Cross – Border Transactions – Tax Aspects

Refresher Course on International Taxation

CA Anil Talreja

22 April 2017

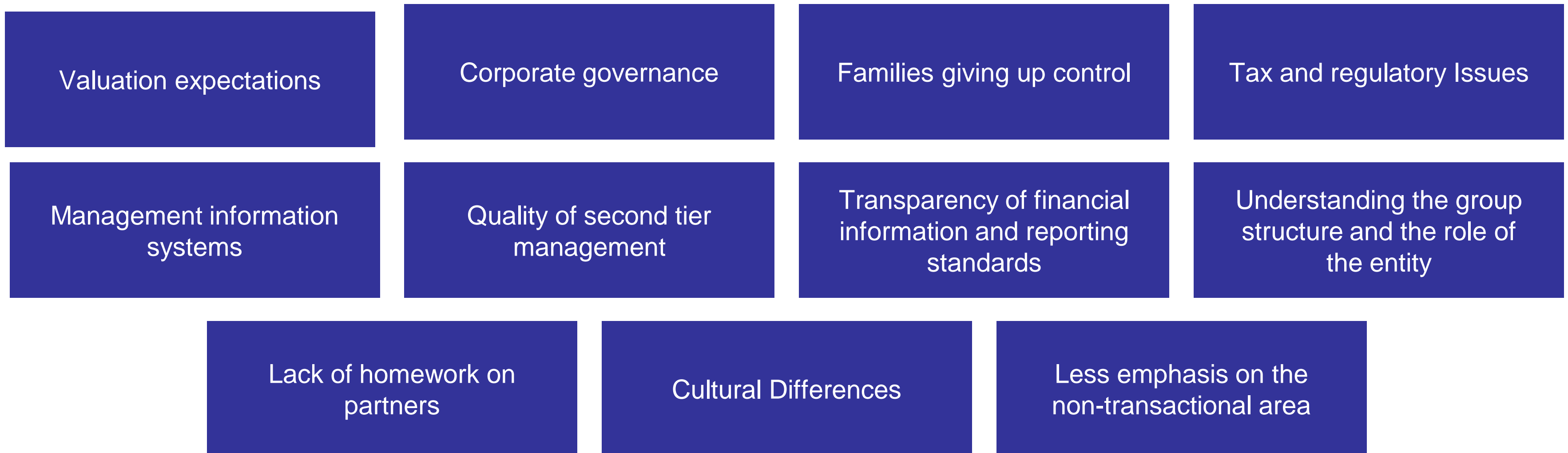
Key Takeaways from the session

- 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



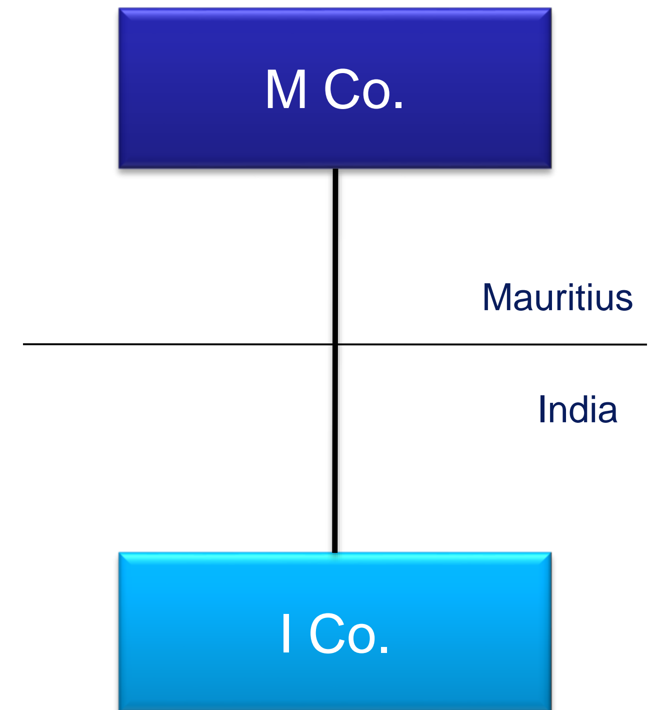
Biggest challenges and barriers to growth for the Indian private equity industry

Cross border M&A

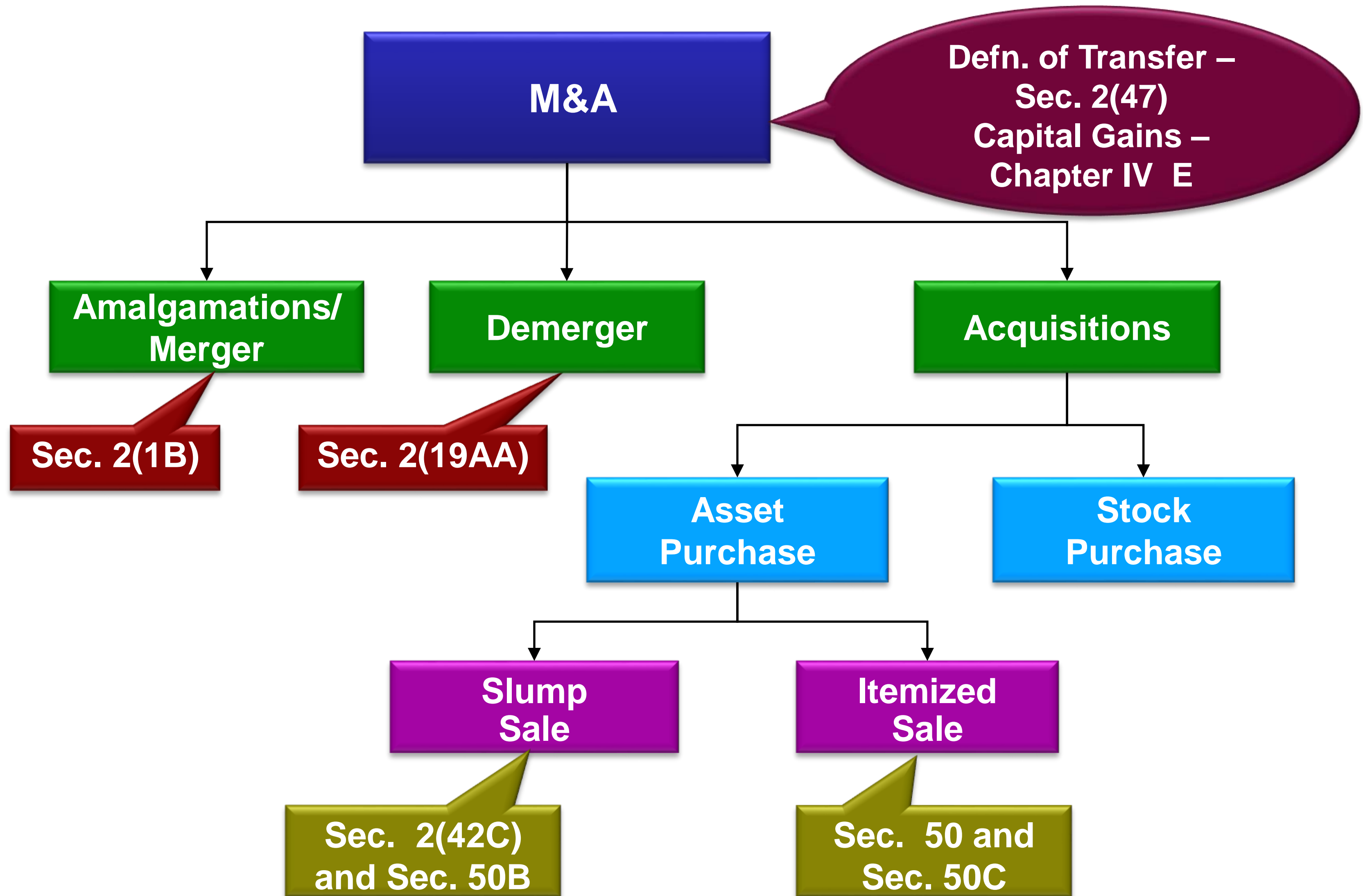
Cross border M&A – Framework

Cross border M&A – Framework

- Merging entity can be a foreign company or and 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



Structuring Aspects

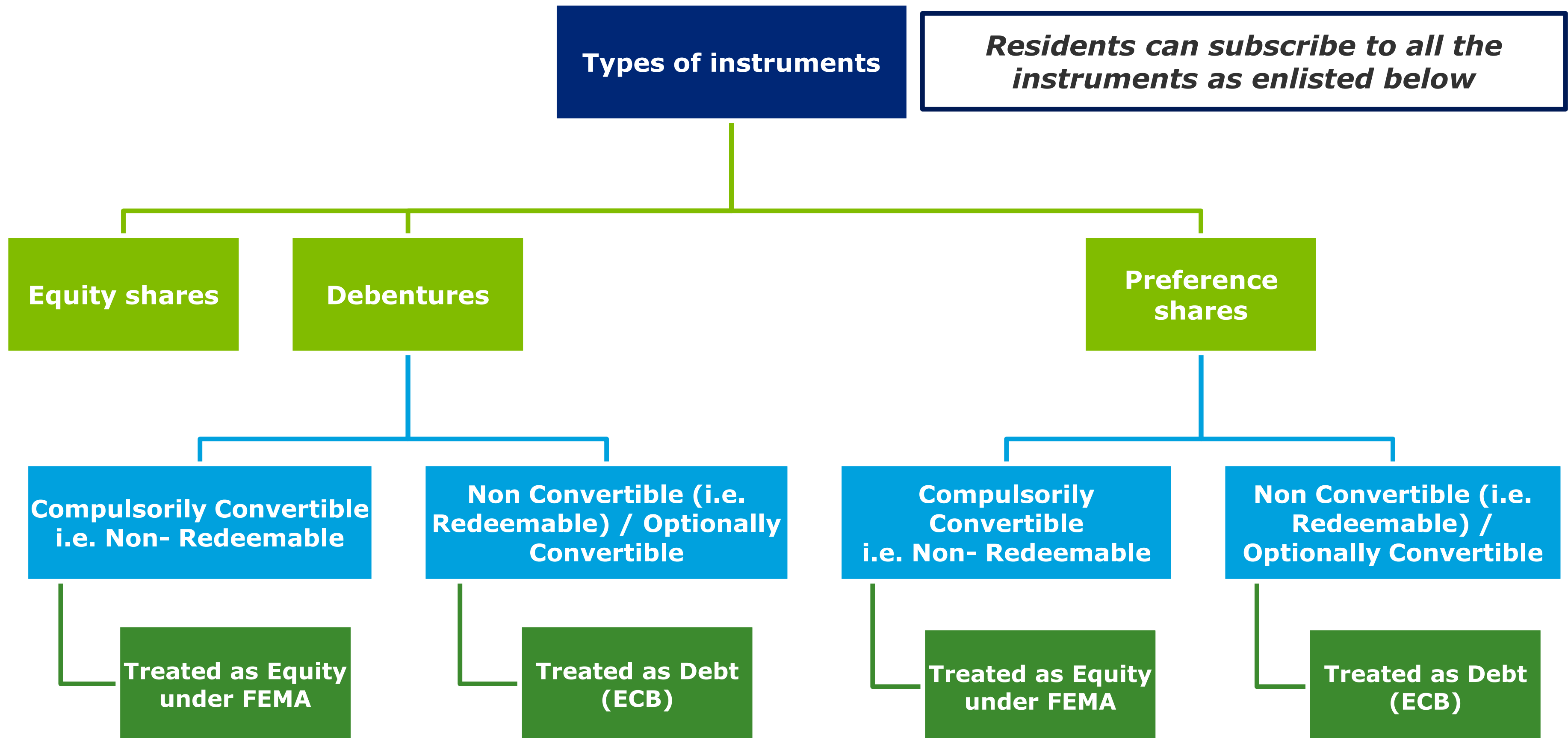
- Acquisition options
  - Amalgamation/Merger
  - Itemised sale
  - Demerger
  - Slump sale
- Leveraging
- Tax optimisation
- Multi-layered Holding Cos
- Intermediate / Offshore entities / SPVs
- Exit options

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

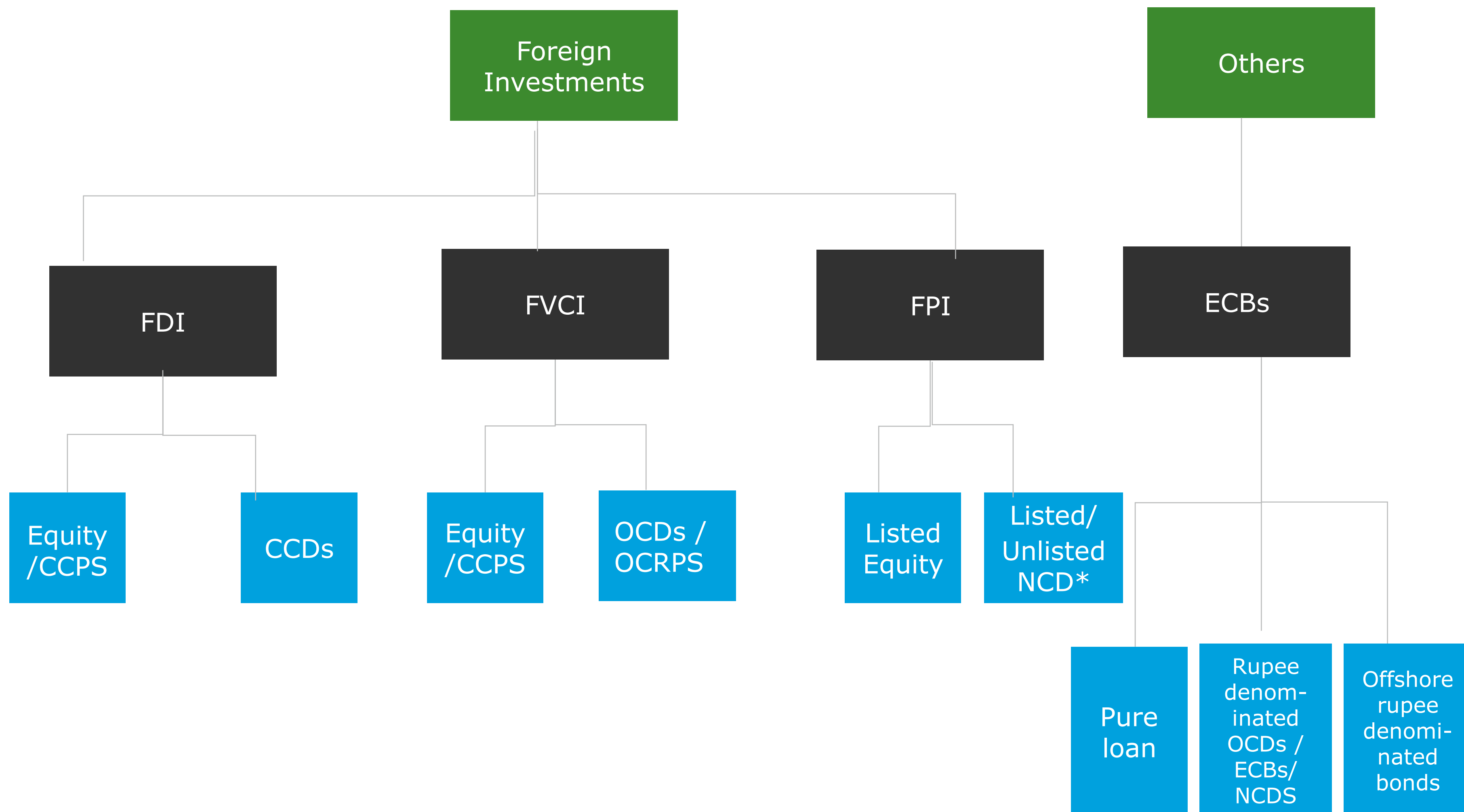
Financing Options

Funding options



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

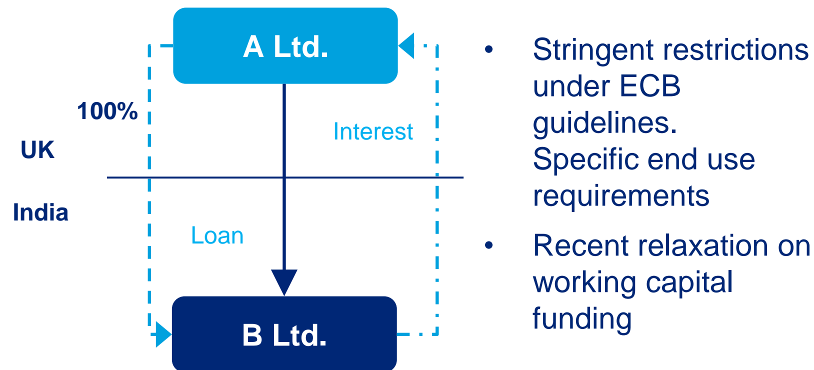
Funding options – Foreign investments



** Including FPIs ZCBs*

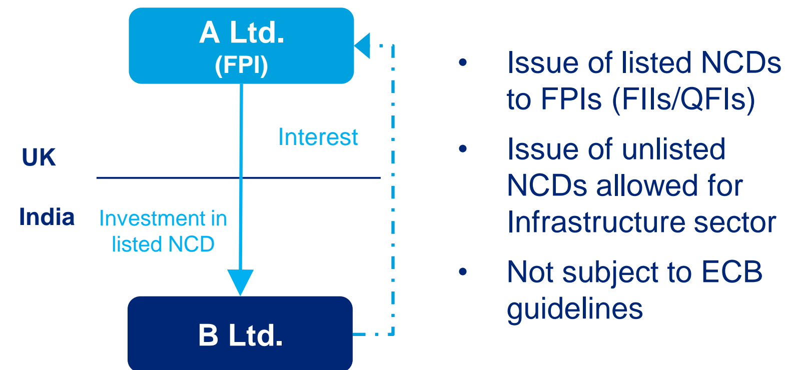
Key funding strategies

External Commercial Borrowings - ECB



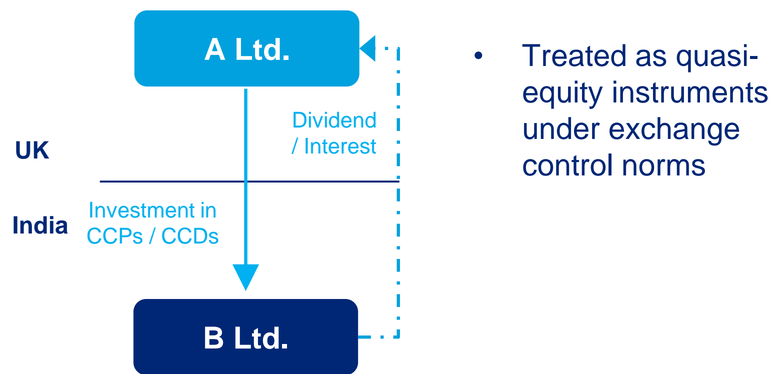
- Stringent restrictions under ECB guidelines. Specific end use requirements
- Recent relaxation on working capital funding

Non Convertible Bond / Debenture - NCD



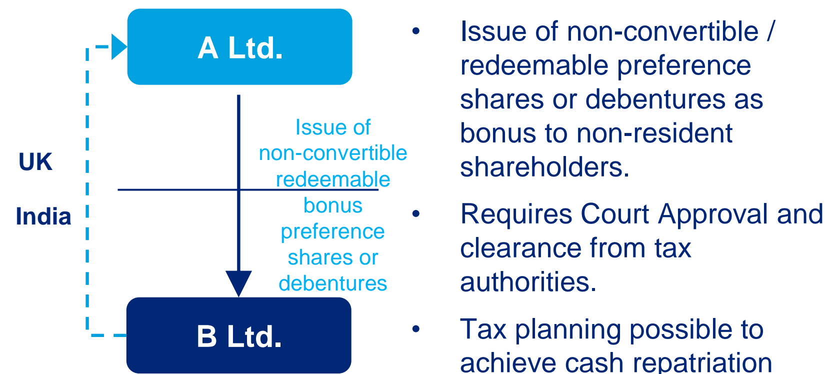
- Issue of listed NCDs to FPIs (FIIs/QFIs)
- Issue of unlisted NCDs allowed for Infrastructure sector
- Not subject to ECB guidelines

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



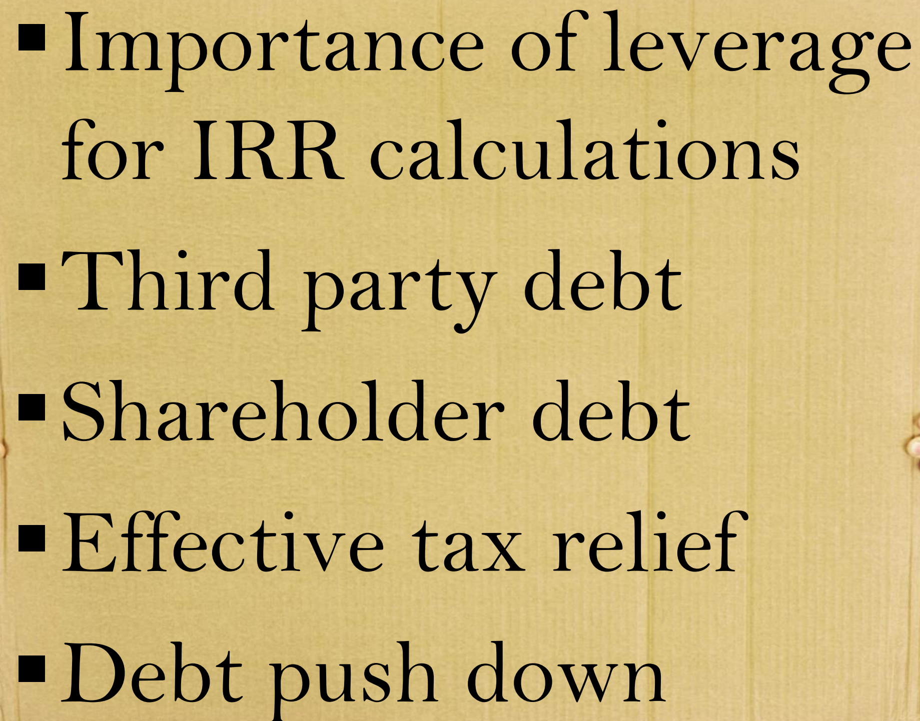
- Issue of non-convertible / redeemable preference shares or debentures as bonus to non-resident shareholders.
- Requires Court Approval and clearance from tax authorities.
- Tax planning possible to achieve cash repatriation

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

Financing Options

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

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

	INR (million)
Proceeds	120
Repay original fund equity	(100)
Profit	20

- 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%........

	INR (million)
Proceeds	120
Debt repaid plus interest	(99)
	21
Repay original fund equity	(10)
Profit	11

- INR 11 million return on INR 10 million of investment is 110% return
- Only works with third party debt!

Third party debt

Characteristics

Security

Servicing

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

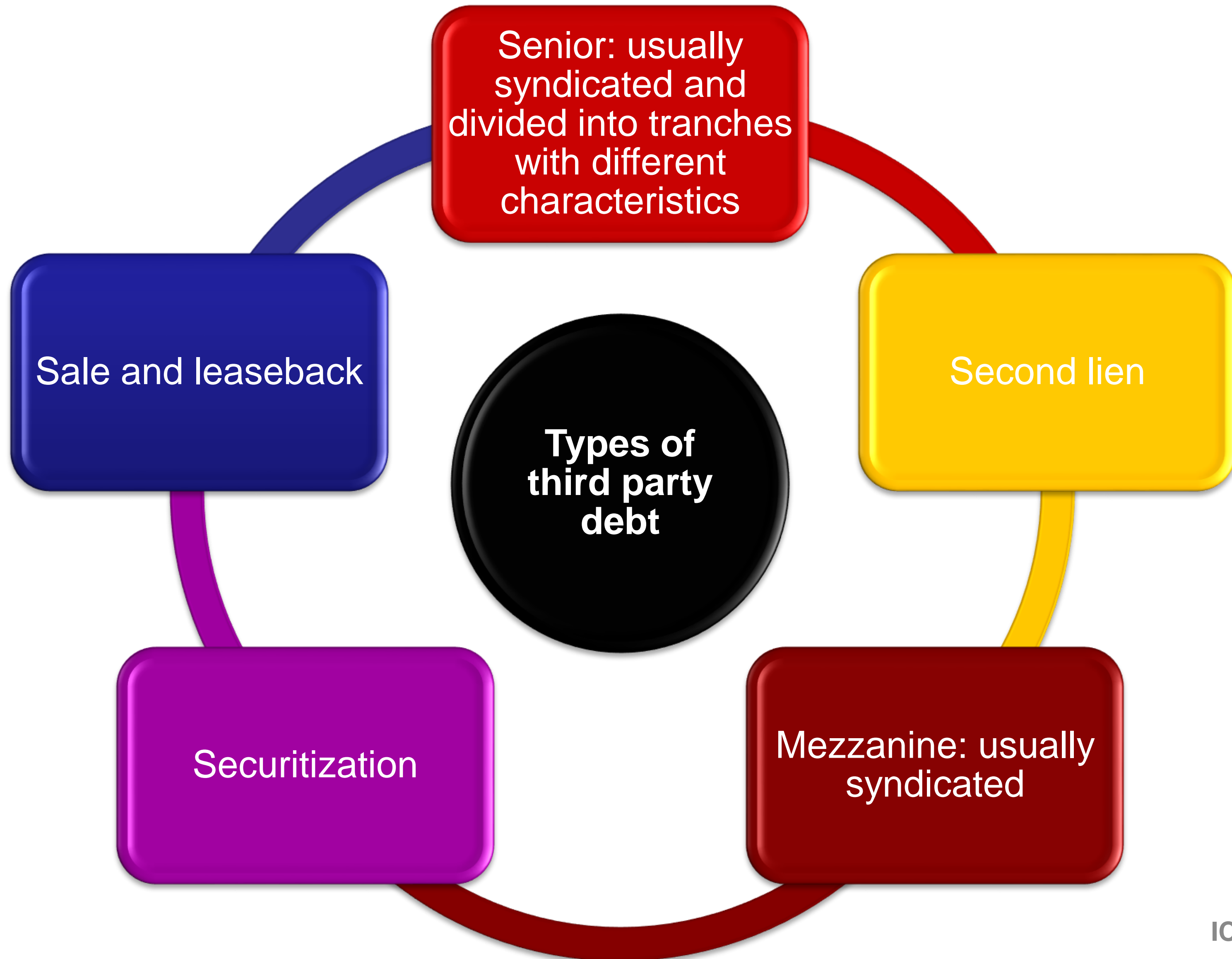
Need to consider how cash can be deployed to service debt

Trapped cash

Need to consider financial assistance constraints

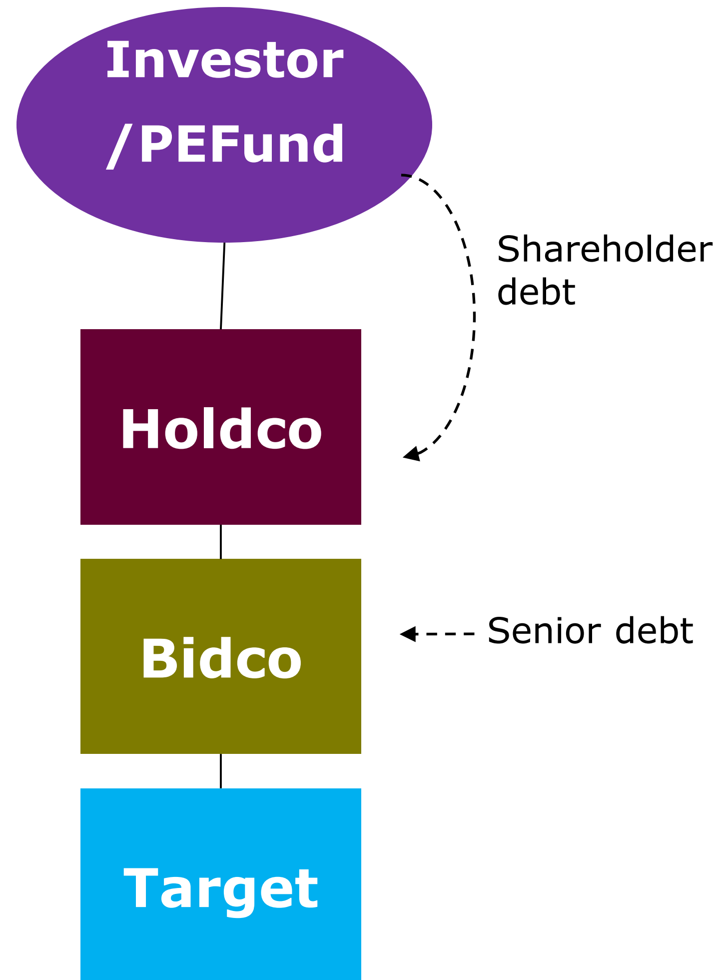
Need to consider tax implications of servicing cash flows

Third party debt



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

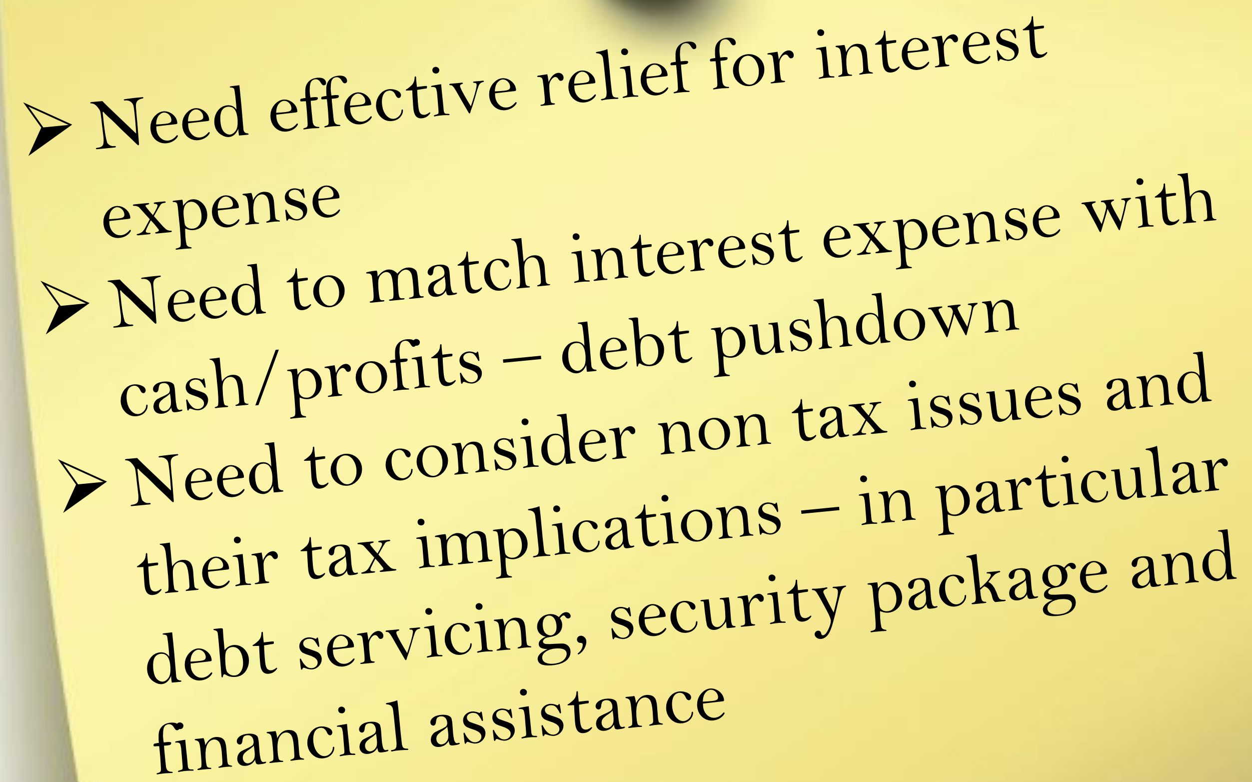
Equity

- Generally harder to return principal
- Generally need reserves to pay dividends

Effective tax relief for interest expense

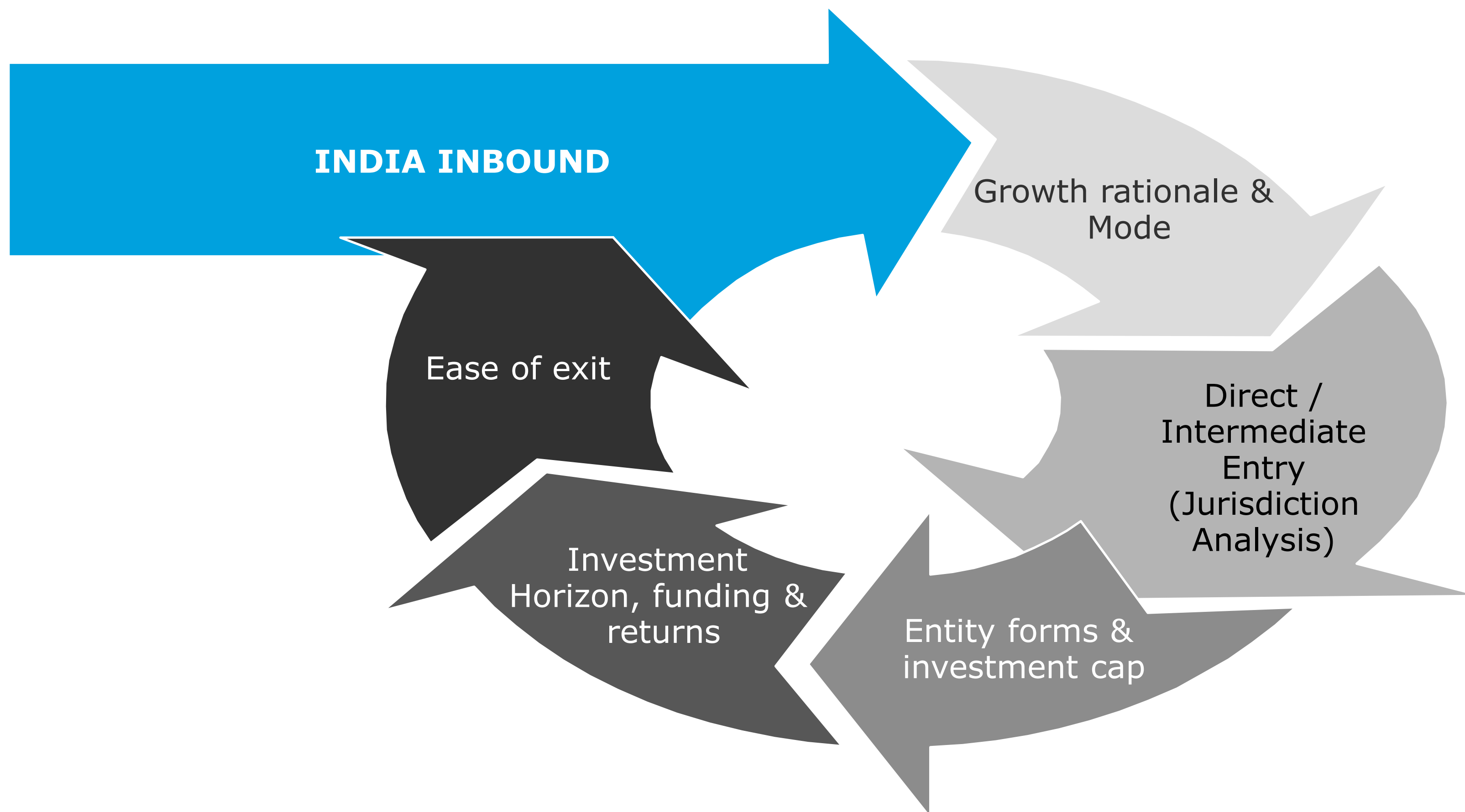
- Deduction available in principle – thin cap rules
- Deduction available on accrual basis
- Need to offset interest expense against target's profits
- Cash tax benefit during investment
- Avoid dry income for investors

Leverage – summary



Inbound Deals

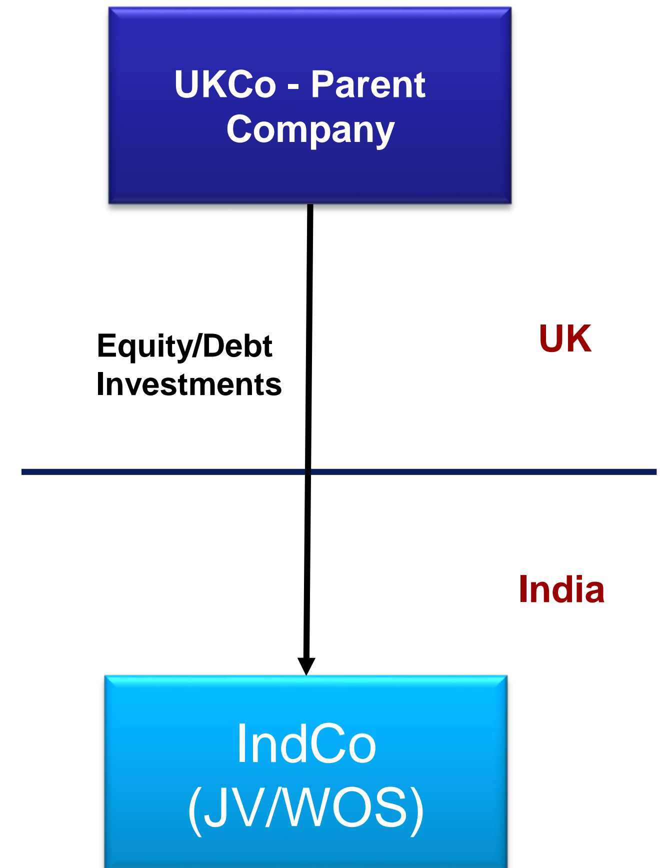
Inbound investments in India- Key decision metrics



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

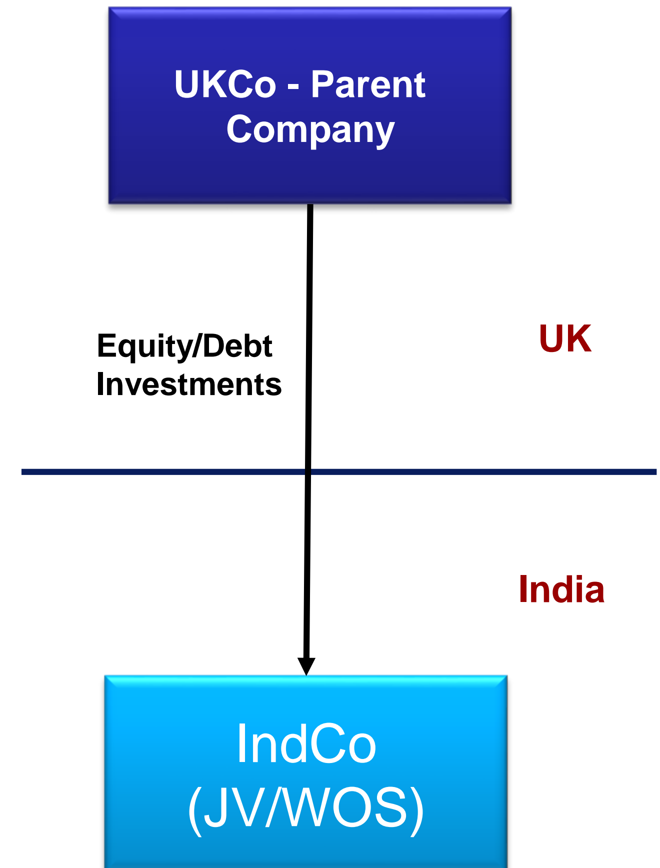
Inbound Deals – Structure I

- 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



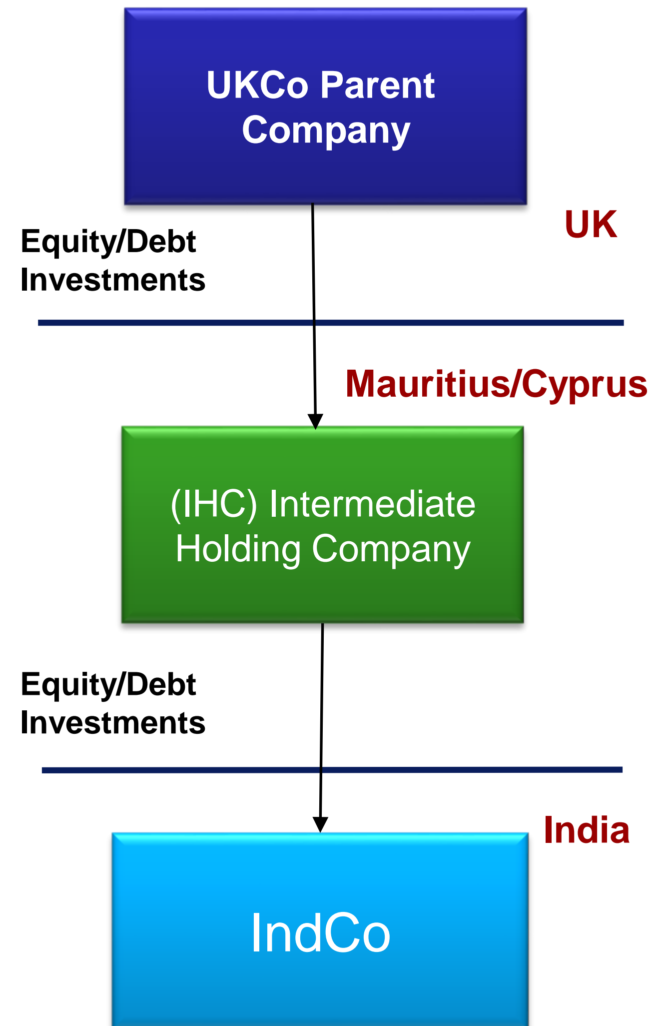
Inbound Deals – Structure I

- 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



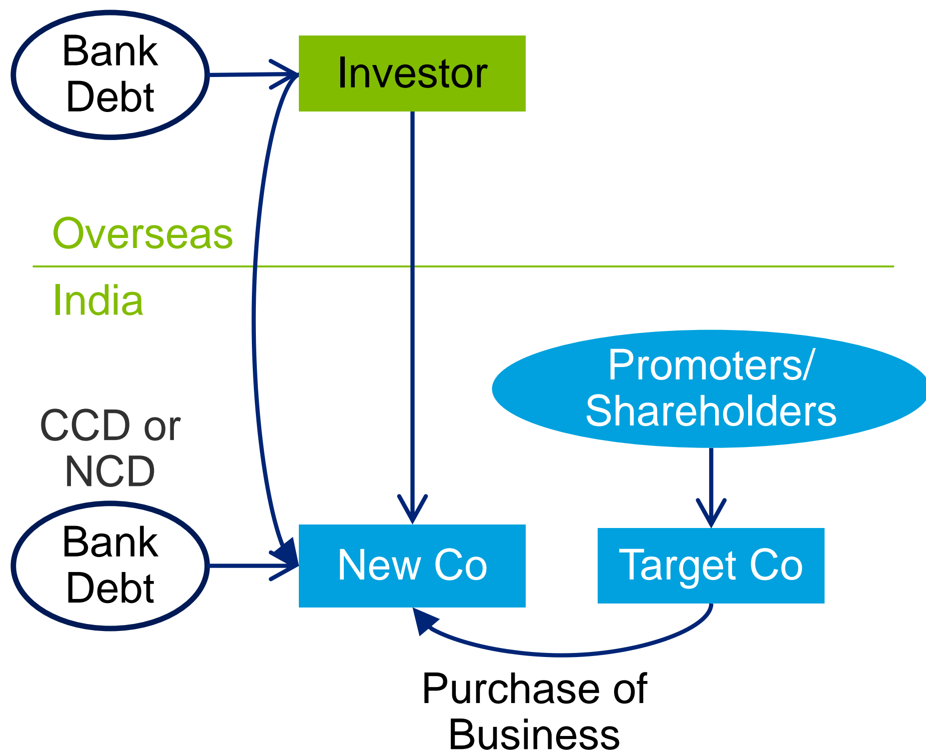
Inbound Deals - Structure I

- 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



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

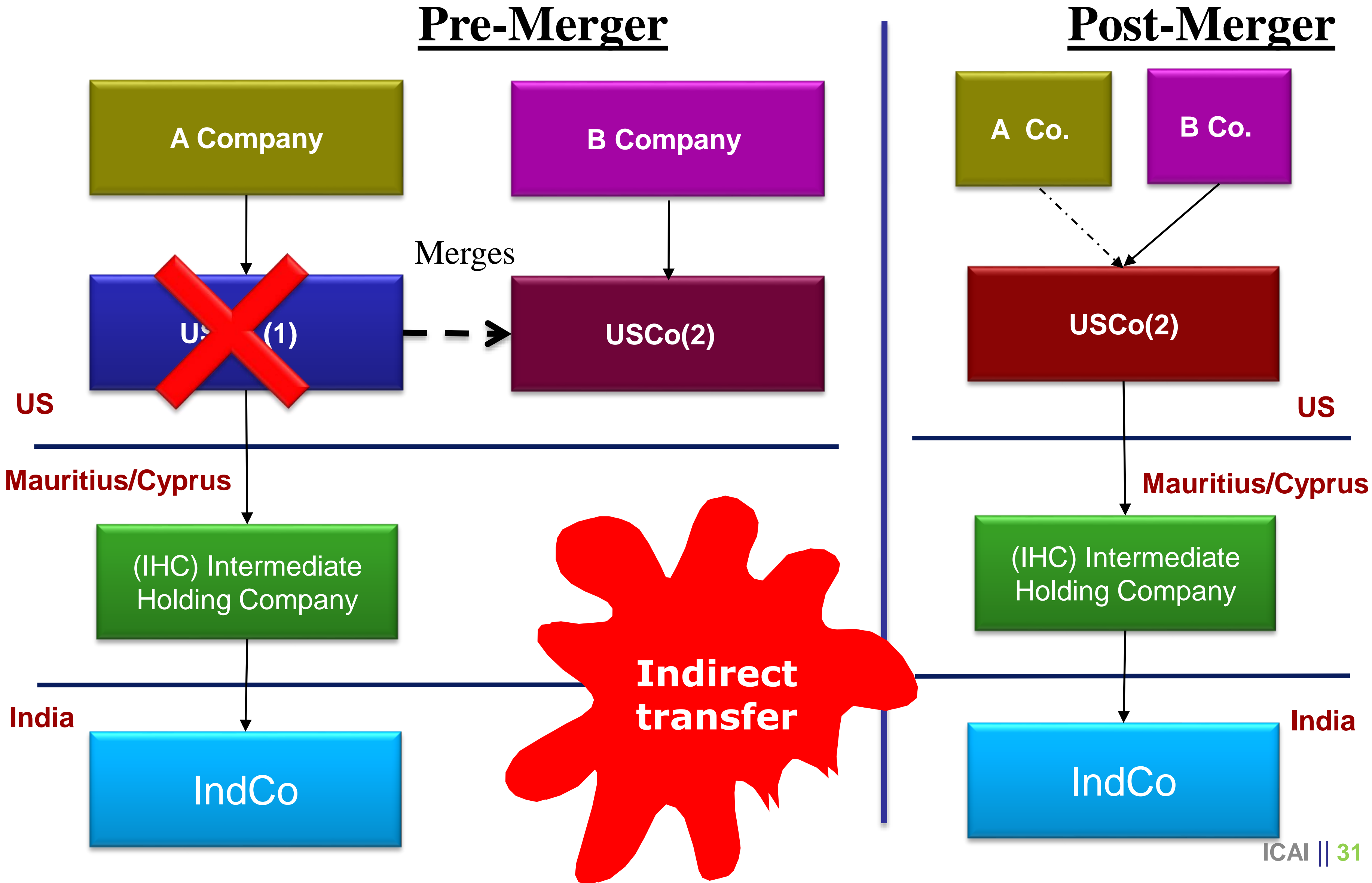
Mechanics

- 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

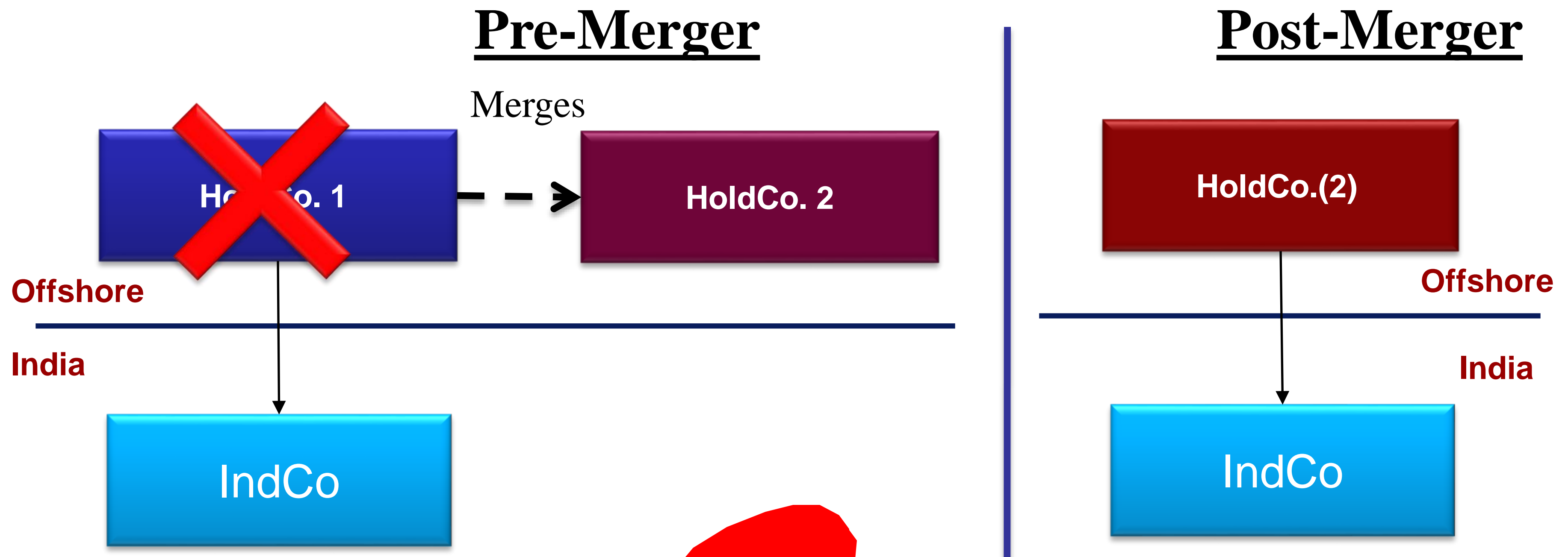
Select considerations

- Promoters preference – Share sale vis-a-vis business sale
- Stamp duty implications

Inbound Deals – Structure III

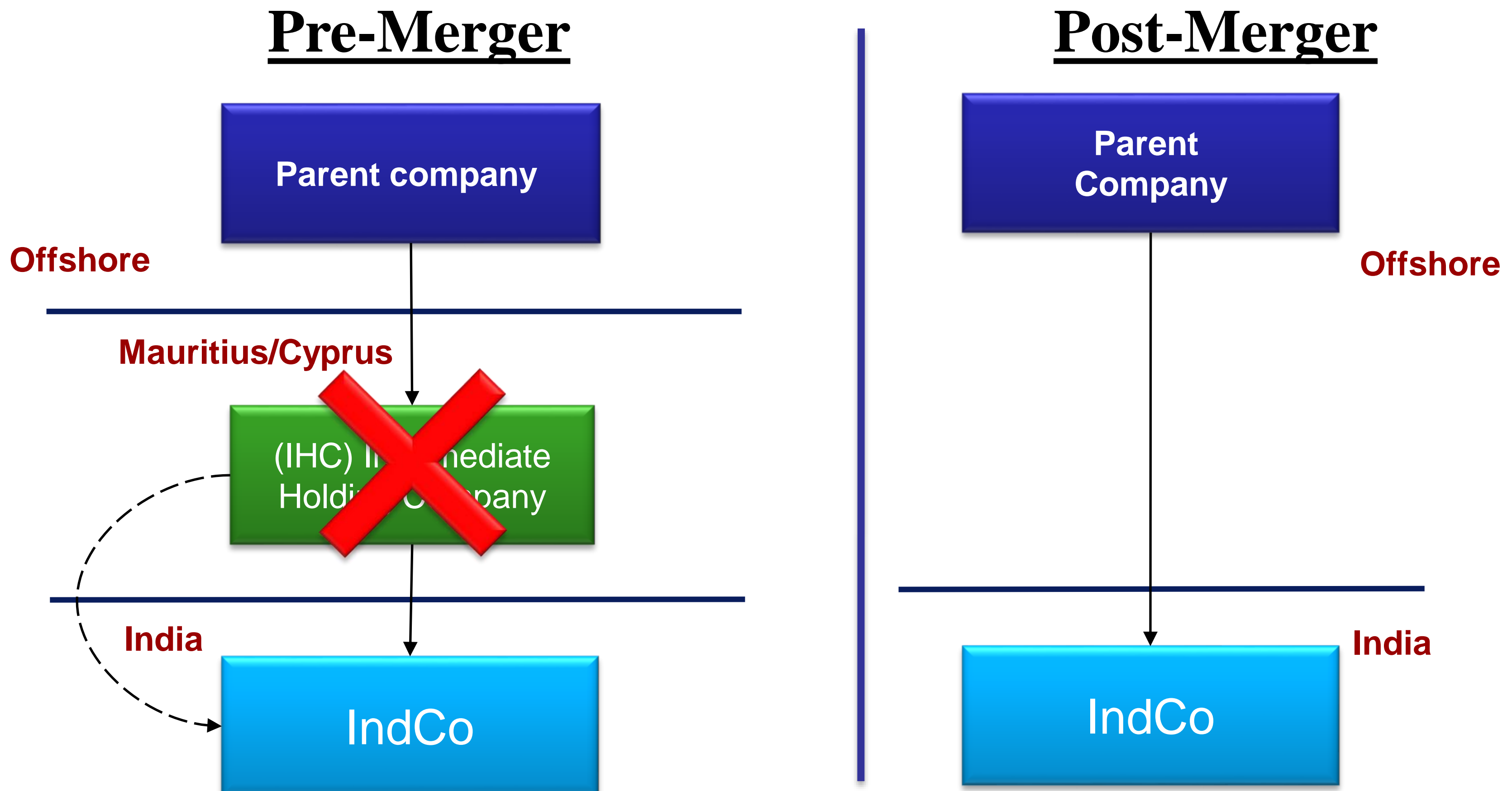


Inbound Deals – Structure IV



- Tax neutrality
- Section 79 implications
- Treaty planning

Inbound Deals – Structure V

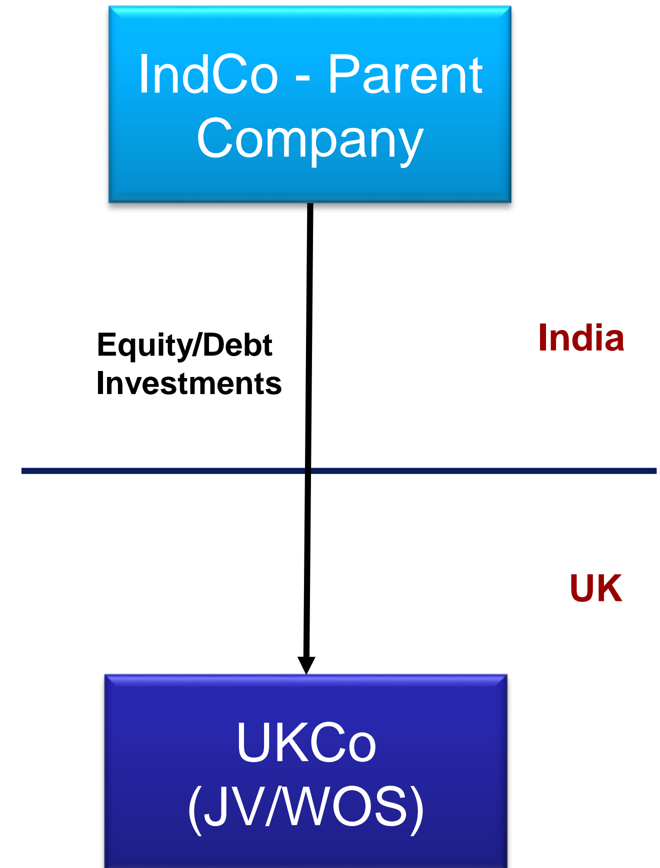


- **Tax neutrality**
- **Planning possible**

Outbound Deals

Outbound Deals – Structure I

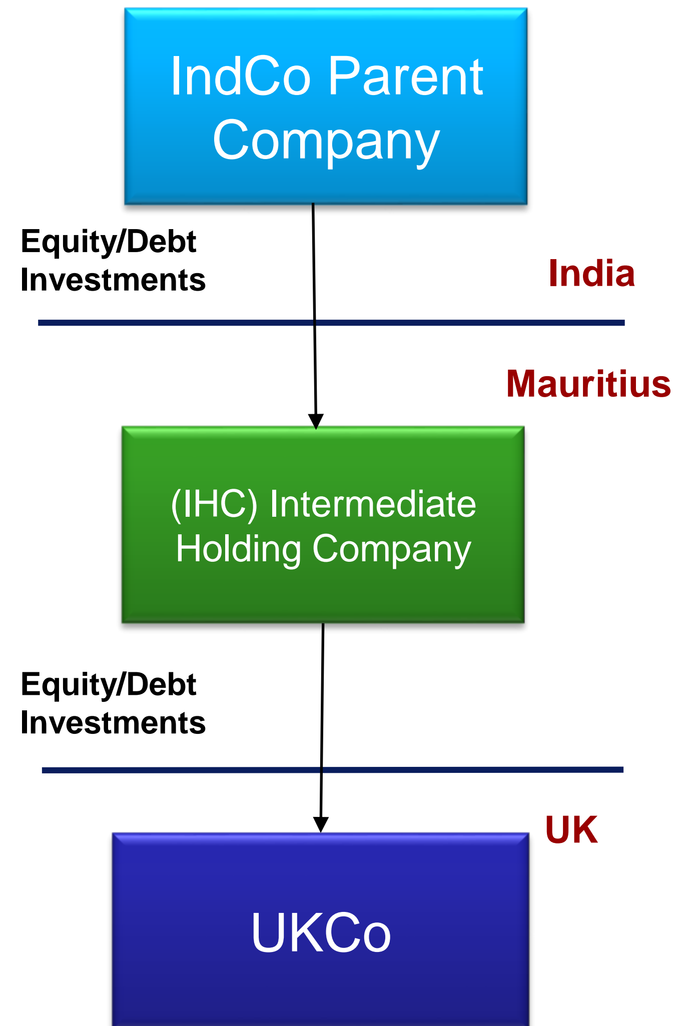
- Investment can be made up to 400% of the net worth of India Co.
- IndCo can borrow to invest in UKCo
  - Borrowings from Bank and Financial Institutions
  - Borrowings from group entities
  - Overseas Borrowing also permitted
- Deductibility of Interest on loan in India
- UKCo profits not taxable in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



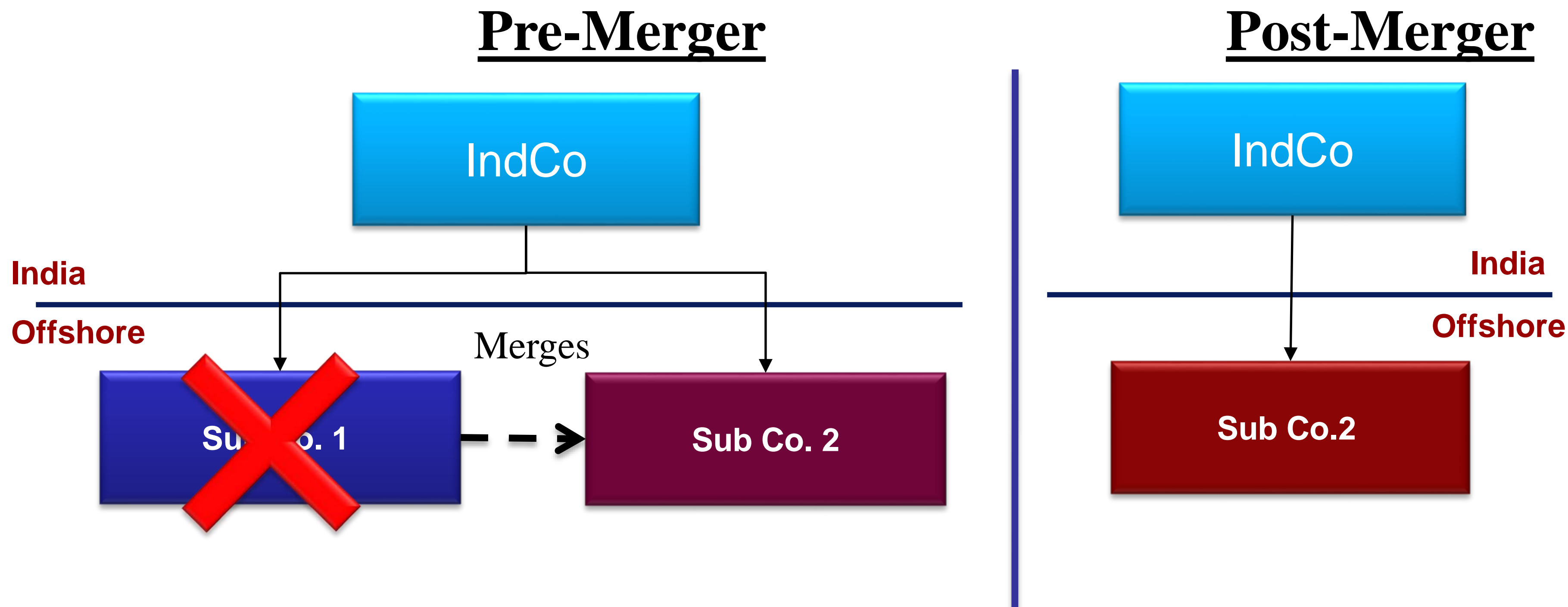
Outbound Deals – Structure II

Important Considerations

- Investment from India can be Equity/Debt
- ECB permitted for this investment
- Return on investment
- Taxability
- Availability of tax credit

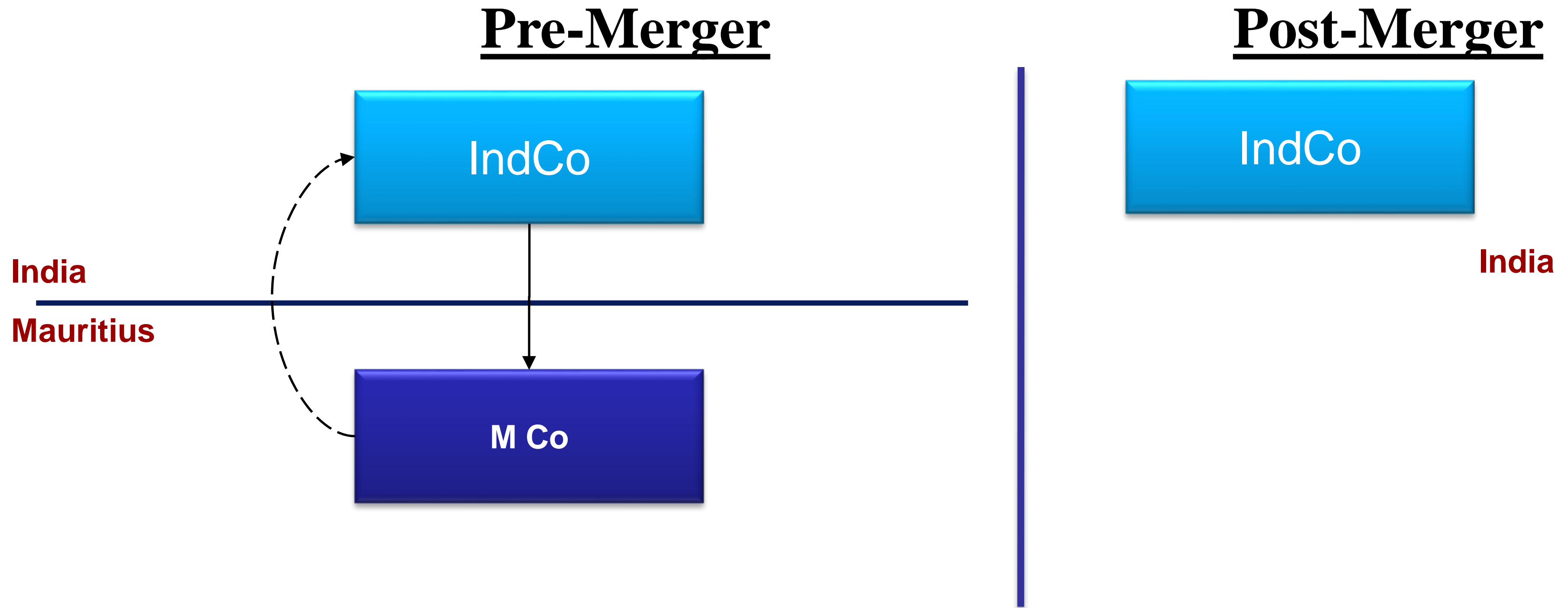


Outbound Deals – Structure III



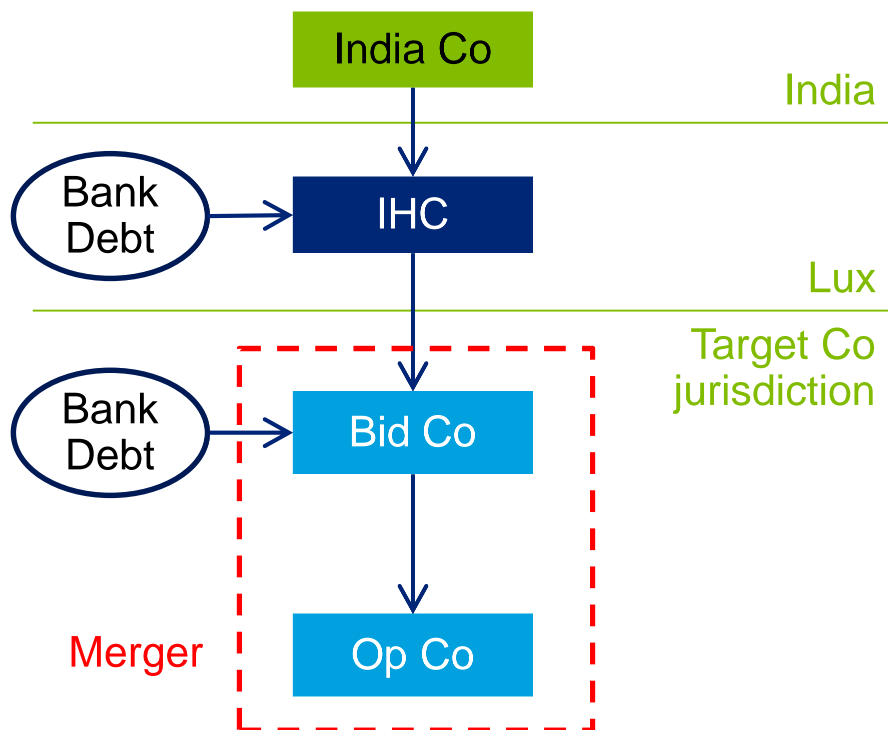
- **Tax neutrality**
- **Transfer Pricing Implications**

Outbound Deals – Structure IV



Profit Repatriation Strategy

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



Facts

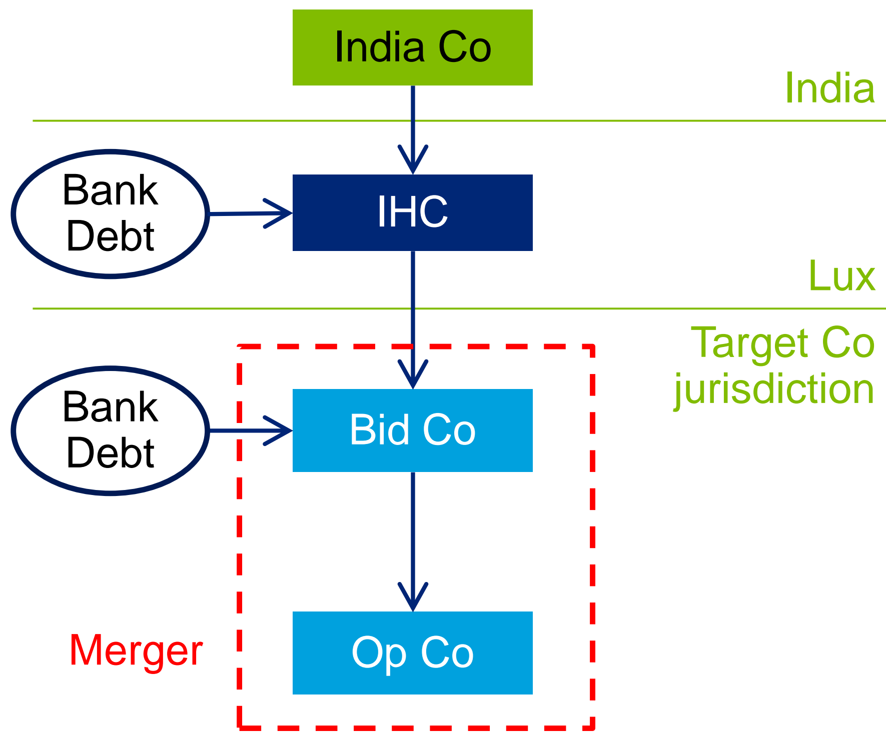
- India Co proposed to make outbound investment in profit making offshore operating company
- India Co raises debt in India or overseas for the proposed acquisition, i.e. leveraged buyout
- India Co desires to claim tax relief on interest

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

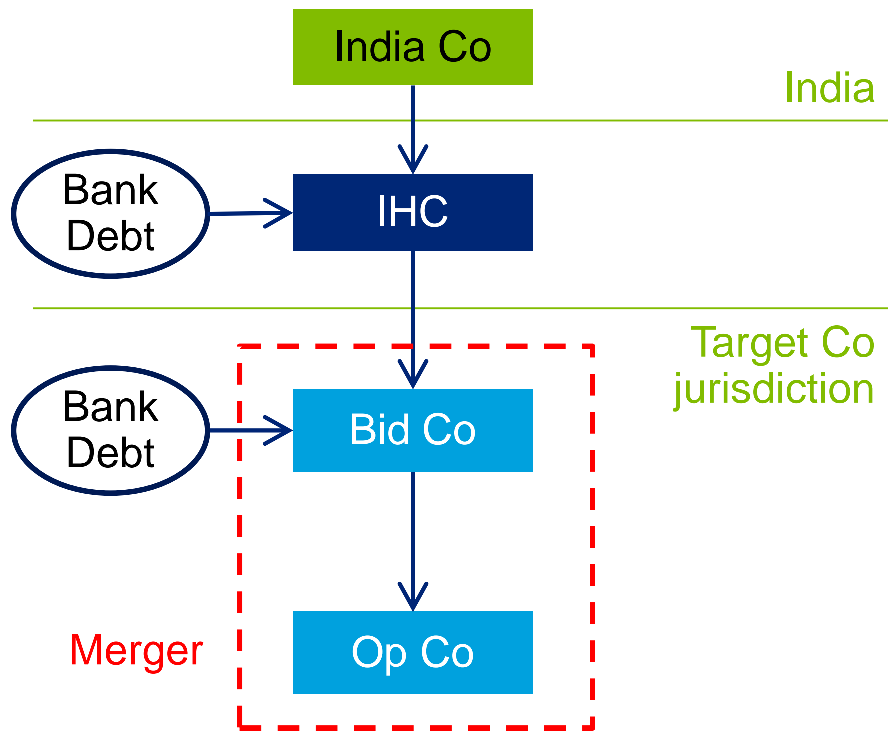


Analysis

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)



Raising debt at IHC level

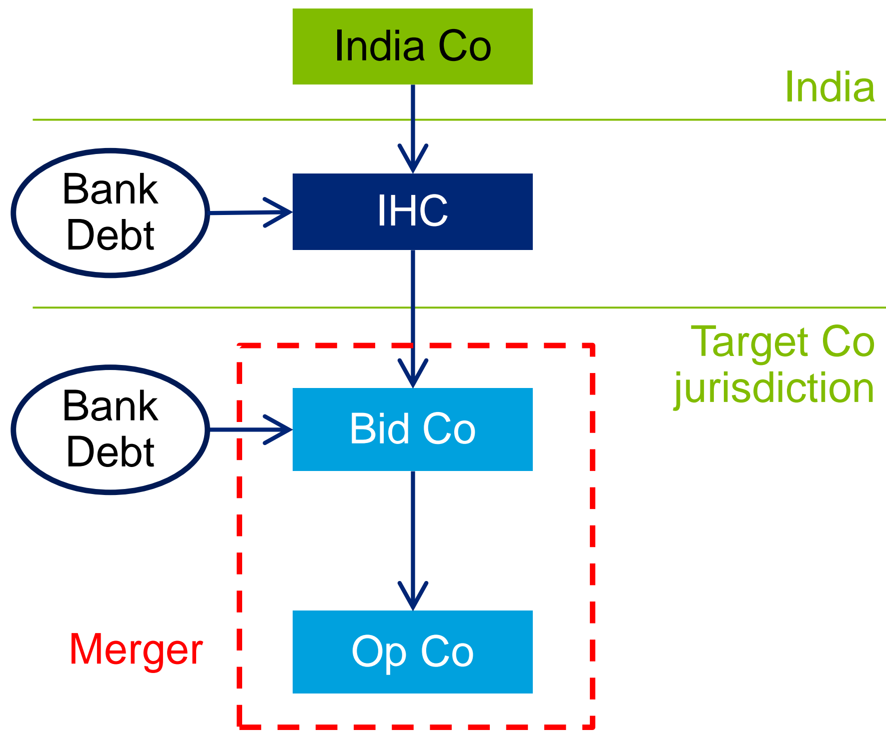
- This provides flexibility of raising debt, negotiating interest rate, etc.
- However, debt push down to Op Co shall be subject to thin capitalisation rules in Op Co jurisdiction
- Further, on account of TP regulations, interest spread shall be taxable in IHC

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

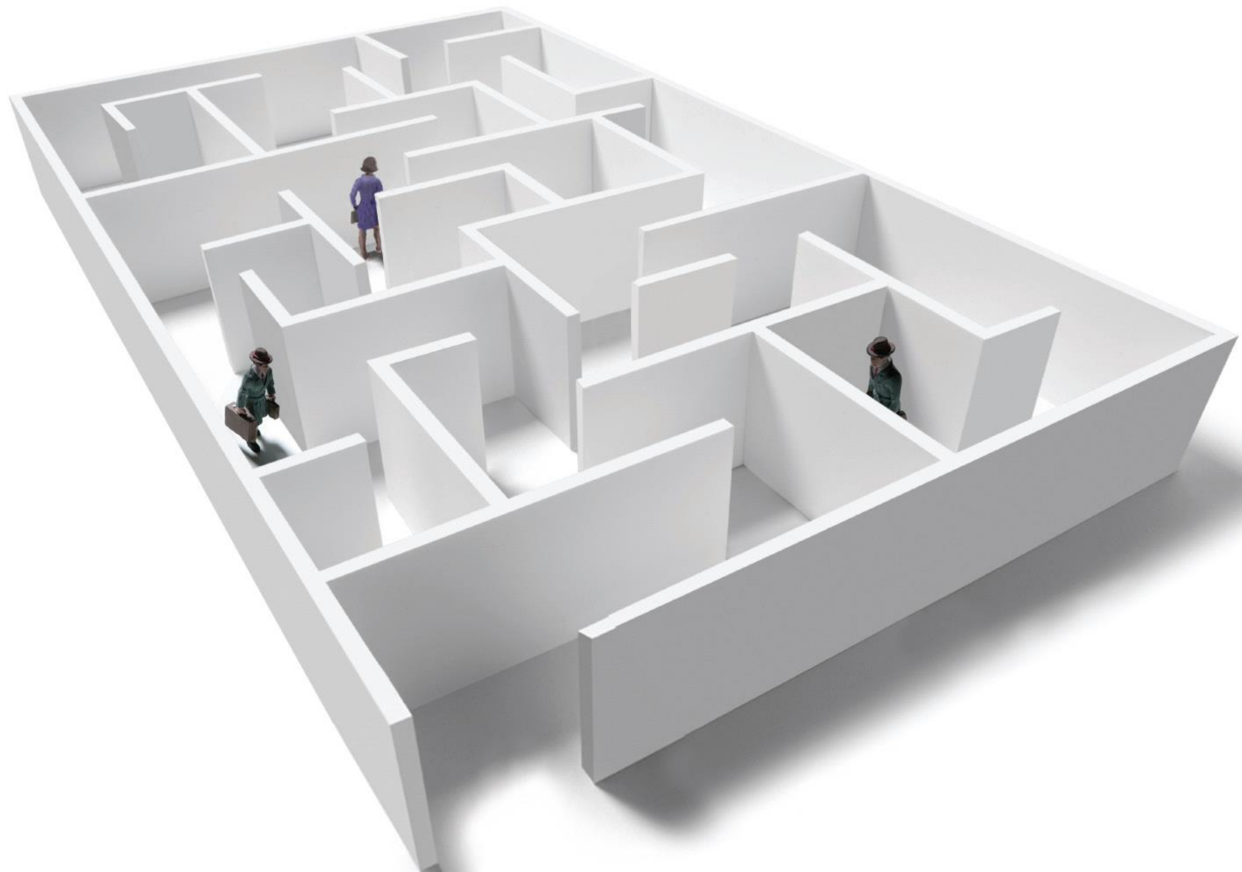
- RBI approval required for outbound investment through more than one level of IHC
- Raising of debt at various levels, lenders preference can justify multi layer SPV structure

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

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<tr><th>Issues</th><th>India</th><th>Overseas</th></tr>
<tr><td>Leveraged buy outs (LBO)</td><td>• 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</td><td>• 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</td></tr>
<tr><td>Amortization of ‘Acquired Goodwill’ under the tax laws</td><td>Not allowed</td><td>Allowed in US, UK, etc.</td></tr>
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Cross Border M&A
Some Issues

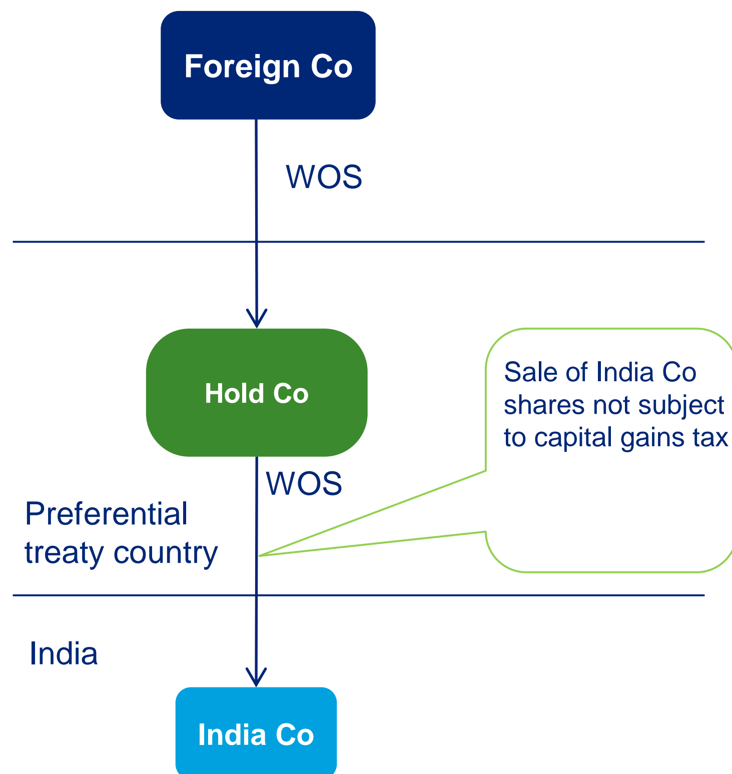
Issues	India	Overseas
Taxability of share swaps	Taxable	Not Taxable in US, UK – subject to conditions
Acquisition through a merger	• Target merges with the WOS of Acquirer • Merger is tax neutral only if shares are issued by the WOS to the shareholders of the Target	• Target merges with the WOS of Acquirer • 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

Amendments in Article 13 will phase out capital gains tax exemptions as under:		
Particulars	**Taxable in India**	**Rate of tax**
Shares acquired on or before 31 March 2017 and sold thereafter	No	N/A
Shares acquired on or after 1 April 2017 and sold on or before 31 March 2019	Yes	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	Yes	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

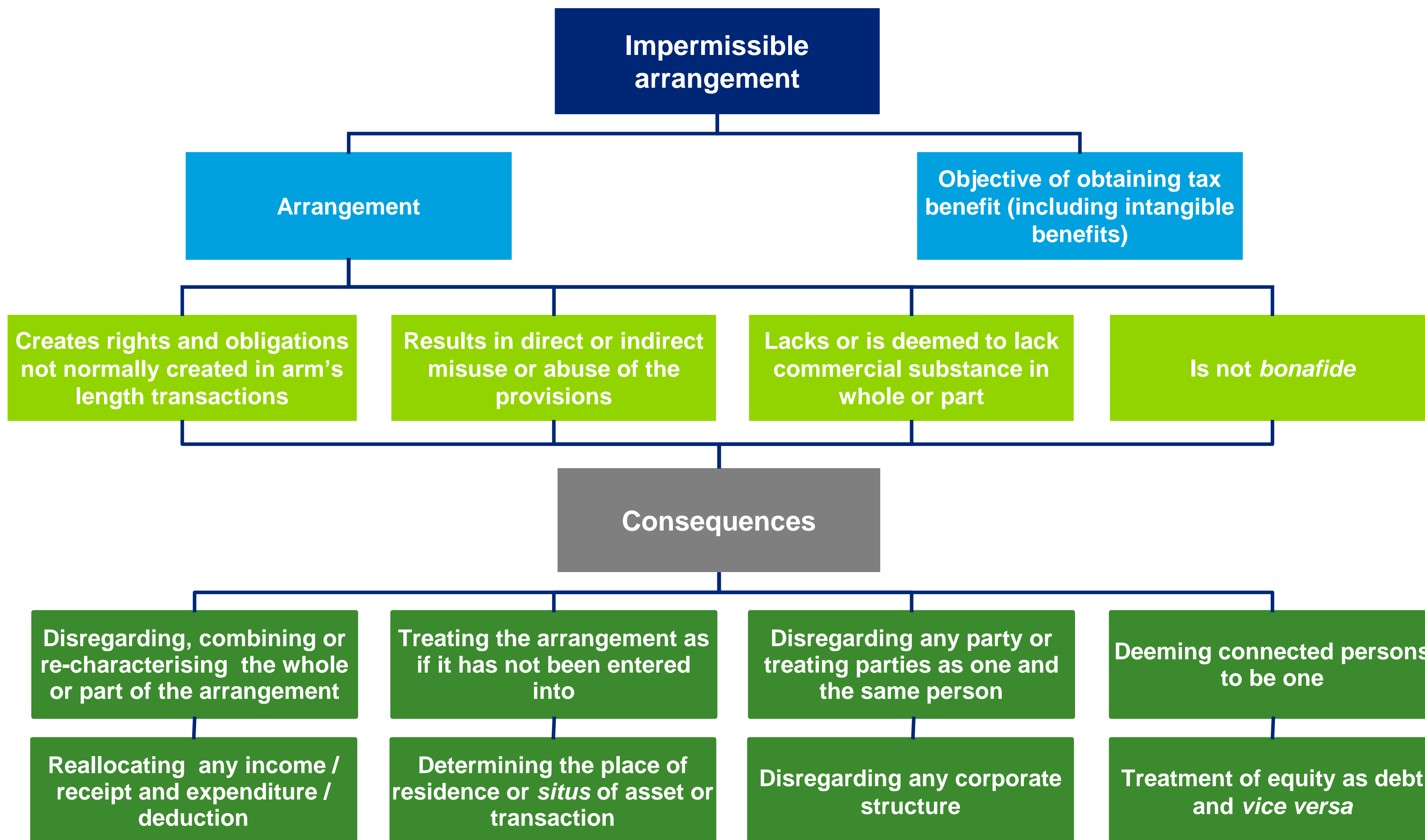
Grandfathering of shares acquired upto 31 March 2017 - capital gains not taxable in India irrespective of when these shares are sold in future; also no LOB conditions required to be met in respect of these shares

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



GAAR – Anti Avoidance legislation

Applicable from 1 April 2017

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

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