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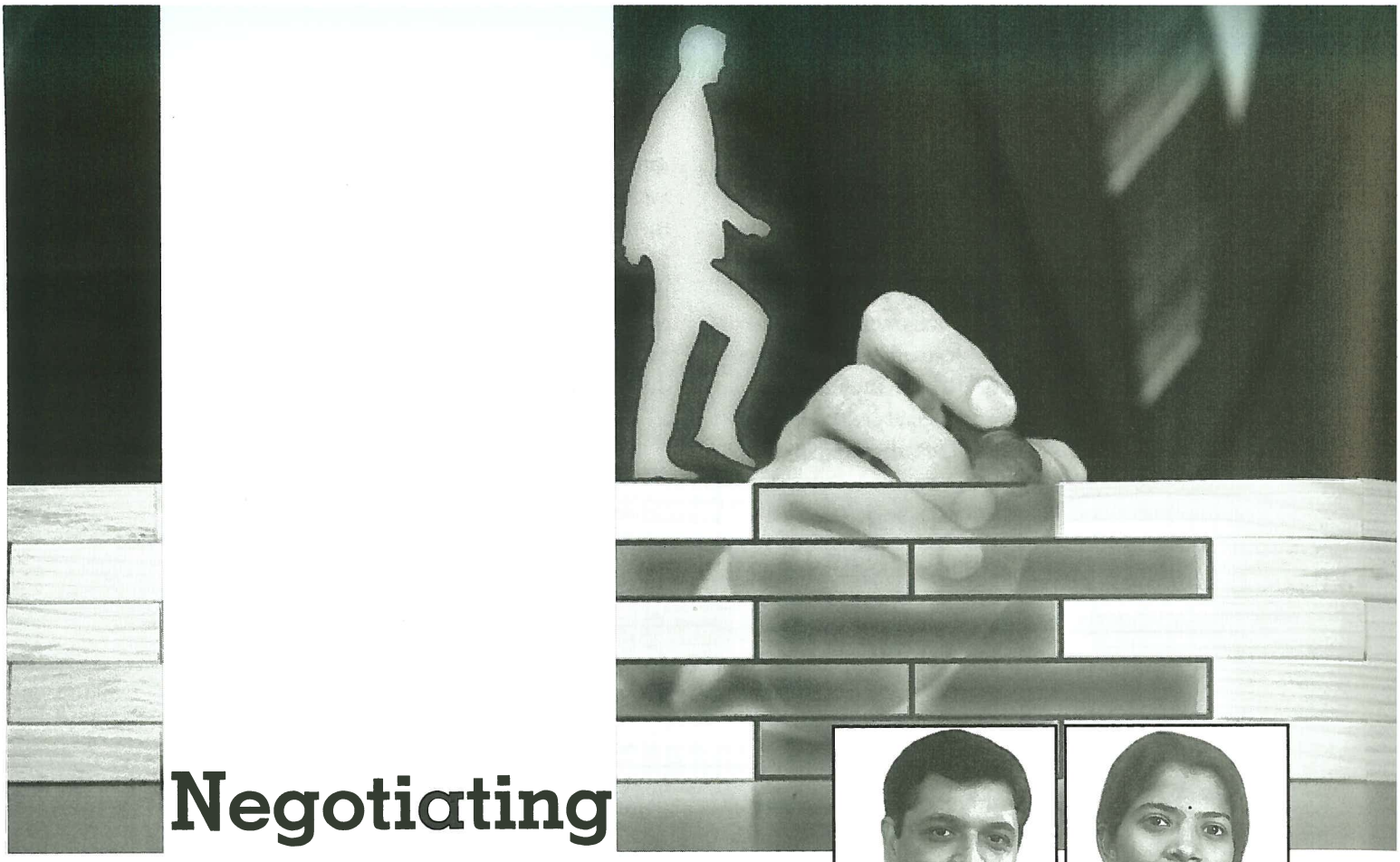

Negotiating Tax Indemnities in Cross-Border Private Equity & M&A Deals

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1. Introduction

Cross-border Private Equity and Mergers and Acquisitions (M&As) could involve transfer of securities/assets/rights in India. Such transfer may be by way of direct transfer of Indian company shares or global acquisition where Indian shares/assets/rights may be transferred indirectly. In both cases, such transfer may trigger tax implications in India.

In light of various complexities involved, there could be lack of consensus between the buyer and the seller on taxability of the transaction and / or the exact quantum of tax liability applicable and consequently, the withholding tax obligations of the buyer. If the transferor is a non-resident from an Indian tax perspective, typically, the buyer is consequently subject to withholding tax obligations, irrespective of the residence of the buyer.

Typically, from the buyer's perspective, they tend to take a more conservative position as failure to discharge withholding tax obligations could

give to onerous consequences, including liability for the tax amount required to be withheld, interest payment and penalty on the tax amounts required to be withheld. On the other hand, from the seller's perspective, they tend to take a more aggressive position considering difficulties in obtaining refund if more tax is withheld. In complex circumstances, claiming a refund may involve significant litigation, along with the costs and efforts attached to it. Further, cash flow could be an issue till the litigation is resolved, which generally could take up to 4-5 years.

Further, post-acquisition, the buyer could also be affected if the target company or any of its subsidiaries had not discharged their tax payment/tax return filing/disclosure/other-tax related obligations prior to the acquisition.

Therefore, for protection of the interests of the buyer, typically, the share purchase agreement/equivalent document generally outlines indemnities provided by the seller to the buyer: (i) in relation to the withholding tax obligation of the buyer with respect to the acquisition; and (ii) in relation to breach of representations and warranties given by the seller to the buyer in relation to discharge of tax payment, tax return filing, disclosure and other-tax related obligations by the target company and its subsidiaries prior to the acquisition.

Such tax indemnity clauses are quite detailed. The scope of indemnity, the period of indemnity, the rights and obligations of the indemnified and indemnifying parties and various other considerations are to a large extent based on the nature and extent of tax-related consideration involved. Therefore, in this article, we first outline the nature of various considerations involved from a tax perspective. We then discuss tax indemnity clauses and various other measures taken to support/ supplement such tax indemnity.

1.1 Transaction specific withholding taxes

There could be lack of consensus between the buyer and the seller on various aspects – the existence of withholding tax liability under domestic law, applicability of relief under tax treaty, the applicability of anti-abuse provisions, computation of capital gains or taxes applicable thereof or the taxes required to be withheld. We outline below some of the key issues in relation to which there is often lack of consensus.

1.2 Tax implication under domestic law

(i) Direct transfers

Generally, transfer of stake held in an Indian company is subject to capital gains tax in India in the hands of the seller, subject to relief under an applicable tax treaty. Having said that, determining the quantum of capital gains could differ significantly depending on the period of holding, applicability of inflation indexation benefit/adjustment for forex fluctuation, whether the shares are listed/unlisted, applicability of minimum alternate tax, status of the seller (resident/non-resident, foreign institutional investor (FII)/non-resident Indian (NRI)/other non-resident investor) etc. For example, in case of transfer of listed shares of an Indian company off-the-floor of the stock exchange, if the seller is a non-resident, there could be lack of consensus between the buyer and seller on whether the capital gains should be taxable at 20% with adjustment for forex fluctuation or at 10% with adjustment for forex fluctuation. While most judicial precedents have taken the latter view, in light of some contrary precedents, there could be lack of consensus.

(ii) Indirect transfers

Even transfer of shares of an offshore entity is subject to capital gains tax in India, if the offshore target entity directly/indirectly holds shares of an Indian entity/other assets in India, subject to satisfaction of prescribed thresholds. One important threshold is that at least 50% of the 'fair market value' of the target entity should be derived from shares held directly/indirectly in Indian entities and other assets in India, if any. In this context, there are specific rules which prescribe how the value of the target entity and how the value of the shares/other assets held in India should be calculated and the date as on which such value should be calculated. Such valuation is an important aspect in relation to

applicability of taxation in India and there could be lack of consensus between the parties in this context.

Further, after determining whether such thresholds are met, it also becomes important to determine the proportionate quantum of capital gains attributable to transfer of shares/other assets in India. There are rules prescribed for this purpose as well. Considering the complexities involved in such calculations, there is risk of disagreement on this count as well.

(iii) Earn-outs/contingent consideration

In several M&As, earn-outs are commonplace. By their very nature, they are in most cases contingent on the performance of the company post acquisition. From an income tax perspective, capital gains accruing from any transfer of capital assets (including shares) are taxable in the same financial year in which the transfer of the capital asset takes place. Typically, payment and quantum of earn-outs are contingent upon performance of the company ranging from 3-5 years. Therefore, only a very minimal component (if at all) may accrue during the same financial year as the acquisition. Thus, there is ambiguity in relation to when such earn-outs should be taxable and the mechanism for discharging the tax liability. There are some judicial precedents which state that contingent consideration cannot be subject to tax in the year of transfer unless it is accrued in that year. However, there is lack of clarity in relation to discharge of tax liabilities upon accrual of such consideration. For example, should tax returns in relation to the year of transfer be modified? How would the buyer's withholding tax liabilities be discharged?

From the Buyer perspective, they typically seek to withhold taxes as if the entire earn-out amount has accrued in the year of transfer. From the Seller's perspective, they seek to negotiate non-withholding for earn-out component of purchase consideration.

1.3 Relief under tax treaty

Earlier, in case of investments made in India from Mauritius, Singapore, etc., relief from capital gains taxation (in case of direct transfer of an Indian company's shares) was available under the India's tax treaties with these countries. With recent amendments to India's tax treaties with Mauritius, Singapore and Cyprus, transfer of investments made on/after April 1, 2017 are subject to tax in India. Investments made up to March 31, 2017 have been grandfathered and should continue to be able to avail relief. Further, relief should also generally continue to be available in case of transfer of capital assets other than shares, for example, debt instruments (convertible/non-convertible), partnership interest in limited liability partnerships, etc.

Relief under tax treaty also becomes important in the context of indirect transfer of shares of an Indian company. Relief in relation to such indirect transfer is available under most tax treaties entered into by India, including the amended tax treaties with Mauritius, Singapore and Cyprus. However some treaties like those with the US, UK, etc., do not provide any relief as the capital gains article in these treaties allow both countries to tax capital gains under their respective domestic laws.

For availing relief under any tax treaty, it is important that the entity should qualify as a tax resident of the jurisdiction in question and should have a tax residency certificate. Further, under some treaties, for example, the India-Singapore tax treaty, the entity should also satisfy certain conditions prescribed under the Limitation of Benefit clause for availing capital gains tax relief.

If a non-resident seller is a partnership/similar entity which is fiscally transparent, it could be debated as to whether the entity could be considered a tax 'resident' of the respective country, which is a basic requirement for availing relief under the treaty. Some treaties specifically provide certain specific requirements in case of such fiscally transparent entities and some do not.

1.4 Applicability of GAAR

Further, from April 1, 2017, General Anti-Avoidance Rules (GAAR) have come into force,

subject to grandfathering benefit for investments made up to March 31, 2017. Therefore, even if relief is available under an applicable tax treaty for investments, for example, under the India-Netherlands tax treaty, it would be important to evaluate applicability of GAAR to the structure, particularly, if the investment was made after March 31, 2017. Applicability of GAAR depends on various subjective factors – including 'tax benefit' being the 'main purpose' of an arrangement, existence of certain tainted elements like lack of commercial substance, abuse of the provisions of the income tax law, etc.

Considering the subjective nature of the various parameters involved, applicability of GAAR could become a contentious issue between the parties.

1.5 Applicability of judicial precedents on anti-avoidance

Even in case of transactions which are grandfathered from applicability of GAAR, general judicial precedents governing anti-avoidance need to be factored in. These judicial precedents have adopted the Westminster or "form over substance" principle. For example, in the case of *McDowell & Co Ltd. vs. CTO*[1], the Supreme Court held that:

> *"Tax planning may be a legitimate provided it is within the framework of the law. Colourable devices cannot be a part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges".*

In applying a judicial anti-avoidance rule, the tax authorities may invoke the "substance over form" principle or "piercing the corporate veil" test after they are able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidance. However, in the absence of a sham or colourable device, the form of a transaction or structure should be respected. The above principles were also reiterated by the Indian Supreme Court in 2012 in *Vodafone International Holdings BV*[2].

Similar to GAAR, considering the subjective nature of the various factors involved, applicability of such anti-avoidance principles could become a contentious issue between the parties.

1.6 Litigation risks

Even if the buyer and the seller are broadly in consensus in relation to the taxability of the transaction in India and the quantum of withholding tax applicable, from the buyer's perspective, there is a concern that the tax authorities may adopt an aggressive position regarding the buyer's withholding tax obligations. In this context, considering the nature of tax litigation hierarchy in India, relief may be available only when the dispute reaches the third level in the hierarchy – i.e., the income tax appellate tribunal. Therefore, from the buyer's perspective, it involves concerns in relation to such potential litigation, along with the costs and efforts attached to it, and concerns regarding cash flows till the litigation is resolved, which may take up to 3-5 years (as a certain portion of the disputed amount generally has to be deposited for seeking stay of recovery proceedings pending appeal proceedings).

2. Pre-acquisition tax obligations of the target entity and its subsidiaries

Post-acquisition, the buyer could be affected if the target company or any of its subsidiaries had not discharged their tax payment/tax return filing/disclosure/other-tax related obligations prior to the acquisition.

Therefore, for protection of the interests of the buyer, generally, the buyer undertakes a

1. 154 ITR 148 (SC).
2. *Vodafone International Holdings BV vs. Union of India, [2012] 34 ITR 1 SC.*

due diligence of the company and its subsidiaries in relation to compliance with applicable laws, including tax laws. Additionally, in the share purchase agreement/equivalent document generally various detailed representations and warranties are sought from the seller and the target company in relation to discharge of tax payment, tax return filings, disclosure and other-tax related obligations prior to acquisition.

Some of the critical aspects analysed during the due diligence process and also covered as part of the reps and warranties are:

1) Major tax exemptions availed: This could involve exemptions sought by companies in the Information Technology (IT) sector by virtue of operating in a Special Economic Zone.

2) Place of Effective Management: In case of global acquisitions where one/more of the promoters key managerial persons are resident in India, it is important to evaluate whether any of the non-Indian companies which are being acquired directly/indirectly could have their 'place of effective management' in India. If they do, the companies would be treated as Indian tax residents and consequently, taxed on their entire global income in India for the relevant years.

3) Permanent Establishment: In case of global acquisitions, if any of the non-Indian companies which are being acquired directly/indirectly have a 'permanent establishment' in India (as defined under the applicable tax treaty), the income earned by such entity could be taxable in India to the extent attributable to the 'permanent establishment' in India.

4) Transfer pricing: This is important in case of cross-border transaction between "associated enterprises" (which term also includes entities, where one is commercially dependent on the other by way of loans, raw materials, commercial rights, IP rights, etc.), where one / both of them are non-residents of India. It is important that the transactions are carried out at arms' length and prescribed documentation is maintained.

3. Tax indemnity

Tax indemnity is a standard safeguard used in most M&A transactions. As discussed above, from the buyer's perspective, there are various risks associated with its withholding tax obligations in relation to the acquisition and there is also a possible risk of certain pre-acquisition violations/non-compliances not being discovered during the due diligence process.

The following key aspects may be considered by parties while structuring tax indemnities:

Scope: The buyer typically seeks a comprehensive indemnity from the sellers for any tax claim or notice that may be raised against the buyer:

(i) in relation to the withholding tax obligation of the buyer with respect to the acquisition/as a representative taxpayer of the seller with respect to capital gains earned on the acquisition; and

(ii) in relation to breach of representations and warranties given by the seller to the buyer in relation to discharge of tax payment, tax return filing, disclosure and other-tax related obligations by the target company and its subsidiaries prior to the acquisition.

For both the above, the indemnity clause typically covers potential tax/withholding tax/ representative taxpayer taxation, interest and penalty costs as well as costs of legal advice and representation for addressing any future tax claim.

3.1 Floor/Deductible

The parties may agree on a minimum amount of claim to arise for the indemnity obligations to be triggered. If the claim amount is higher, there are again two options – the

parties may agree as to whether the minimum amount shall just be a floor/ threshold or whether it shall also be deductible from the total claim amount.

3.2 Cap on indemnity amount

Typically, parties stipulate a cap for the indemnity amount, except in case of indemnity being triggered in certain circumstances, for example, on account of fraud/ wilful misrepresentation by the buyer, etc. For determining an appropriate cap, the nature and extent of tax-related risks need to be evaluated carefully. For example, in case of potential risks under transfer pricing regulations, it may be very difficult to quantify the extent of adjustment that the tax authorities may seek to make, particularly, in light of the subjective elements involved in determination of arm's length price. Therefore, a higher cap may be negotiated by the buyer in such cases.

3.3 Period

Indemnity clauses may be applicable for very long periods. Although a limitation period of seven years has been prescribed for reopening earlier tax cases, the Income-tax Act does not expressly impose any limitation period on proceedings relating to withholding tax liability. An indemnity may also be linked to an advance ruling.

Different periods may also be prescribed for different types of tax claims covered. For example, for reps and warranties related to discharge of pre-acquisition tax obligations (except in relation to withholding tax obligations – domestic/cross-border context), the parties may agree on a limitation period of seven financial years from the end of the financial year in which the acquisition takes place.

3.4 Ability to indemnify

The continued ability and existence of the party providing the indemnity cover is a consideration to be mindful of while structuring any indemnity. As a matter of precaution, provision may be made to ensure that the indemnifying party or its representatives maintain sufficient financial solvency to defray all obligations under the indemnity. In this regard, the shareholder/s of the indemnifying party may be required to infuse necessary capital into the indemnifying party to maintain solvency.

Sometimes back-to-back obligations with the parent entities of the indemnifying parties may also be entered into in order to secure the interest of the indemnified party.

3.5 Conduct of proceedings

The indemnity clauses often contain detailed provisions on the manner in which the tax proceedings associated with any claim arising under the indemnity clause may be conducted, including rights of the indemnifying party to take charge of the proceedings, cap on costs which may be incurred if the proceedings are controlled by the indemnified party, etc.

3.6 Maintenance of books and records by the buyer post-acquisition

From the perspective of the seller, for taking control of proceedings, etc., it may be stipulated that the buyer shall be under an obligation to maintain the books and relevant records of the target entity and its subsidiaries for a mutually agreed time period.

3.7 Adjustment of Purchase Price

If any payment is made by the seller to the buyer by virtue of the indemnity clause, it is important to indicate whether such payment would be deemed to reduce the Purchase Price of the acquisition accordingly.

Different rules may be adopted for different types of tax claims covered. For example, for breach of reps and warranties related to discharge of pre-acquisition tax obligations, any payments made by the seller may be treated as an adjustment to the Purchase Price. However, in case of withholding tax obligations with respect to the transaction, it may be agreed that it shall not lead to any adjustment of the Purchase Price.

3.8 Dispute Resolution Clause

Given that several issues may arise with respect to the interpretation of an indemnity clause, it is important that the dispute resolution clause governing such indemnity clause has been structured appropriately and covers all important aspects including the choice of law, courts of jurisdiction and/or seat of arbitration. The dispute resolution mechanism should take into consideration urgent reliefs and enforcement mechanisms, keeping in mind the objective of the parties negotiating the master agreement and the indemnity.

4. Other measures to support/ supplement tax indemnity

4.1 Contractual representations

Parties may include clear representations with respect to various facts which may be relevant to any potential claim raised by the tax authorities in the share purchase agreement or such other agreement as may be entered into between the parties.

4.2 Escrow

Parties may withhold the disputed amount of tax and potential interest and penalties and credit such amount to an escrow instead of depositing the same with the tax authorities. However, while considering this approach, parties should be mindful of the opportunity costs that may arise because of the funds getting blocked in the escrow account at a nil/very low rate of interest.

4.3 Tax insurance

A number of insurers offer coverage against tax liabilities arising from investments in India. The premium charged by such investors may vary depending on the insurer's comfort regarding the degree of risk of potential tax liability. The tax insurance obtained can also address solvency issues. It is a superior alternative to the use of an escrow account.

If a tax insurance is obtained, sellers may seek to limit its indemnity obligations only to the extent not covered as part of the tax insurance.

4.4 Legal opinion

Parties may be required to obtain a clear and comprehensive opinion from their counsel confirming the tax liability of the parties to the transaction. Relying on a legal opinion may be useful to the extent that it helps in establishing the *bona fides* of the parties to the transaction and may even be a useful protection against penalties associated with the potential tax claim if they do arise.

4.5 Nil withholding certificate

Parties could approach the income tax authorities for a nil withholding certificate in relation to the Purchase Price for the acquisition. There is no statutory time period prescribed with respect to disposal of applications thereof, which could remain pending for long without any clarity on the time period for disposal. However, in January 2014, an internal departmental instruction was issued requiring such applications to be decided upon within one month.

4.6 Advance Ruling

Advance rulings obtained from the Authority for Advance Rulings ("AAR") are binding on the taxpayer and the Government. An advance ruling may be obtained even in GAAR cases. The AAR is statutorily mandated to issue a ruling within six months of the filing of the application, however due to backlog of matters, it is taking about 9 months – 2 years to obtain the same.

However, it must be noted that an advance ruling may be potentially challenged in the High Court and finally at the Supreme Court.

5. Conclusion

With the introduction of GAAR, the negotiation of tax indemnities is going to get more complex given the subject nature of GAAR. It would be interesting to see how the deal makers change their negotiation strategies in light of the recent changes in domestic tax laws and tax treaties.

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