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Cross-border Mergers and Acquisitions: Regulatory Changes in Indian Corporate and Tax Laws

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1. Introduction

The recent notification of Section 234 of the Companies Act, 2013 (CA 2013) signals a further step in the integration of Indian markets within world trade. By virtue of the section, Indian companies are now able to consider outbound mergers and acquisitions (M&As), with companies of certain jurisdictions, which was previously disallowed by Companies Act 1956. This brings cross border M&As into the limelight, affording researchers the opportunity for a discussion on recent regulatory changes in India, in the field of Company Law and Taxation and their potential ramifications on cross border M&As. This paper therefore looks to define and discuss Foreign Direct Investment (FDI), cross border M&As and the various regulatory changes affecting current market dynamics within this narrative.

In the last four years the quantum of M&As in India (both in terms of the value of the M&As and the total number of M&As) has fluctuated. Correspondingly, the Indian Government has instituted several initiatives, regulatory changes and liberalization processes to mitigate such fluctuations, and arguably, increase, Foreign Direct Investment (FDI), through increased investor confidence in the Indian market. These efforts have also led to the increase of sectoral caps for FDI.

The control of sectoral FDI caps has often been a process reflecting the political economy of the moment, as the increase of sectoral caps opens Indian markets to an influx of foreign producers and service providers. This effectively decreases or even eliminates some of the protectionism which domestic stakeholders have become accustomed to. Moreover, FDI caps are subject to various national concerns such as security and traditional values. However, the increase of caps may also be the harbinger of improved technology and knowledge. This paper looks to analyse the increase in FDI caps and the various concerns associated with such changes.

The paper proceeds to look at cross border M&As, as a subset of FDI. It discusses the advantages and disadvantages of cross border M&As, including their operational and financial benefits. The paper then focuses on newly notified provisions of Indian company law, including Section 234 of the CA 2013 and provisions with the Companies Rules 2016, which allow outbound M&As of Indian companies and also contain provisions of validity of cross border M&As. The provisions also increase the involvement of the Reserve Bank of India (RBI), triggering a discussion on the initial intention of streamlining company law, and the increased procedural layers of the final regulations.

The paper then looks at the tax regulations affecting cross border M&As. Treaty advantages accruing out of Double Taxation Avoidance Agreements (DTAAs) have been severely curtailed in recent amendments. Cases such as the *Azadi Bachao Andolan* and

Vodafone have highlighted the issue of the avoidance of capital gains tax through avoidance agreements using cross border M&As and treaty shopping. This has led to the implementation of Specific Anti Avoidance Regulations (SAAR) such as Limitation of Benefit (LoB) clauses in DTAAs with Mauritius and Singapore.

Subsequently, after much debate and discussion, General Anti Avoidance Regulations (GAAR) within the IT Act 1961 have supplemented these SAAR clauses in specific tax treaties. The paper differentiates between SAAR and GAAR and looks at whether the strict application of anti avoidance regulations may be counter productive to an investor friendly image of the Indian market. It highlights the various provisions of the IT Act 1961, which serve to temper anti-avoidance regulations.

Moreover, regulations such as General Anti Avoidance Regulations (GAAR) have been implemented to enhance the control and prevention of tax avoidance through treaty shopping. While it is necessary to reward genuine arrangements with tax benefits and access to the Indian market, and at the same instance punishing those arrangements formed merely to avoid taxes, the paper discusses whether it is important to balance such intentions with keeping an investor friendly image of the Indian market.

2. Foreign Direct Investment (FDI)

We first look at the various definitions of FDI available, firstly as defined by various global organizations and then in the Indian context. According to the Financial Times, FDI is the "Investment from one country into another (normally by companies rather than governments) that involves establishing operations or acquiring tangible assets, including stakes in other businesses." [1] Furthermore, FDI is different from portfolio foreign investments[2] by the "element of control" [of the company or enterprise]. The element of control is 'internationally agreed' to be 10% of voting shares[3].

Such 'international' consensus on the definition of FDI is reflected in the various definitions provided by international organizations. The UNCTAD and OECD, for example, rely on the definition provided by the IMF, and all organizations agree on the 10% threshold[4]. According to the IMF definition, FDI "reflects the objective of establishing a lasting interest[5] by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that

[1] Lexicon, 'Definition of Foreign Direct Investment' (Financial Times) http://lexicon.ft.com/Term?term=foreign-direct-investment

[2] The purchase of a country's securities by nationals of another country; *ibid* (fn 1)

[3] *Ibid* (fn 1)

[4] United Nations Conference on Trade And Development (UNCTAD), 'Foreign Direct Investment' http://unctad.org/en/Pages/DIAE/Foreign-Direct-Investment-%28FDI%29.aspx

[5] This is seen in the existence of a long-term relationship between the direct investor and the direct investment enterprise as well as a significant influence on the management of said enterprise.

of the direct investor." Such a lasting interest is evidenced by a direct or indirect ownership of 10% of an enterprise in another jurisdiction (in the case of FDI)[6].

The UNCTAD further explains that, it is necessary to define which capital flows between the enterprise and entities in other economies should be classified as FDI[7]. Both, the threshold for defining FDI as well as the capital flows designated for and as FDI, are determined by individual jurisdictions[8].

It is therefore pertinent, at this juncture, to observe the definition of FDI in India. FDI in India (including investments and acquisitions) are governed by the terms of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000[9]. Under the Regulations a person or entity outside India, whether incorporated or not, may purchase shares or convertible debentures of an Indian company under the conditions laid down in Schedule 1 of the regulations. The regulations term this as the Foreign Direct Investment Scheme[10].

Under the scheme, FDI is prohibited under sectors listed under Annex A[11]. Schedule 1 provides two routes for FDI – the Automatic Route[12] and the Government Approval Route[13]. Annex B consists of sectors where FDI is permitted under the Automatic Route up to the sectoral caps provided[14]. If an Indian company wishes to engage in business in a sector in Annex A or wishes to issue shares beyond the sectoral caps provided in Annex B, then it must secure the approval of the Secretariat for Industrial Assistance or of the Foreign Investment Promotion Board (FIPB) of the Government of India[15].

India has seen a spate of regulatory initiative in recent times to facilitate corporate trade, including foreign investments. The previous government instituted several of these changes ranging from a revamp of the Companies Act to several trade treaties, and we look at some of these initiatives in this paper. However, the incumbent government, riding on poll promises of further liberalizing the Indian economy has instituted several changes in foreign investment and taxation regulations. One of the more important changes made in India's FDI policy in recent times is the increase of sectoral caps for FDI in various sectors. We look to analyse these changes in sectoral caps first.

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[6] IMF Balance of Payments Manual (International Monetary Fund, 5th edn, 1993) pg 86; OECD Benchmark Definition of Foreign Direct Investment (Organisation for Economic Co-operation and Development, 4th edn, 2008), pg 48

[7] UNCTAD (FDI) (fn 4)

[8] Chitta Ranjan Pal, 'Justification Behind Foreign Direct Investment (FDI) in Indian Economy: a Re-look' (2016) Indian Journal of Applied Research 6(4), 436; The threshold of 10% control, although recommended by international organizations, is often persuasive and countries have their own assigned values.

[9] Mergers and Acquisitions in India (Nishit Desai Associates, 2016), 21

[10] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 (FEMA Regulations 2000) Section 5(1)

[11] FEMA Regulations 2000 (fn 10) Schedule 1 Annex A

[12] FEMA Regulations 2000 (fn 10) Schedule 1(2)

[13] FEMA Regulations 2000 (fn 10) Schedule 1(3)

[14] FEMA Regulations 2000 (fn 10) Schedule 1(2)(1)

[15] FEMA Regulations 2000 (fn 10) Schedule 1(3)

2.1 Liberalization of FDI Caps

A few policy changes (including the increase of FDI caps) may be noticed between the Consolidated FDI policy circulars[16] of 2013[17] and 2014[18]. However, a comparison of the Consolidated FDI policy circulars of 2014 and 2016[19] shows a far more dramatic and significant increase of FDI sectoral caps in a wider range of sectors. Table 1[20] illustrates the changes made between the two Consolidated FDI policy circulars. The next edition of the Consolidated FDI Policy is to be published in 2017. The government in mulling further increases in FDI caps[21] in sectors such as Civil Aviation[22].

Two sectors that have previously shown resistance to changes in sectoral caps have been Defence and the Railways[23]. The railways have traditionally been a "state owned and operated infrastructure facility"[24]. In fact, till the changes brought about by the 2016 Policy, FDI in any activities in the railway sector was prohibited[25]. Previous attempts had been made to liberalize FDI in the railways, such as changes in the Railways Policy of 2012, but a lack of enabling provisions in the Industries Act 1951, and no mention of the sector in the 2013 Consolidated FDI Policy Circular[26] meant the continuing protectionism of the sector[27]. It was through an executive order that the incumbent government circumvented legislative hindrances and expedited the process[28]. The method of using

[16] According to the Press Information Bureau of the Government of India the "Consolidated FDI Policy Circular is a policy framework on Foreign Direct Investment, which consolidates all Press Notes/Press Releases/Clarifications/Circulars issued by DIPP, which are in force"; Press Information Bureau, 'Consolidated FDI Policy Circular 2016', (Ministry of Commerce and Industry, Government of India 2016)
[17] Department of Industrial Policy and Promotion, 'Consolidated FDI Policy Circular 2013', (Ministry of Commerce and Industry, Government of India 2013)
[18] Department of Industrial Policy and Promotion, 'Consolidated FDI Policy Circular 2014', (Ministry of Commerce and Industry, Government of India 2014)
[19] Department of Industrial Policy and Promotion, 'Consolidated FDI Policy Circular 2016', (Ministry of Commerce and Industry, Government of India 2016)
[20] See Annex
[21] Ruchika Chitravanshi and Deepshikha Sikarwar, 'Expect More Liberalized FDI Policy: Nirmala Sitharaman' *The Economic Times* (4th May 2017)
[22] PTI, 'Government Working on "Appropriate Policies" for 100% FDI in Airline' *The Economic Times* (New Delhi 15th March 2017)
[23] FDI is restricted to the construction, operation and maintenance of railway infrastructure of the following: (i) Suburban corridor projects through PPP, (ii) High speed train projects, (iii) Dedicated freight lines, (iv) Rolling stock including train sets, and locomotives/coaches manufacturing and maintenance facilities, (v) Railway Electrification, (vi) Signalling systems, (vii) Freight terminals, (viii) Passenger terminals, (ix) Infrastructure in industrial park pertaining to railway line/sidings including electrified railway lines and connectivities to main railway line and (x) Mass Rapid Transport Systems; FDI Policy 2016 (fn 20)
[24] DSK Legal, 'India: Foreign Direct Investment in the Railway Sector' (Mondaq, 1st October 2015) http://www.mondaq.com/india/x/430932/Inward+Foreign+Investment/Foreign+Direct+Investment+In+The+Railway+Sector
[25] 'FDI cap raised to 100% for Railways, 49% for defence projects' *Business Standard* (New Delhi 7th August 2014); http://www.business-standard.com/article/economy-policy/modi-cabinet-may-liberalise-fdi-regime-for-defence-railway-projects-114080600341_1.html
[26] FDI Policy 2013 (fn 17)
[27] *Business Standard* Article (fn 25)
[28] 'Viability key to FDI in Railway Projects' *Business Standard* (New Delhi 7th August 2014)

executive orders in order to overcome legislative impediment is an often-used process within Indian policy making[29].

Regulating FDI within the Defence Sector, however, is made difficult for very different considerations. While opening the sector to foreign investors, the policy must also be sensitive to national security concerns[30]. The government did, however, see fit to increase FDI in the sector through a series of incremental changes. FDI through the automatic route was first increased to 49% in the 2016 FDI Policy[31] from the previous 26% in the 2014 FDI Policy[32]. Any FDI above the provided caps was subject to clearance by the FIPB and also subject to a 'state-of-the-art' clause[33]. The cap was further increased in 2016, to 100% and the 'state-of-the-art' clause was removed[34] (Government approval is still required for FDIs above 49%). However, the then Defence Minister, Manohar Parrikar, clarified at the time that such an increase in FDI was not arbitrary and would only consider projects "where [India] [does] not have expertise"[35].

Another aspect that policy makers presumably bear in mind, when formulating policy on FDI caps, is the issue of majority control remaining in the hands of Indian stakeholders[36]. The initial raising of Defence FDI caps only to 49% may have been a result of the strong opposition by Indian corporates who insisted on majority control in order for Indian companies to build on their expertise[37]. However, the Indian government has, for a while, been courting global defence companies to manufacture in India with little success due to this issue of controlling stake. Presumably, the raising of caps to 100% may have been a further push to encourage foreign defence companies to invest in India[38]. Therefore, as is often the case with policing foreign investment, policy makers have had to balance concerns between the issue of majority control and the prospect of new local technological advancement and even technology transfer.

The subject of control has been a point of discussion in other sectors as well such as in Insurance. Although the FDI cap for insurance had been increased from 26% to 49% in 2015, there remained a condition of majority Indian control of the management and ownership. However, there was very little clarity on what constituted 'control' or

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29 John Elliott, 'India's FDI Changes Reveal Policy Making Weaknesses' *Financial Times* (London 18th February 2009); The previous government, too overcame opposition to liberalizing FDI caps in 2009 through executive orders in order to open various sectors to foreign investment: See:
'Opening Up' *Business Standard* (New Delhi 13th February 2009)

30 *Business Standard* Article (fn 25)

31 FDI Policy 2016 (fn 19) Clause 5.2.6.1

32 FDI Policy 2014 (fn 18) Clause 6.2.6.1

33 FDI Policy 2014 (fn 18) Clause 6.2.6.2 (xvi) and (xvii) remaining unchanged in FDI Policy 2016 (fn 19) Clause 5.2.6.1

34 Press Note 5 (2016 Series), Clause 5 amended FDI Policy 2016 (fn 19) Clause 5.2.6.1; Department of Industrial Policy and Promotion, 'Review of Foreign Direct Investment (FDI) Policy on Various Sectors', (Press Note 5 (2016 Series), Ministry of Commerce and Industry, Government of India, 24th June 2016)

35 Nayanima Basu, '100% FDI in Defence will be Allowed Only Where there is NO Expertise: Parrikar' *The Hindu Business Line* (Bengaluru 14th February 2017)

36 *Business Standard* Article (fn 25)

37 Dinakar Peri, '100% FDI in Defence: What Does it Mean?' *The Hindu* (New Delhi 18th October 2016)

38 Peri (*The Hindu*) (fn 37)

‘ownership’. These existing guidelines on Indian management and control will have to be verified by the respective regulators, the Insurance Regulatory and Development Authority of India and the Pension Fund Regulatory and Development Authority[39].

3. Mergers and Acquisitions (M&As)

We next look at a particular form of FDI – Mergers and Acquisitions (M&As). A company may invest through FDI into a foreign jurisdiction either by setting up a fresh organization in the foreign jurisdiction through fresh investments (often termed Greenfield investments) or by investing in an already established firm either partially, in the form of a merger, or entirely, as an acquisition (termed Brownfield investments)[40].

This definition was evident in the UNCTAD description of the difference between FDI and M&A which stated thus: “A firm can undertake FDI in a host country in either one of two ways: Greenfield investment in a new facility or acquiring or merging with an existing local firm. The local firm may be privately or state owned: privatisations involving foreign investors count as cross border M&As, which entails a change in the control of the merged or acquired firm. In a cross border merger, the assets and operation of the two firms belonging to two different countries are combined to establish a new legal entity. In a cross border acquisition, the control of assets and operations is transferred from a local to a foreign company, the former becoming an affiliate of the latter.”[41]

There are several advantages to a Greenfield investment by a foreign company and we briefly summarize them here in order to provide a nuanced view on the subject. One of the advantages of entering a market with a fresh investment is the availability of the factors of production such as goods, capital and labour at cheaper rates[42]. Angwin lists other advantages to Greenfield investments. One obvious advantage of an investment into a new market, from the grassroots up, is a more thorough and complete knowledge of both the market and the growing company itself. All acquired knowledge from the experience of forming a new company in a fresh market is most likely to be internalized into the workings of a company. Moreover, progressive knowledge means that strategies may be reversed or changed with changing dynamics of a market, and the constraints of an upfront commitment do not exist[43].

Furthermore, the prerequisite of an acquisition or merger is the availability of a suitable company, to acquire or merge with. A Greenfield investment has no such constraints and an investment may be made at the prerogative of the forming company. Moreover, as an

[39] Remya Nair, ‘Union Budget 2016-17: Insurance, Pension FDI under Automatic Route Now’ *Live Mint* (New Delhi 29th February 2016)

[40] Beena Saraswathy, “Cross-border Mergers and Acquisitions in India: Extent, Nature and Structure”, (2010), Centre for Development Studies, Working Paper

[41] United Nations Conference on Trade and Development, ‘World Investment Report 2000: Cross-border Mergers and Acquisitions and Development’ (Geneva: UNCTAD 2000) 99

[42] Saraswathy (2010) (fn 40)

[43] Duncan Angwin, (2014), ‘In Search of Growth: Choosing Between Organic, M&A, and Strategic Alliance Strategies’ in Scott Moeller (ed), *Mergers and Acquisitions* (Bloomsbury Press, London 2014)

individual entity, the company is not restrained by the compromises required of a merger with another company, including a clash of existing cultures prevalent in the companies prior to a M&A[44].

However Greenfield investments are time consuming as they start from scratch. Internal capabilities take a much longer period to develop and cost more. It is not easy to use existing capabilities as the platform for major leaps in terms of innovation, diversification, or internationalization. Thus companies have to go beyond their own internal capabilities to find growth, and one of the methods to do so is to merge with an already existing company in the target market[45].

In the case of Brownfield investments, therefore, growth objectives may be achieved with less cost and effort compared to a fresh entry. In the case of FDI, foreign companies conveniently gain access to an already established market and benefit from the resources of an established firm. The cost of expenses such as marketing, advertisement, distribution and R&D are considerably reduced[46].

3.1 Defining M&As

According to a report on M&As[47], a 'merger' is "a combination of two or more entities into one; the desired effect being not just the accumulation of assets and liabilities of the distinct entities, but organization of such entity into one business." Such a merger of two companies into one economic entity is considered while keeping long-term business interests in mind, including expansion and diversification[48]. There are several reasons why two companies may choose to merge including, economies of scale, acquisition of technologies, access to sectors/markets, among others. Often M&As are used as consolidation strategies by companies to restructure their operations, in order to face market challenges[49]. Eventually mergers lead to the sharing of risks and financial rewards between these previous individual entities[50].

One other definition to be considered for the purpose of this paper is that of the Report of the Expert Committee on Company Law[51]. According to the report, "mergers and acquisitions are manifestations of an inorganic growth process. While mergers can be defined to mean unification of two players into a single entity, acquisitions are situations where one player buys out the other to combine the bought entity with itself. It may be in the form of a purchase, where one business buys another, or a management buy out,

[44] Angwin (2014) (fn 43)
[45] Angwin (2014) (fn 43)
[46] Saraswathy (2010) (fn 40)
[47] Mergers and Acquisitions in India (Nishit Desai Associates, 2016)
[48] Priyanka Shorewala and Priya Chaudhary, 'Mergers and Acquisitions after "Make in India"', (2016) IOSR Journal of Business and Management 18(3)
[49] Saraswathy (2010) (fn 40)
[50] Shorewala and Chaudhury (2016) (fn 48)
[51] Ministry of Company Affairs, 'Report of the Expert Committee on Company Law 2005' (Irani Report 2005) (New Delhi 31st May 2005)

where the management buys the business from its owners"[52].

In the Indian regulatory context, although FDIs and M&As arising out of FDIs are regulated by the FEMA Regulations, the terms and functioning of a merger or acquisition is defined by the regulations within the Companies Act 2013. The term 'merger' is not defined under the Companies Act, 1956, or under the Income Tax Act, 1961. However, the Companies Act, 2013 without strictly defining the term explains the concept[53]. The Income Tax Act does however define the analogous term 'amalgamation': the merger of one or more companies with another company, or the merger of two or more companies to form one company[54].

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[52] Irani Report 2005 (fn 51) Chapter 10.1

[53] The Companies Act 2013 (CA 2013) Section 232 Merger and amalgamation of companies — (1) Where an application is made to the Tribunal under section 230 for the sanctioning of a compromise or an arrangement proposed between a company and any such persons as are mentioned in that section, and it is shown to the Tribunal—

> (a) that the compromise or arrangement has been proposed for the purposes of, or in connection with, a scheme for the reconstruction of the company or companies involving merger or the amalgamation of any two or more companies; and
>
> (b) that under the scheme, the whole or any part of the undertaking, property or liabilities of any company (hereinafter referred to as the transferor company) is required to be transferred to another company (hereinafter referred to as the transferee company), or is proposed to be divided among and transferred to two or more companies,
>
> […]
>
> 233. Merger or amalgamation of certain companies.— (1) Notwithstanding the provisions of section 230 and section 232, a scheme of merger or amalgamation may be entered into between two or more small companies or between a holding company and its wholly-owned subsidiary company or such other class or classes of companies as may be prescribed, subject to the following, namely:—
>
> […]
>
> 234. Merger or amalgamation of company with foreign company.— (1) The provisions of this Chapter unless otherwise provided under any other law for the time being in force, shall apply mutatis mutandis to schemes of mergers and amalgamations between companies registered under this Act and companies incorporated in the jurisdictions of such countries as may be notified from time to time by the Central Government:

Provided that the Central Government may make rules, in consultation with the Reserve Bank of India, in connection with mergers and amalgamations provided under this section.

> (2) Subject to the provisions of any other law for the time being in force, a foreign company, may with the prior approval of the Reserve Bank of India, merge into a company registered under this Act or vice versa and the terms and conditions of the scheme of merger may provide, among other things, for the payment of consideration to the shareholders of the merging company in cash, or in Depository Receipts, or partly in cash and partly in Depository Receipts, as the case may be, as per the scheme to be drawn up for the purpose.

[54] Income Tax Act 1961 (IT Act 1961) Section 2(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 a manner that—

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

The determination to merge companies is driven by several catalytic factors and is encouraged by the advantages an M&A may provide. We look at some of the discussion highlighting such factors.

3.2 Factors that Encourage M&As

A primary reason for M&As is consolidation[55]. Consolidating through an M&A can reap several benefits to the merged entity. One such benefit is an observable increase in market power for the new company. This is due to the reduction in competition and because the formed company can garner a larger chunk of the market share[56]. Market power describes the ability of a company, as a market participant, to control the price, the quantity or the nature of products sold in the market. A company that has market power over others will use it in order to generate additional profits. Thus the transfer of these additional profits from one market participant to another market participant is a result of higher market power. An example of a benefit of increased market power is the increase of bargaining power with suppliers.

A connected incentive for M&As is synergy and efficiency gains[57], including operational, and financial synergy, and is often cited to justify mergers[58]. According to Gaughan, synergy is the "ability of a corporate combination to be more profitable than the individual parts of the firms that were combined"[59]. Seth, similarly postulates that the value, which is created by combining two companies, creates opportunities that would not have been available to the companies operating separately[60]. The phenomenon may be illustrated by the following equations [61]:

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

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

[55] Consolidation in business is a concept similar to that of a merger, and involves the combining of two separate entities/corporations. However the two concepts are dissimilar in that mergers result in one particular entity surviving while consolidation leads to the emergence of an entirely new entity (See for example Kenneth W Clarkson, Roger LeRoy Miller and Frank B Cross, *Business Law: Text and Cases: Legal, Ethical, Global, and Corporate Environment* (Cengage, 13th Ed, 2015), 797); Literature on M&As however, also use the term in its general definition "to combine several things, especially businesses, so that they become more effective"
(Cambridge English Dictionary, http://dictionary.cambridge.org/dictionary/english/consolidate)

[56] Angwin (2014) (fn 43); Mergers and Acquisitions: The Evolving Indian Landscape (Pricewaterhouse Coopers (PwC) 2017)

[57] PwC (2017) (fn 56)

[58] Jack Koenigstknecht and Bruce Brown, 'Mergers and Acquisitions Operational Synergies: Perspectives on the Winning Approach' (Deloitte 2013);

[59] Patrick A Gaughan, 'Mergers acquisitions and corporate restructurings', (Wiley, 4th Edn, 2007)

[60] Anju Seth, 'Sources of Value Creation in Acquisitions: An Empirical Investigation' (1990 A) Strategic Management Journal 11(6), 431

[61] Phanish Puranam and Bart Vanneste, *Corporate Strategy: Tools for Analysis and Decision Making* (1st Edn, CUP 2016)

$$V(AB) > V(A) + V(B)$$

Where V(AB) is the value of the combined firm and V(A) and V(B) are the values of the individual firm.

The value of the Synergy (S) therefore could be determined by:

$$S = V(AB) – [V(A) + V(B)]$$

We discuss the literature of the two forms of business synergy – Operational and Financial Synergy. Operational synergies allow firms to increase their operating income and growth from existing assets[62]. One of the observable benefits of operational synergies is seen in the “Economies of Scale” allowing the combined firm to become more cost-efficient and profitable[63]. Economies of scale work on the principle that with an increase in the scale of production, the cost per unit of the product simultaneously decreases. This is because fixed costs can now be spread across a larger quantity of the products. A few instances exampled by Junge, of fixed costs that can be spread across a greater scale, are sales and admin expenses due to the merging of headquarters and support functions[64]. Porter and Scherer further provide that advertisement, research and development as well as the optimization of distribution and procurement by reducing transaction costs in the supply chain all benefit from the economies of scale[65]. It is however likely that such synergies are optimal when the operations and cost structures of the merging companies are similar[66]. This is why economies of scale are most observable in horizontal mergers[67].

Another sector where operational synergies may be observed is in market power[68]. Market power, as mentioned earlier is also a beneficial consequence of consolidation, but does demonstrate traits of operational synergies. The monopolistic theory is one explanation of such synergies, where consolidating in the market leads to an enhanced market share and increased ability to prevent competition from entering the market[69], while simultaneously increasing the revenue of the enlarged entity[70]. A controversial synergy arising from market power is the ability to tend towards anticompetitive activities as the market power of merged entities increases[71]. Damodaran postulates that the merger of two firms is more likely to create an oligopoly of pricing power[72].

[62] Aswath Damodaran, ‘The Value of Synergy’, (2005) New York University, Stern School of Business
[63] PwC (2017) (fn 56); Damodaran (2005) (fn 62)
[64] Michael E Porter, *Competitive Strategy* (1980 Free Press, New York)
[65] Porter (1980) (fn 64)
[66] Jacobus T Severiens, ‘Creating Value Through Mergers and Acquisitions: Some Motivations’ (1991) Managerial Finance 17(1), 3
[67] The merger of firms in the same business; Damodaran fn 63
[68] PwC (2017) (fn 56); Angwin (2014) (fn 43)
[69] George J Stigler, ‘Monopoly and Oligopoly by Merger’ (1950) American Economic Review 40(2), 23
[70] George J Stigler, ‘The Dominant Firm and the Inverted Price Umbrella’ (1965) Journal of Law and Economics, 8, 167
[71] James H Lorie and Paul Halpern, ‘Conglomerates: The Rhetoric and the Evidence’ (1970) Journal of Law and Economics, 13(1), 149
[72] Damodaran (2005) (fn 62)

Financial synergies are more focused and include tax benefits, diversification, a higher debt capacity and uses for excess cash. They sometimes show up as higher cash flows and sometimes take the form of lower discount rates[73]. Ultimately financial synergies lead to a lower cost of capital[74]. The increase in size due to the merging of the two firms means there is an increase in assets and simultaneously an increase in debt capacity[75]. This in turn provides access to cheaper capital and allows the firm to borrow more[76] with access to stronger investors[77]. Moreover, an FDI related M&A would also have the added benefit of access to foreign capital[78].

Another financial synergy is the lowering of risk by the diversification of operations (although this is more applicable to the M&A of firms that are unrelated in operations). According to Shrieves and Pashley, when such firms merge their "combined income stream stabilizes" and the "variance in the combined firm's ventures decreases[79]".

Tax efficiency is another visible form of financial synergy[80]. These synergies, however, are unrelated to 'cost of capital' improvements, like the other financial synergies discussed above. One of the tax efficiencies experienced by FDI related M&As is that profits or tax losses may be transferable within the combined company in order to benefit from different tax regimes[81]. Moreover, net operating losses of the merged company may be used to shelter income of the more profitable company prior to merger[82]. Thus, often profit making firms acquire firms making losses for this purpose.

Moving on to a further advantage of M&As, we look at its effects on business extensions. M&As allow firms to reach new markets, not just geographically (FDIs) but also in terms of new products[83]. Simultaneously this could also lead to the access to new technologies[84]. Moreover, M&As allow firms to reduce their dependencies on other firms, by acquiring a company operating on a different but complimentary product in the supply chain[85]. Such dynamics are often labelled as 'economies of scope'[86] and occur when jointly producing two products is cheaper than when two separate firms produce

[73] Damodaran (2005) (fn 62)
[74] Damodaran (2005) (fn 62)
[75] Wilbur G Lewellen, 'A Pure Financial Rationale for the Conglomerate Merger', (1971) Journal of Finance, 26(2), 521
[76] Damodaran (2005) (fn 62)
[77] Angwin (2014) (fn 43)
[78] PwC (2017) (fn 56)
[79] Ronald E Shrieves and Mary M Pashley, 'Evidence on the association between mergers and capital structure', (1984) Financial Management, 13(3)
[80] Carla Hayn, (1989), "Tax attributes as determinants of shareholder gains in corporate acquisitions", Journal of Financial Economics, 23(1), 121
[81] Angwin (2014) (fn 43); We discuss tax laws surround the issue of using beneficial tax regimes in further details below.
[82] Damodaran (2005) (fn 62)
[83] Angwin (2014) (fn 43); PwC (2017) (fn 56)
[84] PwC (2017) (fn 56)
[85] This would be an example of a vertical merger.
[86] Anju Seth, 'Value Creation in Acquisitions: A Re-Examination of Performance Issues' (1990 B) Strategic Management Journal 11(2), 99

them individually[87].

Furthermore, as already mentioned earlier, M&As provide a speed of expansion that is unlikely in a Greenfield investment. This also means that an astute firm can use M&As to expand quickly enough to reap the benefits already mentioned, and find itself in a more advantageous position than its competition[88].

Finally, one other factor that may lead to an M&A is the potential to strip assets or resell them post merging. At times, companies often acquire other companies when they recognize that the underlying assets of the acquired company have a greater value than the company itself. Thus these companies are bought, then ‘unbundled’, and individual business units are eventually sold off[89]. Often acquiring companies sell off the non-core assets of the acquired companies. Sometimes such investment opportunities may arise out of the distress sales by a weaker company[90]. Although such an acquisition may not be particularly important in the context of the economic growth of the company, it may aid in tax minimization or tax efficiency, and thereby an instrument of corporate strategy.

3.3 FDI and M&A trends in India

We now look at some of the current FDI and M&A trends in India. As mentioned earlier, in the last four years the number and value of M&As in India have fluctuated. Although globally there was an increase in M&As between 2013 and 2015, 2016 saw a dip in the total value of global M&As. While the total value of global M&A transactions in 2015 was $4.66 Trillion, an 18% year-on-year decline on such transactions meant that the total value for M&A transactions for 2016 was $3.84 Trillion[91].

India initially saw a decline in total M&A transactions (both, inbound and outbound) from $33 Billion in 2014 to $20 Billion in 2015[92]. However, between January and September 2016 there was an increase in the quantity of Indian M&As to 712 deals – a 135 deal year-on-year increase (EMIS Report 2016[93]). The value for M&A deals in the third quarter of 2016 was a total of $12.2 Billion – the highest quarterly value in 2 years (PwC 2017). The total inbound M&A value for 2016 was $22.135 Billion.

M&As are an integral part of the Indian economy and India’s current growth trajectory pre-empts not only a continuation but also an increase in M&A activity. One of the reasons for such an increase is that, M&As are an instrument of inorganic growth. Therefore a market or an environment that is not conducive to organic growth will see an increase in M&A activity. The Indian markets reflect such dynamics that are conducive to inorganic growth. Although the incumbent government has launched several initiatives and have tried to signal to the market of its intention to make business easier in India,

87 Severiens (1991) (fn 66), 3
88 Angwin (2014) (fn 43)
89 Angwin (2014) (fn 43)
90 PwC (2017) (fn 56)
91 PwC (2017) (fn 56); 2017 M&A Global Outlook (J.P.Morgan 2017)
92 Nishit Desai (M&A Report 2016) (fn 47)
93 EMIS Report 2016 quoted from PwC (2017) (fn 56)

several encumbrances remain for greenfield investments, leading to high gestation periods for seminal projects, such as administrative lethargy and compliance to multiple regulations. Thus, for any business, inorganic growth through M&A continues to be an attractive option[94]. The intensity of such operations is increasing with the de-regulation of various government policies as a facilitator of the neo-liberal economic regime[95]

Gardiner speculates that many managers and investors prefer acquisition to organic growth due to the notion that "profitable organic growth" is more difficult to achieve in a low-inflation, "globalised" world. He clarifies, however, that "there is nothing intrinsic to either disinflation or globalization that requires trend growth to slow or profitability to fall"[96]. Earlier, however, foreign firms were satisfying their market expansion strategy through the setting up of wholly owned subsidiaries in overseas markets[97].

According to Saraswathy, recent trends show foreign companies to have found mergers, acquisitions and similar strategies to be a cost effective and expeditious way to enter the Indian market. Simultaneously, in order to facilitate globalisation, the Indian government also implemented various policies that marked a paradigm shift in the operation and regulation of the domestic firms and opened them for the free play of market forces[98]. We now look at some of the regulations affecting FDI related M&As as well as some of the initiatives of the Indian government aimed at facilitating FDI.

4. Corporate Law Changes Affecting M&As

Previously the provisions of the Companies Act 1956 governed M&As. Currently, Companies Act 2013 (CA 2013), and specifically sections 230-240[99] are applicable to M&As. Section 234 specifically addresses cross border M&As and was notified by the Ministry of Corporate Affairs (MCA), on 13th April, 2017[100]. The MCA also inserted sub-rule 25A (merger or amalgamation of a foreign company with an Indian company and vice-versa) in the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016 (Companies Rules 2016)[101].

The CA 2013 provides a comprehensive set of provisions for the conducting of M&As, ranging from the procedure for the approval of such a merger or acquisition (including shareholder approval), to the formation of the National Company Law Tribunal (NCLT)[102]. Moreover CA 2013 also makes changes in the provisions for minority

94 PwC (2017) (fn 56)
95 Saraswathy (2010) (fn 40)
96 Kevin Gardiner, 'The Market for Mergers and the Boundaries of the Firm' (2006) Forum 7(1), 10
97 Geoffrey Jones, *Multinationals and Global Capitalism: From the Nineteenth to the Twenty-first Century* (1st edn, OUP 2005)
98 Saraswathy (2010) (fn 40)
99 These are the general provisions pertaining to M&As; CA 2013 Chapter XV Compromises, Arrangements and Amalgamations
100 The Gazette of India No. 1050, Part II Section 3(ii)
101 The Gazette of India No. 291, Part II Section 3(i)
102 Which is substituting the function of the High Court to approve Schemes of Arrangement for M&As.

stakeholders in the case of a majority takeover[103], as well as the regulations for capital reduction[104]. Aiding the CA 2013 in regulating the transfer of shares, is the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011[105].

Previously, cross border mergers were governed by Section 394 of the Companies Act 1956, whereby the "transferee company" could only be an Indian company[106] while transferor companies could be any body corporate[107], thus effectively ensuring that only foreign companies could merge with Indian companies but not the other way around. Section 234 of CA 2013, however, explicitly includes cross border M&As (specifically "a foreign company[108] [merging] into a company registered under [the Companies Act 2013] or *vice versa*"[109]) within the provisions of Chapter XV[110], thereby allowing outbound mergers by Indian companies.

Section 234 also provides a few conditions to the validity of a cross border merger. Firstly, such a merger would require approval from the Reserve Bank of India (RBI)[111]. Secondly, the section also mandates that the terms and conditions of the merger provide for the payment of consideration to the shareholders of the merging company "in cash, or in depository receipts, or partly in cash and partly in depository receipts, as the case may be, as per the scheme to be drawn up for the purpose"[112].

Moreover cross border mergers are also governed by the aforementioned Companies Rules, 2016, notified along with Section 234 of CA 2013[113]. While reasserting the prior approval of the RBI for cross border mergers, and the necessity of such mergers complying with the provisions of CA 2013[114], the Companies Rules also provide a few other conditions for the validity of cross border merger. Firstly, the Companies Rules specify that only companies originating from certain jusrisdictions may merge with Indian companies[115]. Secondly, the transferee company "would need to ensure that

[103] CA 2013 (fn 53) Section 236
[104] CA 2013 (fn 53) Section 66
[105] Nishit Desai (M&A Report 2016) (fn 47)
[106] The Companies Act 1956 (CA 1956); Specifically a company within the meaning of the CA 1956
[107] CA 1956 Section 394 (4)(b); The term 'body corporate' was defined to include foreign companies in Bombay Gas Company Pvt. Ltd v Union of India [1997] 89 Comp Cas 195 (Bom); and Andhra Bank Housing Finance Ltd. V Andhra Bank [2003] 47 SCL 513 (AP)
[108] According to the *Explanation* to Section 234 CA 2013, a 'foreign company' for the purposes of this section is defined to be "any company or body corporate incorporated outside India whether having a place of business in India or not"
[109] Thereby allowing the merger of an Indian company into a foreign company
[110] CA 2013 (fn 53) Section 234 (1)
[111] CA 2013 (fn 53) Section 234 (2)
[112] CA 2013 (fn 53) Section 234 (2)
[113] The Gazette of India No. 291 (fn 101)
[114] The Companies (Compromises, Arrangements and Amalgamations) Rules 2016 (Companies Rules 2016) Section 25A (1)
[115] Companies rules 2016 (fn 114) Section 25A (2)(a); These are "jurisdictions:

> (i) whose securities market regulator is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to bilateral Memorandum of Understanding with SEBI, or

valuation is conducted by valuers who are members of a recognised professional body in the jurisdiction of the transferee company and further that such valuation is in accordance with internationally accepted principles on accounting and valuation."[116] Lastly, after these conditions are met, a company will have to seek the approval of the NCLT for a merger[117].

4.1 Companies Act 2013: Analysing Section 234

While the advent of the new Companies Act, and the recent notification of Section 234 have been professed as a welcome move to integrate the Indian economy further into a globalized world economy, the general consensus prevails that much needs to be done, not only to further the intention of liberalization but also to affect a smooth transition of the provisions of the Companies Act itself[118]. Nevertheless, the provisions will aid companies to raise capital, diversifying ownership and achieve other strategic objectives. Within already established corporations, the provision would aid in consolidation of holdings, innovative structuring through externalization/flipping of ownership, holding of intellectual property to achieve commercial objectives[119].

According to the Statement on Objects and Reasons of the precursory Companies Bill 2011[120], the intention behind the provisions on M&As was to simplify the procedure of such transactions. The objective was to implement faster decisions on approvals for mergers and amalgamations and as a consequence more 'effective restructuring in companies' and 'growth in the economy'[121].

(ii) whose central bank is a member of Bank for International Settlements (BIS), and

(iii) a jurisdiction, which is not identified in the public statement of Financial Action Task Force (FATF) as:

(a) a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

(b) a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies."; See Annex B Companies rules 2016

[116] Companies rules 2016 (fn 114) Section 25A (2)(b)

[117] Companies rules 2016 (fn 114) Section 25A (3)

[118] Mehul Shah and Shilpi Jain, 'Companies Act: MCA Notifies Cross Border Merger Provisions' (Khaitan & Co., Mondaq, 19th April 2017) http://www.mondaq.com/india/x/586972/Corporate+Commercial+Law/Companies+Act+MCA+Notifies+Cross+Border+Merger+Provisions; We look at some changes required in other regulations in following sections.

[119] Provision Enabling Cross Border Mergers Notified: India Further Integrates Into the Stream of Globalization (Nishit Desai Associates 2017); There is however an argument that such new opportunities for innovative corporate strategies may result in increased base erosions and profit shifting (BEPS) and new avenues for tax avoidance. Liberalization of corporate laws may often require a corresponding renovation of deterrent regulations such as those relating to tax avoidance. We discuss one such regulation – GAAR – which has recently been implemented and which has a direct effect on cross border M&As, in details below.

[120] The Companies Bill 2011 (CB 2011)

[121] CB 2011 (fn 120) Section 5 (viii) Statement of Objects and Reasons

One might also look towards the previously mentioned Irani Report, in order to examine the intention behind drafting the new CA2013. It would help in analyzing whether the objectives have been achieved via the new regulations. The Irani Report was quick to recognize the difference in administrating Company Law in India and in other jurisdictions around the world[122] – in India it is a central legislation[123]. As a result, it avoids the duplication and confusion arising from depending on sub-national states to administer Company Law[124]. A state control of Company Law would result in multiple frameworks and an obvious obstruction to the quick changes required in a globalized world, with fast changing corporate dynamics and needs, due to 'interagency overlaps' and 'conflicts of jurisdiction', and adherence to multiple sources of compliance structures[125]. The Irani Report thus recommended a "single, comprehensive centrally administered framework". Not only would this obviate the problems associated with multiple frameworks, but also allow a central framework to evolve and easily reform when required[126].

One other issue with CA 1956, that the Irani Report identified and recommended changes to, was the voluminous extent of the Act, owing to the inclusion of procedural aspects of company law. This was disadvantageous because firstly, a lot of the prescribed quantitative limits had become redundant as a result of market changes over time. Secondly, procedural inclusions make a law rigid, as any changes, even to procedural aspects, required parliamentary process. Thus, this resulted in an archaic legislation (i.e. CA 1956), which failed to keep up with the changing and globalized market place. The Irani Committee thus recommended that, while the substantive elements of law remained within the ambit of parliamentary legislation, the procedural aspects be relegated to rules[127].

One of the changes between cross border provisions between CA 1956 and CA 2013 is a higher degree of involvement by the RBI. All cross-border mergers now require prior RBI approval. Previously, in CA 1956, such approval was only required if the FDI dependent M&A was in a sector placed under the approval route. One of the reasons why a broader provision was placed in the new regulations may reflect the possibility that increased cross-border transactions would alter the asset/liability profile of a country[128]. In such a case, higher supervision would be called for.

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[122] One way of predicting the effectiveness of these relatively new Indian regulations would be to compare them to similar regulations in other jurisdictions. However, as the Irani Report 2005 (fn 51) cautions (although they caution in terms of incorporating international best practices), the Indian business scenario demands an Indian model providing adequate solutions to issues of corporate operations[122], and as such a comparison with other jurisdictions may not always be a prudent contemplation.

[123] Irani Report 2005 Chapter II.5

[124] Exceptions such as Stamp Tax for registering mergers, is evidence of the confusion and general hindrance to the smooth functioning of corporations, that can lead from a state control of corporate laws.

[125] Irani Report 2005 (fn 51) Chapter II.4

[126] Irani Report 2005 (fn 51) Chapter II.5

[127] Irani Report 2005 (fn 51) Chapter II.7

[128] Shashwat Sharma *et al*, 'M&A Hotline' (Nishit Desai 2017) http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-

This is reflected further in the increased statutory supervisory roles placed on the RBI. Firstly, any changes made by the MCA to the Companies Rules, must be done after consulting with the RBI. This gives the RBI the opportunity to formulate further eligibility criteria if the current ones are found lacking. Furthermore, the statute provides opportunity for the RBI to present any objections to the NCLT if it so wishes. Moreover, the NCLT has final say in the approval of a merger, and as such is equally capable of highlighting objections to an M&A. Furthermore, no regulatory framework is available for obtaining RBI approval as yet and is certainly a necessity for companies applying for such approval.

If the aim of the current spate of regulatory changes has been to streamline the process of FDI and facilitate the inflow of investments into the economy[129], an added and somewhat unnecessary step in the process is not likely to be an incentivizing visual for corporations looking to invest. This is aggravated by the fact that several sectors also require prior approval from their corresponding sectoral regulator/licensing authorities[130].

While the Irani Report and the general intention of the Government indicates a move towards smoother and more efficient functioning of corporate regulations, and by extension the provisions of M&As provided in CA 2013, it is surprising that fast-track mergers are kept out of the purview of cross-border M&As. Fast-track M&As are available in general through Section 233 of CA 2013. Moreover, as seen earlier, Section 234 provides that all sections in Chapter XV (presumably including Section 233) shall apply to cross-border M&As between Indian and foreign companies. However, this has been limited by the simultaneously notified Rule 25A which limits the applicability of Section 234 to Sections 230 and 232 of CA 2013. All cross-border M&As must be approved by the NCLT and thus Section 233 is made redundant in this context. Effectively, therefore, fast-track M&As are not applicable to cross-border M&As.

One other aspect the new CA 2013 that merits analysis is its effect on corresponding branches of law, specifically taxation. For example, one issue with the new law is that, previously, capital gains tax benefits were available to only inbound M&As. Whether with the incorporation of CA 2013 such benefits are extended to outbound mergers is still unclear and may require modifications to Income tax regulations as well[131]. We therefore look at various aspects of tax law affecting M&As in the next section especially with regards to capital gains tax.

5. Tax Regulations Affecting M&A

The primary topic of discussion involving cross border M&As and taxation is the issue of capital gains tax. The overriding regulation involving taxation in India is the

view/article/provision-enabling-cross-border-mergers-notified-india-further-integrates-into-the-stream-of-global.html?no_cache=1&cHash=5418f7e30f0c194fc0e273645595f2dc

[129] As was envisaged by the Irani Report 2005 (fn 51)

[130] A prior approval of the Insurance Regulatory and Development Authority (IRDA) may be required for undertaking a cross-border merger involving an Indian insurance company

[131] Shah and Jain (2017) (fn 118)

aforementioned Income Tax Act 1961 (the IT Act). As stated above, the 1961 IT Act defines amalgamations as the merger of one or more companies with another company, or the merger of two or more companies to form one company.

The IT Act also defines capital assets[132]. It then defines the parameters of the transfer of capital assets[133], thereby allowing the taxation of capital gains[134]. It provides for the regulation and computation of capital gains[135]. A discussion on the taxation of capital gains in cross border M&As is important, firstly, because the new provisions of cross border M&As in CA 2013 has not been entirely reflected in the IT Act 1961 as yet. Secondly, the avoidance of capital gains tax has been a matter of recent discussion and the subject of several Double Taxation Avoidance Agreements (DTAAs) or the modification of them. We discuss these issues in this section.

Importantly, the IT Act provides for exemptions to a tax on capital gains[136] by excluding transactions which are not regarded as transfers applicable for capital gains tax. If, in a scheme of amalgamation, the amalgamated (read: newly formed) company is an Indian

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[132] IT Act 1961 (fn 54) Section 2(14) "capital asset" means

(*a*) property of any kind held by an assessee, whether or not connected with his business or profession;

but does not include

(*i*) any stock-in-trade [other than the securities referred to in sub-clause (*b*)]], consumable stores or raw materials held for the purposes of his business or profession ;

Explanation 2 For the purposes of this clause

(*a*) the expression "Foreign Institutional Investor" shall have the meaning assigned to it in clause (*a*) of the *Explanation* to section 115AD;

Explanation. For the removal of doubts, it is hereby clarified that "property" includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever;

[133] IT Act 1961 Section 2(47) "transfer", in relation to a capital asset, includes,—

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

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

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

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

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

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

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

[134] The issues related to capital gains tax with regards to domestic M&As is outside the purview of this paper and we limit the discussion to the issues related to cross border M&As only.

IT Act 1961 (fn 54) Section 45 (1) Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, […], be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.

[…]

[135] IT Act 1961 (fn 54) Section 49

[136] IT Act 1961 (fn 54) Section 47

company then the transfer of capital assets is not taxable for capital gains[137]. Even in a transfer of capital assets between two foreign companies, the transfer of shares held in an Indian company[138], or the transfer of shares which derive substantial value from shares held in an Indian company[139], will not attract a capital gains tax, as long as at least 25% of shareholders of the amalgamating foreign companies remain in the amalgamated foreign company, and the transaction does not attract a capital gains tax in the country of incorporation of the amalgamating companies.

Furthermore, any transfer of shares by the shareholders of an amalgamating company in consideration of the allotment of shares in the amalgamated company (provided the resultant company is an Indian company) is exempted from capital gains tax[140]. It is important to note here that this provision pertains to the exemption of tax on the transfer of shares of the amalgamating company and do not include an exemption on the allotment of shares in the amalgamated company[141]. It is also important to note that Section 47(vii) (and perhaps by extension all relevant provisions of Section 47) does not account for composite considerations. Not only are other forms of considerations, such as debentures or bonds, not applicable for the exemption, but also a combination of considerations allowing a mix of shares and other consideration fail to trigger Section 47. The value of the shares shall then be considered as a gross consideration for capital gains[142].

Such exemptions are only applicable for capital gains arising to the transferor company and its shareholders in the case of inbound mergers[143]. However, outbound mergers,

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[137] IT Act 1961 (fn 54) Section 47 (vi) any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company;

[138] Note that an Indian company may not amalgamate to a foreign company without attracting a capital gains tax; IT Act 1961 (fn 54) Section 47 (via) any transfer, in a scheme of amalgamation, of a capital asset being a share or shares held in an Indian company, by the amalgamating foreign company to the amalgamated foreign company, if—

> (*a*) at least twenty-five per cent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company, and
>
> (*b*) such transfer does not attract tax on capital gains in the country, in which the amalgamating company is incorporated;

[139] IT Act 1961 (fn 54) Section 47 (viab) any transfer, in a scheme of amalgamation, of a capital asset, being a share of a foreign company, referred to in the *Explanation 5* to clause (*i*) of sub-section (1) of section 9, which derives, directly or indirectly, its value substantially from the share or shares of an Indian company, held by the amalgamating foreign company to the amalgamated foreign company, if—

> (*a*) at least twenty-five per cent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company; and
>
> (*b*) such transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated;

[140] IT Act 1961 (fn 54) Section 47 (vii) any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company, if—

> (*a*) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company except where the shareholder itself is the amalgamated company, and
>
> (*b*) the amalgamated company is an Indian company;

[141] CIT v Mrs. Grace Collins [2001] 248 ITR 323 (SC); The court held that the allotment of shares would be an extinguishment under Section 2 (47)(ii) and as such a transfer under the IT Act.

[142] ITO v Gautam Sarabhai Trust [1988] 173 ITR 216 (Guj. HC)

[143] Sharma (Nishit Desai 2017) (fn 119)

which were incorporated into the new CA 2013 and notified recently, have not had a corresponding change in the IT Act 1961. Whether such benefits will be or already are extended to outbound mergers, owing to the new provisions of CA 2013 is a matter requiring further clarification. However, assuming they do not, this appears to be a significant disadvantage for outbound mergers as capital gains emerging from such mergers would be taxable for the transferor company[144] making out-bound mergers less attractive.

It is, of course, a matter of regulatory opinion whether such taxation may be seen as an exit tax. This leads to a further debate on whether a certain degree of tax-neutrality must be maintained between all forms of cross-border M&As (in order to inculcate an image of a liberal business friendly regulatory environment) or whether a jurisdiction should maintain a possibility of taxing capital gains from transferred assets. Of course, certain avenues exist to provide ephemeral relief, such as a deferred tax or a tax in instalments. However, such relief is only against immediate taxation and may do little to address concerns of non-neutrality in a cross border M&A tax regime[145].

Once the applicability of Section 47 of the IT Act has been determined, all cross border M&As which do not trigger the exceptions of the provisions would then be susceptible to capital gains tax. The issue that then arises in cross border M&As is that of transactions being taxed by both jurisdictions, amounting to double taxation. We therefore look at various double taxation provisions and the discussion surrounding tax avoidance and jurisdiction shopping.

5.1 Double Taxation Avoidance Agreements (DTAAs)

With the advent of cross border M&As, there is a risk of the same transaction being taxed for capital gains in India as well as in other jurisdictions involved in such arrangements. As such this may prove to be a substantial disincentive for FDI[146]. In order to avoid such instances of double taxation India, by virtue of Section 90(1) of the IT Act, may enter into a Double Taxation Avoidance Agreement (DTAA) in order to "grant relief" from income tax being levied simultaneously in India and any other jurisdiction, and in order to "promote mutual economic relations, trade and investment" [147]. DTAAs also serve the

[144] Sharma (Nishit Desai 2017) (fn 119)
[145] A detailed discussion on the neutrality of a tax regime is beyond the purview of this paper
[146] Tax Issues in M&A Transaction (Nishit Desai Associates 2016)
[147] IT Act 1961 (fn 54) Section 90(1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—

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

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

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

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, as the case may be, or purpose of being tools of information exchange between jurisdictions, in order to prevent or identify instances of tax evasion and the eventual recovery of such tax[148]. Conversely, capital gains tax due to the transfer of shares of an Indian company, can be made redundant through the use of structures involving a holding company in favourable jurisdictions, reflecting the reality DTAAs permit the country of residence of the transferor to levy a tax on capital gains, but such jurisdictions may not tax capital gains at all[149].

In this context we briefly look at: (1) some of the methods used to evade taxation through 'treaty shopping', (2) India's constant effort to stem such tax avoidance, and (3) the possible affects of such efforts on M&As[150]. Section 90(2) allows a tax assessee to choose the most beneficial tax regime[151]. As a result, MNEs and enterprises were able to establish a presence in third party countries that had tax treaties with India and a more beneficial tax regime. Although the Indian tax administration has historically seen these attempts at benefiting from a choice of tax regimes, as a method of tax avoidance[152], it must be noted that the opportunity for treaty shopping is often perceived as a tax incentive to attract FDI into developing countries[153].

Mauritius has often been a preferred route for FDI due to tax benefits accruing from the India-Mauritius treaty[154]. As a result several tax disputes have arisen due to provisions within the treaty, leading to transactions perceived by the Indian tax administration to be instances of egregious tax evasion. We look at the dynamics of these disputes briefly.

The Central Board of Direct Taxes, in 1994, passed a circular stating that "any resident of Mauritius deriving income from alienation of shares of Indian companies will be

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

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

148 IT Act Section 1961 (fn 54) Section 90(1)(c) and (d)

149 Nishit Desai (2016) (fn 146); The Indian government has taken measures to address this issue by negotiating changes in several DTAAs. We discuss this below.

150 The topic of DTAAs, tax avoidance and treaty shopping has been quite extensively dealt with in other literature, and thus we concentrate on the provisions that may have an effect on M&As in this section. For further reading on this topic see for example: Parthasarathi Shome (Ed.), *Insights into Evolving Issues of Taxation: Existing and Continuing Challenges* (1st edn, Wolters Kluwer 2016)

151 IT Act 1961 (fn 54) Section 90 (2) Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.

152 This has led to a fair amount of litigation and jurisprudence, which we discuss briefly below.

153 K R Girish, 'Limitation of Benefits Clause in Tax Treaties: India Experience', in Shome (ed) (2016) fn 150

154 Girish (2016) fn 153; Agreement for Avoidable of Double Taxation and Prevention of Fiscal Evasion with Foreign Countries – Mauritius, Notification No. GSR 920(E), Dated 6-12-1983 (India-Mauritius DTAA)

liable to capital gains tax only in Mauritius as per Mauritius tax law and will not have any capital gains liability in India" [155] The 1994 circular led to several Foreign Institutional Investors (FIIs) investing capital in share in Indian companies, in order to reap the benefits of the DTAA. The Indian tax authorities perceived several of these FIIs not to be genuinely established in Mauritius but rather 'shell companies' looking to take advantage of the DTAA and as a result avoiding taxes. This led to show cause notices by the Indian tax authorities to perceived 'shell companies' in Mauritius. Subsequently, in 2000 a circular by the CBDT stated that a Certificate of Residence issued by Mauritian Authorities was sufficient evidence for accepting the status of residence in order to reap the benefit of the DTAA[156].

A subsequent public interest litigation in the Delhi High Court (the *Azadi Bachao Andolan* case), alleging that the CBDT had exceeded its authority, eventually allowed the Supreme Court (on appeal) to contemplate on the matter[157]. The Supreme Court decided that they could not agree with the argument that "*an act which is otherwise valid in law can be treated as non-est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests*"[158]. The court relied heavily on the principle laid down in the Duke of Westminster case, where the House of Lords stated that "*Every man is entitled if he can to arrange his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax*"[159]. As a result, treaty shopping leading to significant avoidance of Indain income tax, was deemed not to be illegal. Several subsequent cases also relied upon the *Azadi Bachao Andolan* judgement[160].

5.1.1 The Vodafone Case and Retrospective Legislation

One such case which further illustrates the complecated dynamics of FDI and DTAAs, concerns the Vodafone-Hutchinson merger and the long drawn effort of the Indian tax administration to extract tax potentially emitting from an international transaction that was of the nature of an indirect transfer. It led to a tax dispute spanning almost a decade. In this case, Vodafone Group Plc acquired the stakes owned by Hutchinson Telecommunications International, in Hutchinson Essar Ltd. – an Indian telecom joint venture., through a Vodafone subsidiary in the Netherlands (Vodafone International Holdings B.V.). This was done through a share transfer by CGP Ltd., a company

[155] The Central Board of Direct Taxes 'Clarification Regarding Agreement for Avoidance of Double Taxation with Mauritius' (Income Tax Department Circular No. 682, 30th March 1994) Para 3
[156] The Central Board of Direct Taxes 'Clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC)' (Income Tax Department Circular No. 789, 13th April 2000) Para 2
[157] Union Of India (UoI) And Anr. vs Azadi Bachao Andolan And Anr (2004) 1 CompLJ 50 SC
[158] Union Of India (UoI) And Anr. vs Azadi Bachao Andolan And Anr (2004) 1 CompLJ 50 SC Para 170
[159] IRC v Duke of Westminster [1936] AC1 (HL)
[160] See for example GE India Technology Centre Ltd. v. CIT, [2010] 327 ITR 456; Vodafone International Holdings BV v. Union of India, [2012] 341 ITR 1 (SC), In re, Ardex Investments Mauritius Ltd., [2012] 340 ITR 272 (AAR); etc.

incorporated in the Cayman Islands and solely owned by Hutchinson Ltd., Honk Kong. As a consequence of this transaction, Indian tax authorities slapped a show cause notice on Vodafone, alleging that the transaction involved the transfer of capital assets in an Indain company and as such was subject to capital gains tax[161].

The Supreme court, in this case as well, passed a judgement that denied Indian tax administrators any jurisdiction over the transaction[162]. Justice Radhakrishnan, in his separate judgement, elaborated that although "*no court [would] recognise a sham transaction or a colourable device or adoption of a dubious method to evade tax, but to say that the Indo-Mauritian Treaty [would] recognise FDI and FII only if it originates from Mauritius, not the investors from third countries, is pitching it too high, especially when statistics reveals that for the last decade the FDI in India was US$ 178 billion and, of this, 42% i.e. US$ 74.56 billion was through Mauritian route. […] Facts, therefore, clearly show that almost the entire FDI and FII made in India from Mauritius under DTAA does not originate from that country, but has been made by Mauritius Companies/SPV, which are owned by companies/individuals of third countries providing funds for making FDI by such companies/individuals not from Mauritius, but from third countries.*"[163] In essence he therefore upheld the validity of the India-Mauritius DTAA and its supremacy over India's domestic tax laws.

As a consequence, the then government, through the Finance Act 2012, modified certain provision of the IT Act in order to retrospectively impose taxes in cases such as Vodafone[164] since, through retrospectivity, the law that underlay the Supreme Court ruling became invalid and its verdict inaaplicable. Through the Finance Act, the definition of 'capital assets'[165] was changed by including an explanantion that "'property' includes and *shall be deemed to have always included* any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever [*Emphasis added*]"[166], thereby retrospectively including such rights included in the provision. In the Vodafone case, these would imply that the rights in the Indian company, which were transferred by Hutchinson to Vodafone, would be a capital asset.

Similarly, the definition of a transfer of capital assets[167] was modified to include the explanation that ""transfer" includes and *shall be deemed to have always included* disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been

[161] For a detailed view of the Vodafone – Hutchinson acquisition, see the facts of the case in Vodafone International Holdings BV v. Union of India, [2012] 341 ITR 1 (SC)
[162] Vodafone International Holdings BV v. Union of India, [2012] 341 ITR 1 (SC), Para 92
[163] Vodafone International Holdings BV v. Union of India, [2012] 341 ITR 1 (SC), Para 99
[164] Nikhi Kanekal and Kian Ganz, 'Vodafone-Hutch deal: Retrospective change to I-T Act' *Live Mint* (New Delhi/Mumbai 17th March 2012)
[165] IT Act 1961 (fn 54) Section 2(14)
[166] Finance Act 2012 Section 3(i)
[167] The IT Act 1961 (fn 54) Section 2(47)

characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India [*Emphasis added*]"[168].

Finally, in the provisions regarding 'income deemed to accrue or arise in India'[169] a further explanation was inserted to clarify that "an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India"[170].

These changes, predictably, created discontent amongst businesses and corporations, even prompting Vodafone counsel Harish Salve to say that "the Indian government was back to its old socialist ways. […] We should show that we have institutions in this country which work. I think the country will pay a dear price for this. I think we are on course for elections this year. It's a government which is politically rattled. They don't want to take tough decisions and introduce reformist measures. This is waging war on foreign investment."[171] Members of the legal fraternity were justifiably apprehensive of the impact of a retrospective regulation on FDI. Hitesh Jain, partner in AMT Legal, felt that the regulation would place India on a "circumspect list" with foreign investors, however, adding that India's 'strong fundamentals' may assist in checking any significant impact on foreign investors[172].

5.1.2 DTAA modifications

A ramification of the spate of judgments, preventing the collection of tax in cross border M&As has been the negotiations and recent modifications of the existing DTAAs. Starting with the India-Mauritius DTAA, this 34-year-old treaty[173] was amended and notified in August 2016[174], and the amendments came into effect from the 19th of July 2016 for shares acquired on or after the 1st of April 2017. Under the new changes, India will be able to tax capital gains arising from the alienation of shares of an Indian resident company acquired on or after 1st April 2017[175]. It is important to note that the changes do not have a retroactive effect and as such capital gains acquired before the 1st of April 2017 will be exempted from taxation[176]. Furthermore, capital gains arising between the 1st of April 2017 and the 31st of March 2019, will be subject to a limited tax of 50% of

[168] Finance Act 2012 (fn 166) Section 3(v)
[169] The IT Act 2012 (fn 54) Section 9(1)
[170] Finance Act 2012 (fn 166) Section 4(a)
[171] Kanekal and Ganz (*Live Mint*) (fn164)
[172] Kanekal and Ganz (*Live Mint*) (fn164)
[173] India – Mautritius DTAA (fn 154)
[174] The Central Board of Direct Taxes, 'Notification of Protocol for amendment of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, and for the encouragement of mutual trade and investment between India and Mauritius' (Ministry of Finance, Government of India, 29th August 2016)
[175] India – Mauritius DTAA (fn 154) Article 13 Section 3A
[176] India – Mauritius DTAA (fn 154) Article 29 (a)

the domestic tax rate of India[177]. The provision is subject to the fulfilment of a Limitation of Benefits (LOB) clause[178], which we discuss below.

Similar amendments have been negotiated within the India – Cyprus DTAA[179], with a starting date of 1st April 2017[180], whereby source based taxation has been instituted, replacing the previous residence based taxation[181]. Under the amendments made in the India – Singapore DTAA[182] too, residence based taxation has been replaced by source based taxation[183], and a starting date of 1st April 2017 has been negotiated[184]. Thereby, through these modifications of various DTAAs, the Indian tax authorities have been able to stem the tax avoidance by MNEs in perceived tax haven jurisdictions for companies, potentially acquiring valuable revenue thus far remaining legally uncollectible.

One of the conditions maintained within these DTAAs, and a concept in need of further explanation, is that of a 'Limitation of Benefits' (LoB). Infact, in the earlier discussed *Vodafone* case, one of the reasons given by the Supreme Court, for the judgement was the absence of an LOB clause[185]. A discussion on LoB clauses is important because, in certain cases the eligibility to claim tax relief under a DTAA may be conditional upon the satisfactions of such a clause. Essentially, a LoB clause disentitles an entity to the benefits from certain provisions if its affairs are arranged with the primary purpose to take advantage of those provisions, thereby effectively disallowing shell or conduit companies from reaping the benefits of the DTAA[186]. In the amended India – Mauritius DTAA, for example, the LoB clause disallows a shell/conduit company from being eligible for the benefits of the DTAA and defines such a company to be "any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State"[187]. Furthermore, such an entity is also "deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less than Mauritian Rs.1,500,000 or Indian Rs. 2,700,000 in the respective Contracting State"[188]. An entity may prove itself not to be a shell/conduit company if it is listed in a recognized stock exchange of a Contracting State[189]. The India – Singapore DTAA has identical LoB conditions[190]

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177 India – Mauritius DTAA (fn 154) Article 13 Section 3B

178 India – Mauritius DTAA (fn 154) Article 27A

179 Agreement Between the Government of the Republic of India and the Government of the Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Notification No. SO 64(E) [NO.3/2017 (F.NO.504/05/2003-FTD-I)], 10th January 2017 (India – Cyprus DTAA)

180 India – Cyprus DTAA (fn 179) Article 30 (a)

181 India – Cyprus DTAA (fn 179) Article 13

182 Agreement for avoidance of double taxation and prevention of fiscal evasion with Singapore (Notification No. GSR 610(E), 8th August 1994 as amended by Notification No. SO 1022(E), 18th July 2005 and Notification No. SO 2031(E), 1st September 2011) (India – Singapore DTAA)

183 India – Singapore DTAA (fn 182) Article 13

184 India – Singapore DTAA (fn 182) Article 31 (a)

185 Vodafone International Holdings BV v. Union of India, [2012] 341 ITR 1 (SC), Para 95

186 See for example India – Mauritius DTAA (fn 154) Article 27A and India – Singapore DTAA (fn 182) Article 3; Noticeably, The India – Cyprus DTAA does not include an LOB Clause

187 India – Mauritius DTAA (fn 154) Article 27A(2)

188 India – Mauritius DTAA (fn 154) Article 27A(3)

189 India – Mauritius DTAA (fn 154) Article 27A(4)(a)

excepting their limit of expenditure on operations, which in this case is Singapore $200,000 or Indian Rs. 50,00,000[191].

5.2 General Anti Avoidance Rules (GAAR)

Provisions such as LoB clauses are often termed Special Anti-Avoidance Regulations (SAAR). However, India (and several other jurisdictions) had, for some time, been mulling a more general codification of anti-avoidance tax regulations – which finally culminated in the inclusion of the General Anti Avoidance Rules (GAAR) into the IT Act, 1961. This paper looks at the relationship between GAAR and cross border M&As. As mentioned earlier, one of the benefits of cross border M&As is the distribution of taxes, either through the distributive accounting as a result of a merger, or through treaty shopping for a beneficial tax system. However, as a result of the implementation of GAAR, M&A arrangements have to be carefully implemented in order not to fall foul of the IT Act. Cases such as the previously discussed *Azadi Bachao Andolan* and *Vodafone* have been strong influences towards changing the prevalent regulation, in order to come down on cross border arrangements (M&As) with little or no commercial value but having a heavy effect on tax base erosion.

GAAR are found under Chapter XA of the IT Act (Sections 95 – 102). The provisions define certain commercial arrangements to be 'impermissible avoidance arrangements'[192] if the main purpose of such arrangements is to accrue a tax benefit[193]. One of the provisos making Section 96 applicable (and one that is important in analysing cross border M&As) is the notion of 'commercial substance'[194]. Thus if an agreement is said to lack commercial substance it is deemed to be an impermissible avoidance agreement and attract the punitive and consequential provisions of GAAR.

The concept of commercial substance is defined by Section 97 of the IT Act, 1961. Accordingly, an arrangement is deemed to lack commercial substance if "the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part"[195]. Furthermore, an arrangement also lacks commercial substance if it involves "round trip financing"[196], "an accomodating party"[197], elements within the arrangement that "have the effect of offsetting or cancelling each other"[198], or if it is a "transaction which is conducted through one or more persons and

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[190] India – Singapore DTAA (fn 182) Article 3
[191] India – Singapore DTAA (fn 182) Article 3(3)
[192] IT Act 1961 (fn 54) Section 95
[193] IT Act 1961 (fn 54) Section 96
[194] IT Act 1961 (fn 54) Section 96 (1)(c)
[195] IT Act 1961 (fn 54) Section 97 (1)(a)
[196] IT Act 1961 (fn 54) Section 97(1)(b)(i); Round trip financing is defined by Section 97 (2) to be an arrangement where, through a series of transactions, funds are transferred amongst the parties to the arrangement, and such transfers have no substantial commercial substance other than to provide a tax benefit to the parties.
[197] IT Act 1961 (fn 54) Section 97(1)(b)(ii); An accommodating party to an arrangement is defined by Section 97 (3) as a party whose main purpose of participation is to provide a tax benefit to the assessee.
[198] IT Act 1961 (fn 54) Section 97(1)(b)(iii)

disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction"[199].

It is prudent to understand why an otherwise seemingly legal transaction, is often looked upon disparagingly by tax authorities. The Shome Committee Report, tasked with 'finalising GAAR guidelines', reminisces extensively on the subject. In that context, the report differentiates between tax mitigation, evasion and avoidance. The Report asserts that the Indian government is not averse to the idea of tax mitigation. In fact, it is often seen to be the right of the taxpayer to compute taxes in a way allowed by tax legislation, that would allow him to pay the 'least tax possible'[200], and thereby minimise tax liabilities. The idea of tax mitigation extends to the arrangement of company structures, including the use of commercial arrangements such as M&As, as long as the 'main purpose'[201] behind such arrangement is not reducing taxes. Tax evasion, contrarily, is the use of illegal means, such as the falsification of records and suppression of facts to reduce tax liabilities. It is, of course, illegal in the eyes of the law, and subject to punitive regulatory repercussions.

The concept of tax avoidance falls within an ethical grey area, as it concerns commercial arrangements that have legal form but lack 'commercial substance'. The Shome Committee Report recognizes it to be "a business arrangement to avoid tax [that] may not reflect its embedded legislative intent"[202]. In the Indian context, therefore, the substance of a commercial arrangement is analysed in conjunction with the legal form of such arrangements. However, not all jurisdictions may subject anti tax avoidance regulations to the same legal principles. Although the principle of substance-over-form has been the basis of anti-tax avoidance regulations in several other jurisdictions, others have decided scrutinizing commercial arrangements on form alone. We look at some comparable jurisdictions in the following paragraphs[203].

5.2.1 Comparative GAAR Provisions

China has codified GAAR, as recently as in 2014 (coming into force in 2015), through its 'Administrative Measures for general anti-avoidance Rules'[204] (GAAR China), which specifically apply to cross-border transactions[205]. However the necessity for anti avoidance regulations was prescribed even earlier in Article 47 of its Enterprise Income

[199] IT Act 1961 (fn 54) Section 97(1)(b)(iv)
[200] Ministry of Finance, 'Final Report on General Anti Avoidance Rules (GAAR) in Income-tax Act, 1961' (New Delhi 2012) (Shome Committee Report) 19; Also see IRC v Duke of Westminster [1936] AC 1 (HL)
[201] The concept of 'main purpose' is the differentiating factor behind tax mitigation and avoidance, and is discussed below.
[202] Shome Committee Report 2012 (fn 200) 3
[203] See also a discussion on comparative tax law in Annexe 4 of the Shome Committee Report 2012 (fn 200)
[204] State Administration of Taxation No. 32 (国家税务总局令第 32 号), 'Administrative Measures for general anti-avoidance Rules' (一般反避税管理办法), (State Administration of Taxation (国家税务总局令), Government of the People's Republic of China 2014) (GAAR China)
[205] GAAR China (fn 204) Article 2

Tax Law (EITL)[206] calling for adjustments on enterprises making 'arrangements not for any reasonable commercial purpose'. The EITL is further supplemented by Chapter 10 of Circular [2009] No 2[207]. China, not unlike India, dictates that when scrutinizing arrangements for tax avoidance one should look at the prescribed factors "from the perspective of the substance over form principle"[208]. However, China is far less prescriptive than the Indian GAAR provisions in defining a 'tax avoidance arrangement'[209]. Circular 2, however, provides further clarification on what can be perceived as a 'tax avoidance arrangement'[210].

To continue with another example of a BRICS nation, Russia, contrarily, has no codified GAAR. Instead, it relies on the judicial interpretation of GAAR like rules. This is problematic because the Tax Code of the Russian Federation (Russian Tax Code), the primary tax law of Russia, does not define tax avoidance[211]. In fact, earlier judgements of the Constitutional Court of the Russian Federation seemingly favoured form over

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[206] Enterprise Income Tax Law of the People's Republic of China (中华人民共和国企业所得税法) 2007 (Government of the People's Republic of China, 2007) Article 47 In case an enterprise makes any other arrangement not for any reasonable commercial purpose, which causes the decrease of its taxable revenue or income, the tax organ may, through a reasonable method, make an adjustment.
(第四十七条 企业实施其他不具有合理商业目的的安排而减少其应纳税收入或者所得额的，税务机关有权按照合理方法调整)

[207] Circular [2009] No. 2 (国税发〔2009〕2 号), 'Notice on Printing and Distributing the Measures for the Implementation of Special Tax Adjustment (Trial Implementation) (关于印发《特别纳税调整实施办法（试行)), (State Administration of Taxation (国家税务总局令), Government of the People's Republic of China 2009)

[208] Circular [2009] No. 2 (fn 207) Chapter 10 Article 93 Chapeau

[209] GAAR China (fn 204) Article 4 (第四条) Tax avoidance arrangements have the following characteristics:
(1) to obtain tax benefits for the sole purpose or primary purpose;
(2) to comply with the provisions of the tax law, but with its economic substance does not match the way to obtain tax benefits.
(避税安排具有以下特征：
（一）以获取税收利益为唯一目的或者主要目的；
（二）以形式符合税法规定、但与其经济实质不符的方式获取税收利益)

[210] Circular [2009] No.2 (fn 207) Article 92 Inaccordance with the provisions of Article 47 of the CITL and Article 120 of the CITLIR, the tax authorities can initiate a general anti-avoidance investigation on enterprises where the following tax avoidance arrangements are identified:
(1) abuse of tax incentives;
(2) abuse of tax treaties;
(3) abuse of the forms of company organization;
(4) the use of tax havens;
(5) other arrangements without reasonable business purposes.
(国税发〔2009〕2 号 第十章一般反避税管理 第九十二条税务机关可依据所得税法第四十七条及所得税法实施条例第一百二十条的规定对存在以下避税安排的企业，启动一般反避税调查：
（一）滥用税收优惠；
（二）滥用税收协定；
（三）滥用公司组织形式；
（四）利用避税港避税；
（五）其他不具有合理商业目的的安排)

[211] Evgeniy Pustovalov, Eugen Zakharov and Andrey Savitsky, 'Tax Avoidance Revisited: The Russian Federation', (National Reports, EATLP 2016)

substances by deeming that reduction of taxes using legal means would absolve the tax payer from liability for non-payment of taxes[212].

However, later Russian judgements have introduced the concept of 'mala fide intentions' and 'unjustified tax benefits'. For example the Constitutional Court, in 2001 introduced the idea of a 'bad faith taxpayer'[213]. Similarly, the Russian Supreme Arbitrazh Court, in 2006, in a single judgement established a connection between the concepts of "unjustified tax benefit", "actual economic substance" of a transaction and the "business purpose" of a taxpayer's actions[214], thereby providing judicial acknowledgement to concepts related to anti-avoidance of tax[215]. Efforts to codify GAAR were made in 2015 when a draft law[216] was introduced to the Russian State Duma, whereby terms such as"abuse of rights", and description of mala fide contractors was to be introduced into the Russian Tax Code[217]. However, the draft form has not been implemented into law as yet[218].

We now look at two common law jurisdictions that are examples of advanced economies in order to provide a more nuanced discussion on GAAR – the US and the UK. The US does not have codified GAAR provisions. Rather, they rely on several common law doctrines to prevent tax avoidance structures[219]. One such overriding principle (common to GAAR provisions in several jurisdictions) is the principle of 'substance over form' whereby even if the form of the arrangement does not fall foul of any legislation, if it's substance [or effect] is deemed to avoid taxation, it will be seen as an arrangement formed to avoid taxes. The US Supreme Court has held in *Gregory v Helvering* that, "[a]s a general rule, the incidence of taxation depends on the substance rather than the form of the transaction." Similarly, the principles of 'business purpose' and 'sham transaction' look at transactions, which have no other purpose other than to accrue a tax benefit, and as such may be regarded as void[220]. The principle of 'step transaction' allows a

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212 See Judgment of Constitutional Court of Russian Federation of 27 May 2003 No. 9-П in the case concerning the review of constitutionality of the provision of Article 199 of the Criminal Code of the Russian Federation in connection with complaints of P.N.Beletsky, G.A.Nikova, R.V.Rukavishnikov, V.L.Sokolovsky and N.I.Talanov

213 Constitution Court Ruling 138-0 of 25 July 2001

214 Resolution No. 53 dated 12October 2006 of the Plenum of the Russian Supreme Arbitrazh Court ("Resolution No. 53")

215 Due to the difficulty in obtaining Russian judgements, reliance for the above discussion has been sought from the discussions in case of the Permanent Court of Arbitration, In the matter of an Arbitration Before A Tribunal Constituted in Accordance with Article 26 of the Energy Charter Treaty and the 1976 UNCITRAL Arbitration Rules Between Hulley Enterprises Limited (Cyprus) and the Russian Federation PCA Case No. AA 226 18th July 2014; Para 289

216 Draft Federal Law No. 529775-6 "Concerning the Introduction of Amendments to Parts One and Two of the Tax Code of the Russian Federation"

217 'Concept of Unjustified Tax Benefit Could be Codified' (Tax Flash Russia, Issue No.16, Pricewaterhouse Coopers (PwC) 2014)

218 Aleksei Nesterenko and Anna Ivanova, 'Unjustified Tax Benefits: New Approaches to Evidence' (Tax Messenger, Ernst & Young (EY), 2017); http://www.ey.com/ru/en/services/tax/ey-tax-messenger-27-april-2017

219 See Shome Committee Report 2012 (fn 200) Annexe 4; See also James R. Repetti, 'United States' in Hugh J. Ault and Brian J. Arnold (eds.), *Comparative Income Taxation* (Kluwer Law International, 3rd Edn, 2010) 173

220 Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971)

transaction to be seen as a whole when evaluating whether it is designed to evade tax, if a step or part of it is deemed or can be evaluated to be so. It is interesting to note that all the above doctrines have been addressed either by the GAAR provisions in the IT Act 1961, or by the Shome Committee Report, in the Indian context.

The only principle previously enshrined in common law, which now has been codified in US legislation is that of 'economic substance'. Previously, an important judgement using the principle of economic substance, was the case of *Knetsch v US*, where the Supreme Court stated that "the inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them."[221] The principle can now be found codified in Section 7701(o) in the Internal Revenue Code, which 'clarifies' that a "transaction shall be treated as having economic substance" only if "the transaction changes in a meaningful way the taxpayers economic position", and "the taxpayer has a substantial purpose for entering into such transaction". The code further clarifies that the "economic substance doctrine means the common law doctrine under which tax benefits […] are not allowable if the transaction does not have economic substance or lacks business purpose."

The UK too does not have a codified GAAR and rely on common law principles and judicial interpretations for anti avoidance along with SAARs. Anti-avoidance jurisprudence previously relied on the principle found in the earlier mentioned case of IRC v Duke of Westminster, allowing the taxpayer to compute taxes in a way allowed by tax legislation, that would allow him to pay the 'least tax possible'[222]. However, subsequent case law has evolved on the principle, allowing for a measure of control on tax avoidance. The W.T. Ramsay Ltd. v. Commissioners of Internal revenue case[223], for example, encompassed the 'step transaction' principle, allowing the whole transaction to be regarded as tax avoidance if a part or step was deemed to be so.

The UK has, however, been considering a regulatory approach to GAAR (similar to India), for a while, culminating in the commissioning of Graham Aaronson QC, for a GAAR report and the eventual publishing of a draft GAAR[224]. The draft identifies "abnormal arrangements" which may achieve an "abusive tax result". A significant difference in the draft GAAR from the Indian GAAR, and indeed previously used common law principles in the UK, is the disregard for step transactions and the mandate to analyse whether the entire transaction is used for tax evasion[225].

[221] Knetsch v. United States, 364 U.S. 361 (1960)
[222] IRC v Duke of Westminster[1936] AC 1 (HL)
[223] Ramsay (W T) Ltd v IRC, Eilbeck (Inspector of Taxes) v Rawling [1982] A.C. 300
[224] HM Treasury, 'GAAR Study: Report by Graham Aaronson QC' (HM Treasury and The Rt Hon David Gauke MP, HM Government of the United Kingdom of Great Britain and Northern Ireland, 2011) (Draft GAAR UK)
[225] Draft GAAR UK (fn 224) Appendix I Section 7(2)

5.2.2 Applicability of GAAR to cross border transactions

Compared to other jurisdictions, the Indian GAAR is much broader in scope. By virtue of Section 96 (2) of the IT Act 1961, cross border transactions, which may have a step or part designed to avoid taxation or where one of the purposes is to avoid taxes, may be judged in its entirety to be an impermissible avoidance arrangement[226]. However, the IT Act also provides safeguards to limit its applicability.

One such safeguard is the threshold limit for GAAR to apply. The Shome Committee Panel had, in its report recommended that GAAR be applied to very selective cases, above a high threshold of INR 3 Crores[227]. According to the Panel, this would render GAAR to be an anti-deterrent instrument, rather than a revenue-generating device[228]. Although Chapter 10A of the IT Act does not specifically mention a threshold, a clarifying notification by the Central Board of Direct Taxes (CBDT notification) put the threshold at INR 3 Crores[229].

The GAAR provisions are also subject to a grandfather clause in Section 95(2), whereby all transactions and arrangements made before the 1st of April 2017 may not be assessed under Chapter X-A[230]. This is further asserted by Section 10U(1)(d) of the Income Tax Rules, 1965[231]. This allows M&As, occurring before the mentioned date, a certain sense of security and an assurance to foreign investors against any retrospective application. The reader will recall from the earlier discussed *Vodafone* case that retrospective application of laws was a serious concern driving investor confidence (or the lack thereof) in the Indian market[232].

5.2.3 The Hierarchy between GAAR and SAAR

A further clarification required in terms of cross border M&As is the hierarchy of GAAR and SAAR. The discussion would also extend to LoB Clauses found in DTAAs with India. If there is an instance where a SAAR is applicable the question arises, whether GAAR would also apply. Two general principles of law may be applicable (and therefore require analysis) in a discussion on the hierarchy of GAAR and a specific treaty tax obligation; those of *Lex specialis derogat legi generali* and *Pacta sunt servanda.*

[226] IT Act 1961 (fn 54) Section 96 (2)
[227] Shome Committee Report 2012 (fn 200) Section 3.18 Threshold to be prescribed for applying GAAR Provisions
[228] Shome Committee Report 2012 (fn 200) Annex 4; The Shome Committee derives this from their analysis of US GAAR.
[229] Department of Revenue, 'Clarification on Implementation of GAAR Provisions under the Income Tax Act, 1961, Circular No. 7 of 2017' (Ministry of Finance, Central Board of Direct Taxes, Government of India 2017) (GAAR Clarification) Question 14
[230] IT Act 1961 (fn 54) Section 95 (2)
[231] Income Tax Rules 1962 Rule 10U (1) (d)
[232] See Section 5.1.1 above

Lex specialis dictates that, where a specific rule is available, a general rule will not apply[233]. According to the Shome Committee, this is a 'settled principle' in law. Therefore, the Committee recommended that, "*where SAAR [was] applicable to a particular aspect/element, then GAAR [would] not be invoked to look into that aspect/element. Similarly where anti-avoidance rules [were] provided in a tax treaty in the form of limitation of benefit […] etc., the GAAR provisions [would] not apply overriding the treaty. If there is evidence of violations of anti-avoidance provisions in the treaty, the treaty should be revisited, but GAAR should not override the treaty*".[234]

The CBDT clarification is not as unambiguous. It asserts that SAAR may not be sufficient in all cases and thus there is a "need for general anti-abuse provisions in the domestic legislation". However, it does add, "GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case"[235]. The notification extends the same reasoning to LoB clauses in DTAAs but clarifies that if a LoB clause "sufficiently addresses" a case of avoidance, then GAAR will not be invoked[236].

The other legal principle that might come into play, in an interaction between GAAR and SAAR provisions of a treaty, is that of *Pacta sunt servanda*[237]. Incorporated in the Vienna Convention on the Law of Treaties, 1969 (The Vienna Convention), it states "*Every treaty in force is binding upon the parties to it and must be performed by them in good faith*"[238]. Girish, in his analysis of the principle in terms of International Tax Law, proposes that a combined reading of Article 18[239], 26 and 31[240] deems that

[233] Oxford Reference 'Lex Specialis Derogat Legi Generali' (OUP) http://www.oxfordreference.com/view/10.1093/acref/9780195369380.001.0001/acref-9780195369380-e-1303

[234] Shome Committee Report 2012 (fn 200) Section 3.19 GAAR vs SAAR; and GAAR vs LOB

[235] GAAR Clarification (fn 229) Question 1

[236] GAAR Clarification (fn 229) Question 2

[237] Girish (2016) (fn 153)

[238] The Vienna Convention on the Law of Treaties 1969 (The Vienna Convention) Article 26

[239] The Vienna Convention Article 18 Obligation not to Defeat the Object and Purpose of a Treaty prior to its Entry into Force

A State is obliged to refrain from acts which would defeat the object and purpose of a treaty when:

(a) It has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval, until it shall have made its intention clear not to become a party to the treaty; or

(b) It has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed.

[240] The Vienna Convention Article 31 General Rule of Interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) Any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;

(b) Any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:

‘circumstances and situations’ of tax abuse “amounts to an abuse of the [Vienna] Convention” and may be disregarded in the context of treaty benefits [241] (including treaties such as DTAAs).

The principle of *Pacta sunt servanda* is, therefore, important in the context of whether the principle may be circumvented, in the case of treaty abuse. Whether tax avoidance may be seen in the context of treaty abuse is a matter of discussion. Girish points to the OECD Model Tax Convention and the UN Model Double Taxation Convention as evidence[242].

The UN Model Double Tax Convention explicitly states (in its commentary of the Articles) that “where the application of provisions of domestic law and the provisions of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of *pacta sunt servanda* […]. Thus, if the application of these rules had the effect of increasing the tax liability of a taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions should prevail under public international law.” [243] The commentaries are however, quick to point that “such conflicts will often be avoided and each case must be analysed based on its own circumstances”[244]. This may be because “a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules”[245] or the tax treaty provisions themselves may “depend on the application of domestic law”[246] or “the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty.”[247]

The OECD Model Tax Convention also addresses the last point, and states, in the commentaries to Article 1, that while “the principal purpose of double taxation conventions is to promote […] exchanges of goods and services, and the movement of capital and persons” such conventions also serve the purpose of “[preventing] tax

(a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
(b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
(c) Any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

[241] Girish (2016) (fn 153)

[242] Girish (2016) (fn 153)

[243] The United Nations Model Double Taxation Convention between Developed and Developing Countries, (Department of Economic and Social Affairs, The United Nations, 2011) (UN Model Double Taxation Convention) Section 15 Article 1 Commentary

[244] UN Model Double Taxation Convention (fn 243) Section 16 Article 1 Commentary

[245] UN Model Double Taxation Convention (fn 243) Section 17 Article 1 Commentary

[246] UN Model Double Taxation Convention (fn 243) Section 18 Article 1 Commentary

[247] UN Model Double Taxation Convention (fn 243) Section 19 Article 1 Commentary

avoidance and evasion"[248]. Therefore, "as a general rule, [there is] no conflict between [domestic tax laws/rules] and the provisions of the tax convention".[249]

6. Conclusion

In the past few years several regulatory changes have been implemented which have had/may have an affect on cross border transactions (including M&As). Conscious policy changes designed to encourage inward FDI and increase investor confidence in the Indian market have catalysed the evolution of corporate regulations, investment laws and taxation. Simultaneously, tax regulations, which prevent double taxation, have had to be tempered significantly to avert tax avoidance while balancing a friendly market outlook. In this paper, we therefore looked at some such significant changes potentially affecting FDI related M&As including:

1. The increase in FDI sectoral caps in FEMA Regulations 2000,
2. Provisions of Companies Act 2013 affecting cross border M&As (specifically Section 234 CA 2013),
3. Double Taxation Avoidance Agreements encouraging FDI, and
4. The corresponding GAAR provisions necessary to prevent the abuse of such treaties through tax avoidance structures.

We also use the paper as an opportunity to expand on the various definitions of FDI and cross border M&As and the benefits and disadvantages of such instruments over other similar instruments of trade.

One 'large-scale' change in corporate regulations has been in the increase of sectoral caps for foreign direct investment. Under FEMA Regulations 2000, sectors of investment under Annex B have individual caps beyond which automatic investment is prohibited (investment beyond the sectoral cap is either disallowed or required Government Approval). The control of such caps is a matter of trade and political concerns as the increase of such caps allow greater integration to world trade, but may mean reduced protection of domestic producers, traders and service providers. The increase of these sectoral FDI caps has, therefore, been a gradual incremental process, often dependent on the political climate of the time. This gradual increase may be witnessed through a comparison of the Consolidated FDI policy circulars between 2013 and 2016. The annex to this paper provides a comparison of the Consolidated FDI policy circulars of 2014 and 2016 where the changes have been particularly stark.

The changes in FDI sectoral caps have often been the result of a compromise against conventional values such as traditional sectoral protectionism of sensitive sectors (such as through nationalisation of Railways), security concerns (FDI in Defence sectors), and

[248] Article of the Model Convention with Respect to Taxes on Income and on Capital, (The OECD Committee on Fiscal Affairs, The OECD, 2003) (OECD Model Tax Convention) Commentaries on the Articles of the Model Tax Convention Section 7
[249] OECD Model Tax Convention (fn 248) Commentaries on the Articles of the Model Tax Convention Section 9.2

domestic majority control in order to appease domestic stakeholders (the Defence as well as the Insurance sector). Policy makers have had to balance such concerns arising from the influx of FDI while not limiting the infusion of valuable foreign technology and expertise, the prospect of new local technological advancement and even technology transfer. Such issues are sensitive enough to provide significant legislative and parliamentary hindrance to their institution. Thus the incumbent government have often had to circumvent parliamentary approval by resorting to executive orders.

A certain form of FDI that has been subject to judicial scrutiny and resultant regulatory changes in the last decade has been M&As. Foreign firms have felt both mergers and acquisitions to be an effective way to enter the Indian market, though cross border M&As have fluctuated somewhat. FDI in the form of Greenfield investments (characterised by the fresh investments into a new jurisdiction) has its own advantages such as readily available factors of production, the ability to quickly change strategies to counter market changes and an eventual thorough and complete knowledge of both the market and the growing company itself. However they have a marked disadvantage to cross border M&As in that they are time consuming as their internal capabilities take a much longer period to develop and cost more

M&As may look beyond internal capabilities to find growth, and one of the methods to do so is to merge with an already existing company in the target market. Thus growth objectives are achieved with less cost and effort compared to a fresh entry as these companies have access to an already established market and benefit from the resources of an established firm.

M&As also lead to several synergy and efficiency gains, which may either be operational or financial. Operational gains include those derived from economies of scale such as cost efficiency and increased profitability, ultimately leading to an increased market power. Financial efficiencies are discovered through the lowering of risk through diversification, an increase in debt capacity and a corresponding increase in available capital and tax benefits. Tax benefits appear when net operating losses of the merged company may be used to shelter income of the more profitable company from taxation. Furthermore, profit and tax loss may be distributed within the combined company. Such advantage is further increased when companies are able to treaty shop to look for the most advantages jurisdictions to avoid taxes.

The advantages of operational synergies may be highlighted by regulation in order to attract FDI. Thus, regulations such as the Companies Act 2013 was implemented to replace archaic and increasingly inadequate corporate regulations such as Companies Act 1956, in order to highlight a more inviting regulatory structure and a FDI friendly market. Financial synergies, on the other hand, especially tax benefits, are regulated in a more austere fashion. Thus, treaty advantages accruing out of DTAAs have been amended and severely curtailed in recent changes. Moreover, regulations such as GAAR have been implemented to enhance the control and prevention of tax avoidance through treaty shopping. The paper first looks at the CA 2013 before moving on to the tax provisions affecting FDIs such as cross border M&As.

Provisions relating to cross border M&As (Section 234) within the CA 2013, was notified (and thereby finally implemented) only as recently as 2017. The notification of Section 234 firstly, replaced Section 394 of CA 1956 thereby allowing outbound cross border M&As. Previously, only inbound cross border M&As was allowed. This provision, along with increased investment caps, meant a higher connectivity of Indian markets with world markets. Secondly, the notification of Section 234 meant that the new dynamics of cross border M&As were brought within the fold of the streamlined provisions of CA 2013.

Section 234 also provides conditions for the validity of a cross border M&A. This includes the approval of the Reserve Bank of India (RBI) and the payment of consideration to shareholders of the merging companies. Further provisions of validity are provided by the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016 (Companies Rules 2016), whereby, cross border companies looking at M&As are restricted to certain jursidictions. The Companies Rules also contains provisions for the valuation and accounting provisions of the transferee company.

Pre-CA 2013 documents such as the Companies Bill 2011 and the Irani Report 2005 hint at the purpose of the CA 2013 to streamline the regulation of Company Law in India. One of the ways recommended by the Irani Report, was to segregate the procedural sections, which mired the workings of the CA 1956. This was implemented through two separate regulations – the CA 2013 and the Companies Rules 2016.

While the segregation of the procedural rules may have streamlined the CA 2013, one criticism of the new Act has been the increased involvement of the RBI, thereby changing the procedural and compliance dynamics between investor companies and regulatory bodies. Moreover, the Ministry of Corporate Affairs (MCA) would now have to seek RBI approval for amendments to the CA 2014. Moreover, as already mentioned, cross border M&As require RBI approval. However, this is only an intermediary step before the final approval of the National Company Law Tribunal (NCLT). Therefore, a criticism levelled here is the increase of an unnecessary procedural step. Furthermore, the lack of any framework to acquire RBI approval as well as the necessity of some sectors to acquire approval of sectoral regulators and licencing authorities as well signifies the increase in complexity in procedure, when the intention was to streamline processes for FDI. Thus while much has been done to streamline operational synergy advantages of a cross border M&A through regulatory changes in Indian company law, much can be and still needs to be done in a constructive and objective manner, to streamline the legal framework further.

Financial synergies on the other hand have invited stricter regulations, especially in terms of tax efficiencies. Cases such as the *Azadi Bachao Andolan* and *Vodafone* have highlighted the issue of the avoidance of capital gains tax through avoidance agreements using cross border M&As and treaty shopping. This, in turn has resulted in amendments to several DTAAs and the inclusion of LoB clauses within such treaties. Such amendments hope to encourage genuine transactions while curtailing schemes constructed with the sole purpose of acquiring a tax benefit by taking advantage of the treaty in question.

Amendments to DTAAs and tax treaties have been supplemented with the implementation of GAAR in the IT Act 1961. Similar in concept to LoB clauses, GAAR relegates certain commercial arrangements to being “impermissible avoidance arrangements” if the main purpose of such arrangements is to acquire a tax benefit. GAAR have generally been discussed in various jurisdictions and the paper provides an overview of a few such jurisdictions as a comparison to Indian GAAR. We find the Indian GAAR to be wider in scope than GAAR provisions in other jurisdictions by including cross border arrangements within the purview of “impermissible avoidance arrangements” even if only a step or a part is designed to avoid taxes or where one of the purposes is to avoid taxes. However, the strict applicability of the GAAR is tempered by other provisions of the IT Act 1962, which includes a threshold limit (INR 3 Crores), and a grandfathering clause.

Changes such as a broader scope for GAAR in India, as compared to GAAR in other jurisdictions may have a negative impact on the attractiveness of inward foreign investment. However, simultaneous changes resulting in more and more sectors opening up for investment can only add to the attractiveness of the Indian market. While avenues for tax avoidance may have become less prolific, a genuine arrangement having commercial substance is welcomed in many more investment sectors. Moreover, regulations such as GAAR provide stability for the investment environment, where once such a climate was determined by the lengthy and often unpredictable activism (or restraint) of the judiciary. It is however, prudent to admit that both, the notification of cross border M&As in CA 2013 and the inclusion of GAAR, are incredibly recent to have had a noticeable impact for statistical analysis. What it may have already had, however, is an impact on the image of the Indian market and perhaps the promise of a more inclusive and inviting investment culture.

7. Annex

Table 1: FDI Sectoral caps

Sector	2016		2014	
	Cap	Route	Cap	Route
Plantation Tea, Coffee, Rubber, Cardamom, Palm Oil Tree, Olive Oil Tree	100%	A	100% (Tea only)	G
Defence	49%	A – 49% G >49% (Case by Case)	26%	A – 26% G > 26% (Case by Case)
Broadcasting Carriage Service				
Teleports, DTH, Cable (MSOs), Mobile TV, HITS	100%	A– 49% G > 49%	74%	A – 49% G >49% – 74%
Cable Networks (Other MSOs)	100%	A - 49% G > 49%	49%	A
Broadcasting Content Services				
Terrestrial Broadcasting (FM)	49%	G	26%	G
Up-Linking of News and Current Affairs TV Channels	49%	G	26%	G
Up-Linking of Non-News and Current Affairs TV Channels/ Down-Linking of TV Channels	100%	A	100%	G
Civil Aviation				
Non-scheduled air transport Services	100%	A	74% FDI (100% NRI)	A – 49% G >49%-74%
Ground Handling Services	100%	A	74% FDI (100% NRI)	A – 49% G >49%-74%
Satellites establishment and Operations	100%	G	74%	G
Trading				
Duty Free Shops	100%	A	Not Listed	
Railway Infrastructure (Construction operation and maintenance of listed activities)	100%	A	Not Listed	
Financial Services				
Asset Reconstruction Companies	100%	A	100% of paid up capital of ARC (FDI + FII/FPI)	A – 49% G > 49%
Credit Information Companies	100%	A	74% (FDI + FII/FPI)	A
Infrastructure Company in the Securities Market	49%	A	49% (FDI + FII/FPI) 23% FDI 26% FII/FPI	A
Insurance	49%	A	26% (FDI + FII/FPI + NRI)	A
Pension	49%	A	Not Listed	
White Label ATM Operators	100%	A	Not Listed	

Source: FDI Consolidated Policy 2014 and 2016. Table collated by author

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