Steel
Videocon	Thomson SA	France	290	Electronics
VSNL	Teleglobe	Canada	239	Telecom

[25] See http://trak.in/tags/business/2007/08/16/indian-mergers-acquisitions-changing-indian-business/ last visited 5-5-2010.
[26] See http://apac.globalthoughtz.com/index.php/top-10-valuable-global-acquisitions-by-indian-companies/ last visited 5-5-2010.

If you calculate top 10 deals itself account for nearly US $ 21,500 million. This is more than double the amount involved in US companies' acquisition of Indian counterparts.[27]

4.2.4 Graphical representation of Indian outbound deals since 2000.

Figure 1.2



Source: http://ibef.org

Indian outbound deals, which were valued at **US$ 0.7 billion in 2000-01**, increased to **US$ 4.3 billion in 2005**, and further crossed US$ 15 billion-mark in 2006. In fact, 2006 will be remembered in India's corporate history as a year when Indian companies covered a lot of new ground. They went shopping across the globe and acquired a number of strategically significant companies. This comprised 60 per cent of the total mergers and acquisitions (M&A) activity in India in 2006. And **almost 99 per cent of acquisitions were made with cash payments.**

4.2.5 Table 1.3: Cross-border Merger and acquisition: India[28]

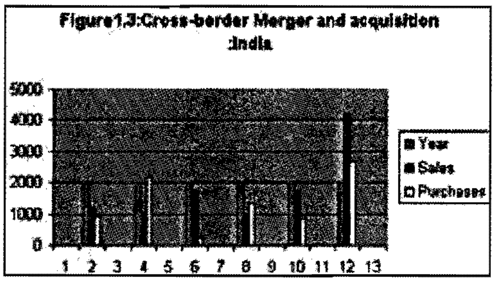
(US $ Million)

Year	Sales	Purchases
2000	1219	910
2001	1037	2195
2002	1698	270
2003	949	1362
2004	1760	863

[27] See http://trak.in/tags/business/2007/12/24/indian-company-tata-buys-jaguar-land-rover/ last visited 5-5-2010.

[28] Source: UNCTAD world investment report 2006

2005	4210	2649
Total	10873	8249



4.2.6 Table 1.4: Foreign acquisition by Indian firms 2000-2006

Foreign Acquisitions by Indian Firms: 2000 – 2006

A. SECTORAL COMPOSITION

Sector	Number	Percentage
IT/Software/BPO	90	29.4
Pharmaceuticals & healthcare	62	20.3
Automotive	27	8.8
Chemicals & fertilizers	19	6.2
Consumer goods	17	5.5
Metals & mining	15	4.9
Oil & gas	14	4.6
Others	62	20.3
TOTAL	306	100.0

Table 1.4: Reflects the foreign acquisition by Indian firms during last 6 years. Table clearly depicts that % of foreign acquisition by Indian firms was highest in IT/Software and BPO sector, i.e., 29.4% while foreign acquisition by Indian firms in pharmaceuticals & healthcare sector was 20.3% during last 6 years which was second highest. Number of foreign acquisition is also highest in IT/Software and BPO sector i.e., 90 firms while pharmaceuticals & healthcare sector and other sectors are in second number with 62 foreign acquisition. While in the automotive, chemical & fertilizers, Consumer goods, metals and mining and oil and gas sectors, the number of firms acquired by Indian firms were 27 firms, 19 firms, 17 firms, 15 firms and 14 firms respectively.

CHAPTER 5 – TAX LAW ISSUES PERTAINING TO CROSS-BORDER MERGERS AND ACQUISITIONS

A merger to take effect depends on several aspects which have been in depth discussed in chapter 3 above. However the main objective and focus of this paper being the "Taxation Aspect" of Cross-border mergers, this chapter extensively deals with the various tax law issues involved in Cross-border Mergers and Acquisitions.

5.1 Introduction

Practically there are only a few transactions states that do not tax. Many countries do not have laws sophisticated enough to deal with contemporary Cross-Border M&A.[29] The usual tax implications of a Cross-border merger are (1) capital gains tax to the shareholder of the target company, to the target company or to the transferee company and (2) loss of jurisdiction to tax the global income of the transferor company.

As most of the countries treat their residents and non-residents differently for tax purposes[30] 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,[31] loss of taxing jurisdiction over the global income of the transferor company[32] etc.

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[29] Brauner Yariv; Taxing Cross-border Mergers and Acquisitions; 6 Fla. Tax Rev. 1027

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

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

[32] Usually every country enjoys power to tax worldwide income a company resident in the country; See; Section 5(1) of the Income Tax Act. As per the section the income accrued or arose on a resident is taxable in India.

There is a wide range of disparity in the taxing principles itself among different nations. 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 broader 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,[33] United States, and several of the OECD are example for the countries that tax the income of the resident abroad.

When a company in one country merges with another company abroad, merging company would become the resident of that country as a result of which the resident country of the transferor company loses jurisdiction over Transferor Company's foreign income (income abroad). Many multinational corporations involve in 'corporate inversions' for avoiding the tax jurisdiction of the home country.[34] These corporate inversions are effected by altering the corporate structure of company through cross-border merger wherein the resultant company would be a resident of low corporate income tax jurisdiction.[35]

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 rates is prohibitively costly if the country whose taxing jurisdiction the company is situated follows the real seat

[33] Section 5(1) of the Income Tax Act 1961.
[34] *Id*
[35] *Id*

principle.[36] 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 company may be treated as resident of more than one country. Nonetheless, it is argued that, many jurisdictions claiming taxing jurisdictions over a company creates 'no conceptual or practical barrier'.[37] But the 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.[38] 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.[39] This is apparent from the fact that many countries, including India, do not tax (for capital gains) a domestic merger or an international merger when the amalgamated company is an Indian company; while such 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. This tax aspect acts as a major factor in deciding to import

[36] Kane Mitchell A. *et al*; Corporate Taxation and International Charter Competition; 106 Mich. L. Rev. 1229
[37] *Id*
[38] In India section 6(3) of the Income Tax Act allows a company to be treated as a resident if the control and management of the Company was wholly in India in the financial year concerned.
[39] 6 Fla. Tax Rev. 1027

or export capital. It is argued that ideally, the investment decision should not be influenced by such tax considerations; but shall be based on economic merit of the investment.[40]

5.2 Capital Gains Tax and Cross-border Mergers

Several countries extend certain tax concessions to the participants in the Mergers for it is thought that otherwise certain efficient and beneficial transactions[41] may not happen. Further the 'transfer' of the capital involved in merger does not justify capital gains tax.[42] Although the merger process involves transfer in the capital, it does not result in realization of the capital but the shareholders of the transferor or the transferee company hold the capital on the substituted basis. The capital gains tax would be imposed when the shareholder or 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 the transferor companies escaping the taxing jurisdiction the above benefit is not extended to Cross-border mergers in many countries, including India. Assuming that mergers are generally beneficial to society and involve synergy, the desirability of not extending the benefit of capital gains tax exemption to Cross-border merger is to be examined.

5.3 Exit Tax and Real Seat approach – Antidote to Corporate Tax Avoidance

Many corporate inversions take place in the US, with the motive to reduce tax burden by escaping the tax jurisdiction of the US. This process typically involves incorporating

[40] 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.
[41] Mergers are considered beneficial since they are believed to create synergy and increase efficiency.
[42] 6 Fla. Tax Rev. 1027

a company in an offshore tax haven and then merging the US Company with such offshore company as the resultant company. It is felt that atleast in short term the tax competition (the term refers to attempt of countries to attract capital by not taxing or imposing very nominal rate of tax) may lead to suboptimal level of capital distribution in the world.[43] 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 advantage 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.

5.4 Exit Tax and its effect on Cross-border mergers

One 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

[43] 106 Mich. L. Rev. 1229; the article describes the way in which corporate taxation distorts the selection of corporate laws by the companies across the globe. The article argues that the corporate charter competition is getting distorted due to tax like exit tax and other tax policies of different nations. Corporations migrate because of tax consideration to countries of inferior corporate law resulting in distortion of corporate charter competition. The article suggests that when the corporate migration is purely for the reason of corporate law then such transactions shall not be taxed by way of entry or otherwise. However when the reason behind the corporate migration to another country is purely tax avoidance such taxes may be imposed.

refer to tax that was deferred till the actual realization of the gain.[44] The shares or the assets of the company would have undergone some capital appreciation in the country which would not be 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.

5.5. Real Seat Approach and Place of Incorporation Approach *vis-à-vis* Tax driven Cross-border Mergers

Another way to disincentivise the corporate migration, through Cross-border merger, for tax purpose would be making the real seat[45] 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) place of incorporation method and (2) real seat rule.

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

[44] *Id* (106 Mich. L. Rev. 1229)

[45] Real Seat refers to the place of actual control of the company rather than a place of incorporation of the company. Different criteria would be taken into consideration for the determination of it like place where the board of directors meet, place of principle business, place of meeting of shareholders etc.

like limited liability,[46] separate legal personality etc. On the other hand corporate migration through Cross-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 with a foreign company would be able to change the tax law that govern it, even if its real seat does not change.

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[47] 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 it the tax haven follows Place of Incorporation for tax purpose then the corporation would have to incorporate there (or the merged company should be incorporated there) despite the inferior corporate law they might have. Universal application of real seat principle is advisable for tax purpose.[48]

United States applies the place of incorporation rule for tax purposes and also taxes the global income of the firm. The combined effect of these factors gives the companies a chance and reason to migrate to a new corporate location through the Cross-border

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

[47] 106 Mich. L. Rev. 1229; US follows the Place of Incorporation rule in tax matter and also imposes tax on the global income of the company, which is considered as the reason for the company to migrate from the US to other jurisdictions through merging with the companies in tax havens.

[48] 106 Mich. L. Rev. 1229; the advantage of using real seat principle is that because of tax reasons the company would not be constrained to incorporate in a low tax location.

merger route. Since the rule for determining the corporate and the tax location, is the same in the US relocation for the purposes 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 in some countries in the European Union follow the real seat rule to determine both the corporate and tax locations. Some countries follow Place of Incorporation rule for the purpose of corporate location and real seat for tax purpose.[49] However the 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[50] is different when tax questions are involved. In the case the company tried to relocate its real seat (control and management) from UK to Netherlands. The UK law prohibited a company which is resident in the UK for tax purpose (whose management and control were in UK) 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 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

[49] 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.
[50] The Queen v. H.M. Treasury & Comm'rs of Inland Revenue, ex parte Daily Mail & Gen. Trust plc; Case 81/87.

revenue may not be interfered with by the ECJ. The countries in EC could be free to adopt real seat principle for tax purposes as most of them do now.

5.6 Tax Driven Cross-border mergers

The tax related reason for the corporate migration is the lower tax burden the company may have after the merging into the foreign company. This in most of the cases is due to the low corporate income taxes applicable in the country of merged company. It is a common feature among the US corporations to migrate to some tax haven, often Bermuda, in order to avoid the US tax on their global income. This is possible because these tax havens follow place of incorporation rule for the tax purpose. It is argued these tax aspect bring in a lot of distortions in corporate choice of location[51] and revenue loss to nations. However it would be difficult to bring uniformity in tax rates since the countries would be reluctant to cede their sovereign right to determine the tax rates.[52] This triggers a 'race to the bottom' in the tax laws. This would become a matter of greater concern if such low tax places do not have proper corporate governance standard also.

5.7 Section 368 of the Internal Revenue Code and Cross-border mergers

Seven types of tax free acquisitive reorganizations are set forth in section 368 of the Internal Revenue Code of the US. These tax free acquisitive reorganizations includes (1) the reorganization under section 368(a)(1)(A) which is a merger of target directly

[51] 106 Mich. L. Rev. 1229.
[52] So is the case of exit tax. It would be a Herculean task to convince the countries not to impose it.

into an acquirer with the target's shareholders receiving stock in the acquirer (2) The section 368(a)(2)(D) reorganization which is a merger of a target into a subsidiary (Acquiring Subsidiary) of the acquiring corporation (Acquiring Parent) (3) in reorganization under section 368(a)(1)(C) an acquiring corporation acquirers substantially all of a target's assets in exchange solely for voting stock of the acquirer etc.[53]

If a foreign corporation is involved in the transaction then the effect of Section 367 should also be considered to determine the tax exemption. Under section 367 certain gains which are not organised for the capital gains tax purposes can be reorganized. Such gains can be with relation to the exchange of securities[54] or transfer of assets of the target to the acquiring firm,[55] in relation to reorganization under section 368 of the Internal Revenue Code.[56] The purpose of enacting the section was to deter certain schemes designed to avoid US taxation.

US taxes a foreign corporation if the income is 'effectively connected' with the conduct of a trade or business within the United States.[57] Further absent section 367, a reorganization which involves the transfer of assets of the target, would not attract any

[53] Thomson 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. 1193

[54] Section 354 of the Internal revenue Code

[55] Section 361 of the Internal revenue Code

[56] Thomson 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. 1193

[57] This is as opposed to the tax on the global income for domestic corporations.

tax for the target or the shareholders of the target. This can be used as a mechanism to transfer assets of the US Company to a foreign entity and reduce the tax exposure in the US. Section 367 (a) (1)[58] denies corporate status to foreign transferee corporation[59] of the reorganizations. The effect of denial status of corporation is that it would not be eligible for tax-free consideration under section 361 and section 354 of the Internal Revenue Code. However the treasury has power to promulgate regulation to make this sweeping denial of corporate status inapplicable to certain transfers of property to foreign corporations.[60] There are exceptions as well to the rule; the rule does not apply to (1) "the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization.[61] (2) certain transfers of property to a foreign corporation to be used in the active conduct by the corporation in a trade or business outside the US.[62]

By regulation there are certain exceptions provided for this recognition rule.[63] These conditions under the rule are very complex and are calculated to prevent tax avoidance by investing through a foreign country. For example in reorganization involving the transfer by a US person of the stock of US Target to Foreign Acquirer non-recognition

[58] Section 367(a)(1): If, in connection with any exchange described in section 354 [relating to tax-free treatment for a shareholder of a target that exchanges target stock for stock of an acquiror pursuant to the reorganization as defined in section 368] or 361 [relating to tax-free treatment for a target that exchanges its assets for stock of an acquiror pursuant to reorganization as defined in section 368], a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognised on such transfer, be considered to be a corporation.
[59] This provision would not apply when the transferee corporation is in US Corporation, in which case Section 367(b) would apply.
[60] Section 367(a)(1) of the Internal Revenue Code.
[61] Section 367(a)(2) of the Internal Revenue Code.
[62] Section 367(a)(3) of the Internal Revenue Code.
[63] Rule which recognise the gain for the purpose of capital gain tax.

treatment would be available if :- (1) the shareholders of US Target end up owning, in the aggregate, less than 50% of the stock of Foreign Acquirer; (2) none of the shareholders of US Target end up being 5% or more shareholders of Foreign Acquirer; (3) the active trade or business test is satisfied; and (4) US Target complies with the reporting requirements to ensure that the above four conditions are satisfied.[64] If these conditions are not met then the transaction would attract capital gains tax.

Section 367 applies (1) the acquisition US Target by a Foreign Acquirer; (2) the acquisition of a Foreign Target by a US Acquirer; and (3) the acquisition of Foreign Target by a Foreign Acquirer. The section would however apply only if both the target and the acquirer are publicly held companies.[65] If the transferor company (target) is a foreign company the corporate status is denied only to the extents "which are necessary or appropriate to prevent the avoidance of federal income taxes".[66] Thus, it is clear that the approach is much relaxed when the transferee company is US Company.

5.8 The European Union's Council Directive on Common System of Taxation on Cross-border Mergers and Acquisitions

The commission of European Community issued a directive on for a common system of taxation

"applicable to mergers, divisions, transfer of assets and exchanges of shares concerning

[64] There are complex conditions to be met for other types of re-organisation as well to be eligible for non-recognition rule.

[65] 66 U. Cin. L. Rev. 1193

[66] Section 367(b)(1) of the Internal Revenue Code.

companies of different Member States.[67] The council directives are applicable only in the case of merger between the companies of member states.[68] The directive in its preamble recognises the need to 'avoid the imposition of tax in connection with mergers, divisions, transfer of assets or exchanges of shares.[69]

A merger is defined as 'an operation whereby one or more companies, ...transfer all their assets and liabilities to another existing company in exchange for the issue to their shareholders of securities representing the capital of that other company, and, if applicable a cash payment not exceeding 10% of the nominal value.... of those securities'.[70] Art. 2 (d) defines exchange of shares as:-

'an operation whereby a company acquires a holding in the capital of another company such that it obtains a majority of the voting rights in that company in exchange for the issue to the shareholders of the later company, in exchange for their securities, of securities representing the capital of the former company, and, if

[67] Council Directive 90/434/EEC of 23 July 1990 on the Common System of Taxation Applicable to Mergers, Division, Transfer of Assets and Exchanges of Shares Concerning Companies of Different Member States.
[68] Art. 1; (Council Directive on Cross-border Mergers and Acquisitions)
[69] Preamble; (Council Directive on Cross-border Mergers and Acquisitions)
[70] Article 2(a) of Council Directive 90/434/EEC of 23 July 1990 the Common System of Taxation Applicable to Mergers, Division, Transfer of Assets and Exchanges of Shares Concerning Companies of Different Member States:-
'Merger' shall mean an operation whereby:

- one or more companies, on being dissolved without going into liquidation, transfers all their assets and liabilities to another existing company in exchange for the issue to their shareholders of securities representing the capital of that other company, and, if applicable, a cash payment not exceeding 10% of the nominal value, or, in absence of a nominal value, of the accounting par value of those securities,
- two or more companies, on being dissolved without going into liquidation, transfers all their assets and liabilities to a company that they form, in exchange for the issue to their shareholders of securities representing the capital of that new company, and, if applicable, a cash payment not exceeding 10% of the nominal value, or, in absence of a nominal value, of the accounting par value of those securities,
- a company, on being dissolved without going into liquidation, transfers all their assets and liabilities to the company holding all the securities representing its capital.

applicable, a cash payment not exceeding 10% of the nominal value.... of the securities issues in exchange'

This essentially means a scenario of the acquiring company issuing its share to the shareholders of the target company. Both merger and exchange of the shares shall not give rise to any taxation of income or capital gains.[71] Further a member country shall not impose capital gains tax with reference to 'the assets and liabilities' transferred.[72] Assets and liabilities under the article is a limited concept and embraces only assets of the target that remain within the target countries incorporation. Art. 11 of the directive empowers the member states to disallow the tax benefits if the principle object of merger or exchange of shares is tax avoidance or tax evasion.

5.9 Capital Gains Tax Treatment of Mergers under Income Tax Act

The Income tax Act does not define 'merger'. The term defined is amalgamation which is defined under section 2(1B).[73]

[71] Art. 8; (Council Directive on Cross-border Mergers and Acquisitions)
[72] Art. 4; (Council Directive on Cross-border Mergers and Acquisitions)
[73] Section 2(1B) of Income Tax Act:- (1B) "Amalgamation:, in relation to companies, means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such 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 amalgamation becomes the liabilities of the amalgamated company by virtue of the amalgamation;
(iii) shareholders holding not less than three fourth 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

Amalgamation under the Income Tax Act 1961

For the purpose of Income Tax Act a merger between companies to be considered as an amalgamation has to meet the following conditions:-

(i) All the property and

(ii) Liabilities

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

(iii) Shareholders holding not less than three fourth in value of the shares in the amalgamating company becomes shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a result of the acquisition of the property of one company pursuant to the purchase of such property by then other company or as a result of the distribution of such property to 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

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.

basis (in place of their shares in the amalgamating company). Nonetheless such stipulations are not there in the EC directive and US Internal Revenue Code provisions. Further no cash payment is contemplated in India inlike in US and EU. Further the concept of merger under EC directive and US is wider than that in India; that is to say that in these jurisdictions, tax exemption is available for a wider variety of merger transactions.

Clearly mergers that do not need meet the above conditions are not amalgamations 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.

5.10 Capital Gains Tax on Merger in India

Capital gains tax is a tax on profits and gains arising out of transfer of a capital asset.[74] Income includes Capital gains as well[75] and hence is taxable as any other income. The taxable event in case of capital gains is the transfer of capital assets absent which there

[74] Section 45 of the Income Tax Act:- "(1) 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 income of the previous year in which the transfer took place."
[75] Section 2(24) of the Income Tax Act.

is no question of capital gains tax.[76] The taxable event occurs on the date of the transfer of the capital assets.[77] Transfer in relation to capital assets, *inter alia*, includes:-

(i) the sale, exchange or relinquishment of the assets; or

(ii) the extinguishment of any rights therein.[78]

In a lease, the ownership of a property remains with the lessor and her transfers only the right to use the property. An order to give *mesne* profits to the lessor does involve transfer of capital assets to attract capital gains tax since the property was not transferred.[79] Insurance amount received for destruction of the property cannot be considered as capital gains.[80] The property destroyed cannot be considered as property transferred because 'extinguishment of rights' in capital assets presupposes continued existence of the capital assets.[81] Further in a transfer there shall be a continued existence of asset and of the transferee.[82] However 'extinguishment of rights' can be independent of and otherwise than on account of transfer.[83]

[76] *Achuthan Pillai and Co v. Commissioner of Income tax*; 238 ITR 458; a civil suit was instituted 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. Kerela High court answered the question in negative and held that it did not constitute transfer of capital assets.

[77] *Commissioner of Income tax v. Nirmla Textiles*;224 ITR 378; the controversy was whether a gain in question was short term capital gain or a long term capital gain. The Gujrat High court held that the taxable event is the date of transfer and the question of the long term and short term has to be calculated on the basis of such date.

[78] See section 2(47) of the Income Tax Act.

[79] *Supra*; See 238 ITR 458

[80] See *Vanika Silks Mills v. CIT*; 191 ITR 647; see also; *Neelamai Agro v. CIT*; 259 ITR 651.

[81] *Id*

[82] *Id*

[83] Commissioner of Income Tax v. Grace Collis; MANU/SC/1540/2001

This apart certain transactions, which other would qualify to be transfer as per the definition of the 'transfer' are excluded from the purview of the term transfer.[84] Many of these are transactions involved in corporate restructuring like mergers, demerger[85] etc. However these benefits are extended only if the amalgamated company/resultant company is an Indian company.

Transfer of capital assets by an amalgamating company to amalgamated company is not a transfer if:-

(1) the transfer is under a scheme of amalgamation;

(2) the amalgamated company is an Indian company.[86]

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 amalgamating company only if the amalgamated company is an Indian company when there is no occasion that the amalgamating company can be taxed.[87]

[84] Section 47 of the Income Tax Act.
[85] Section 47 of the Income Tax Act.
[86] Section 47: "Nothing contained in section 45 shall apply to the following transactions
(vi) any transfer, in a scheme of amalgamation, of a capital assets by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company.
[87] Vyas Dinesh; The Law and Practice of Income Tax:- Kanaga, Palkhivala and Vyas; Lexis Nexis Butterworths; ninth Edition 2004; page 1141.

Section 47(ii) exempts any transfer of shares of amalgamating company by shareholder in a scheme of amalgamation if:-

(i) such transfer is made in consideration of 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,[88] but by virtue of Section 47 (vii) it is not liable for capital gains tax.

Under 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.

It is to be noted that the benefit of Section 47(ii) and Under 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.

[88] Commissioner of Income Tax v. Grace Collis; MANU/SC/1540/2001

There is a criticism that the section assumes that these transactions are 'transfer' 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.[89] However in *Commissioner of Income Tax v. Grace Collis,*[90] Supreme Court has held that such transactions are 'transfer' as it involves 'extinguishment of right' of the shareholders. So 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.

Hence it is, further, 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 falls under the kind of countries which exempts mergers from capital gains taxes but when the amalgamated company is a foreign company such exemptions are not available.

But it is to be noted that if there is a 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 realization of the capital appreciation.

While there is considerable force in the above argument a blanket denial of the exemption from capital gains tax is not desirable option. In the first place there is no

[89] *Supra;* (Vyas Dinesh; The Law and Practice of Income Tax.
[90] MANU/SC/1540/2001

actual realization of the capital appreciation in the event of a merger whether domestic or cross-border. Secondly the reasons for not taxing the domestic merger are equally true for cross-border mergers as well.

Further as we have seen above in the US there is no blanket denial of capital gains tax exemption in the case of the transferee company being a foreign corporation. In the US there are complex rules applicable for the purpose of preventing tax evasion. Within the EU the directive mandates that there shall be no tax if the companies of member state merge. Both the EC directive and the US Internal Revenue Code contain provisions to prevent tax avoidance and evasion.

The capital gains tax in the cases 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 take place.

5.11 Residence of Company – Indian Approach

In India the scope of total income for resident and non-residents 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 accrue or arise in India, to a non-resident, are taxable in India.[91] 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 twofold 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.[92] 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 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.[93] The control and management is a question of fact. The control and management do not refer to day to day affairs of the company but it refers to the place of controlling and managing power

[91] Section 5 of the Income Tax Act.

[92] Section 6(3); Income Tax Act:- "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.

[93] In Re: Advance Ruling P. No. 13 of 1995; MANU/AR/0001/1995; the question was whether a French Company (ABC) 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 a resident of France however as the company is expected to establish offices in India those would be treated as permanent establishments in India.

of the company; or where the head and brain of the company is situated.[94] The Bombay High Court explaining the concept observed:-

It is that authority to which the servants, employees and agents are subject, 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. 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."

"A company may have a dozen local branches at different places outside India, it may send out agents fully armed with authority to deal 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."

The expression "control and management" means *de facto* control and management and not merely the right or power to control and manage. The company can be resident of India even if the substantial business of the company is abroad.[95] The court held that distinguishing between the scope the term 'affairs' in section 6(3) has a wider meaning that the term 'business' in Double Taxation Avoidance Treaty with Greece.[96] The word "affairs" within the meaning of section 6(3) of the IT Act, 1961, means affairs which

[94] Narottam and Pareira Ltd. Commissioner of Income tax, Bombay City; 11953] 23 ITR 454 (Bom); the case was decided under Income Tax Act 1922 and not under the current IT Act. The company in question had its meeting of the board of directors held in Bombay and also the meetings of the shareholders. However lion's share of its income was from Ceylon. The court explained the 'control and management under section 4 A of the Income Tax Act 1922. On the facts the court found that the management of the company was in Bombay.

[95] *Id*

[96] Universal Cargo Carriers Inc. and Anr v. Commissioner of Income-tax; [1994] 205 ITR 215 (Cal)

have some relation to income.[97] Assessee Company under liquidation is under control and management of the liquidator. So a foreign bank undergoing liquidation in India is a resident in India.[98] The place of management and control is not the same as controlling shareholding of the company. So the place of residence of a majority shareholder cannot be considered as a place of management and control for that reason.

The avowed purpose of the principle of real management is protection of revenue, however India cannot be considered as protectionist as UK where only substantial control and management of the company need to be in the UK to consider the company as a resident in UK.[99]

The control and management rule would be proved handy 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 a danger of the resultant company to be taxed in both the jurisdictions as resident; since more than one country may treat the place of management and control as situated in their country. This would be highly unfair a result not in the interest of the useful business combinations. India chances of these types of scenario may be less since here the company would be resident if the control and management of the company is situated *wholly* in India, which is less likely. Whereas in countries like the UK which may result in more than one country treating the company as resident of it taxing accordingly.

[97] CIT v. Bank of China; MANU/WB/0183/1985.

[98] *Id*

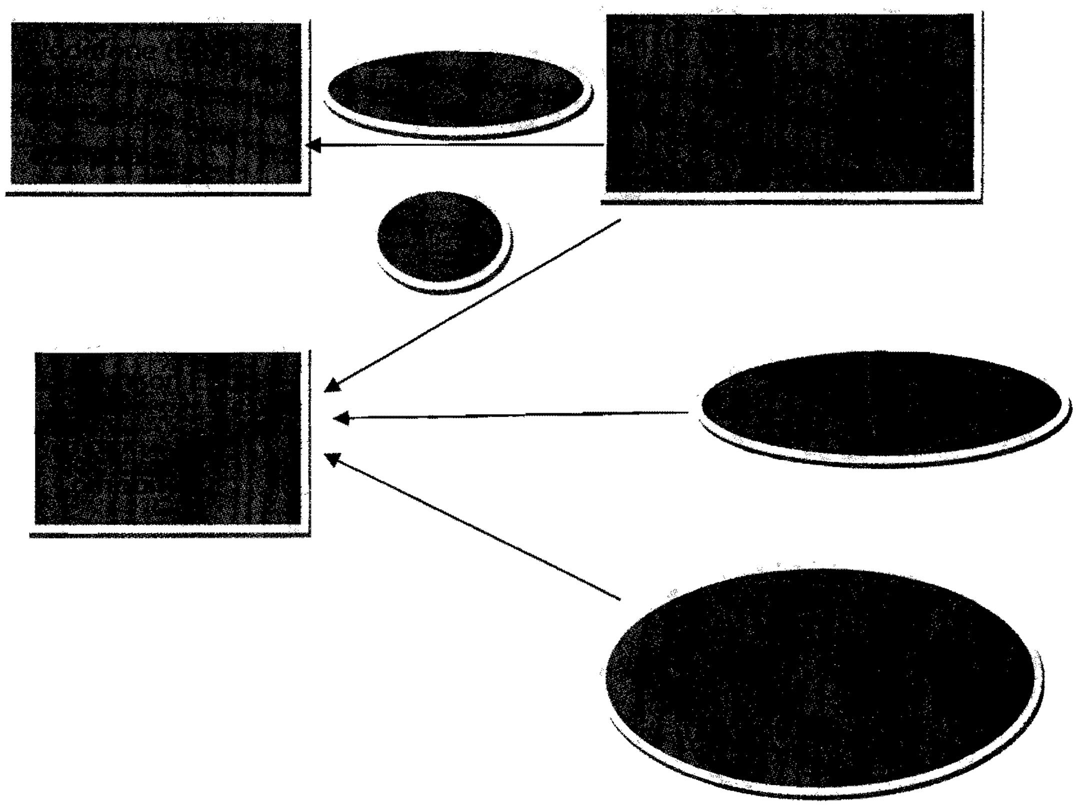
[99] News land Shipping v. Thew; 8 T.C. 208; page 355.

India follows both the incorporation principle and the control and management test. In this approach also there are chances that the same company would be treated as residents of more than one country; one as place of incorporation and others as place of management and control.

5.12 International Taxation –Recent significant pronouncements

Chargeability of Capital Gain Tax on the Transfer of a Capital Asset in India, Consequent to Transfer of Shares in the Company, as Income arising in India!

Vodafone International Holdings BV v. Union of India [(2008) 175 Taxmann 399 (Bom. HC)], December 3, 2008



Hutchison Essar Ltd. ("Hutch India"), a company incorporated in India, was a joint venture of the Hong Kong-based Hutchison Telecommunications International Ltd ("Hutch Hong Kong") and the India-based Essar Group. Hutch India was in the business of providing telecommunication service in India. Hutch Hong Kong held 67% of the shares of Hutch India through CGP Investments Holdings Ltd ("the Cayman Islands SPV"), an SPV registered in Cayman Islands, and some other shareholders.

The stake of Hutch Hong Kong in the Cayman Islands SPV was acquired by Vodafone, a UK-based mobile phone group, through a Netherlands based SPV, viz. Vodafone International Holdings BV ("Vodafone") for a total consideration of $10.7 billion. The Indian Foreign Investment Promotion Board approved the said transaction on the condition that Vodafone would comply with all Indian municipal laws. Pursuant to the consent of Essar Group, a new joint venture called the Vodafone Essar Ltd. (the new name of Hutch Essar Ltd.) came into existence.

As a result of this sale, capital gains, estimated at $ 2 billion, accrued to the Cayman Islands SPV. Considering from the point of view of jurisdictions, it is clear that the sale transaction took place between the Dutch SPV (owned by a UK group) and the Cayman Islands SPV (owned by a Hong Kong company). The ultimate effect however was the transfer of controlling shares of an Indian company.

The Indian Revenue, being of the view that the transaction would give rise to capital gains chargeable to tax in India and that Vodafone was, in terms of section 195 of the Income tax

Act, 1961 (the "Act"), under an obligation to withhold tax at source while making the aforesaid payment of sale consideration, issued a notice to Vodafone show cause why it should not be treated as an assessee-in-default for not withholding the Indian capital gains tax on the payment of the sale consideration.

Section 9 of the Act[100] treats any income derived, inter alia, from the transfer of a capital asset in India as income arising in India. The Revenue's case, briefly stated, was that the sale consideration received by Hutch Hong Kong was earned towards the transfer of its business/ economic interests as a group in India and that the subject-matter of the transaction was transfer of tangible and intangible interests of Hutch Hong Kong in the Indian company and not an innocuous acquisition of shares of the Cayman Islands SPV.

In a writ petition filed before the High Court of Bombay (the "Court"), Vodafone challenged the aforesaid show cause notice on the ground that the same was without jurisdiction. Vodafone argued that the aforesaid transaction was a transfer of share capital of a non-resident company (the Cayman Islands SPV) and was not a transfer of capital asset situated in India and that such transfer took place in Cayman Islands, being the registered office of the Cayman Islands SPV. Vodafone further argued that the controlling interest in a company was not an asset separate and distinct from the shares but was an incidence arising from the holding from a particular number of shares. Since by virtue of the acquisition of shares of the Cayman Islands SPV, Vodafone acquired the controlling interest only indirectly, there was no direct transfer of a capital asset situated in India so as to give rise to the alleged tax liability. It was Vodafone's

[100] Section 9 of the Income-tax Act 1961: Income deemed to accrue or arise in India.

case that the section 9 of the Act was not attracted on the facts of the case, and consequently, the show cause notice was without jurisdiction. Vodafone also contended that the procedural provisions of section 195 of the Act relating to withholding tax cannot be applied since section 195 does not have extra-territorial jurisdiction.

The Court dismissed the writ petition filed by Vodafone terming it as premature. The court, however, made certain pertinent observations pertaining to tax implications of transactions in India, which have far reaching implications. On the question whether the conditions under section 9(1)(i) were satisfied, the Court observed that income had been earned towards sale consideration of the business and economic interests of Hutch India in India since the subject matter of transfer was not the shares of the Cayman Islands SPV simpliciter, which the Court held was a shell company, but rather the interests, tangible and intangible, in the India. The Court particularly viewed the transfer of telecommunication license as robust.

The Court further observed that Hutch Hong Kong could not have transferred its controlling interest in Hutch India without extinguishing its rights in the shares of Hutch India. The transaction resulted in acquisition of the assets in the form of interest in the joint venture of Hutch India so as to fall within the ambit of term "transfer" as defined in section 2(47) of the Act, qua Hutch Hong Kong. The Court also observed that shares can either be assets in themselves or, in some cases, a mode of transferring some other assets. Since very purpose of the transaction was to enable Vodafone to successfully pierce into the Indian mobile market so as to enlarge its global presence, the transaction amounted to a transfer of capital asset and

Vodafone became a successor in interest in the JV as well as a co-licensee to operate mobile telephony in India.

The Court further stated that any profit or gain which arose from the transfer of a group company in India has to be regarded as profit or gain of the entity which actually control it. The Court noted that the income arising out of the sale accrued not to the Cayman Islands SPV but to Hutch Hong Kong and was treated as profit of Hutch Hong Kong and distributed to the shareholders of Hutch Hong Kong. In arriving at the conclusion that the jurisdiction of the Revenue could not be said to be wanting, the Court also cited (with approval) the American principle of the *"Effects Doctrine"* which recognizes the right of a State to impose liabilities upon persons not within its allegiance, for conduct outside its borders that has consequences within the borders of such State. Applying the Effects Doctrine, the Court held that since very purpose of the transaction was acquisition by Vodafone of the controlling interest held by Hutch Hong Kong in Hutch India, the transaction would certainly be subject to the municipal laws of India.

The show cause notice also required Vodafone to produce certain documents, including the original agreement between Vodafone and Hutch Hong Kong. On failure of Vodafone to produce the said agreement even before the High Court, the High Court held that adverse inference could be drawn against Vodafone notwithstanding that the onus of proving the document was not on Vodafone.

The Court held that a matter involving disputed questions of fact cannot be gone into in a writ petition. The Court further held that the questions of chargeability of tax and of the obligation to deduct tax at source, as revealed by the show-cause notice and the chronological list of dates, could be answered only after investigation into voluminous facts and perusal of numerous complicated agreements. On the issue of validity of the show cause notice, the Court held that the notice issued by the Revenue could not be said to be extraneous, irrelevant or erroneous on its face or not based on any material at all.

Subsequently, Vodafone filed a Special Leave Petition (SLP) before the Supreme Court, the ultimate arbiter in India, against the aforesaid decision of Bombay High Court.

The Supreme Court on January 23, 2009 has dismissed the SLP filed by Vodafone against the decision of the Bombay High Court. However, the Supreme Court has directed the revenue authorities to answer jurisdictional fact and preliminary issues on constitutionality of the provisions raised by Vodafone and has granted liberty to Vodafone to move directly to HC, in case the revenue authorities answers jurisdictional facts negatively.

Implications Of The Case

Offshore funds and multinational companies used to channelise their investments into India through recognised tax favourable jurisdictions. The main reasons for such structures were to provide flexibility of exit i.e. negate the applicability of India's foreign exchange regulations to transfers from one non-resident to another, and to avoid the applicability of the Act and consequently payment of Indian capital gains tax.

The outcome of Vodafone's case will determine how, and the manner in which such holding structures are created and exits structured. The uncertainty that has arisen by reason of such lack of clarity, pending final decision on Vodafone's case is now requiring a rethink by foreign corporations and individuals making investments into India.

CHAPTER 6 – TAX TREATIES BETWEEN INDIA AND OTHER COUNTRIES

6.1 The Nature of Tax Treaties

Section 90 of the Income Tax Act empowers the Government of India to enter into an agreement with the Government of any country outside India for the following purposes-

(a) For granting relief in respect of:

(i) income on which have been paid both income-tax under this Act and income-tax in that country; or

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country 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

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act and under the corresponding law in force in that country, or in 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.

The Central Government may, by notification in the Official Gazette, make such provisions as may be necessary for the implementing the agreement made by it with the Government of any country outside India.

Whereas clause (a)(i) and (b) above both provide relief from double taxation, the other two clauses cover two distinct circumstances. Clause (a)(i) provides for relief in the case where income-tax *has already been paid* both in India and in the foreign country on the same income. Clause (b), on the other hand, provides for avoidance of double taxation. This, in the case of clause (a)(i) the tax has first to be paid and only then does the right to relief arise. In the case of clause (b), tax shall not be paid in either country and thus double taxation is completely avoided.[101]

Clause (a)(ii) was introduced by the Finance Act, 2003 so as to provide that the Central Government may enter into an agreement with the Government of any country outside India for outside India for granting relief in respect of income-tax chargeable under the Income-tax Act or under the corresponding law in that country to promote mutual economic relations, trade and investment.

Clause (c) provides for tackling the problem of tax evasion and tax avoidance by restoring to unwarranted means by the tax payers. Clause (d) provides for the recovery of tax.

6.2 Interpretation of Tax Treaties; Treaty Shopping

Section 90 empowers the Government of India to enter into an agreement with the Government of any country outside for the purpose of avoidance of double taxation for

[101] See Shell Company of India Limited v. CIT, (1964) 51 ITR 669 (Cal); Reference may also be made to CIT v. Carew and Co. Ltd., (1979) 120 ITR 540 (SC).

exchange of information etc. Such agreements have the force of law. In fact they virtually replace the Income-tax Act. In CIT v. Davy Ashmore India Ltd.,[102] while dealing with the interpretation of Tax Treaties, it was held that the conclusion is inescapable that in case of inconsistency between the terms of the agreement and the taxation statute, the agreement alone would prevail.

An important principle which needs to be kept in mind in the interpretation of the provision of an international treaty, including one for double taxation relief, is that treaties are negotiated and entered into at political level and have several considerations as their bases. The main function of the Double Taxation Avoidance Tax Treaty should be seen in the context of aiding commercials relations between treaty partners and as being essentially a bargain between two treaty countries as to the division of tax revenues between them in respect of income falling to be taxed in both jurisdictions. The treaty should in fact be interpreted as an independent code notwithstanding any contrary provision under the Income-tax Act.

Agreements for avoidance of double-taxation made by India with other countries are based on the UN model convention or OECD[103] model convention. The objective of such agreements is to avoid taxation of same income twice, in India and also in the country of entrepreneur's domicile. It is, however, still not infrequent that attempts are

[102] (1991) 190 ITR 626 (Cal).
[103] See http://www.oecd.org/home/0,2987,en_2649_201185_1_1_1_1_1,00.html last visited 10-052010

made to avoid payment of tax in India by adopting "colourable devices", which practice is known as "Treaty Shopping".

"Treaty Shopping" is a graphic expression to describe the act of a resident of a third country taking advantage of a fiscal treaty between two contracting nations.

The issue of 'Treaty Shopping" has been discussed in detail by the Supreme Court in the *Union of India v. Azadi Bachao Andolan*[104] case, where the Apex court was seized with the problems relating to the tax treaty between India and Mauritius.

It was submitted that several offshore companies were incorporated in Mauritius with the motive of taking undue advantage of the tax treaty between India and Mauritius. Such practice amounted to a fraud and the court must be astute to interdict all attempts at treaty shopping. The Supreme Court however, held, that: "Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, or for other non-tax reasons, unless it leads to a significant loss of tax revenues. Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology."

Developing countries need foreign investments, and the treaty shopping opportunities can be additional factor to attract them. The use of Cyprus as a treaty haven has helped

[104] 263 ITR 706

capital inflows into Eastern Europe. Madeira (Portugal) is attractive for investments into the European Union. Singapore is developing itself as a base for investment is South-East Asia and China. Mauritius today provides a suitable treaty conduit for South Asia and South Africa.

In recent years, India has been the beneficiary of significant foreign funds through the "Mauritius conduit". Although the Indian economic reforms since 1991 permitted such capital transfers, the amount would have been much lower without the Indian-Mauritius tax treaty.[105]

The developing countries allow treaty shopping to encourage capital and technology inflow, which developed countries, are keen to provide to them. The loss of tax revenue could be insignificant compared to the other non-tax benefit to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or treaty shopping leads to other tax abuses.

"There are many principles in fiscal economy, which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long-term development. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy," the Supreme Court observed.

[105] Roy Rohatgi, Basic International Taxation, pages 373-374.

6.3 Tax Treaties vis-à-vis The Indian Income Tax Act

As per section 90(2) of the Income-tax Act, "where the Central Government has entered into an agreement with the Government of any country outside India 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".

It is an established position in law that the provisions of the agreement for avoidance of double taxation prevail over the general provisions contained in the Income-tax Act. In fact, the tax treaties themselves provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country except where the provisions to the contrary have been made in the tax treaty. This proposition of law has been confirmed by Circular No. 333, dated April 2, 1982[106] issued by the Central Board of Direct Taxes. The text of the Circular is as under-

Conflict between the provisions of the Income-tax Act , 1961, and the provisions of the Double Taxation Avoidance Agreement-Clarification—

1. "It has come to the notice of the Board that sometimes effect to the provisions of double taxation avoidance agreement is not given by the assessing officers when they find that the provisions of the agreement are not in conformity with the provisions of the Income-tax Act.
2. The correct legal position is that where a specific provision is made in the double taxation avoidance agreement, the provision will prevail over the general provisions

[106] 137 ITR 1 (St.)

contained in the Income-tax Act. In fact the Double Taxation Avoidance Agreements which have been entered into by the Central Government under section 90 of the Income-tax Act, also provides that the laws in force in either country will continue to govern assessment and taxation of income in the respective countries except where the provisions to the country have been made in the Agreement.

3. Thus, where a Double Taxation Avoidance Agreement provides for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income-tax Act. Where there is no specific provision in the agreement, it is the basic law, i.e. the Income-tax Act that will govern the taxation of income."

In support of the proposition that a tax treaty overrides the provisions of Income-tax Act, a reference to the following cases may be made:-

(i) *Commissioner of Income-tax v. Visakapatanam Port Trust*[107]

(ii) *Commissioner of Income-tax v. Davy Ashmore India Ltd.*[108]

(iii) *Commissioner of Income-tax v. V. S.R.M. Firm and Others*[109]

(iv) *P. No. 11 of 1995*[110]

(v) *Arabian Express Line Ltd. of United Kingdom v. Union of India*[111]

(vi) *Application No. P-16 of 1998*[112]

(vii) *Commissioner of Income-tax v. Estienne Andre and others*[113]

[107] (1983) 144 ITR 146 (AP).
[108] (1991) 190 ITR 626 (Cal).
[109] (1994) 208 ITR 400 (Mad).
[110] (1997) 228 ITR 55 (AAR).
[111] (1995) 212 ITR 31 (Guj).
[112] (1999) 236 ITR 103 (AAR).
[113] (2000) 242 ITR 422 (Bom).

(viii) *Commissioner of Income-tax v. R.M. Muthiah*[114]

(ix) *Timken India Ltd. v. Commissioner of Income-tax*[115]

(x) *Union of India v. Azadi Bachao Andolan*[116]

(xi) *Commissioner of Income-tax v. P.V.A.I. Kulandagan Chettiar*[117]

(xii) *Emirates Fertilizer Trading Company WLL*[118]

6.4 More beneficial Provisions to Apply

Section 90(2) specifically provides that where the Central Government has entered into an agreement with the Government of any country outside India 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 the Income-tax shall apply to the extent they are more beneficial to that assessee. It is clear that where there is a conflict between the provision as contained in the tax treaty and the provision of the Income-tax Act, a tax payer can take advantage of that provision which is more beneficial to him.[119]

The explanation inserted in section 90 by the Finance Act, 2001 with retrospective effect from 01.04.1962 provides that where a foreign company has not made the prescribed arrangement for declaration and payment within India, of the dividends (including dividends on preference shares) payable out of its income in India, it can be taxed at a higher rate at which a domestic company is charged, and such higher rate

[114] (1993) 202 ITR 508 (Kar).
[115] (2002) 256 ITR 460 (Cal).
[116] (2003) 263 ITR 706 (SC).
[117] (2004) 267 ITR 654 (SC).
[118] (2005) 272 ITR 84 (AAR).
[119] *Arabian Express Line Ltd. of UK & Others v. Union of India*, [(1995) 212 ITR 31 (Guj)].

shall not be regarded as 'less favourable charge' on the foreign company. The provisions of the explanation are apparently intended to penalize those foreign companies which do not make prescribed arrangement for declaration and payment of dividends in India.

The explanation has been further amended by Finance Act, 2004, again with retrospective effect from 01.04.1962. The effect of the amendment is that a higher rate of tax can be charged from a foreign company compared to the tax chargeable on the Indian company irrespective of the fact whether the foreign company makes prescribed arrangements for declaration or payment of dividend in India or not.

6.5 No Relief if Tax Not Paid in One Country

The provisions of section 90 which empowers the Central Government to enter into agreement for avoidance of double taxation with other countries are intended to grant relief to a tax payer where his income has been subjected to tax both in the foreign country and in India. This power can be exercised only for avoidance of double taxation of the same income under the Indian Income-tax Act and the corresponding laws in force in the foreign country. Thus, the liability to pay tax both in India and the foreign country entitles a tax payer to claim relief under the provisions contained in the agreements for avoidance of double taxation. It, therefore, follows that if a tax payer pays or is liable to pay tax under the laws in force in one country alone, he cannot claim any relief from non-existent burden of double taxation under the agreement for avoidance of double taxation. Such agreements are intended for the benefit of those tax payers only who are liable to pay tax twice on the same income.

In a case before the Authority for Advance Ruling,[120] the applicant applied for ruling as to whether he was entitled to the benefit of the ADDT between India and UAE. It was contended before the Authority that there is no law in force in Dubai making the applicant's income liable to tax there. In other words, his income was not liable to tax in Dubai at all. Therefore, the Authority held that the applicant is not entitled for any relief in India. It was observed by the Authority as under:

"There is no law in force in Dubai making the applicant's income liable to tax. Whether the income earned in India or in UAE, is of no consequence. The applicant is not liable to pay any tax thereon under the laws of the UAE. Therefore, no question of granting relief to the applicant from double taxation can arise. The applicant cannot get any relief on account of double taxation unless there is a corresponding tax law in force in the UAE, in respect of his income which is taxable in India."

The Authority for Advance Ruling took a similar view by observing that "the applicant, an individual who is not liable to pay any income-tax in Oman at all cannot get the advantage of the double taxation avoidance agreement between Oman and India."[121] It may be pointed out here that the Authority for Advance Ruling had departed from its earlier reported decisions in *213 ITR 317 and 222 ITR 562.* In both these cases, the

[120] Cyril Eugene Pereira, (1999) 239 ITR 650 (AAR).
[121] (2000) 241 ITR 61 (AAR)

benefit of tax relief was granted to the applicants in India despite the fact that their income was not liable to tax outside India. Similar views have been taken by the Authority in the case of *Abul Razak A. Meman.*[122] Further reference may be made to *Union of India v. Azadi Bachao Andolan* case where the Supreme Court observed that "the test of liability for taxation is not determined on the basis of an exemption granted in respect of any particular source of Income, but by taking into consideration the totality of the provisions of the income-tax law that prevails in either of the Contracting States.[123] Merely because, at a given time, there may be an exemption from income-tax in respect of any particular head of income, it cannot be contended that the taxable entity is not liable to taxation. They urge that upon a proper construction of the provisions of Mauritian Income-tax Act it is clear that FIIs incorporated under Mauritius laws are liable to taxation; therefore they are "residents in Mauritius within the meaning of the DTAC".

Even unilateral tax relief under section 91 would be available only if the income is taxed both in a foreign country as well as in India.[124]

6.6 Treaties for Avoidance of Double Taxation

There are three Model Conventions, namely, The United States Model Income Tax Convention of September 10, 1996, United Nations Model Double Taxation Convention on Income and on Capital, 1995. The Agreements for Avoidance of Double Taxation

[122] (2005) 276 ITR 306 (AAR).
[123] Also see in this connection K.V.AL M. Ramanathan Chettiar v. CIT, (1973) 88 ITR 169 (SC).
[124] CIT v. United Commercial Bank, (1994) 206 ITR 641 (Cal).

(AADTs) which India has made with other countries are usually based on one of the three conventions.

In pursuance of the powers given by section 90, the Government of India has entered into agreements for avoidance of double taxation with the following countries-----

Sr. No.	Name of the Country	Sr. No.	Name of the Country	Sr. No.	Name of the Country	Sr. No.	Name of the Country
1.	Armenia	22.	Isreal	43.	Poland	63.	Ukraine
2.	Australia	23.	Italy	44.	Portuguese Republic	64.	Union of Soviet Socialist Republic
3.	Austria	24.	Japan	45.	Qatar	65.	United Arab Emirates
4.	Bangladesh	25.	Jordan	46.	Romania	66.	United Arab Republic
5.	Belarus	26.	Kazakistan	47.	Russian Federation	67.	United Kingdom
6.	Belgium	27.	Kenya	48.	Singapore	68.	United States of America
7.	Brazil	28.	Korea	49.	Slovenia	69.	Uzbekistan
8.	Bulgaria	29.	Kyrgyz Republic	50.	South Africa	70.	Vietnam

9.	Canada	**30.**	Libyan Arab Jamahiriya	**51.**	Spain	**71.**	Zambia
10.	China	**31.**	Malaysia	**52.**	Sri Lanka		
11.	Cyprus	**32.**	Malta	**53.**	Sudan		
12.	Czech Republic	**33.**	Mauritius	**54.**	Sweden		
13.	Czechoslovakia	**34.**	Mongolia	**55.**	Swiss Confederation		
14.	Denmark	**35.**	Morocco	**56.**	Syrian Arab Republic		
15.	Finland	**36.**	Namibia	**57.**	Tanzania		
16.	France	**37.**	Nepal	**58.**	Thailand		
17.	Germany	**38.**	Netherlands	**59.**	Trinidad & Tobago		
18.	Greece	**39.**	New Zealand	**60.**	Turkey		
19.	Hungary	**40.**	Norway	**61.**	Turkmenistan		
20.	Indonesia	**41.**	Oman	**62.**	Uganda		
21.	Ireland	**42.**	Philippines				

6.6.1 <u>Agreement with Mauritius</u>

Interpretation of the tax treaty with Mauritius has been subject matter of controversy in India. The controversy started after CBDT issued a Circular[125] clarifying that a certificate of Residence issued by the Mauritian authorities will constitute sufficient

[125] Circular No. 789 dated 13.04.2000.

evidence for accepting the status of residence as well as ownership for applying the provisions of the tax treaty. The Circular further clarified that the test of residence would also apply in respect of income from capital gains on sale of shares. Accordingly FIIs etc., which are resident in Mauritius, would not be taxable in India on income from capital gains arising in India on sale of shares. The above Circular was however, declared as an invalid circular and was quashed by the Delhi High Court in *Shiv Kant Jha v. Union of India*[126] but the Supreme Court reversed the decision of the Delhi High Court and declared the Circular to be a valid Circular.[127]

The CBDT has also issued another Circular No. 1/2003 dated 10.02.2003 clarifying that in case of a company if its place of effective management is in India, then notwithstanding its being incorporated in Mauritius. It would be taxed under the tax treaty in India.

6.6.2 Agreement with U.K.

Article 27 of the tax treaty with UK authorities the competent authorities to develop appropriate bilateral procedures, condition, methods and techniques for implementation of Mutual Agreement Procedure (MAP). Accordingly the competent authorities of India and UK have signed a Memorandum of Understanding regarding suspension of collection if taxes during the pendency of MAP. The said MOU provides that tax demand should be suspended on furnishing of a bank guarantee. The details of MAP are

[126] (2002) 256 ITR 563.
[127] Also see Union of India v. Azadi Bachao Andolan.

contained in instruction No. 3/2004 dated 19.03.2004. In order to give effect to Mutual Agreement Procedure (MAP) as provided in the tax conventions, the Government of India has inserted two new rules, namely Rules 44G and 44H providing for procedure to be adopted for redressal of grievances.

6.7 Countries with which No Agreements Exists

Section 91 of the Income-tax Act provides for relief of tax paid in another country in relation to an income which is chargeable to tax in India. However, in order to claim relief, the criteria are not only that the foreign income be included in the total income in the assessment made under the Income-tax Act in India, but that it should also be subjected to tax in India.[128] The object of this section, as pointed out by the Supreme Court of India in the case of *K.V.AL M. Ramanathan Chettiar v. CIT*[129], is that the amount of Indian Income-tax paid or the amount of tax paid in the foreign country, whichever is lower, is allowed as a deduction from the tax payable under the Act on such doubly taxed income. Tax deducted at the source, for the purposes of these provisions shall be considered as income-tax paid.[130]

Section 91 reads as under-

(1) If any person who is resident in India in any previous year proves that, in respect of his income which accrued or arose during that previous year outside India (and

[128] CIT v. C.S. Murthy (1988) 169 ITR 686 (AP).
[129] (1973) 88 ITR 169 (SC).
[130] CIT v. Clive Insurance Co. Ltd., (1978) 113 ITR 636 (SC).

which is not deemed to accrue or arise in India), he has paid in any country with which there is no agreement under section 90 for the relief or avoidance of double taxation, income tax, by deduction or otherwise, under the law in force in that country, he shall be entitled to the deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax of the said country, whichever is lower, or at the Indian rate of tax if both the rates are equal.

(2) If any person who is a resident in India in any previous year proves that in respect of his income which accrued or arose to him during that previous year in Pakistan he has paid in that country, by deduction or otherwise, tax payable to the Government under any law for the time being in force in that country relating to taxation of agricultural income, he shall be entitled to a deduction from the Indian income-tax payable by him----

(a) of the amount of the tax paid in Pakistan under any law aforesaid on such income which is liable to tax under this Act also; or

(b) of a sum calculated on that income at the Indian rate of tax; whichever is less.

(3) If any non-resident person is assessed on his share in the income of a registered firm assessed as resident in India in any previous year and such share includes any income accruing or arising outside India during that previous year (and which is not deemed to accrue or arise in India) in a country with which there is no agreement under section 90 for the relief or avoidance of double taxation and he proves that he has paid income-tax by deduction or otherwise under the law in force in that country in respect of the income so included he shall be entitled to a deduction from the

Indian Income-tax payable by him of a sum calculated on such doubly taxed income so included at the Indian rate of tax or the rate of tax of the said country, whichever is the lower, or at the Indian rate of tax if both the rates are equal.

A question may arise as to whether a person, though 'resident' but not 'ordinarily resident', is also covered by section 91. However, a reading of the definition of 'resident' in section 2(42), it becomes clear that any person who is a resident as per section 6, whether called a 'bare resident' or 'not ordinarily resident', should be covered by section 91.

Section 2(42) reads as under-

"'resident means a person who is resident in India within the meaning of section 6."

The provisions of section 91 are applicable to that income only which accrues or arises outside India and which is not deemed to accrue or arise in India. These provisions will not, therefore, apply to the income which is deemed to accrue or arise in India, namely:

(a) income through or from any business connection in India, or property in India, or source of income in India, or transfer of asset situated in India;

(b) salary if it is earned in India;

(c) dividend paid by an Indian company outside India;

(d) interest;

(e) royalty;

(f) fees for technical services;

(g) the use or right to use any industrial, commercial or scientific equipment; and

(h) rendering of any services in respect of (a) to (g) above.

An identical provision existed in Clause (ii) of the Explanation to section 44-D of the Indian Income-tax Act 1922. The Board have advised that the words 'after deduction of any relief due under the provisions of this Act,' in the aforesaid provision, would also include any relief allowed to an assessee, under any agreement, for avoidance of double taxation entered in to by the Central Government with the Government of any foreign country under section 90 of the 1961 Act (section 49 of the 1922 Act). Consequently, any relief granted to an assessee under an agreement for avoidance of double taxation, such as under the agreement for the avoidance of double taxation between India and Pakistan, will have to be deducted from the amount of the Indian Income-tax and super-tax chargeable on the total income, in calculating the 'Indian rate of tax' for determining the amount of unilateral relief from double taxation."

CHAPTER 7 – GENERAL CONCLUSION

There is a clear lack of global regime to facilitate Cross-border mergers. Nations tend to resort to protectionist measures both is respect of Corporate laws and Taxation laws.

As far as merger of a foreign company with Indian company is concerned the company law allows it. However the possibility would depend on the Taxation law regulations amongst others in both the country of the transferor company and that of the transferee company. The taxation of the mergers (amalgamation as defined under the Indian Income-tax Act 1961) is conducive because of the capital gains tax exemption available. However this exemption does not extend to any cash paid to the share holder of the transferee company. Further the scope of the term amalgamation under Income-tax Act (for which alone the exemption from capital gains tax is available) is much restricted as compared to the same in the US (*tax free reconstructions under the Internal Revenue Code*) and EC (*Definition of Merger under Directive on Common System of Taxation on Cross-border Mergers and Acquisitions*).

One of the major factors that influence many corporate decision is tax, more is it so in the Cross-border mergers. Because of the political reluctance to forgo taxing jurisdiction and concerns over revenue loss many countries follow, not so open approach towards Cross-border mergers. Although the concerns cannot be considered misplaced, these taxing strategies on the part of the nations have the potential to defeat otherwise beneficial Cross-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 leads to the corporation even after merger to remain resident country of the Transferor Company 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-s-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 a solution to the problem. Further such double taxation avoidance treaties may not exist between the concerned countries.

> In India since both a company incorporated in India and company having control and management *wholly* in India, there are increased chances of double taxation in this approach. However, since, the *whole* management and control of the company shall be in India in order to attract the residential status the chances are somewhat mitigated. It can be seen that a merger just to avoid taxing jurisdiction is not a desirable option because to achieve that the company may be moving into regime with inferior corporate laws. So consistent following of real seat principle is desirable in tax matters. India should adopt *substantial* management and control test and not incorporation principle in respect of taxation matters.

The *second* issue is that the tax which is imposed in the nature of exit tax. India does not tax, the shareholder or the transferor or transferee company in an amalgamation for capital gains, which is welcome. Nonetheless India by denying the exemption from capital gains tax when the transferee company is a foreign company joins the League of Nations who imposes taxes in the nature of exit tax. Free movement of capital across border, is hindered in this way. The claim to tax is not tenable always because (1) the taxing jurisdiction over the assets are not lost, necessarily (2) from the point of view of the shareholders or the company there is no realization of the appreciation of the value of the shares or the assets. Although there are many countries, like India, to impose exit taxes, there is an effort realize tax free mergers between companies resident in different nations; the European Union directive on Tax-Free Cross-border Mergers and Acquisitions being an example. The US stands out in the group for a tax free Cross-border merger is possible although its possibility is very strictly circumscribed by section 367 of the Internal Revenue Code. The provision takes into account merger that are designed primarily to avoid tax. Similar anti-tax avoidance provision is present in the European Council's directive as well. These illustrate that, although it could be complex, the tax avoidance can be addressed without taxing all the Cross-border mergers with a foreign company as amalgamated company. It is high time for India to start thinking in that direction.

Coming to the Vodafone case, the judgment is being seen as having serious and far reaching implications on the Cross-border mergers and acquisitions, wherein business being transferred between nonresidents abroad includes operations in India. The Revenue, as per the newspaper reports, has issued show cause notices (to about 400 companies) in various cases involving transactions similar to that of Vodafone. What kind of impact the aforesaid decision would have on the investment climate in India is yet to be seen, however, the tremor can certainly be felt.

Given the certainty of the favourable tax treatment given to Mauritus holding companies under the India-Mauritius double taxation avoidance agreement, a structure being adopted by many investors is to hold Indian shares through a Mauritian holding company structure and exit such investments through sale of the shares of the Indian company rather than sale of the holding company itself. The problem with such a structure is that Indian foreign exchange regulations still need to be complied with. Such extra layers of regulatory compliances increases both costs and time to complete transactions.

Accordingly, despite the availability of the above structure, it will be good for the Indian courts to provide certainty to Indian tax treatement for transfers of foreign parents/holding companies of Indian subsidiary companies. The final ruling on the issue is thus eagerly awaited. "The uncertainty that has arisen by reason of such lack of clarity, pending decision on Vodafone's case is now requiring a rethink by foreign corporations and individuals making investments into India."

The potential investors would need to be therefore extra careful while structuring their cross-border mergers and acquisitions transactions lest they are slapped with unwarranted and unexpected tax liability from strange quarters which they have not factored in their negotiations and to minimize the chances of litigation.

It is true that the tax payers are trying to employ all possible kills to defeat the legal provisions and keep their affairs outside the fold of taxability. This has a great impact on the State's revenue. It is here, where the judiciary has to play a major role by striking the balance between the rights of the tax-payer and the interest of the revenue. Analysis of the judicial trend in India shows that the judiciary is not constant in its approach. Still in the process of maintaining balace between the rights of taxpayer as well as those of collector it has given contradicting opinions. Most of the time it has taken extreme steps by supporting the tax-payers and upholding tax avoidance as perfectly valid as in the cases of *CIT v. Raman and company,*[131] *Union of India v. Azadi Bachao Andolan,*[132] or held that legal avoidance should be curbed, as in the case of Mcdowell *and Co. Ltd. V. Commercial Tax Officer*[133] A thorough study of these cases shows that the judiciary has come completely opposite and conflicting opinions on the basis of the analysis of same set of cases. This also gives rise to the prevailing uncertainties among the approaches adapted by the judiciary.

The approach taken by the legislature to address the issue of tax avoidance is more of an experience based and addressing the short term issues, rather being a long term remedy and, also, it lacks foresightedness. This shows that in India despite of having such a well planned system of taxation based on the principles of *raj dharma* we have not learnt any lessons from our predecessors and their socio economic set up. We just read about it, and glorified it and forgot it. Otherwise they have significance till date. There is a need to bring harmonisation in tax system, and the process of tax collection should be balancing. As stated my Manu, in tax administration "Both extremes should be avoided namely, either complete absence of taxes or exorbitant taxation. The King should arrange the collection of taxes in such a manner that the subjects should not feel the pinch of paying taxes."

[131] (1968) 67 ITR 11 (SC)
[132] 263 ITR 706
[133] (1985) 154 ITR 14 (SC)

Suggestions

1. One of the prime concerns of Cross-border merger is the change in residence of the company and consequent revenue loss. India follows both the incorporation and place of management and control test (place where the whole management of the company is situated) to determine the place of residence. This may have the result of the resultant company of the Cross-border merger being taxed in more than one jurisdiction as resident, which is not desirable. (A double taxation avoidance agreement can provide only partial solutions to the problem, if at all it exists between the countries concerned). At the same time place of incorporation rule would cause tax driven corporate migration to tax havens through Cross-border mergers. Hence the approach should be 'substantial control and management.' India shall change this regime.

2. Even among countries that allow capital gains tax free, several countries do not extend the tax exemption to amalgamation involving foreign company. In India such tax exemption is available if the amalgamated company is an Indian company and not otherwise. This is in nature of Exit tax. The taxes in the nature of Exit tax are not recommendable since there is no actual realisation of the appreciation of the capital (to attract Exit tax in the form of capital gains tax) in Cross-border mergers and it may have the effect of discouraging the socially beneficial transactions. India shall allow the foreign amalgamated company to be foreign company for tax free merger, subject to conditions that would prevent tax avoidance/evasion.

3. The countries should be alive to the Cross-border mergers for avoiding tax. Such tax driven mergers are not advisable as it may have the incidental effect of the company moving to a country which has a lesser corporate law standard and suboptimal allocation if capital.

4. The purpose of the legislature to bring capital gains as a head of income for taxation was with a view to enlarge the tax base. A larger tax base reduces the tax burden of the payee. The law relating to the taxation of amalgamations should be amended to bring specific provisions, instead of dealing the mergers under the general provisions for capital gains taxation to make the tax regime more clear and transparent.

5. The tax benefits of the amalgamation are not being extended to the service sector. It is the service industry which is showing a fast growth in India and which accounts for a significant amount of GDP as well as the exports of the country. So tax benefits should indeed be extended to the service sector as well.

6. The tax provisions relating to amalgamations are to be carefully revisited and redrafted to accommodate more mergers under its purview, and the benefits to be extended to those companies.

Survival of the fittest is the rule very much applicable in the business world. Amalgamation / Merger is the prescribed way for the companies to be fit for competition and avoid weaknesses of any nature. Keeping in view the process of liberalisation and globalisation of the economy, the amendments suggested above may go a long way to address the long awaited corporate need. The time is just right and there is every reason to encourage more and more corporate restructuring through the inorganic techniques keeping in mind the favourable and amicable provisions of the Income-tax Act and the Companies Act. Hence, it can be safely concluded that corporate restructuring through Amalgamations / Mergers is the order of the day and the tax and corporate law provisions, with their prescribed amendments will only favour these inorganic techniques.

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