

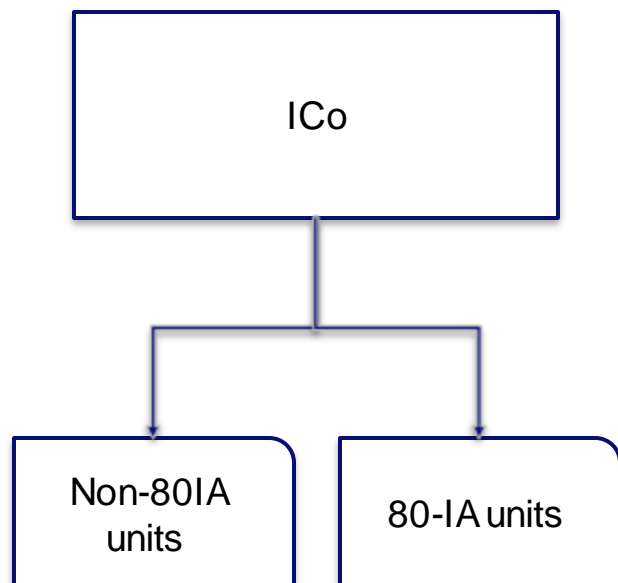
# Tax and Regulatory Aspect in Restructuring

Presentation by:

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# Case Study 1: Restructuring to obtain benefit u/s 115BAA

# Background



- ❑ ICo had set up a pipe manufacturing unit 10 years ago. Further, 4 years ago, it extended its operations in the business of execution of various water supply and irrigation projects.
- ❑ The undertaking engaged in execution of water supply and irrigation projects is eligible for 80IA deduction.
- ❑ It has been making consistent profits and has reserves of approximately Rs. 30 crore.
- ❑ The Company wants to take the benefit of lower tax rate u/s 115BAA (25.17%)

# Options

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## ❑ Transfer of Non-80IA unit

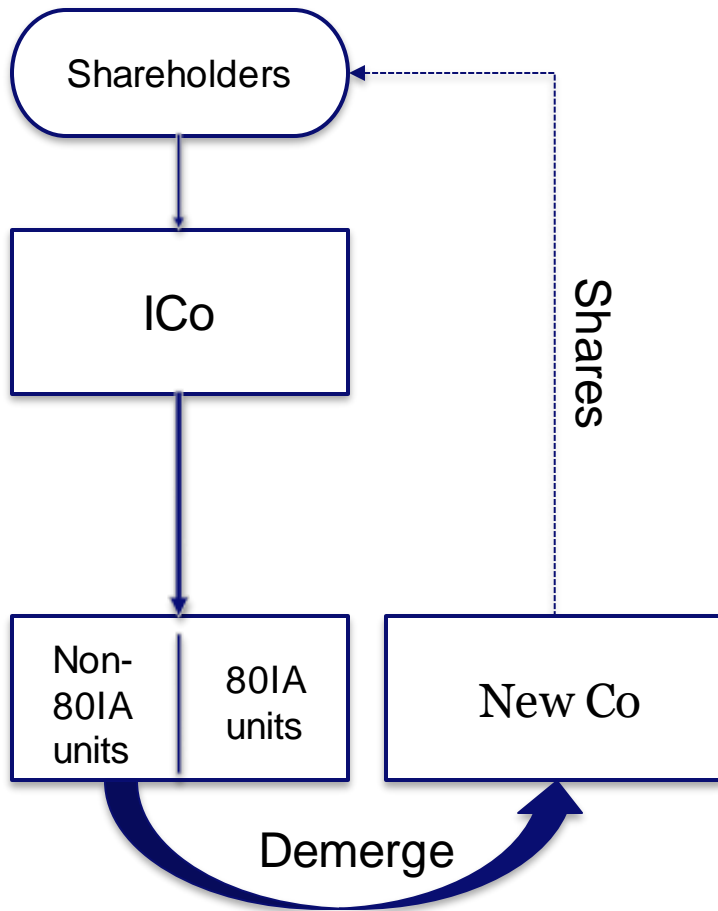
- Demerger
  - With NCLT approval
  - Without NCLT approval
- Slump Transfer
  - At book value
  - At Fair value
  - Slump Exchange
  - Gift of undertaking

## ❑ Transfer of 80IA unit

- Slump Transfer
  - At book value
  - At Fair value
  - Slump Exchange
  - Gift of undertaking
- Demerger without NCLT approval

Benefit of 80IA will be lost  
on demerger with NCLT  
approval of 80IA unit

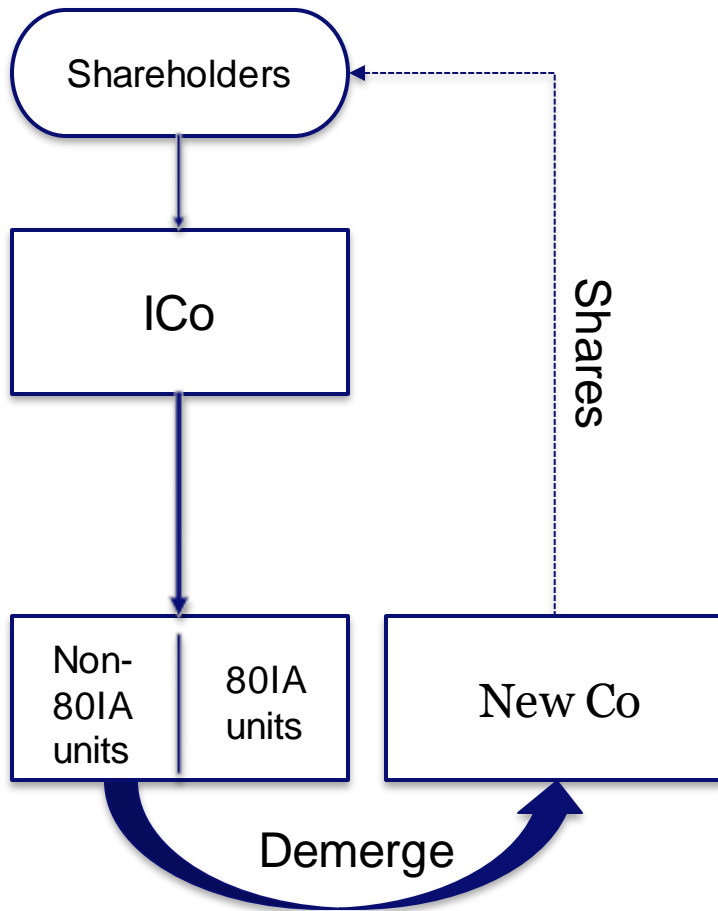
# Demerger of Non-80IA unit (1/6)



## ❑ Demerger with NCLT approval

- Scheme u/s 230 r.w. S. 232 of the Co's Act
- Increased time frame (3-6 months)
- Lower stamp duty - if concessional rate available in the State
- Compliant demerger u/s 2(19AA) of IT Act

# Demerger of Non-80IA unit (2/6)



## ❑ Demerger without NCLT approval

- Transfer - S. 180 of Co's Act - special resolution - providing for direct allotment to shareholders of transferor instead of allotment to transferor
- Lesser time frame (1-2 months)
- Lower stamp duty possible - Transfer of immovable property effected by conveyance and transferring the movable property by agreement to sell followed by delivery
- Non-compliant demerger

# Demerger of Non-80IA unit (3/6)

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## Issues in Demerger without NCLT Approval:

- ❑ Distribution of dividend in kind
  - S. 123 prohibits distribution of dividend in kind
  - Indian Seamless Enterprises Ltd., In re [2015] 61 taxmann.com289 (Bom. HC) – Rejected scheme u/s 230 for distribution of assets to shareholders
  - S. 180 exception to S. 123?
- ❑ Non-compliant demerger under IT Act
  - Diversion of income at source? – S. 180(4) of Co's Act – “.... *Stipulate conditions ... including conditions regarding the use, disposal or investment of sale proceeds...*”
    - However reduction of capital not permitted
    - CIT v. Salora International Ltd. [2016] 386 ITR 580 (Del. HC) (SLP granted)

# Demerger of Non-80IA unit (4/6)

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- Capital gains in the hands of Company
  - Slump exchange?
- Dividend in the hands of shareholders u/s 2(22)(a)
- 56(2)(x) - Receipt of shares – loss in value of existing shares is consideration given by the shareholders
  - Miss Dhun Dadabhoy Kapadia v. CIT [1967] 63 ITR 651 (SC)
  - Sudhir Menon HUF v. ACIT [TS-146-ITAT-2014] (Mum. Trib.) – rights issue
  - DCIT v. Dr. Rajendra Pai [TS-299-ITAT-2016] (Bang. Trib.) – bonus issue



# Demerger of Non-80IA unit (5/6)

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## Benefits of a compliant demerger:

- ❑ In the hands of demerged company - Exempt u/s 47(vib)
- ❑ S. 56(2)(x) – not applicable to transactions covered under
  - S. 47(vib) – receipt by resulting company; and
  - S. 47(vid) – receipt by shareholders of demerged company
  - Assumption of legislature is not law
    - CIT v. Madurai Mills [1973] 89 ITR 45 (SC)
- ❑ No deemed dividend

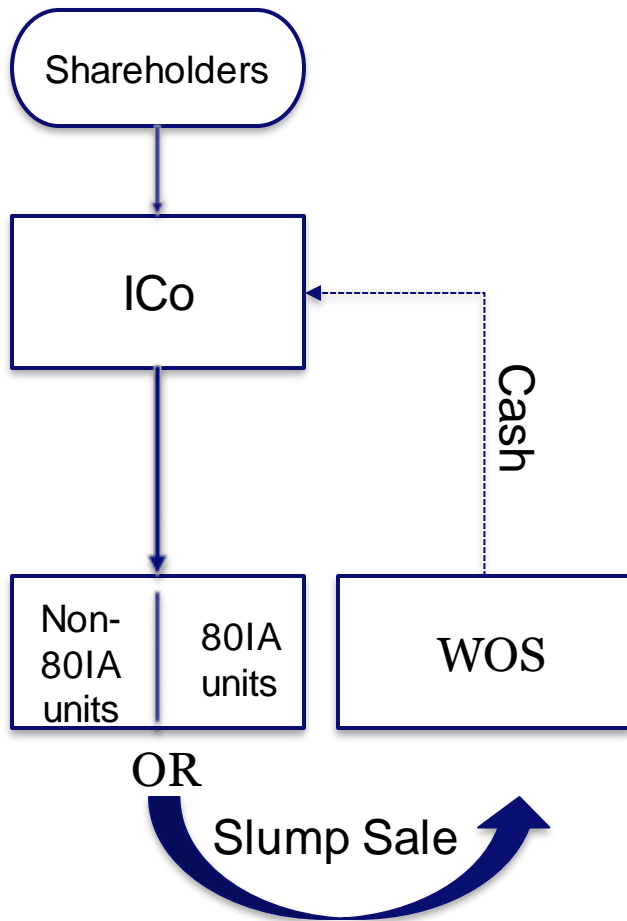
# Demerger of Non-80IA unit (6/6)

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## Common Issues:

- ❑ MAT Credit transfer? – Adani Gas Ltd. ACIT [2016] TIOL146 (Ahm Trib) – transferred to resulting company; DCIT v. TCS E-Serve International Limited [2019] TS 516 (Mum T) – continued with demerged company
  - If not transferred – 80IA unit will have to utilize higher MAT credit
  
- ❑ Commercial justification of split – risk of GAAR?

# Slump Sale of 80IA / Non-80IA unit (1/4)



## Key Considerations:

- ❑ 80IA deduction to continue - CBDT Circular 1/2013 dated January 17, 2013
- ❑ Lower stamp duty possible – Transfer of immovable property effected by conveyance and transferring the movable property by agreement to sell followed by delivery
- ❑ Easy implementation as compared to demerger.
- ❑ Time: 1-2 months

# Slump Sale of 80IA / Non-80IA unit (2/4)

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## ❑ Slump sale at book value

- Exempt u/s 47(iv) of IT Act
- If WOS is delinked before 8 years - Nil capital gains - GAAR?
  - Slump sale through NCLT
  - Ind AS -103 – Appendix C – book value accounting

## ❑ Slump sale at fair value

- Exempt u/s 47(iv) of IT Act
- If WOS is delinked before 8 years – capital gains

# Slump Sale of 80IA / Non-80IA unit (3/4)

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## ❑ Slump exchange

- S. 50B to not apply – no capital gains
  - SREI Infrastructure Finance Ltd. v. ITSC (251 CTR 129) (Delhi HC) – Against
  - CIT v. Bharat Bijlee Ltd. (365 ITR 258) (Bom HC)
  - ITO v. Datex Ohemda (India) Pvt. Ltd. (TS-320-ITAT-2018) (Kol. Trib)

## ❑ Gift of undertaking

- Achievement of segregation without loss of value to shareholders / company
- If WOS is delinked before 8 years - Nil capital gains - GAAR?
  - Slump gift through NCLT

# Slump Sale of 80IA / Non-80IA unit (4/4)

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- ❑ Implications in the hands of buyer (applicable to all alternatives)
  - 56(2)(x) - Is 'Undertaking' a property u/s 56(2)(x)?
  - If immovable property transferred by conveyance and movable property under agreement to sell followed by delivery – itemized sale?
  - No ascertained / determined consideration
    - CIT v. B.C. Srinivasa Shetty [1981] 128 ITR 294 (SC)

# Common considerations for all options

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- ❑ 80IA unit to continue to be liable to MAT @ 17% - MAT credit to be absorbed over the years and then it can opt for lower rate of tax
  
- ❑ No GST implications –
  - Transfer of business – neither supply of goods nor service
  - Transfer of business – not in the course of business
  - Specific exemption (under service notification) for transfer of business as a going concern
  
- ❑ Transfer of unutilized ITC pertaining to transferred unit – optional
  - ITC shall be apportioned in the ratio of value of assets of the new unit as specified in the demerger scheme (CBIC Clarification – Circular No. 133 03/ 2020-GST dt. March 23, 2020 – explained in the next slide)

# Apportionment of ITC on partial transfer of business

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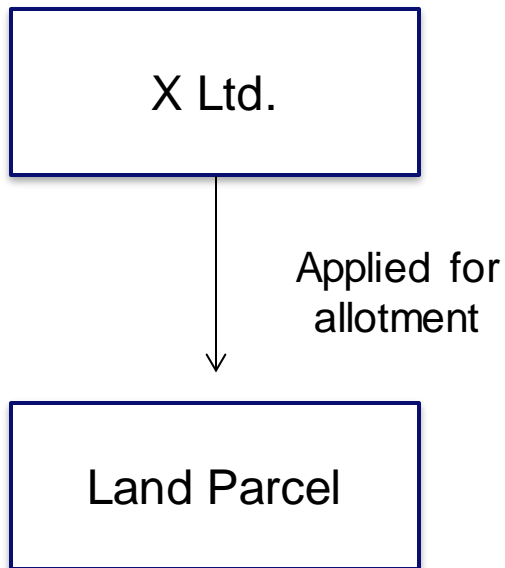
- ❑ Rule 41(1) of CGST Rules to be applied to all forms of partial transfer of business
- ❑ Value of entire assets of business (whether ITC has been availed or not) to be considered
- ❑ Value of assets on the appointed date as per the scheme to be considered
- ❑ Value of assets to be taken at State level and not all India level
- ❑ Form ITC 02 (for transfer of ITC) to be filed only in those States where both transferor and transferee are registered
- ❑ Ratio of value of assets to be applied to total unutilised ITC (C+S/U+I)
- ❑ Transferor at liberty to decide ITC to be transferred under each head (C/S/U/I) within total eligible amount of ITC
- ❑ Unutilised ITC balance available as on the date of filing Form ITC 02 to be taken



# Case Study 2: Restructuring to obtain benefit u/s S. 115BAB

# Background (1/2)

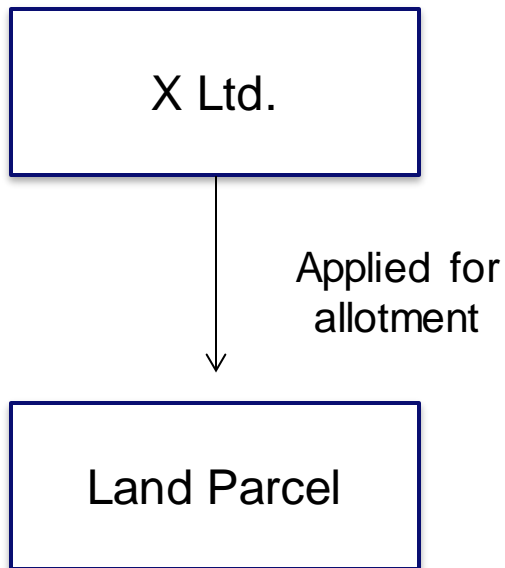
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- ❑ X Ltd. is a domestic closely held Co. incorporated in June 2019 for the purpose of textile manufacturing. It is a Joint Venture Co.
- ❑ It intends to set-up a manufacturing facility in Rajasthan
- ❑ It has applied to Rajasthan State Industrial Development and Investment Corporation ('RIICO') for allotment of a land parcel on which it intends to set-up the manufacturing facility

# Background (2/2)

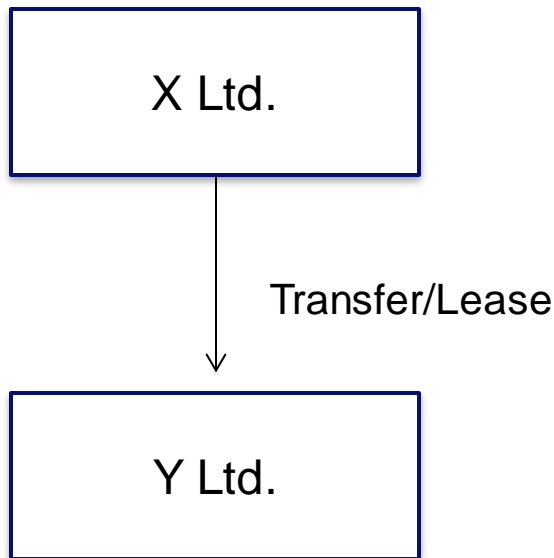
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- ❑ The manufacturing activity is yet to commence and the project is still under development stage
- ❑ It has also entered into know-how agreement for the purpose of set-up of manufacturing facility and production of textiles
- ❑ It is not eligible to claim benefit of lower-rate of tax available under S. 115BAB since it is not incorporated on or after October 1, 2019
- ❑ It is evaluating various options which can be adopted to claim benefit of S. 115BAB

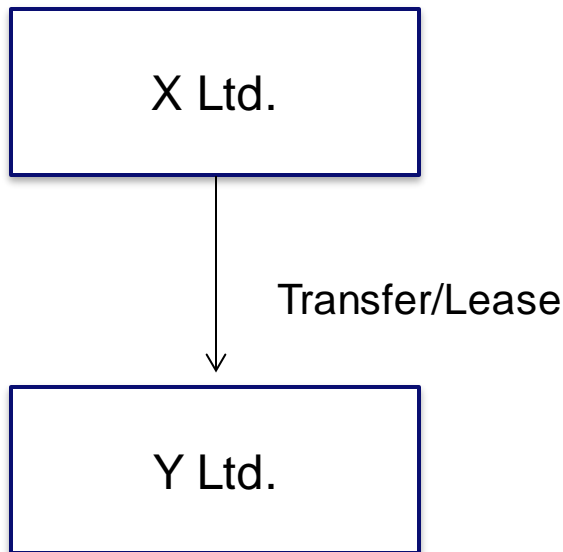
# Option 1: Sale of project-in-progress (1/2)

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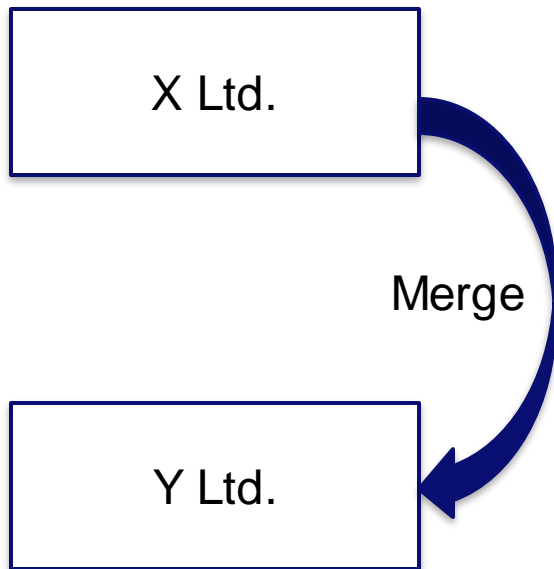
- ❑ A new company, say Y Ltd., can be incorporated.
- ❑ The shareholding pattern, MOA and AOA of Y Ltd. can be identical to that of X Ltd.
- ❑ The project which was originally proposed to be undertaken in X Ltd. can be taken over by Y Ltd.
- ❑ Two options available for take over of land by Y Ltd. from X Ltd.:
  - Transfer of land from X Ltd. to Y Ltd.;
  - Y Ltd. to take the land on long term lease from X Ltd.

# Option 1: Sale of project-in-progress (2/2)



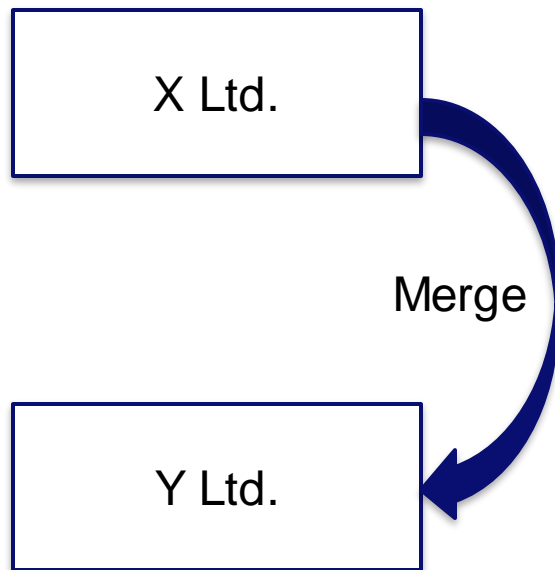
- ❑ Transfer of concept and development on arm's length terms
- ❑ The know-how agreements can be re-entered in the name of Y Ltd. Other agreements, etc. should be executed in the name of Y Ltd.
- ❑ Disadvantages:
  - Stamp-duty cost
  - Regulatory restrictions on transfer / lease
  - Delay in commencement of manufacturing process
- ❑ GST
  - On transfer of land – No GST
  - On lease premium / lease rentals - GST payable - ITC can be claimed

# Option 2A: Incorporation of New Co. followed by a merger (1/2)



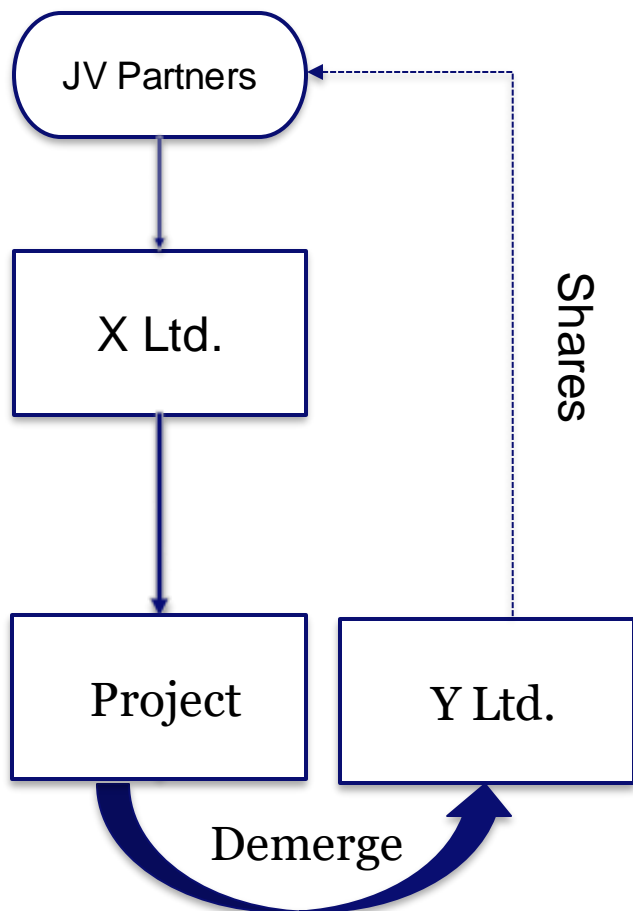
- ❑ A new company, say Y Ltd., can be incorporated at any date on or after October 1, 2019
- ❑ The shareholding pattern, MOA and AOA of Y Ltd. can be identical to that of X Ltd.
- ❑ X Ltd. to be merged with Y Ltd.
- ❑ As a result of merger, the Land and the know-how agreement will be vested in Y Ltd.

# Option 2A: Incorporation of New Co. followed by a merger (2/2)



- ❑ Post-merger, the manufacturing activities can be commenced in Y Ltd.
- ❑ NCLT approval required
- ❑ Disadvantages:
  - Stamp-duty cost
  - NCLT approval – 3-6 months

## Option 2B: Demerger of Project (1/4)



- ❑ A new company, say Y Ltd., can be incorporated at any date on or after October 1, 2019
- ❑ X Ltd. can demerge the project (which includes land and know-how agreement) to Y Ltd.
- ❑ Lower stamp duty - if concessional rate available in the State



# Option 2B: Demerger of Project (2/4)

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## Issues:

- ❑ Non-compliant demerger? – No ‘undertaking’ in existence
  
- ❑ Tax implications under the IT Act for non-compliant demerger:
  - Capital Gains in the hands of the demerged company:
    - No receipt by Demerged Co. – diversion of income at source
    - Deemed receipt? – Hindustan Unilever v State of Maharashtra [AIR 2004 SC 326]; CIT v. Salora International Ltd. [2016] 386 ITR 580 (Del. HC) (SLP granted)

# Option 2B: Demerger of Project (3/4)

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- 56(2)(x) – It specifically exempts cases of qualifying demerger – Whether 56(2)(x) gets triggered in case of non-qualifying demerger?:
  - Demerged Company:
    - No receipt
    - Deemed Receipt? – Refer earlier slide
    - Issue of adequacy will have to be examined
  - Resulting Company:
    - Demerger of specific asset i.e., property – adequacy of consideration to be examined
    - Aamby Valley Ltd. v. ACIT [TS-80-ITAT-2019 (Del. Trib)] – Statutory vesting v. receipt

# Option 2B: Demerger of Project (4/4)

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- Shareholders of demerged company:
  - Receipt of shares – loss in value of existing shares in consideration given by the shareholders
    - Miss Dhun Dadabhoy Kapadia v. CIT (1967) (63 ITR 651) (SC)
    - Sudhir Menon HUF v. ACIT [TS-146-ITAT-2014] (Mum. Trib.) – rights issue
    - DCIT v. Dr. Rajendra Pai [TS-299-ITAT-2016] (Bang. Trib.) – bonus issue
  
- Shareholders of resulting company:
  - Receipt of benefit is not a thing (property)

# Common Income-tax issues (1/3)

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- ❑ Whether 're-construction of business already in existence'?
  - X Ltd. has no business in existence as on date
  - Project is still under development stage
  - Land to be acquired is still under acquisition stage
  - Manufacturing activity to commence in the Y Ltd. – business came 'in existence' in Y Ltd.
  
- ❑ Business can be said to have been set-up once the manufacturing facility is in place:
  - CWT v. Ramaraju Surgical Cotton Mills (63 ITR 478) (SC)
  - CIT v. Sarabhai Sons (P.) Ltd. (90 ITR 318) (Guj. HC)
  - Western India Vegetable Products Ltd. v. CIT (26 ITR 151) (Bom. HC)

# Common Income-tax issues (2/3)

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- ❑ GAAR? – objective of S. 115BAB achieved inasmuch as new company set-up on or after October 1, 2019 for manufacturing
  
- ❑ GAAR - None of the tainted element present since the merger –
  - Is an arm's length transaction
  - Will not result in misuse or abuse of provisions of the Act;
  - Will not lack commercial substance since resources, namely Land in X Ltd. and project under Y Ltd., can be effectively used
  - Transfer/Merger/Demerger are some of the bonafide means and is commonly used by companies for various reasons

# Common Income-tax issues (3/3)

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- ❑ Option 2A & 2B– additional arguments for GAAR
  - Whether ‘re-construction of business already in existence’:
    - Re-construction of company but not re-construction of business?
  
- ❑ SAAR test passed - seeking benefit provided by section is misuse or abuse of the Act?

# Case Study 3: Restructuring by Deleveraging

# Background

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- ❑ Co. A was set up 3 years ago. At the time of being set up, the initial funding was done partly by equity and partly by raising loans, in the ratio of 1:2, from Banks as well as its group companies
- ❑ The loans were raised from the Bank and group companies for various purposes such as term loans for purchase of capital assets and working capital loans. Further, it even has unpaid advances for trading liabilities and outstanding creditors for capital assets
- ❑ Due to the ongoing Covid-19 pandemic, its operations have been severely hit and it has incurred huge losses due to the complete shut down of its operations during the lockdown. The losses are almost equal to its net-worth plus half the loan liability
- ❑ Co. A is analyzing various options to deleverage the debt in order to ease its already distressed position



# Options

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- ❑ Waiver / partial waiver of loan / interest or moratorium / concessional loan
  
- ❑ Convert loan / interest into equity / quasi equity
  - Convert loan / interest into equity
  - Issue compulsorily / optionally convertible preference shares or debentures in lieu of loan

# Whether an Arm's length transaction?

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- ❑ Companies Act - S.188 - “arm's length transaction” means a transaction between two related parties that is conducted **as if they were unrelated**, so that there is **no conflict of interest**.
- ❑ Income Tax - S.92F - "arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in **uncontrolled conditions**;
- ❑ Government concessions (Economic Package) - Banks – key object to preserve business
- ❑ Act of group company to restructure loan during Covid – similar to act of 3<sup>rd</sup> party lender -
  - Arm's length?
  - Shareholder activity?
    - Micro Ink Ltd. v. ACIT (175 TTJ 8) (Ahm.); ACIT v. Nimbus Communications Ltd. (145 ITD 582) (Mum.)

# Option 1: Waiver / partial waiver of loan (1/5)

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In the hands of borrower:

## ❑ Section 28(iv) – benefit or perquisite?

- Receipt of money – not receipt in kind - Commissioner v. Mahindra and Mahindra Ltd. [2018] 93 taxmann.com 32 (SC) - not taxable u/s 28(iv)

## ❑ Section 41(1) – cessation of trading liability?

- Waiver of loan taken for acquiring capital assets - Commissioner v. Mahindra and Mahindra Ltd. [2018] 93 taxmann.com 32 (SC) - not taxable u/s 41(1)

# Option 1: Waiver / partial waiver of loan (2/5)

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In the hands of borrower:

- Waiver of loan taken for trading activity –
  - Solid Containers Ltd. v. DCIT (308 ITR 417) (Bombay HC) - taxable;
  - CIT v. Compaq Electric Ltd. [2019] 101 taxmann.com 400 (SC) (SLP dismissed) – not taxable since nothing was claimed as a deduction – capital receipt
  
- Whether taxable u/s 28(i)? (Commercial accounting?)
  - CIT v. U.P. State Industrial Development Corpn. [1997] 92 Taxman 45 (SC)

# Option 1: Waiver / partial waiver of loan (3/5)

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- ❑ Non-speaking SLP dismissal - not binding in nature:
  - Kunhayammed v. State of Kerala (245 ITR 360) (SC) (3 judge)
  - Khoday Distilleries Ltd. v. Sri Mahadeshwara Sahakara (Civil Appeal No. 2433 of 2019) (SC 3 judge)
  - Hemalatha Gargya vs. CIT (2003) 259 ITR 1 (SC)
- ❑ Obiter of Supreme Court is binding:
  - Municipal Committee, Amritsar v. Hazara Singh (Criminal Appeal No. 228 of 1972) (SC) (3 judge)
  - G.M. Foods v. ITO (58 taxmann.com 16) (Cal. HC)
  - L.B. Kharawala v. ITO (147 ITR 67) (Guj. HC)

# Option 1: Waiver / partial waiver of loan (4/5)

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- ❑ MAT – waiver of loan - credit to Statement of Profit and Loss
  - B & B Infotech Ltd. V. ITO (155 ITD 1040) (Bang. - Trib.)(Against) (confirmed by Kar HC – 396 ITR 420)
  - M/s. JSW Steel Limited v. ACIT [2017] (82 taxmann.com 210) (Mum Trib) (Favour) (after considering Bangalore Tribunal)
  - Relevance after S. 115BAA?
  
- ❑ 56(2)(x) applicable in the hands of borrower?
  - No constructive receipt
  - Implications of SC ruling in CIT v Mahindra & Mahindra [[2018] 404 ITR 1 (SC)] categorically holding that waiver amounts to capital ‘receipt’
  - Receipt of a benefit v. receipt of a thing (property)
  - Waiver of loan is not a property

# Option 1: Waiver / partial waiver of loan (5/5)

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In the hands of lender:

- ❑ Bank – bad debts u/s 36(1)(vii)
- ❑ Group Company –
  - Business loss - commercial expediency? – S.A. Builders v. CIT [2007] 288 ITR 1 (SC)
    - ACIT v. Tulip Star [2012] 21 taxmann.com 97 (SC) – S.A. Builders (*supra*) needs reconsideration

# Option 1A: Waiver / partial waiver of interest or moratorium (1/4)

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## Waiver / partial waiver of interest:

### □ Waiver of past interest:

- In the hands of Lender –
  - Business Loss?
  - Real Income Theory:
    - State Bank of Travancore v. CIT [1986] (SC) (158 ITR 102)
    - CIT v. Excel Industries Ltd. [2013] (SC) (358 ITR 295)
    - CIT v. Lucas Indian Services Ltd. [2009] (Mad. HC) (315 ITR 275)



# Option 1A: Waiver / partial waiver of interest or moratorium (2/4)

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- In the hands of borrower –
  - If loan taken from bank:
    - No interest claimed earlier u/s. 43B since no payment – No addition u/s. 41(1) - ACIT v. Spel Semiconductor Ltd. [2013] 35 taxmann.com 304 (Chennai - Trib.)
  - If loan taken from group company - If interest not claimed as expense in earlier years – no addition u/s. 41(1):
    - ACIT v. Spel Semiconductor Ltd. [2013] 35 taxmann.com 304 (Chennai - Trib.)
    - Fertilizer Corporation of India Ltd. v. ACIT [2019] 69 ITR(T) 183 (Del. Trib.)
  
- Capital receipt?

# Option 1A: Waiver / partial waiver of interest or moratorium (3/4)

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## ❑ Waiver of future interest:

- In the hands of lender – No interest accrued on account of change in terms of loan agreement – No interest income chargeable to tax:
  - CIT v. Shoorji Vallabhdas & Co. [1962] 46 ITR 144 (SC)
  - CIT v. Birla Gwalior (P.) Ltd. [1973] 89 ITR 266 (SC)
- In the hands of borrower – No interest payable – No expense allowable as expenditure

# Option 1A: Waiver / partial waiver of interest or moratorium (4/4)

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## Moratorium given:

### In the hands of the lender –

- Interest chargeable to tax even though not receivable in the current year?
- Interest agreed to be paid at a specified date – Interest does not accrue any date prior thereto?
  - DIT v. Credit Suisse First Boston (Cyprus) Ltd. [2012] (351 ITR 323) (Bom. HC)

### In the hands of the borrower:

- Lender is bank – Interest allowed as deduction on payment basis – S. 43B
- Lender is group company – Interest allowable as expenditure?

# Option 1B: Concessional Loan

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- ❑ Under the revised terms of the agreement, the loan period to be extended with waiver of interest / reduction in rate of interest
  
- ❑ Tax implications on modifications of terms of agreement – Same as Option 1A
  
- ❑ Discount loan to Present Value?
  
- ❑ GAAR?
  - Not a bonafide means?

# Option 2A: Convert loan into equity (1/5)

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## Income Tax:

- ❑ Loan given to group company – capital asset?
  - CIT v. Siemens Nixdorf Information Systemse GmbH [2020] 114 taxmann.com 531 (Bom. HC)
  - CIT v. Babebhai Alias Lavkumar Kantilal [1981] 128 ITR 1 (Guj. HC)
  - CIT v. East India Charitable Trust [1994] 206 ITR 152 (Cal. HC)
  
- ❑ Capital gains / loss in the hands of group company?
  - Loan is of Rs. 100 and shares issued are worth Rs. 90 – capital loss allowable?
  - Loan is of Rs. 100 and shares issued are also worth Rs. 100 – No capital gains

# Option 2A: Convert loan into equity (2/5)

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- ❑ 56(2)(x) in the hands of lender?
  - Equity in lieu of loan – consideration?
  - Today's realisable value of loan – no / very low value – does it amount to consideration?
  
- ❑ Valuation of equity shares
  - Current equity values impacted by Covid-19 to be considered? or
  - Should long term equity value be considered?
  - If current equity shares are valued at Rs. 3 (face value Rs. 5) and the resident lender agrees to convert the loan at Rs. 10 taking the long term equity value – can 56(2)(viib) be applied in the hands of borrower?
    - No constructive receipt
    - Allotment for consideration other than cash

# Option 2A: Convert loan into equity (3/5)

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## ❑ Violation of S. 269T?

- Book entry - Not a repayment in cash – not a violation
  - ITO v. Indepesca Overseas Pvt. Ltd. [2017] (ITA No. 3554/Mum/2015) (Mum. Trib.)
  - Arkit Vincom Pvt. Ltd. v. ACIT [2018] (ITA No. 2397/Kol/2016) (Kol. Trib.)

# Option 2A: Convert loan into equity (4/5)

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## Company law

- ❑ S. 62(3) – Section to not apply if:
  - There is a **prior agreement** for conversion of loan into shares
  - Such agreement has been approved by a **special resolution**
    - Special resolution not passed at the time of acceptance of loan – Raj Singh Chopra v. Jagat Singh Chopra [2018] 90 taxmann.com 156 (NCL-AT) – loan cannot be converted
    - Convert old loan into new convertible loan?
    - Shares can be issued under S. 62(1)(c) – for cash / other than cash
- ❑ **SEBI ICDR** – Preferential issue guidelines to apply on conversion of loan to equity?



# Option 2A: Convert loan into equity (5/5)

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## FEMA

- If lender is a foreign party –
  - ECB guidelines - Conversion permitted, subject to compliance with FEMA regulations w.r.t. sectoral caps & pricing guidelines (on the date of conversion), reporting the conversion to RBI, consent of other lenders or at least information to be exchanged with other lenders etc.

# Option 2B: Quasi Equity (1/7)

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- Various commercial considerations while structuring quasi equity instruments –
  - Conversion ratio can be kept open
  - Allowability and taxability of interest
  - Flexibility in terms of liquidity and conversion to equity
  - Eg: if conversion is optional:
    - If the company is not doing well, the lender may opt not to convert to equity and recover money along with other lenders
    - If the company is doing well, then the company may decide to issue shares in the market and repay the loan

# Option 2B: Quasi Equity (2/7)

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- ❑ Structuring options of compulsorily / optionally convertible preference shares or debentures in lieu of loan:
  - Compulsory with fixed formula for conversion
  - Compulsory without fixed formula for conversion
  - Optional with the option in the hands of shareholder / debenture holder
  - Optional with the option in the hands of Company
  - Optional with the option in the hands of both shareholder / debenture holder and Company
  - Compulsory / Optional with interest
  - Compulsory / Optional without interest
  
- ❑ Each option will have minor variations in tax primarily vis-à-vis interest – its allowability and taxability

# Option 2B: Quasi Equity (3/7)

---

## On issue of compulsorily / optionally convertible preference shares or debentures in lieu of loan

### ❑ Income Tax

- Same as option 2A other than 56(2)(viib)
- Applicability of 56(2)(viib) in the hands of borrower on issue of preference shares where lender is a resident?
  - No receipt of consideration

### ❑ Company Law

- Preferential issue – comply with S. 62 r.w. S. 42 and applicable rules
- Additionally comply with S.71 in case of issue of debentures

### ❑ SEBI ICDR – Comply with provisions of Preferential issue

# Option 2B: Quasi Equity (4/7)

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## □ FEMA

- On issue of compulsorily convertible preference shares or debentures – equivalent to conversion into equity
  - ECB Guidelines: Conversion permitted, subject to compliance with FEMA regulations w.r.t. sectoral caps & pricing guidelines (on the date of conversion), reporting the conversion to RBI, consent of other lenders or at least information to be exchanged with other lenders etc.

- On issue of optionally convertible preference shares or debentures

Optionality clause:

- If equity risk is taken by borrower: Characterised as equity instrument – Definition of equity instrument as per the Non-Debt Instrument Rules, 2019 – *“Equity instruments can contain an optionality clause subject to a minimum lock-in period of one year or as prescribed for the specific sector, whichever is higher, but without any option or right to exit at an assured price.”*
  - ECB Guidelines - conversion permitted as above

# Option 2B: Quasi Equity (5/7)

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- If equity risk is not taken by borrower: Characterised as ECB
  - Change in terms and conditions of ECB
    - Compliance with ECB norms
    - Report to the Department of Statistics and Information Management (DSIM) through revised ECB Form not later than 7 days of change

# Option 2B: Quasi Equity (6/7)

---

On conversion of compulsorily / optionally convertible preference shares or debentures into equity:

- ❑ Capital gains - Exempt u/s 47(x) (debentures) and 47(xb) (preference shares)
- ❑ 56(2)(viib)?
  - No constructive receipt
- ❑ 56(2)(x)?
  - Absence of a specific exclusion in the proviso to S. 56 for exempt transfer u/s. 47(x) and 47(xb)
  - Upon conversion it is mere working out of pre-existing rights of the holder or mere discharging of obligation by the issuer
  - Stage of application of S. 56(2)(x) is the stage of issuance of convertible instrument (securities)

# Option 2B: Quasi Equity (7/7)

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On conversion of compulsorily / optionally convertible preference shares or debentures into equity:

## ❑ Company Law

- On conversion of Debentures - exemption from compliance with preferential issue norms
- On conversion of Preference shares –
  - Variation in rights?
    - Comply with S. 48
  - Fresh issue?
    - Comply with S. 62 r.w. S. 42?

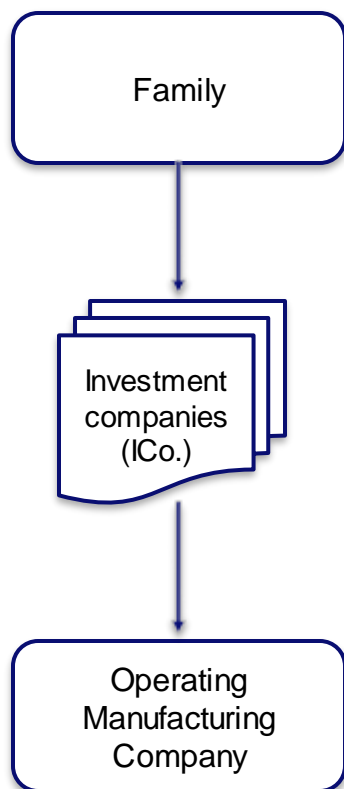
## ❑ SEBI ICDR –

- On conversion of debentures - Preferential issue guidelines to not apply on conversion of debentures in terms of section 62(3) of the Companies Act
- On conversion of preference shares – variation in rights or fresh issue?



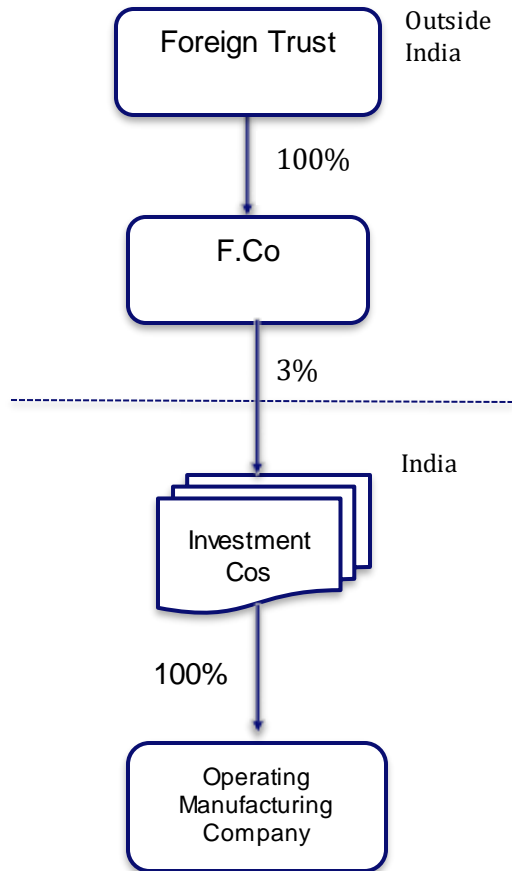
# Case Study 4: Externalisation of Structure – Family Holding

# Background



- ❑ A family has both resident and non-resident members
- ❑ These family members have invested in and carry on business in different geographies through entities incorporated in various jurisdictions
- ❑ In India, they are carrying on manufacturing activities through an operating manufacturing company which is held by three investment companies (non-NBFCs) having cross holdings in each other and 50% in each being held by family members
- ❑ Family wants to consolidate their global holdings under a foreign private trust wherein the family members are beneficiaries

# Structure to achieve



## Steps:

- ❑ Settlement of Foreign Trust
  - Settlor - Non-residents
  - Trustee – Non- resident
  - Beneficiaries – Both residents and non-residents
- ❑ Trust to incorporate a company outside India (F.Co.)
- ❑ Transfer of holding from family members to FCo.
  - Fresh issue of nominal (3%) shares
    - Followed by buyback / capital reduction
  - Gift of shares
  - Sale of shares

# Foreign Trust – FEMA (1/2)

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- ❑ Whether LRS Funds can be used for setting up foreign trust ?
  - Two views
    - Permissible – akin to gift permitted under LRS
    - Not permissible – not a specified capital account transaction – RBI approval required
      - Trust may be settled only by non-resident family members
  
- ❑ Whether Indian Resident can become beneficiaries of a foreign trust?
  - Two views
    - Permissible – beneficial interest in a trust is only a right against the trustee and consequently, does not give rise to any asset – therefore not a capital account transaction. Analogy - W.O. Holdsworth vs. The State of Uttar Pradesh [1958] 33 ITR 472 (SC)
      - Discretionary Trust – only a hope - CWT v. Estate of HMM Vikramsinhji of Gondal [2014] 225 Taxman 166 (SC)
    - Not permissible – not a specified capital account transaction – RBI approval required

# Foreign Trust – FEMA (2/2)

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- ❑ Whether foreign trust will have any monetary limit for distribution of trust property to resident beneficiaries ?
  - Resident beneficiary entitled to receive distribution from foreign trust without any limit – subject to repatriation of the same to India
  
- ❑ Investment by Foreign Trust in an Indian Company – permissible?
  - No – Foreign Trust is an unincorporated entity and therefore, cannot make direct investment – A.P.(DIR Series ) Circular No.14 dt. September 16, 2003
  - Can invest (in permissible sectors) through a company incorporated outside India (F.Co)

# Foreign Trust – Taxation (1/3)

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## ❑ Taxation on settlement

- No tax on settlor – S. 47(iii) – abundant caution
- Beneficiary – S. 56(2)(x) – Specific exemption to trust settled solely for the benefit of relatives
- Grey area if not eligible for the statutory exemption
  - Trustee – underlying obligation
  - Beneficiaries – only has a right against trustee - not a specified property u/s 56(2)(x)

## ❑ Residential Status of Trust

- Settlor? (Non-resident)
- Beneficiaries? (Residents and non-residents)
- Trustee – better view [CIT v. Venu Suresh Sanjay Trust [1996] 221 ITR 649 (Madras HC) Companies Incorporated in Mauritius, In re [1997] 224 ITR 473 (AAR) (para 59)]
  - Non-resident – Control and management should be outside India

# Foreign Trust – Taxation (2/3)

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## □ Taxation of Trust Income

- Mainly of two kinds
  - Dividend from FCo. – not taxable in India – CBDT Circular No. 4/2015 dt. March 26, 2015
  - Capital gains on sale of shares of FCo. – indirect transfer – taxable if FCo. derives value substantially from Indian assets
- Discretionary Trust – maximum marginal rate – 42.74%?
  - Risk – specific rate of tax u/s 112 v. MMR
    - Favour - Mahindra & Mahindra Employees' Stock Option Trust v. ADCIT [2015] 44 ITR(T) 658 (Mumbai - Trib.)
    - Against - DCIT v. India Cements Educational Society [2016] 46 ITR(T) 80 (Chennai - Trib.)

# Foreign Trust – Taxation (3/3)

---

- Taxation of distribution by the foreign trust to Indian resident beneficiaries
  - Distribution is in the same financial year in which the income is earned by the discretionary trust;
    - AO has the right to tax the beneficiary instead of the Trustee – S. 166 - CIT v. Smt. Kamalini Khatau [1994]209 ITR 101 (SC)
  - The distribution is in the subsequent financial year.
    - JCIT vs. Late Smt. Shantaben M. Patel (ITA 5000/Mum/2001)
    - Shri Dwarka Prasad Agrawal v. ITO (ITA 4591/Mum/2016)



# Inheritance Tax

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- ❑ Beneficial interest in discretionary trust – no passing on death
- ❑ Holding through inter-locked structure –
  - Only 3% held by Trust – balance is inter-locked
  - Valuation?
    - whether to be unlocked? or value of only 3% to be considered unless there are specific rules?

# Transfer of holding from Family Members to FCo.

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## Option 1:

Fresh issue of nominal shares (say 3%) to F.Co by ICos followed by buyback / capital reduction of shares held by family members

### On fresh issue

- Under FEMA – to be at fair value (FDI permissible if ICos not registered as NBFCs)
- Trust settled by Non-resident - no round tripping
- 56(2)(viib) in the hands of ICo. – not applicable as issue to non-resident
- 56(2)(x) in the hands of FCo. – no implication – as issue is at fair value
- Cash flow required by FCo. only to the extent of nominal stake of 3%

# Transfer of holding from Family Members to FCo.

---

## ❑ On Buy-Back

### ▪ Company Law

- Buyback of entire stake held by family at issue price plus nominal value
- Buyback to be within 25% of equity shares plus free reserves (S.68 of Co's Act, 2013)
- No NCLT approval required

### ▪ FEMA

- Buyback from resident family members – not applicable
- Buyback from non-resident family members - to be done at fair value or lower than fair value - No RBI Approval is required
- RBI may question the buyback – as it gives benefit to a non-resident (FCo.) (akin to gifting shares to non-resident)

# Transfer of holding from Family Members to FCo.

## ❑ On Buy-Back

### ▪ Income-tax

- Nominal tax to be paid by Company u/s 115QA
- In the hands of family members – exempt - S. 10(34A) – No S. 50CA implication
- S. 56(2)(x) – Not a capital asset
  - Commercial Tax Officer & Ors vs State Bank Of India [2016] 11 TMI 416 (SC);
  - Vora Financial Services P. Ltd. v. ACIT [2018] TS 346 (Mum Trib)
- Transfer-pricing
  - In the hands of non-resident shareholders – exempt – no transfer pricing
  - In the hands of Company
    - No income or expense
    - Whether distributed income is part of the total income? – CIT v. Khatau Makanji Spg. & Wvg Co. Ltd. [1960] 40 ITR 189 (SC)

# Transfer of holding from Family Members to FCo.

---

## ❑ On Capital Reduction

### ▪ Company Law

- NCLT approval required (S. 66 of Co's Act, 2013)
- Capital reduction of entire stake held by family members at NIL consideration
  - Permissible under Section 66 of the Companies Act, 2013?
  - S. 66 of Companies Act – *company . . . may . . . reduce the share capital in any manner . . .*
  - Favour
    - ACG Arts & Properties (Mum. NCLT); V.M. Salgaocar & Brother (Mum NCLT); O3 Capital Global Advisory (Bang. NCLT)
  - Against
    - Ansa Decoglass Pvt Ltd (Mum. NCLT)

# Transfer of holding from Family Members to FCo.

---

## ❑ On Capital Reduction

- FEMA
  - Capital reduction of shares held by resident family members – not applicable
  - Capital reduction is a unilateral act of the Company – no transfer by non-resident family members
  - RBI may question the capital reduction – as it gives benefit to a non-resident (FCo.) (akin to gifting shares to non-resident)

# Transfer of holding from Family Members to FCo.

## ❑ On Capital Reduction

- Income-tax
  - S. 45 & 48 – No consideration – computation mechanism fails – No capital gains tax
    - Bennett Coleman & Co. Ltd. v. ACIT [2011] 12 ITR(T) 97 (Mumbai T SB) – Bombay High Court appeal admitted
  - S. 50CA not applicable
  - S. 56(2)(x) – no receipt by the company
  - Transfer Pricing
    - Capital reduction is a unilateral act of the Company – not a transaction
    - In the hands of Company
      - No income or expense?

# Transfer of holding from Family Members to FCo.

---

- ❑ GAAR implications for both buyback and capital reduction:
  - Commercial substance?
  - Rule 10U – GAAR Grandfathering – transfer of investment made prior to April 1, 2017
  - S. 115QA levies an additional income tax. The definition of the tax benefit under Rule 10U(3)(iv) refers to saving of ‘tax’. ‘Tax’ is defined u/s 2(43) of the IT Act to mean income tax and does not include additional income tax.
  - Additional safeguard in Capital reduction – approved by NCLT



# Transfer of holding from Family Members to FCo.

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- GAAR consequences
  - Deem the buyback at fair value instead of nominal value?
    - Section 98 - consequence of invoking GAAR is an inclusive definition but only empowers the tax officer to disregard or re-characterize the transaction or to reallocate the accrual of income among the parties. Section 98 does not empower the tax officer to deem the fair value as the accrual of income (fair value of shares as buy back price)
  - 50CA in the hands of family members?
  - Recharacterize as gift from family members to FCo.? – 56(2)(x) in the hands of FCo

# Transfer of holding from Family Members to FCo.

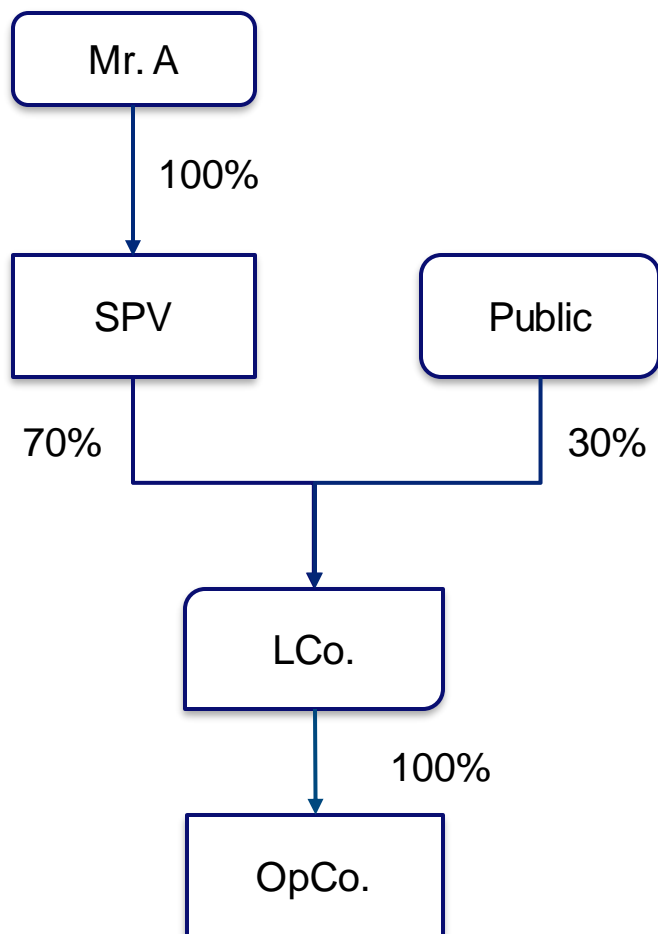
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## Options 2 & 3:

- ❑ Gift of shares by family members to FCo. – permissible?
  - Rule 9(4) of Non-Debt Instrument Rules, 2019 ('FEMA NDI Rules') – whether includes gift for the benefit of relatives?
  - Subject to conditions and will require RBI approval
  - S. 56(2)(x) in the hands of FCo.
  
- ❑ Sale of shares to FCo.
  - Transfer at fair value – FEMA pricing guidelines and S. 50CA, 56(2)(x) of Income Tax Act, 1961 - capital gains in the hands of family members
  - Cash flow issue

# Case Study 5: Distribution of profits from a company

# Background



- ❑ Mr. A through SPV is a promoter holder of LCo., a listed company. SPV holds 70% stake in LCo.
- ❑ The business operations are undertaken in OpCo, a wholly owned subsidiary of LCo.
- ❑ There are huge accumulated profits in OpCo. which are not yet distributed to LCo. – proposed to be distributed in coming years
- ❑ There is huge securities premium but small accumulated profits in LCo.
- ❑ Distribution from LCo. would require cashflow from OpCo.

# Distribution from LCo.

---

LCo. is evaluating options for distribution in years to come of profits (made in OpCo.) to its shareholders –

## Two Alternatives

- ❑ Dividend in coming years
- ❑ Issue of Bonus Redeemable Preference Shares today and redemption in coming years

# Alternatives for distribution from LCo. (1/4)

---

## Dividend

- ❑ Distribution from OpCo. to LCo. in coming years
- ❑ Same year declare dividend from LCO. – S. 80M benefit available in hands of LCo.
- ❑ Dividend taxable in the hands of shareholders – maximum rate 35.88%

# Alternatives for distribution from LCo. (2/4)

---

## Issue and redemption of bonus redeemable preference shares (RPS)

- ❑ Issue bonus RPS today
  - Use available securities premium – S. 63 of Co's Act
  - Nominal face value and redeemable at premium
    - at the time of redemption (S. 55 of Co's Act)
      - Profits only to the extent of face value required
      - Redemption premium can be adjusted against securities premium
  - Staggered redemption – after 1, 2 and 3 years

# Alternatives for distribution from LCo. (3/4)

---

## Issue and redemption of bonus redeemable preference shares (RPS)

### □ Issue bonus RPS today

- No tax on issue of bonus shares

– S. 2(22) not attracted at the time of issue as there is no distribution of assets of the company

- Shashibala Navnitlal v. CIT Guj HC (54 ITR 478) [1964]
- Briggs of Burton (India) (P.) Ltd., In re Delhi AAR (274 ITR 595) [2005]



# Alternatives for distribution from LCo. (4/4)

---

## Issue and redemption of bonus redeemable preference shares (RPS)

- Redemption of RPS in coming years
  - Distribution from OpCo. to LCo. – equivalent to amount required for redemption each year
  - Taxation on redemption of RPS?
    - Buy-back tax (S.115QA)
    - Dividend
    - Capital Gains

# Tax implications on redemption of RPS (1/5)

---

## Buyback

- ❑ Whether redemption of RPS is purchase by company?
  - Definition u/s 115QA – does not restrict to buy-back u/s 68 of Co's Act
  - SC in Anarkali Sarabhai v. CIT (224 ITR 422) [1997]

*“.....In effect, the company has bought back the preference shares from the shareholders.....When a preference share is redeemed by a company, what a shareholder does in effect is to sell the share to the company. Such a transaction is nothing but sale of the preference shares by the shareholders to the company.”*

# Tax implications on redemption of RPS (2/5)

---

## Buyback

- ❑ Whether redemption of RPS is purchase by company?
  - Proposition redemption is purchase further supported in
    - CIT v. Enam Securities (P.) Ltd. (Bom HC) 345 ITR 64 [2012]
    - Parle Biscuits Pvt Ltd v. ACIT (Mum ITAT) (5318&5319/Mum/2006) [2011]
    - Shri Uday K. Pradhan v. ITO (Mum ITAT) (4669/Mum/2014) [2016]
  - Alternatively, instead of redemption u/s 55 of Co's Act, company may buy-back preference shares u/s 68 of Co's Act – special resolution required and SEBI (Buy-back) Regulations to be complied

# Tax implications on redemption of RPS (3/5)

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## Buyback

### □ Tax implications

- Tax @ 23.30 u/s 115QA payable by LCo.
- Exempt in the hands of shareholders – S 10(34A)
- S. 80M benefit not available in hands of LCo. – if amount from OpCo.

Is distributed as dividend

# Tax implications on redemption of RPS (4/5)

---

## Dividend

- ❑ Under S. 2(22)(d) – capital reduction
  - Redemption of RPS is not capital reduction
    - Explanation to S. 55 of Co's Act
    - Parle Biscuits Pvt Ltd v. ACIT (5318&5319/Mum/2006) [2011]
    - Shri Uday K. Pradhan v. ITO(4669/Mum/2014) [2016]
  
- ❑ Under S. 2(22)(a) – release of all or any part of profits
  - Shashibala Navnitlal v. CIT (54 ITR 478) [1964] (Guj HC) – redemption of RPS amounts to dividend to the extent of accumulated profits in the year of issue
    - Post 115QA and Apex Court's decision in Anarkali Sarabhai – whether above to apply?
    - If no accumulated profits on date of issue (irrespective of status on redemption) – no dividend

# Tax implications on redemption of RPS (5/5)

---

## Capital Gains

- ❑ If not exempt u/s 10(34A) [buy-back] - redemption of RPS amounts to transfer
  - Capital gains chargeable in the hands of shareholders
  - Cost of acquisition – nil [S. 55(2)(aa)]
  - Period of holding – from the date of allotment [Clause(f) of Explanation 1 to S. 2(42A)]
  - Tax on STCG – slab rate (highest rate 42.74%)
  - Tax on LTCG – @ 23.30%
  
- ❑ S. 80M benefit not available in hands of LCo.

# Distribution from OpCo. to LCo. and further from LCo. to shareholders

## Dividend

- ❑ S. 80M benefit available in hands of LCo.
- ❑ Shareholders pay tax @ 35.88% (highest rate)

## RPS

- ❑ S. 80M benefit not available - LCo. to pay tax @ 25.17% (S. 115BAA) or 34.94% (normal rate)
- ❑ Buy back tax @ 23.30%

Where there is no step down subsidiary (i.e. no 80M benefit required) – distribution through redemption of bonus RPS is beneficial

# Distribution from OpCo. to LCo.

---

- ❑ Transfer of profits – not necessary
  - RPS with nominal face value can be redeemed if minimum profits to the extent of face value of RPS are available in LCo.
  
- ❑ Transfer of funds otherwise than through dividend –
  - Merger of OpCo. Into LCo.
  - Investment in new WOS and merger of WOS with LCo.
  - Inter-corporate deposit (ICD) from OpCo. To LCo.



# Alternatives for distribution from OpCo. to LCo. (1/5)

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## **Merger of OpCo. with LCo.**

- ❑ Post merger entire profit and funds of OpCo. will be housed in LCo.
  
- ❑ Merger of WOS (OpCo.) into HoldCo. (LCo.)
  - Can be undertaken through fast track route – S. 233 of Co's Act – no NCLT approval
  - No fresh issue – amalgamated company holds 100% shares
  - No tax implications - Complaint merger u/s 2(1B) - Exempt u/s 47(vi) and 47(via)
  - CBDT Circular No. 5-P dated 9 October, 1967 - transfer of assets and passing of reserves from subsidiary to holding company (as a result of merger) is not a dividend from subsidiary to parent

# Alternatives for distribution from OpCo. to LCo. (2/5)

---

## Investment in WOS and merger of WOS with LCo.

- ❑ OpCo. to incorporate a new WOS –
  - Surplus cash available in OPCo. – invested in WOS
  - No tax implications – transfer from a HoldCo. to WOS
  
- ❑ Merger of WOS (sub-subsubsidiary) into LCo.
  - Whether Registrar of Companies will approve fast track route? – S. 233 applies to HoldCo and its WOS
    - “subsidiary” [S.2(87) of Co’s Act] includes sub-subsubsidiary
    - WOS not defined

# Alternatives for distribution from OpCo. to LCo. (3/5)

---

## Investment in WOS and merger of WOS with LCo.

- ❑ Merger of WOS (sub-subsidiary) into LCo.
  - No fresh issue – amalgamated co. or its subsidiary holds 100% shares
  - No tax implications – Compliant merger u/s 2(1B) – Exempt u/s 47(vi) and 47(via)
  - CBDT Circular No. 5-P dated 9 October, 1967 (referred earlier)
  - GAAR?
    - Consider as dividend from OpCo. to LCo.
    - Argument – is an alternative to merger of OpCo. into LCo. which is tax neutral

# Alternatives for distribution from OpCo. to LCo. (4/5)

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## ICD from OpCo. with LCo.

- ❑ Interest-free deposit extended from OpCo. to LCo.
  - Will not impact consolidated results
  - Transaction between HoldCo. and WOS
    - No special resolution required u/s 188 of Co's Act
    - Need not comply with Regulation 23 of SEBI LODR
  - As good as transaction with a division – not raise concern from corporate governance point
  - Inter-corporate deposit - not governed by S. 186 or S. 73 of Co's Act
    - Deposits are different from loan - Pennwalt India Ltd. v. ROC, Maharashtra (Bom HC)

# Alternatives for distribution from OpCo. to LCo. (5/5)

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## ICD from OpCo. with LCo.

### ☐ Income-tax

#### ▪ Deemed dividend?

- Specific provision u/s 2(22)(e) deeming loan as dividend for companies other than companies in which public are substantially interested
- LCo. and OpCo. - companies in which public are substantially interested
- In absence of specific provision - cannot be brought to tax

#### ▪ GAAR?

- SAAR restricted to specific entities - can it be extended applying GAAR?

# Case Study 6: Externalisation of Structure

# Facts

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- ❑ B Ltd. is engaged in e-commerce business. B Ltd. has operating subsidiaries in India and abroad.
- ❑ B Ltd. has received investment from Indian as well as foreign investors.
- ❑ B Ltd. is looking for listing on London Stock Exchange. The merchant bankers have advised that the listed company should be based in a jurisdiction with dynamic financial markets such as Netherlands, UK or USA.
- ❑ The fair value of B Ltd. is 10x the cost of investment to the investor and the investments have been made prior to April 1, 2017. However, the Rule 11UA value of shares of B Ltd. is less than or equal to the cost of acquisition to the investors.

# Option 1 – Swap of shares

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- ❑ The merchant banker will form an Overseas Holding Company (OHC) with a nominal capital (say 1\$).
  
- ❑ All the Investors will swap the shares of B Ltd. with the shares of OHC based in UK or USA or Netherlands.
  
- ❑ India Taxation
  - Indian Investor – Exchange – Capital Gains Tax
  - Singapore – DTAA – Singapore has the right to tax\*
  - Mauritius – DTAA – Mauritius has the right to tax\*
  - USA Investor – DTAA – India has the right to tax
  - Netherlands – DTAA – Netherlands has the right to tax

\* shares acquired prior to April 1, 2017.



# Option 1 – Swap of shares

---

- What is the consideration received for transfer of shares of B Ltd.
  - S. 48 – Full value of the consideration (shares of OHC)
    - Fair value of shares received is the consideration
      - CIT v. Gillanders Arbuthnot & Co. [1973] 87 ITR 407 (SC) (5 Judge); CIT v. George Henderson and Co. Ltd [1967] 66 ITR 622 (SC) (3 Judge)
      - Income tax Department - How to Compute Your Capital Gains - Tax Payers Information Series – 3
    - Fair value of OHC shares will have to factor in the right to acquire the shares of B Ltd. pursuant to the exchange transaction.
    - Fair value being higher – 50CA & Rule 11UAA will not be relevant.

# Option 1 – Swap of shares

---

- ❑ Section 56(2)(x) on receipt of shares of OHC to the Investors
  - Receipt of shares of OHC - for adequate consideration (shares of B Ltd.) – 56(2)(x) – N.A.
  - Place of Receipt – if shares received by investor outside India – place of receipt outside India
  - Scope of S. 5 – received outside India ?
    - Additionally, Foreign Investor – If shares of OHC received outside India – No deeming fiction u/s 7 or 9 to deem the place of receipt in India – S. 56(2)(x) should not apply.

# Option 1 – Swap of shares

---

## ❑ FEMA Swap of Shares

- Automatic Route – Acquiring shares of F Co. pursuant to issue of shares by I Co. is permitted under the Automatic Route (subject to valuation and sectoral cap). (FAQ 19 of ODI) (FDI Master Direction Para 1.4.5)
- Approval required if shareholders wants swap shares of I Co. with the shares of F Co.
  - Impediments – FEMA Master Direction on FDI (Para 7.1) – Only recognises sale/gift/merger/de-merger as mode of divestment (applicable to foreign investor).
  - Impediments – FEMA Master Direction on FDI (Para 7.13) – requires the Resident to receive payment on transfer of shares of Indian Company to a non-resident in the bank account (applicable to Indian investor).
  - FEMA Master Direction on ODI (B.4)– permits swap of shares as a mode of funding investment in JV/WOS (subject to valuation).

# Option 2 – Merger

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## □ Steps

- Step 1 – Investors will form an OHC with mirror shareholding of B Ltd.
- Step 2 – OHC will incorporate a wholly owned subsidiary in India (SPV).
- Step 3 – B Ltd. will be merged in the SPV and the SPV will allot nominal equity shares to the investors in lieu of their shareholding in B Ltd.

# Option 2 – Merger

---

- ❑ Merger is tax neutral ?
  - Yes, the requirement is 75% of the shareholders (in value) of the amalgamating company should become shareholders of amalgamated company (S. 2(1B)).
  - No requirement to issue shares pursuant to merger considering the fair value of the amalgamating company.
  
- ❑ Merger tax neutral – compulsory convertible preference shares are issued to equity shareholders ?
  - Yes, the requirement is allotment of shares to the shareholders of amalgamated company.
  - No requirement to allot the same class of shares held in the amalgamating company (equity for equity).

# Option 2 – Merger

---

## □ GAAR

- Main Purpose – commercial reason – foreign listing – company based in jurisdiction with dynamic financial market.
- No tax saving for Resident Shareholders – will pay tax when they sell shares of the OHC.
- No tax saving for the Non-Resident Investors having treaty protection from capital gains on sale of shares of B Ltd. (Singapore, Mauritius & Netherlands). (OECD Commentary Article 29 – Example D – Minority Investor benefiting from structure – PPT N.A.)

# Option 2 – Merger

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## □ GAAR (cont.)

- Rule 10U – GAAR Grandfathering – transfer of investment made prior to April 1, 2017
- CBDT FAQ - GAAR will not interplay with the right of the taxpayer to select or choose the method of implementation
- Consequence – Merger recharacterized as exchange of shares of B Ltd. for the shares of OHC.

# Option 2 – Merger

---

## □ FEMA

- OHC having Indian Investors will form a Sub. in India

- RBI FAQ ODI

Q 64. Can an Indian Party(IP) set up a step down subsidiary/joint venture in India through its foreign entity(WOS/JV) directly or indirectly through step down subsidiary of the foreign entity?

Ans: No, the provisions of Notification No. FEMA 120/RB-2004 dated July 7, 2004, as amended from time to time, dealing with transfer and issue of any foreign security to Residents do not permit an IP to set up Indian subsidiary(ies) through its foreign WOS or JV nor do the provisions permit an IP to acquire a WOS or invest in JV that already has direct/indirect investment in India under the automatic route. However, in such cases, IPs can approach the Reserve Bank for prior approval through their Authorised Dealer Banks which will be considered on a case to case basis, depending on the merits of the case.



# Option 3 – De-Merger

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## □ Facts

- Step 1 – Foreign Investors will form an OHC with nominal share capital.
- Step 2 – OHC will incorporate a wholly owned subsidiary in India (SPV).
- Step 3 – Substantially the entire business of B Ltd. will be demerged into the SPV against equity shares issued by the OHC (holding company of the SPV) to the investors. The share swap ratio will be based on fair value of the demerged business of B Ltd.

# Option 3 – De-Merger

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## ❑ De-merger is tax neutral ?

- The definition of resulting company (S. 2(41A)) – is wide enough to permit issuance of shares by the holding company when the undertaking is transferred to wholly owned subsidiary.

*“Resulting company means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger”*

- Example of de-merger where shares are allotted by the holding company
  - Thomas Cook Insurance Services (India) Ltd., In re [2016] 194 COMP CASE 390 (Bombay)
  - Vyome Biosciences Private Limited (MANU/ND/8352/2018) (NCLT - Ahmedabad)

# Option 3 – De-Merger

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## □ GAAR

- In addition to the defences discussed in Merger Option (Option 2) –
  - None of the four tainted element is present –
    - Arm's length – the shares are issued at fair value.
    - Misuse or abuse of the provisions – the definition of resulting company specifically contemplates issue of shares by the holding company. Use of law and not misuse
    - Lacks commercial substance – purpose of listing OHC
    - Not ordinarily employed for bona fide purpose – NCLT approval, past instances of such schemes.

# Option 3 – De-Merger

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## □ FEMA

- Not covered by FEMA Cross Border Merger Regulations
  - Resulting Company definition only includes company to which assets & liabilities are transferred.
- RBI approval will be required for the de-merger. OHC being owned by Non-Resident – No RBI approval will be required for setting up subsidiary in India.
- Value of shares allotted to Resident Individual being higher than LRS limit may be a deterrent for the RBI to grant approval.
  - Resident may explore transferring their holding in a LLP/Company (LRS limit only for Individual).

# Option 4 – Buyback

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## □ Facts

- Step 1 – Investors will form an OHC with mirror shareholding of B Ltd.
- Step 2 – OHC will acquire 5% shares of B Ltd. at fair value.
- Step 3 – B Ltd. will buy back 95% of equity shares at nominal price above the original issue price (say issue price is Rs 10 and the buy back is at Rs 11) u/s 68 of the Companies Act, 2013.

(Assume that the total outflow for the buy-back is less than 25% of total paid-up equity capital and free reserves.)

# Option 4 – Buyback

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## □ Companies Act

- Buyback of more than 25% equity shares permissible u/s 68 of Companies Act, 2013?

*“the buy-back is twenty-five per cent or less of the aggregate of paid-up capital and free reserves of the company:*

*Provided that in respect of the buy-back of equity shares in any financial year, **the reference** to twenty-five per cent in this clause shall be construed with respect to its **total paid - up equity capital** in that financial year”*

- The language of the proviso would suggest that paid-up preference share capital has to be excluded for computation of the monetary limit for buy back of equity shares (paid up equity share capital + free reserves)

# Option 4 – Buyback

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## □ Income Tax

- 115QA –tax on domestic companies not listed on recognised stock exchange on distributed income on buy back – tax rate 20%
- 10(34A) – exempts income in the hands of shareholders
- S. 56(2)(x) – Not a capital asset
  - Commercial Tax Officer & Ors vs State Bank Of India [2016] 11 TMI 416 (SC);
  - Vora Financial Services P. Ltd. v. ACIT [2018] TS 346 (Mum Trib)
- S. 50CA – 10(34A) exemption

# Option 4 – Buyback

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## □ Income Tax

### ▪ Transfer Pricing

- 115QA levies additional income tax on distributed income (buy back price less issue price).
- S. 92 – ‘income’ has to be computed having regard to the arm’s length price.
- B Ltd. has 10 Investors. Same price being paid to all the 10 Investors which would even include non-associated enterprise (minority shareholders). Therefore, applying the comparable uncontrolled price method the buyback is at arm’s length price.



# Option 4 – Buyback

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- GAAR
  - Commercial Purpose & Grandfathering (discussed in Merger Option)
  - S. 115QA levies an additional income tax. Rule 10U safeguard - tax benefit is less than Rs. 3 crores. The definition of the tax benefit under Rule 10U(3)(iv) refers to saving of 'tax'. 'Tax' is defined u/s 2(43) of the IT Act to mean income tax and does not include additional income tax.
  
- GAAR Consequence
  - Deem the buyback at fair value instead of nominal value ?
    - Section 98 - consequence of invoking GAAR is an inclusive definition but only empowers the tax officer to disregard or re-characterize the transaction or to reallocate the accrual of income among the parties. Section 98 does not empower the tax officer to deem the fair value as the accrual of income (fair value of shares as buy back price)
  
  - Same as merger – capital gains – swap of shares of OHC for B Ltd. shares.

# Option 4 – Buyback

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- FEMA
  - Formation of OHC and acquiring 5% stake in B Ltd.
    - Discussed in Merger Option – RBI FAQ – approval may be required.
  - Buyback at lesser price
    - Resident (B Ltd.) acquiring shares from non-resident at price less than fair value of shares – in compliance with RBI pricing guidelines – No RBI Approval is required.
    - RBI may question the buyback – as it gives benefit to a non-resident (OHC) (akin to gifting shares to non-resident)?

# Option 5 – Capital Reduction

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## □ Facts

- Step 1 – Investors will form an OHC with mirror shareholding of B Ltd.
- Step 2 – OHC will acquire 5% shares of B Ltd. at fair value.
- Step 3 – B Ltd. pursuant to capital reduction application u/s 66 of Companies Act, 2013 to NCLT will cancel balance 95% of equity shares for nil consideration.

# Option 5 – Capital Reduction

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## ❑ Companies Act

- Capital Reduction for Nil consideration is permissible under Section 66 of the Companies Act, 2013 ?
- S. 66 of Companies Act – *company . . . may . . . reduce the share capital in any manner . . .*
- Favour
  - ACG Arts & Properties (Mum. NCLT)
  - V.M. Salgaocar & Brother (Mum NCLT)
  - O3 Capital Global Advisory (Bang. NCLT)
- Against
  - Ansa Decoglass Pvt Ltd (Mum. NCLT)

# Option 5 – Capital Reduction

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## □ Income Tax

- S. 45 & 48 – No consideration – computation mechanism fails – No capital gains tax
  - Bennett Coleman & Co. Ltd. v. ACIT [2011] 12 ITR(T) 97 (Mumbai T SB) – Bombay High Court appeal admitted
- 50CA may not apply
- 56(2)(x) – no receipt by the company
- GAAR – akin to buy back in Option 4 – additional safeguard – approved by NCLT.
  - Consequence – increase in value of OHC shares is characterised as consideration for capital reduction and charged to capital gains tax.

# Option 5 – Capital Reduction

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## □ Income Tax

- Transfer Pricing ?
  - Transaction between two Associated Enterprises ?
    - Unilateral act of the shareholders only consented by the Company
  - No charging provision – transfer pricing is not applicable
    - Redington (India) Ltd. v. JCIT [2014] 49 taxmann.com 146 (Chennai - Trib.) – Favour
    - Vodafone India Services (P.) Ltd. v. DCIT [2018] 89 taxmann.com 299 (Ahmedabad - Trib.) – Against
  - Arm's length – same theory as buyback

# Option 5 – Capital Reduction

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- FEMA
  - Formation of OHC and acquiring 5% stake in B Ltd.
    - Discussed in Merger Option – RBI FAQ – approval may be required.
  - Capital Reduction for Nil consideration
    - Recognised mode of transfer (extinguishment of shares) for non-resident shareholders as per FEMA FDI Regulations (sale/gift) ?
    - RBI may question the capital reduction – as it gives benefit to a non-resident (OHC) (akin to gifting shares to non-resident) ?

# Option 6 – Reverse Merger

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## □ Facts

- Step 1 – B Ltd. will form a 100% Subsidiary outside India (say in Netherlands) (Operating Company/bona fide business).
- Step 2 – B Ltd. will transfer its entire business (other than investments) to a new wholly owned subsidiary formed in India for a cash consideration equal to the book value of the business of B Ltd. B Ltd. will fund the new subsidiary by subscribing to its equity, the amount of the subscription being equal to the cash consideration payable by the new subsidiary.
- Step 3 – B Ltd. will merge into its 100% foreign subsidiary and the foreign subsidiary will allot shares to the shareholders of 'B' Ltd. Foreign Subsidiary will thus come to hold the shares of the new Indian subsidiary in which will be housed the entire business of B Ltd.



# Option 6 – Reverse Merger

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## □ Income Tax

- Slump Sale at book value
  - S. 47(iv) – exemption at the time of transfer – withdrawn – at the time of merger in Step 2.
  - Sales consideration equivalent to the Cost of acquisition – no capital gains tax
    - Sale – consideration cannot be substituted with fair value of asset transferred
      - CIT v. Gillanders Arbuthnot & Co. [1973] 87 ITR 407 (SC) (5 Judge)

# Option 6 – Reverse Merger

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- GAAR – slump sale – at book value ?
  - Main purpose is to shift the business is an Indian Company to comply with FEMA Regulation (one merger of B Ltd. with OHC – the India business operations would have resulted in a branch – under FEMA a branch can carry on limited activities).
  - No tax advantage of slump sale – slump sale at book value is to avoid tax on a group restructuring exercise not impacting economic ownership of business.
  - S. 98 does not empower the tax officer to deem the fair value of undertaking as consideration. However, empowers the tax officer to combine the steps and deem that shares of subsidiary are allotted to against transfer of undertaking – taxation in case of exchange – fair value of shares received i.e. Fair value of the underlying business.

# Option 6 – Reverse Merger

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- Income Tax Reverse Merger
  - Not exempt u/s 47 – Palkhivala Commentary 8<sup>th</sup> Edition – S. 47 exemption is out of abundant caution
    - Indian Investors
      - Receiving shares of amalgamated company in lieu of shares of amalgamating co. (where shares of amalgamating co. constitute capital asset in India)– in principle taxable, CIT v. Grace Collis (248 ITR 323) (SC) [2001]
    - Foreign Investors
      - Subject to treaty protection (as discussed in Case Study 1 – Option 1 – swap of shares) – taxation same as Indian Investors.
    - B Ltd.
      - No capital gains on amalgamating company – as no consideration is received - Banca Sella S.p.A., In re (72 taxmann.com 360) (AAR New Delhi) [2016]

# Option 6 – Reverse Merger

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- Income Tax Reverse Merger
  - Not exempt u/s 47
    - Foreign Subsidiary
      - No tax consequence under the general tax provisions.
      - S. 56(2)(x)
  - Assets of B Ltd. primarily consists of shares - for adequate consideration (issuing shares that would comprise 100% share capital after merger)
    - S. 56(2)(viib) (may apply on issue of shares to India Resident)
  - Fair market value of shares has to be equal to value of consideration received (100% shares).

# Option 6 – Reverse Merger

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## □ FEMA

- FEMA – Automatic Route subject to Compliance with FEMA Cross Border Merger Regulations.
  - Para B 15 of Master Direction on ODI - Impediment ?

### ***B.15 Transfer by way of sale of shares of a JV / WOS***

*An Indian Party. . . may transfer by way of sale . . . any share or security held by it in a JV or WOS outside India subject to the following conditions:*

*the overseas concern has been in operation for at least one full year and the Annual Performance Report together with the audited accounts for that year has been submitted to the Reserve Bank;*

# Option 7 – Slump Sale

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## □ Facts

- Step 1 – Investors will form an OHC with mirror shareholding of B Ltd.
- Step 2 – OHC will incorporate a wholly owned subsidiary in India (SPV).
- Step 3 – B Ltd. to sell the entire e-commerce undertaking to SPV at book value against issue by SPV of 0.1% Non-Cumulative Preference Shares redeemable after 20 years or Non-Convertible Debenture redeemable after 6 months.
- Step 4 – B Ltd. to undergo voluntary liquidation and transfer Preference Shares/cash received on redemption to debentures to its shareholders.

# Option 7 – Slump Sale

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## □ Income Tax

### ▪ Slump Exchange Taxable ?

- CIT v. Bharat Bijlee Ltd. (365 ITR 258) (Bom HC) – Favour
- SREI Infrastructure Finance Ltd. v. ITSC (251 CTR 129) (Delhi HC) – Against
- If taxable – Fair value of consideration received – fair value of preference shares or fair value of debentures

### ▪ 50CA & 56(2)(x)

- Applicable in case of transfer of undertaking ?
  - Consideration is for the undertaking and not for individual asset of the undertaking – CIT v. Mugneeram Bangur & Co. [1965] 57 ITR 299 (SC)
  - Undertaking is one concept which is not divisible into components or ingredients - Rustom Cavasjee Cooper v. UOI (40 Comp Cas 325)(11 Judge)

# Option 7 – Slump Sale

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- ❑ GAAR – slump sale – at book value ?
  - Same as Option 6.
  - Consequence – Slump exchange at fair value ?
    - Section 98 does not empower the tax officer to deem the fair value as the accrual of income. (discussed in Option 6 - Buy Back)
  - Tax officer may consider increase in fair value of shares of OHC as income of the Investors
    - Increase in value of OHC shares is offset by reduction in value of shares of B Ltd.
- ❑ FEMA
  - Discussed in Merger Option – RBI FAQ – approval will be required to set up Indian SPV.



# Thank You