

Specific Tax Risk Mitigation Safeguards for Private Equity Investments

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In order to mitigate tax risks associated with provisions such as those taxing an indirect transfer of securities in India, buy-back of shares, etc., parties to M&A transactions may consider or more of the following safeguards. These safeguards assume increasing importance, especially with the GAAR coming into force from April 1, 2015 which could potentially override treaty relief with respect to tax structures put in place post August 30, 2010, which may be considered to be 'impermissible avoidance arrangements' or lacking in commercial substance.

- **Nil withholding certificate:** Parties could approach the income tax authorities for a nil withholding certificate. 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. In the last few years, there have not been many instances of such applications that have been responded to by the tax authorities. However, recently, in January 2014, an internal departmental instruction was issued requiring such applications to be decided upon within one month. The extent to which the instruction is adhered to remains yet to be seen.
- **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 8-10 months 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. There have been proposals in the 2014-15 Budget to strengthen the number of benches of the AAR to relieve this burden.
- **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.
- **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.
- **Tax insurance:** A number of insurers offer coverage against tax liabilities arising from private equity investments. 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.
- **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.

- **Tax indemnity:** Tax indemnity is a standard safeguard used in most M&A transactions. The purchasers typically seek a comprehensive indemnity from the sellers for any tax claim or notice that may be raised against the purchaser whether in relation to recovery of withholding tax or as a representative assessee. The following key issues may be considered by parties while structuring tax indemnities:
 - Scope: The indemnity clause typically covers potential capital gains tax on the transaction, interest and penalty costs as well as costs of legal advice and representation for addressing any future tax claim.
 - 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 ITA does not expressly impose any limitation period on proceedings relating to withholding tax liability. An indemnity may also be linked to an advance ruling.
 - 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.
 - 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.
 - 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.