Outbound Mergers – Yet another impetus for buoyant M&A market in India?

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In the backdrop

Section 394 of the Companies Act, 1956 (the erstwhile Companies Act) permitted cross border merger where the surviving or resulting company has to be an Indian company (inbound merger). The entity being merged could be one or more Indian company or foreign company. Inbound mergers were permissible under the erstwhile Companies Act. However, outbound merger, whereby an Indian company merges into a foreign resulting company, was not on statute.

These corporate restructuring provisions contained under the erstwhile Companies Act were reframed, based on the recommendations of the expert committee formed under the Chairmanship of *Dr. Jamshed J. Irani*.

The expert committee suggested for outbound merger of an Indian company with a foreign company. Another suggestion of the expert committee on outbound merger was to allow the Indian shareholders to receive Indian Depository Receipts (IDR) in lieu of Indian shares, especially in listed companies or foreign securities in lieu of Indian shares so that they become members of the foreign company or holders of security with a trading right in India (especially in listed companies). The expert committee noted that apart from amendments to the Companies Act, suitable changes may be necessary in the Income Tax Act (the IT

Act), Foreign Exchange Management Act (exchange control regulation) and provisions relating to IDR to enable merger of an Indian Company with a foreign entity. The Committee, therefore, recommended adoption of international best practices and a coordinated approach while bringing amendments to the code of merger in the Companies Act.

Merger provisions as per the Companies Act, 2013 (the CA 2013)

The provisions relating to compromises, arrangements and amalgamations are contained in Sections 230-240 of the CA 2013. The Ministry of Corporate Affairs (the MCA) on 7 December 2016 notified some of these sections. Section 234 of the CA 2013 enabling cross border mergers has been notified[1] (file:///C:/Users/Asus/Downloads/Outbound%20Merger%20(1).docx#_ftn1) and made effective from 14 April 2017.

With outbound mergers now permissible under the CA 2013, Indian companies can explore new possibilities of intra-group reorganizations, flipping the ownership structures to create international holding companies, consolidation of holdings, providing strategic exits to its Investors etc. These provisions could also benefit foreign companies as they can acquire smaller Indian companies more easily through this route.

Newly notified Section 234 and amendment in Rules

The newly notified Section 234 of the CA 2013 provides for a merger of a foreign company with an Indian company and vice-versa. Section 234 empowers the Central government to notify countries with which an Indian company can merge. Further, it empowers the Central government to make rules, in this regards in consultation with the Reserve Bank of India (RBI).

The MCA has inserted Rule 25A in the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016. As per Rule 25A, the Indian company going for outbound merger has to fulfill certain conditions. Refer to access the Annexure Part 1 (http://www.taxsutra.com/sites/taxsutra.com/files/webform/Annexure_Outbound%20merger.pdf) which lists such conditions.

Corresponding amendment in Exchange Control Regulations

In India, current account transactions are liberalized to great extent. However, capital account transactions are not fully liberalized and are monitored by the RBI. On 26 April 2017, the RBI has come out with draft guidelines, called "Foreign Exchange Management (Cross Border Merger) Regulation 2017, whereby automatic approval will be granted to cross border mergers. The draft Regulation provides for fulfillment of certain conditions for an outbound merger, to fall under Automatic route. The draft guidelines have been released expecting public comments. The final guidelines would be notified thereafter. Refer to Annexure Part 2 (http://www.taxsutra.com/sites/taxsutra.com/files/webform/Annexure_Outbound%20merger.pdf) which lists such conditions.

Issues arising from outbound merger

Some of the issues that may come as a challenge to such Indian company are discussed in this Article. The MCA and the RBI may at a later date come out with clarification or may include the same in final guidelines to be issued:

Foreign company doing business in India

As per the extant exchange control regulations, a person who is not a resident of India can conduct any business in India, by opening a liaison office or a branch office after obtaining prior approval of the RBI. Carrying of business in India under the automatic route is granted only to Banking and Insurance companies, holding license from regulatory authorities. A branch of a foreign company, also after obtaining the RBI approval is permitted to carry on only specified activities. The branch office is not allowed to carry on manufacturing activities. This implies that foreign companies in certain specified sectors only can establish a branch office in India.

Post outbound merger, a situation may arise whereby the foreign company would hold office premise or a factory or sales outlet in India. The draft guidelines do not provide whether a separate RBI approval would be required by the foreign company to carry on the Indian companies' business, post merger. The foreign company may hold any asset in India which a foreign company is permitted to acquire as per the FEMA provisions. Where foreign company becomes owner of office premises or a factory or a sales outlet in India and if such asset is not permitted to be acquired or held by the foreign company, it would have to sell such asset within 180 days from the date of sanction of the scheme by NCLT.

A nod from the NCLT and other authorities necessary

In India, corporate reorganizations involving merger of two or more companies require approval of the NCLT. After obtaining the approval of the RBI, the Indian company has to file an application with NCLT. Typically obtaining an approval from the NCLT would take 5-6 months.

A careful evaluation of the regulations of the jurisdiction of the foreign company with which a merger is intended is necessary. Additional requirements include local compliance that may be specified by the foreign jurisdictions need to be complied with.

For companies operating in regulated sectors, a prior approval the sectoral regulatory authority would be necessary. In cases involving merger of listed entities in any of the jurisdictions, compliance with the requirements of respective securities and exchange board would be imperative.

Payment of consideration

No company can raise funds in India by issuing IDR unless it has obtained prior permission of Securities and Exchange Board of India (SEBI). Currently, issue of IDR is governed by a host of regulations. Companies (Issue of Indian Depository Receipts) Rules, 2004 (IDR Rules) notified by the MCA, SEBI Circular[2] (file:///C:/Users/Asus/Downloads/Outbound%20Merger%20(1).docx#_ftn2) regarding issue of IDR and relevant FEMA Regulations[3] (file:///C:/Users/Asus/Downloads/Outbound%20Merger%20(1).docx#_ftn3) specify various conditions like eligibility, procedure for transfer of IDR, etc.

A question therefore arises, to what extent a company issuing IDR as consideration, would be granted exemption from compliance with these regulations.

Further, a reading all the extant regulations with regards to issue of IDR implies that foreign companies that meet the eligibility thresholds only, would be permitted to issue IDR. The other companies would have to mandatorily discharge the consideration in cash.

The draft RBI regulations permit payment of consideration, by issue of shares of the foreign company to the shareholders of the Indian company up to permissible limits under LRS. However, CA 2013 has no such provisions and therefore any payment mode other than cash and IDR would be *ultra-vires* the CA, 2013. Therefore, necessary amendment is required in CA, 2013 to that effect.

Valuation

The draft RBI regulations require the valuation in case of cross boarder merger to be done as per internationally accepted principles on accounting and valuation. Thus the requirements under the CA, 2013 and exchange control regulations are at par.

Cross border Demerger

It may be noted that although the doors have now been opened for Indian companies for outbound mergers, the law is still silent on cross-border demergers. Under Section 394 of the Companies Act, 1956, a foreign company could transfer its business/undertaking to an Indian company. Now, with a liberalized approach being adopted for cross border merger, similar relaxation for cross border demerger could be expected.

Tax Implications under the IT Act and Stamp duty

The transfer of assets in a scheme of merger would be taxable under Section 45 of the IT Act. The IT Act, presently, grants tax exemptions under Section 47(vi) to mergers, only if the transferee is an Indian company. There are no similar exemptions for an outbound merger. Thus, the tax payers opting for an outbound merger may suffer from a tax disadvantage, if similar exemption for outbound merger is not provided in the IT Act. The provisions for carry forward of losses and MAT credit would also require a relook.

Another major tax issue that requires considerations is whether foreign company would be considered to have a Permanent Establishment (PE) in India. Once the business of the Indian company is transferred to a foreign company, the later would have to carry out the operations in India. The Indian tax authorities would view this as foreign company having a fixed PE in India. Thus, the profit attributable to the PE in India would be taxable at the rate of 40% (plus surcharge and education cess). Further, taxation of a foreign company having a PE in India is subject to litigations and therefore, even risk arising from having a PE in India would have to be factored before going for outbound merger. Further complications would be added by transfer pricing in case of cross border transaction with associated enterprises (including with head office). The foreign company is then required to comply with TP documentation and other compliance requirements in India. Further, carrying on business would also require the foreign company to compulsorily obtain a Permanent Account Number (PAN) and a Tax Deduction Account Number (TAN).

The companies would also have to account for the stamp duty payable on sale of assets, which have to be compulsorily disposed off, in addition to the amount payable on the NCLT's order.

Concluding remarks

The provisions enabling cross-border merger is a welcome amendment. Outbound mergers with foreign entities is a norm in many overseas jurisdictions and enabling these provisions in India is a step towards globalization facilitating ease of doing business in India.

Lack of tax neutrality, compliance and disclosure requirements connected with issue of IDR and requirement under exchange control regulations for foreign company to conduct business in India, without an Indian entity, may make outbound merger an unattractive restructuring option. Involvement of listed entities in any of the jurisdictions could complicate things further. Corresponding amendments/clarifications in the relevant regulations could help push the case forward.

Disclaimer

The information contained in this article is of a general nature and reflects the law in India as of the present date. The content is intended to provide general information about the subject matter and should not be relied on as a basis for business decisions since conclusions and positions may vary due to individual facts and circumstances of each particular case. A detailed analysis of the tax and regulatory implications by a competent qualified Indian tax advisor would need to be done prior to undertaking any business transactions.

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[1] (file:///C:/Users/Asus/Downloads/Outbound%20Merger%20(1).docx#_ftnref1) MCA Notification dated 13 April 2017 [F. No. 1/37/2013 CL. V]

[2] (file:///C:/Users/Asus/Downloads/Outbound%20Merger%20(1).docx#_ftnref2) SEBI Circular No. SEBI / CFD / DIL / DIP / 20 /2006 / 3 / 4 dated April 3, 2006.

[3] (file:///C:/Users/Asus/Downloads/Outbound%20Merger%20(1).docx#_ftnref3) Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 and Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004.
