Rejig in M&A tax clauses likely post India-Mauritius treaty change

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The amendment in the tax treaty warrants a relook at the indemnity clauses in the agreements

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The amendment in the India-Mauritius tax treaty will necessitate a relook at the tax indemnity clauses that are part of share purchase agreements between buyers and sellers in M&A deals, where the latter are foreign investors that have come in through Mauritius prior to April 1, 2017.

In the past, if the treaty benefit was available, the buyer would not withhold the capital gains tax and would be provided a contractual indemnity by the seller. In some cases, an insurance policy would be taken to cover any future tax liability.

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Indemnity clause

With the new protocol coming into play, buyers will no longer be willing to take that risk. The parties may now renegotiate the indemnity clause to ensure that the buyer is protected from future tax liability on the capital gains tax. Additional provisions may be included in the share purchase agreements, or a part of the sale consideration may be kept in an escrow account, to be given later to the buyer or seller as the case may be.

"The practice of sellers providing a "tax indemnity" to buyers is likely to reduce. Buyers will now deduct the capital gains tax and leave it to the sellers to seek refunds, if applicable, at a future date. This will likely make convergence on the transaction price more difficult in the short term, till the market digests this change," said Ratnadeep Roychowdhury, Co-head, private equity and sovereign wealth funds, Nishith Desai Associates.

"This amendment warrants a relook at the indemnity clauses in the agreements, and a relook at the process of indemnity trigger and claims encapsulated in the agreements to ensure that the buyer is safeguarded should any demand notices be raised by the income tax authorities for not deducting taxes at source," added Yashesh Ashar, Partner, Illume Advisory.

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Underwriting parameters

According to Roychowdhury, the changes proposed by the protocol will also impact the tax withholding insurance products currently available in the market as the underwriting parameters will have been fundamentally altered.

This will require insurers to revisit the basis of their underwriting. Typically, underwriters go ahead with such products when they get a "should-level" of opinion from a big four firm, implying there is more than a 75 per cent chance that there will be no tax liability. Insurers charge 3-4 per cent of the coverage given.

"I will no longer be able to give a "should-level" opinion which an insurer can use for underwriting the capital gains withholding indemnity product. Will there now be a market for such products? For insurers, the probability of a capital gains tax liability becomes a big unknown," said a senior official from a big four firm.

The proposed amendment in the tax treaty with Mauritius will introduce a principal purpose test, which is a much higher threshold than GAAR. This test may have to be applied to all future exits, irrespective of the date of investment, without grandfathering of investments made prior to April 1, 2017, said experts.

"The private equity industry fears indiscriminate use of these provisions to deny them the tax exemption on capital gains. This can certainly affect the sentiments of the PE players to commit more capital to India as there is no certainty in application of tax treatment under tax treaties," said Punit Shah, Partner, Dhruva Advisors.

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