Cross - Border Transactions – Tax Aspects

Refresher Course on International Taxation
CA Anil Talreja
22 April 2017
Key Takeaways from the session

- M&A Framework
- Cross border M&A
- Financing Options
- Inbound Deals
- Outbound Deals
- Exit Strategies
- Typical Issues
- Refresher – update on cross border tax
  Incl. Case Studies
M&A - Framework
Doing deals in India – key issues to consider

Valuation expectations
Corporate governance
Families giving up control
Tax and regulatory Issues

Management information systems
Quality of second tier management
Transparency of financial information and reporting standards
Understanding the group structure and the role of the entity

Lack of homework on partners
Cultural Differences
Less emphasis on the non-transactional area

Biggest challenges and barriers to growth for the Indian private equity industry
Cross border M&A
Cross border M&A – Framework

- Business Dynamics
- Legal & regulatory framework
- Identifying and delivering synergies
- Business Environment
- Cultural Issues
- Accounting treatment
- Tax regimes & treaties
Cross border M&A – Framework

- Merging entity can be a foreign company or an Indian company under the Indian Companies Act
  - Local foreign laws to be complied with

- Draft notification issued by MCA on 13 April 2017 re cross border mergers

- US, Mauritius, etc. allow companies to merge with foreign companies

- Netherlands, Singapore, etc. do not have any specific provisions for cross border merger
Highlights of tax provisions

M&A

Amalgamations/Merger
  - Sec. 2(1B)

Demerger
  - Sec. 2(19AA)

Acquisitions
  - Asset Purchase
  - Stock Purchase
    - Slump Sale
      - Sec. 2(42C) and Sec. 50B
    - Itemized Sale
      - Sec. 50 and Sec. 50C

Defn. of Transfer – Sec. 2(47)
Capital Gains – Chapter IV E

Sec. 2(19AA)
Sec. 2(1B)
Sec. 2(42C) and Sec. 50B
Sec. 50 and Sec. 50C
Sec. 50C
Structuring Aspects

- Acquisition options
  - Amalgamation/Merger
  - Itemised sale
  - Demerger
  - Slump sale

- Leveraging

- Tax optimisation

- Multi-layered Holding Cos

- Intermediate / Offshore entities / SPVs

- Exit options
Some Fundamentals...

Examination of the scope and implications under the domestic law and under the Treaty

Triangular cases - scope and implications of different treaties may vary

Factors for treaty entitlement:
- Treaty residence
- Beneficial ownership
- Impact of LOB
- BEPS
- POEM
Financing Options
Funding options

Types of instruments

Residents can subscribe to all the instruments as enlisted below

- Equity shares
  - Compulsorily Convertible i.e. Non-Redeemable
    - Treated as Equity under FEMA
  - Non Convertible (i.e. Redeemable) / Optionally Convertible
    - Treated as Debt (ECB)

- Debentures
  - Compulsorily Convertible i.e. Non-Redeemable
    - Treated as Equity under FEMA

- Preference shares
  - Non Convertible (i.e. Redeemable) / Optionally Convertible
    - Treated as Debt (ECB)

Historically deals in India have been structured with equity, CCPS and CCDs as possible funding instruments. Recently Government has imposed tax on buyback of shares @20% (plus applicable surcharge and education cess). With increasing tax cost it has become imperative to consider alternative structuring modes. Funding instruments could be structured to meet the commercial requirements and be tax efficient as well.
Funding options – Foreign investments

- **FDI**
  - Equity / CCPS
  - CCDs

- **FVCI**
  - Equity / CCPS
  - OCDs / OCRPS

- **FPI**
  - Listed Equity
  - Listed/Unlisted NCD*

- **ECBs**
  - Pure loan
  - Rupee denominated OCDs / ECBs / NCDS
  - Offshore rupee denominated bonds

*Including FPIs ZCBs
Key funding strategies

External Commercial Borrowings - ECB

- Stringent restrictions under ECB guidelines. Specific end use requirements.
- Recent relaxation on working capital funding.

Non Convertible Bond / Debenture - NCD

- Issue of listed NCDs to FPIs (FIIs/QFIs).
- Issue of unlisted NCDs allowed for Infrastructure sector.
- Not subject to ECB guidelines.

Compulsorily Convertible Preference shares –CCPs & Compulsorily Convertible Debentures - CCDs

- Treated as quasi-equity instruments under exchange control norms.

Non-Convertible Redeemable Bonus Preference Shares or Debentures

- Issue of non-convertible / redeemable preference shares or debentures as bonus to non-resident shareholders.
- Requires Court Approval and clearance from tax authorities.
- Tax planning possible to achieve cash repatriation.

Tax rates indicated are base rates. Surcharge & cess applies to domestic tax rates.
## Financing Options

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Equity</th>
<th>Debt</th>
<th>Quasi Debt (Preference stock)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term</td>
<td>Long Term</td>
<td>Medium to long term</td>
<td>Medium to long term</td>
</tr>
<tr>
<td>Pay outs</td>
<td>Dividend</td>
<td>Interest</td>
<td>Dividend</td>
</tr>
<tr>
<td>Taxability</td>
<td>DDT payable @ c.20%</td>
<td>Withholding tax @ 0 / 5/10 / 15 / 20%</td>
<td>DDT would be payable @ c.20%</td>
</tr>
<tr>
<td>Tax credit</td>
<td>Not available under most Treaties (check domestic laws of home country)</td>
<td>Available</td>
<td>Not available under most Treaties (check domestic laws of home country)</td>
</tr>
<tr>
<td>Deductibility</td>
<td>Dividends and DDT not deductible</td>
<td>Interest paid at arm’s length allowed as deduction</td>
<td>Dividends and DDT not deductible</td>
</tr>
<tr>
<td>Usage</td>
<td>No restrictions</td>
<td>In accordance with ECB guidelines</td>
<td>No restrictions/in accordance with ECB guidelines</td>
</tr>
</tbody>
</table>
Leveraged buy out (LBO) – structuring implications

- Importance of leverage for IRR calculations
- Third party debt
- Shareholder debt
- Effective tax relief
- Debt push down
Effect of leverage

- Main fund objective is to maximize investors’ return
- For example – buy a company for INR100 million and sell it 12 months later for INR 120 million

<table>
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<tr>
<th>INR (million)</th>
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<tbody>
<tr>
<td>Proceeds</td>
</tr>
<tr>
<td>Repay original fund equity</td>
</tr>
<tr>
<td>Profit</td>
</tr>
</tbody>
</table>

\[\begin{align*}
\text{INR} & \quad \text{120} \\
\text{Proceeds} & \quad \text{120} \\
\text{Repay original fund equity} & \quad (100) \\
\text{Profit} & \quad 20
\end{align*}\]

- INR 20 million return on INR100 million of investment is 20% return
Effect of leverage

Buy a company for INR 100 million and sell 12 months later for INR 120 million – but borrow INR 90 million of purchase price at 10%........

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<th>INR (million)</th>
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<tbody>
<tr>
<td>Proceeds</td>
</tr>
<tr>
<td>Debt repaid plus interest</td>
</tr>
<tr>
<td>Repay original fund equity</td>
</tr>
<tr>
<td>Profit</td>
</tr>
</tbody>
</table>

INR 11 million return on INR 10 million of investment is 110% return

Only works with third party debt!
Third party debt

Characteristics
- Cash paid yield
- Priority repayment – structural/contractual priority
- Repayment may be single bullet or amortized

Security
- Supported by assets of target
- “Debt pushdown”
- Tax implications of security package

Servicing
- Need to consider how cash can be deployed to service debt
- Trapped cash
- Need to consider financial assistance constraints
- Need to consider tax implications of servicing cash flows
Third party debt

Senior: usually syndicated and divided into tranches with different characteristics

Sale and leaseback

Securitization

Second lien

Mezzanine: usually syndicated
Leverage – structuring

- Can we get relief for interest on senior and shareholder debt?
- Can we get relief on accruals basis?
- How will senior debt be serviced and secured?
- What legal issues will this present?
- What tax issues does this raise?
Other modes of financing

Shareholder debt
- Investment can be quickly and easily repaid
- Interest can be charged without need for distributable reserves
- Sweetens management equity
- May get tax relief for some or all of interest (but only of value if effective relief is available)
- Structural and contractual subordination
- Can create “dry” income for investors

Equity
- Generally harder to return principal
- Generally need reserves to pay dividends
Effective tax relief for interest expense

- Deduction available in principle – thin cap rules
- Deduction available on accrual basis
- Need to offset interest expense against target’s profits
- Cash tax benefit during investment
- Avoid dry income for investors
Leverage – summary

- Need effective relief for interest expense
- Need to match interest expense with cash/profits – debt pushdown
- Need to consider non tax issues and their tax implications – in particular debt servicing, security package and financial assistance
Inbound Deals
Inbound investments in India- Key decision metrics

These decisions are primarily functions of extant tax and regulatory laws in India besides India’s political and overall socio-economic landscape – Global tax initiatives like BEPS do also have bearing.
Inbound Deals – Structure I

- Simple Investment Structure
- Sector Specific Limits for investment (foreign participation)
- IndCo subject to tax in India

Income Flows
- Interest from IndCo to UKCo
- Dividend from IndCo to UKCo
- Availability of tax credit
Inbound Deals – Structure I

- Dividend from IndCo
  - Not taxable in India
  - No WHT in India
  - Taxable in UK
  - Underlying tax credit available in the UK
  - Dividend Distribution Tax paid by IndCo. - to be considered as underlying tax credit
  - Tax credit mechanism in case of MAT paid in India and credit claimed in subsequent years in India
Inbound Deals - Structure I

- Investment made via a IHC
- IHC could be a resident of Mauritius, Cyprus
  - Treaty Benefits
  - Capital Gains Exemption
  - Cyprus – could be preferred
  - Alternate Jurisdictions which may be considered – Netherlands, Singapore
  - Recent update on Beneficial Treaties with India
Inbound Deals – Structure II- Leveraged buyout – Business Acquisition

**Transaction Structure**

- **Investor**
- **New Co**
- **Target Co**

**Facts**

- Investor to acquire Target Co
- Investor to fund the acquisition through debt
- The deal could be structured as acquisition of business from Target Co

**Mechanics**

- Investor to incorporate New Co in India
- Investor to fund New Co through CCD or NCD
- New Co to acquire business from Target Co
- Interest deduction can be claimed against business profits

**Select considerations**

- Promoters preference – Share sale vis-a-vis business sale
- Stamp duty implications
Inbound Deals – Structure III

Pre-Merger

A Company

USCo(1)

B Company

USCo(2)

Merges

Post-Merger

A Co.

B Co.

USCo(2)

(IHC) Intermediate Holding Company

Mauritius/Cyprus

India

IndCo

Indirect transfer

USCo(2)

(IHC) Intermediate Holding Company

Mauritius/Cyprus

India

IndCo
Inbound Deals – Structure IV

Pre-Merger

HoldCo. 1 → HoldCo. 2

Merges

Post-Merger

HoldCo.(2) → Industry

• Tax neutrality
• Section 79 implications
• Treaty planning
Inbound Deals – Structure V

**Pre-Merger**

- **Parent company**
- Offshore
- Mauritius/Cyprus
- (IHC) Intermediate Holding Company
- India
- **IndCo**

**Post-Merger**

- **Parent Company**
- Offshore
- India
- **IndCo**

- **Tax neutrality**
- **Planning possible**
Outbound Deals
Outbound Deals – Structure I

- Investment can be made up to 400% of the net worth of India Co.
- IndCo can borrow to invest in UKCo
  - Borrowings from Bank and Financial Institutions
  - Borrowings from group entities
  - Overseas Borrowing also permitted
- Deductibility of Interest on loan in India
- UKCo profits not taxable in India
- Dividends from UKCo. to IndCo. taxable in India – availability of tax credit
Important Considerations

✗ Investment from India can be Equity/Debt

✗ ECB permitted for this investment

✗ Return on investment

✗ Taxability

✗ Availability of tax credit
Outbound Deals – Structure III

Pre-Merger

India

Offshore

Sub Co. 1

IndCo

Merges

Sub Co. 2

Post-Merger

India

Offshore

Sub Co. 2

IndCo

• Tax neutrality
• Transfer Pricing Implications
Outbound Deals – Structure IV

Pre-Merger

India

Mauritius

M Co

IndCo

Post-Merger

India

IndCo

Profit Repatriation Strategy
Outbound Deals – Structure V
Debt push down in overseas operating country

**Facts**
- India Co proposed to make outbound investment in profit making offshore operating company
- India Co raises debt in India or overseas for the proposed acquisition, i.e. leveraged buyout
- India Co desires to claim tax relief on interest

**Mechanics**
- India Co to make the investment through an IHC. IHC to incorporate Bid Co in Target Co jurisdiction
- Debt could be raised at IHC level or Bid Co level
- Post acquisition, Op Co to merge with Bid Co Interest deduction can be claimed against merged Op Co profits
Outbound Deals – Structure V
Debt push down in overseas operating country (contd.)

Transaction Structure

Analysis
If debt raised at India level
- If debt is raised in India for outbound investment, the interest payable shall not be tax deductible since dividends received are taxed at a concessional rate
Outbound Deals – Structure V
Debt push down in overseas operating country (contd)

Transaction Structure

Raising debt at IHC level
- This provides flexibility of raising debt, negotiating interest rate, etc.
- However, debt push down to Op Co shall be subject to thin capitalisation rules in Op Co jurisdiction
- Further, on account of TP regulations, interest spread shall be taxable in IHC

Raising debt in Target Co jurisdiction
- This is most preferable for claiming tax relief
- To the extent commercially feasible, debt should be raised at operating entity level depending upon profitability level to absorb interest, lender’s flexibility, interest rate, etc.
Outbound Deals – Structure V
Debt push down in overseas operating country (contd)

Transaction Structure

Multiple SPVs
- RBI approval required for outbound investment through more than one level of IHC
- Raising of debt at various levels, lenders preference can justify multi layer SPV structure
Exit Strategies
Exit Strategies

- **Outright Sale - Capital gains**

- **Shareholder’s agreement and implications thereof – Right of First Refusal; Tag Along rights, Drag Along Rights**

- **Liquidation process – long drawn and Court approval process**

- **Initial Public Offering (IPO)**
Typical Issues
# Cross Border M&A

## Some Issues

<table>
<thead>
<tr>
<th>Issues</th>
<th>India</th>
<th>Overseas</th>
</tr>
</thead>
</table>
| **Leveraged buy outs (LBO)** | • Deductibility of interest on debt taken for acquisition of controlling stake in Target:  
  - When Target is an Indian company  
  - When Target is a foreign company  
  • To use the cash flows of the Target to service the debt it can be merged with the acquirer – however, interest deductibility debatable | • Interest on debt taken abroad through a SPV acquiring shares of the Target, is allowed as a deduction against operating income of Target, either by:  
  - group consolidation, where the SPV and the Target are assessed as single entity; or  
  - Pass-through status to certain entities; or  
  - Subsequent merger of acquirer with Target |
| **Amortization of ‘Acquired Goodwill’ under the tax laws** | Not allowed                                                      | Allowed in US, UK, etc.                                                 |
## Cross Border M&A
### Some Issues

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<thead>
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<th>Issues</th>
<th>India</th>
<th>Overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxability of share swaps</td>
<td>Taxable</td>
<td>Not Taxable in US, UK – subject to conditions</td>
</tr>
</tbody>
</table>
| Acquisition through a merger   | • Target merges with the WOS of Acquirer  
• Merger is tax neutral only if shares are issued by the WOS to the shareholders of the Target | • Target merges with the WOS of Acquirer  
• Shares of the acquirer directly issued to the shareholders of the Target  
• Merger is still a tax neutral merger (US) |
Other Aspects

| Base Erosion and Profit shifting ("BEPS") | • Major initiative by the OECD  
| | • Outcome will change international/domestic tax rules and principles |
| Place of Effective Management (POEM) | • Automatic Trigger  
| | • Shareholder v/s. Management  
| | • Change in organisation reporting structure  
| | • Dos and Don'ts |
Refresher – cross border tax rules
Interplay of GAAR and Tax Treaties

Impact on structure through Mauritius / Cyprus / Singapore / Netherlands (preferential treaty countries)

Investment into India through holding companies in preferential treaty country may come under the GAAR scanner:

- Can be covered under “lack of commercial substance” or “transaction is entered or carried on in a manner not normally employed for bona-fide business purposes” if substance is missing
- In the past capital gains exemption in India is availed based on tax residency certificate issued by the Mauritius tax authorities

Impact of Amendment to treaty by India with Mauritius/Singapore/Cyprus
## Capital gains amendment in a nutshell

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Taxable in India</th>
<th>Rate of tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares acquired on or before 31 March 2017 and sold thereafter</td>
<td>No</td>
<td>N/A</td>
</tr>
<tr>
<td>Shares acquired on or after 1 April 2017 and sold on or before 31 March 2019</td>
<td>Yes</td>
<td>50% of the domestic tax rate, subject to fulfillment of the LOB conditions</td>
</tr>
<tr>
<td>Shares acquired after 1 April 2017 and sold after 1 April 2019</td>
<td>Yes</td>
<td>Domestic tax rate</td>
</tr>
</tbody>
</table>

Amendments in Article 13 will phase out capital gains tax exemptions as under:

- Shares acquired on or before 31 March 2017 and sold thereafter are not taxable in India.
- Shares acquired on or after 1 April 2017 and sold on or before 31 March 2019 are taxable at 50% of the domestic tax rate, subject to fulfillment of the LOB conditions.
- Shares acquired after 1 April 2017 and sold after 1 April 2019 are taxable at the domestic tax rate.
Impact of the Amendments

Shares

Capital gains to be taxable in India on transfer of shares of a company resident in India, if shares are acquired on or after 01 April 2017

Grandfathering of shares acquired upto 31 March 2017 - capital gains not taxable in India irrespective of when these shares are sold in future; also no LOB conditions required to be met in respect of these shares

Transition period of April 2017 to March 2019 in respect of investments in shares acquired on or after April 2017 and sold upto March 2019 shall enjoy 50% reduction in Indian domestic tax rates

LOB conditions to be satisfied in the transition period to avail the benefit of concessional tax rate

Capital gains on shares acquired from 1 April 2017 and transferred after 1 April 2019 onwards would be fully taxed at Indian domestic tax rates
GAAR – Anti Avoidance legislation

Impermissible arrangement

Arrangement

- Creates rights and obligations not normally created in arm’s length transactions
- Results in direct or indirect misuse or abuse of the provisions
- Lacks or is deemed to lack commercial substance in whole or part
- Is not bonafide

Consequences

- Disregarding, combining or re-characterising the whole or part of the arrangement
- Treating the arrangement as if it has not been entered into
- Disregarding any party or treating parties as one and the same person
- Deeming connected persons to be one
- Reallocation of any income/receipt and expenditure/deduction
- Determining the place of residence or situs of asset or transaction
- Disregarding any corporate structure
- Treatment of equity as debt and vice versa

Applicable from 1 April 2017
GAAR – Anti Avoidance legislation

Implications

• Every ‘tax planning’ measure potentially open to challenge by the Revenue
• Principle of substance over legal form sought to be introduced
• Investment vehicles based out of Mauritius / other tax efficient jurisdictions may not be eligible for claiming tax treaty benefits in India
  – Gains arising on disposal of Indian investments could then be subject to tax in India
  – except where a listed company’s shares are transferred, Securities Transaction Tax [STT] is paid and the shares have been held for more than one year prior to the transfer
  – Prolonged litigation and uncertainty for taxpayers

Perceivable mitigation strategy

• Infuse adequate ‘substance’ into the investment vehicles
• In addition, structure investment vehicles to a jurisdiction where the meaning and definition of substance is clearly established e.g. Singapore
  – A Singapore investment vehicle could give some resistance to the Indian tax authorities, in case they were to invoke GAAR
  – This will have to be examined in greater detail

Applicable from 1 April 2017
Transfer of unquoted shares

Full value of sale consideration

• Currently, there are anti abuse provisions in case of transfer of immovable property at a price less than stamp duty
• Similar provision has been inserted with respect to transfer of shares of a company (other than quoted share) for consideration less than the Fair Market Value (FMV)
• In such an event the FMV of the shares transferred to be deemed to be the full value of consideration for computing capital gains
• FMV for this purpose to be determined in accordance with the manner to be prescribed
• Quoted share is defined to mean share quoted on any recognised stock exchange and traded regularly

Issues that may arise

• Such transfer may also be taxed in the hands of the acquirer as Income from other sources notwithstanding the capital gains paid by the seller
• Whether the provision to cover listed shares though not traded regularly and how to determine the trading regularity for such shares
Conversion of preference shares to equity shares

Tax neutrality

- Currently, conversion of bond or debenture of a company into shares of that company is not regarded as transfer
- However, no similar tax exemption was available in case of conversion of preference shares of a company into its equity shares
- It is proposed that the conversion of preference share of a company into equity share of that company will not be regarded as transfer
- In determining the period of holding of such equity shares, the period of holding of the preference shares shall be included
- The cost of acquisition of the converted equity shares shall be deemed to be the cost of acquisition of preference share
Open Session
Thank you