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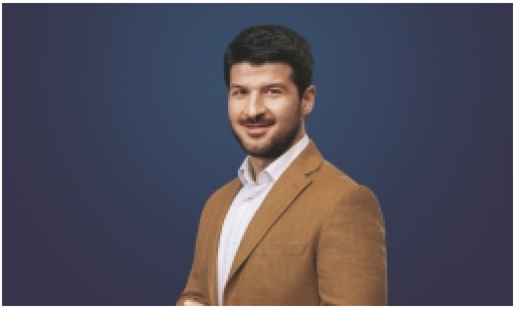
Mergers and Acquisitions in India Certain Tax and Regulatory Aspects



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Mergers and Acquisitions in India

– Certain Tax and Regulatory Aspects

Preface

In the dynamic landscape of business, mergers and acquisitions play a pivotal role in reshaping industries and redefining the trajectory of businesses. The Indian economy, with its burgeoning market potential and evolving regulatory framework, has witnessed a significant surge in M&A activities in recent years. As businesses strive for growth, expansion, and strategic realignment, understanding the intricacies of M&A transactions becomes paramount.

India has witnessed a significant number of approximately 28,229 announced deals since 1996, amounting to an impressive cumulative value of over USD 1 trillion. The year 2022 saw a noteworthy increase in M&A activity, with 1,491 deals announced, surpassing the previous year's count by 7%. Moreover, the total value of these deals also experienced a substantial surge, soaring by 94% from USD 69 billion in 2021 to an impressive USD 135 billion in 2022 (Data as per IMAA).

Generally, M&A are undertaken to gain access of the market through an established brand, to enter into a new market or product segment, to get a market share, to eliminate competition, to reduce tax liabilities, expand the customer base, to acquire competence or to set off accumulated losses of one entity against the profits of other entity or to focus on core business.

As India continues to witness rapid economic growth and market evolution, M&A remains a cornerstone of corporate strategy for organizations seeking to capitalize on growth opportunities, expand market presence, and create value for stakeholders. This publication aims to serve as a trusted resource for professionals, practitioners, and students alike, providing them with the knowledge, tools, and insights needed to navigate the complex and dynamic world of M&A in India.

In this publication, we have endeavoured to summarize the concepts regarding:

- India's Geo – Political Developments
- Booming Start- up Eco-system
- Key drivers of Mergers, Acquisition, Divestments & Corporate Restructuring
- Modes of Acquisitions & Divestments
- Key drivers of Private Equity / Venture Capital

Preface

The aforementioned concepts have been discussed in the light of the following mentioned Regulations and Acts:

- Income Tax Act, 1961
- Goods and Service Tax Regulations
- Stamp duty Regulations
- Foreign Exchange Management Regulations
- Companies Act, 2013
- Securities Exchange Board of India (SEBI) Regulations
- Competition Act, 2002
- Financial, Tax and Legal Due Diligence

With the hope that the corporates, professionals and every other person reading this find this publication as beneficial as we want it to be for them, we feel extremely pleased to present this to you.

Happy reading!

March 2024

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Chapter 1: Indian Economy

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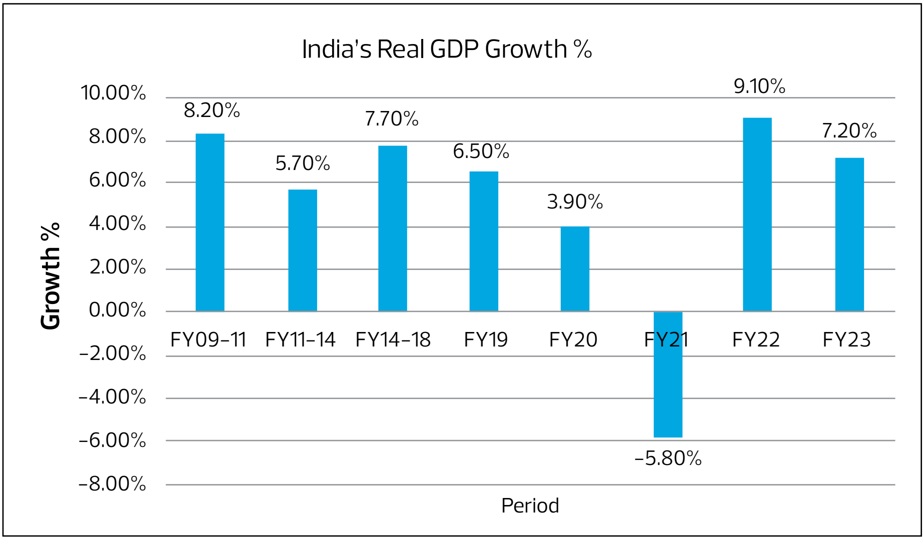
1.0 Indian Economy – Overview

Most business organisations in India are growing rapidly due to overall growth and formalisation of the economy, booming capital and private equity markets, evolution of debt market and debt instruments, foreign investment and start-ups. This has resulted in unprecedented activity for mergers, acquisitions, strategic investments and other corporate actions. Certain key factors driving these developments are listed below:

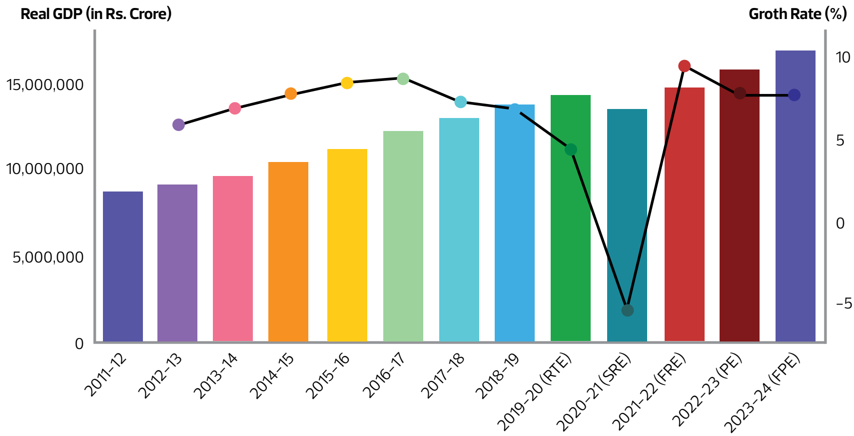
1.1 Fastest Growing Large Economy

India is the fastest growing large economy in the world with Gross Domestic Product (GDP) growth rate of 7.2% for FY2023. The Indian economy has been consistently growing at an average rate of 7% for the past 15 years as evident from the chart below:



Source: Reserve Bank of India (RBI) Annual Report, Moneycontrol

Annual GDP Estimates (in Rs. Crore) and Growth Rates (%) at Constant Prices (Bse 2011-12)



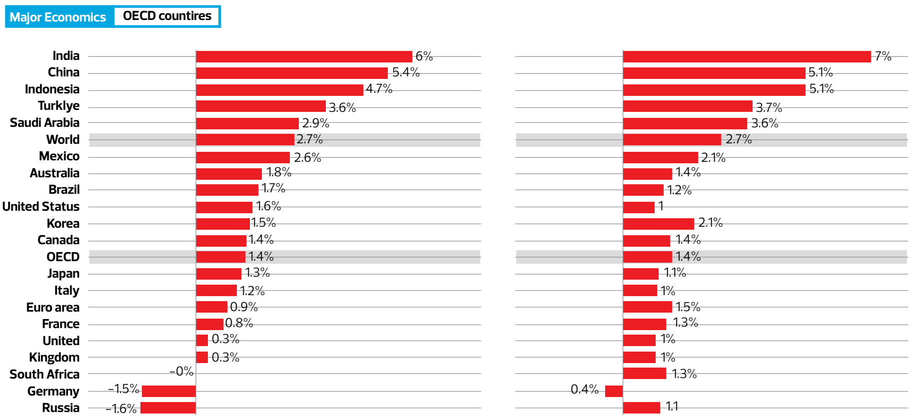
Source: Ministry of Statistics and Programme Implementation

The following table provides a snapshot of the size of the Indian economy and global economy:

Particulars	India	China	USA	European Union
GDP (Current)(2024)	USD 4,112 billion	USD 18,566 billion	USD 27,974 billion	USD 19,350 billion
Annual GDP growth rate (2024)	6.3%	4.2%	1.5%	1.5%
10-year CAGR (GDP) (2013-2023)	7.5%	7.9%	2.4%	1.9%
10-year CAGR (per Capital GDP) (2013- 2023)	5.7%	7.4%	1.5%	1.9%
FDI Inflow (2022)	USD 49 billion	USD 189 billion	USD 285 billion	USD 150 billion

Real GDP growth projection for 2023 and 2024

%, year-on-year



Source: OECD Economic Outlook June 2023 OECD

Recently, India has become the 4th largest economy in the world with GDP surpassing US$ 4 trillion. According to IMF projections, India is expected to continue to grow at a compounded annual growth rate of 6% to 8% per annum for the next 10 years making it the global economic hotspot.

India has attracted substantial foreign investment. For the FY 2022-23, India attracted a foreign investment of US$ 70.97 billion and emerged as the 3rd largest recipient of foreign investment globally.

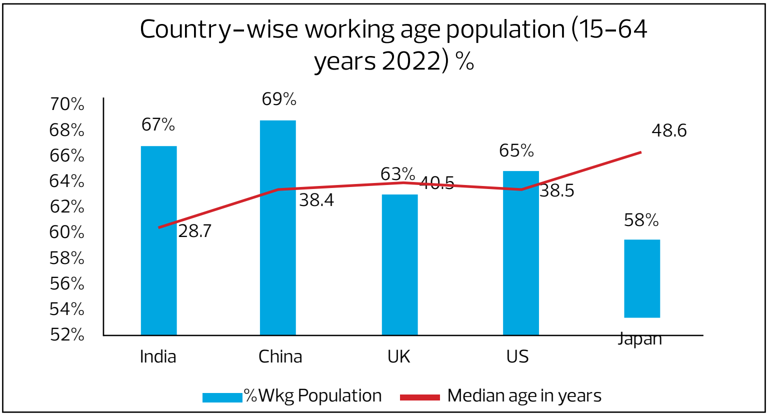
1.2 Political System and Government

India is the world's largest democracy enshrined in its Constitution adopted in 1950. It provides for a parliamentary system of Government with federal and state governments. It has 3 independent arms the Legislature, the Executive and the Judiciary. The Election Commission's impartial functioning and the Rule of law has resulted in truly democratic and vibrant structure. Since independence in 1947, India has undergone several transitions of power from ruling party to the opposition and vice versa in a smooth manner and without any disruption.

India now has a majority elected government. India's foreign policies have been constructive and promote regional and global stability. In the current geo-political context, these aspects assume great significance and have earned India respect and confidence of global political and economic community.

1.3 India's Demographic Dividend & Tech Savvy Workforce

India is home to more than 600 million people aged between 18 and 35, with 65% under the age of 35. India's demographic dividend is expected to persist at least until 2055–56 and will peak around 2041, when the share of the working-age population 20–59 years is expected to hit 59%. (Source: S&P Global)



Source: World Bank Data

Benefits:

i. India has the largest pool of information technology workforce with over 50% share of the global offshoring for technology services. The latest developments on technology and digital revolution such as machine learning, artificial intelligence, cloud computing, IoT, automation, mobile computing will continue to drive the demand for Indian IT workforce.

ii. A younger population provides necessary skill sets and work force to drive the manufacturing thrust resulting from "Make in India" and other geo-political factors.

iii. India has a large domestic market and with the rising economic prosperity and disposable income, the domestic economy will generate large scale employment and result in multiplier effect.

iv. Countries with aging population are required to spend significant proportion of their resources on healthcare and social security.

1.4 Geo-political Developments

In the past 5 years, there have been major geo-political developments such as the bi-polarization of the world, large scale conflicts (Russia – Ukraine and Israel – Palestine) and political instability in several countries. The Western nations are finding a reliable long term partner in India and are making much larger investment in capital markets and diversifying manufacturing facilities in India.

1.5 Booming Start-up Eco-system

India has emerged as the 3rd largest ecosystem for startups globally with over 112,718 DPIIT-recognized startups (Source: Invest India). India ranks #2nd in innovation quality with top positions in the quality of scientific publications and the quality of its universities among middle-income economies. As of October 2023, India is home to 111 unicorns with a total valuation of US$ 349 billion.

State of Indian Start-up Economy – Quick Snapshot

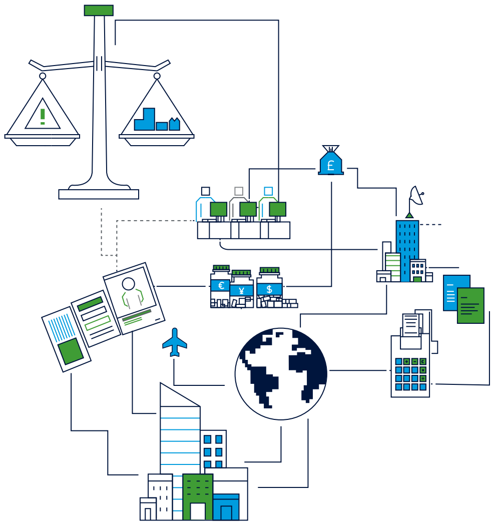
- 3rd Largest Startup Ecosystem in the World
- 68k+ Indian Start-ups launched till date
- 110+ Indian Unicorn Startups
- USD 450 Bn+ Combined Valuation of Indian Startups
- USD 141 Bn Funding raised by Indian Startups
- 1.2K M&A Deals Recorded

(Source: Invest India - Data between 2014 till June 2023)

Chapter 2: Mergers, Acquisition, Divestments & Corporate Restructuring

Chapter 2: Mergers, Acquisition, Divestments & Corporate Restructuring

2.1 Key Drivers



At a macro level, the heightened activities of mergers, acquisitions, divestments, capital raising, and corporate restructuring (referred to as M & A) are due to India's emergence as the fastest growing large economy in the world with consistent growth outlook for the next decade, political and social stability, visionary leadership, digital revolution, Make in India, infrastructural thrust, geo-political factors and start up eco system.

Mergers and acquisitions (M&A) in India are driven by a variety of factors, reflecting both global trends and India-specific conditions. Some key drivers for M&A activity in India include:

2.1.1 Industry Consolidation & Operational Efficiency:

M&A can be a strategy for companies to consolidate their market position, achieve economies of scale, and enhance competitiveness. It can result in cost synergies through consolidation of operations, elimination of duplicate functions, and streamlining of processes, leading to improved operational efficiency and profitability.

2.1.2 Globalization and Cross-Border Deals:

Indian companies are increasingly looking beyond domestic borders for growth opportunities, while foreign investors are attracted to India's growth story. Cross-border M&A allows companies to expand their geographic footprint, access new customer segments, and leverage synergies on a global scale. With India being one of the fastest-growing major economies, foreign companies often seek to enter or expand their presence in the Indian market through acquisitions.

2.1.3 Succession:

In several cases, large businesses have been established by visionary leaders but are now facing succession issues due to family situation or lack of organisational leadership.

2.1.4 Technology and Innovation:

In a rapidly evolving technological landscape, companies often acquire innovative startups or established players to gain access to new technologies, intellectual property, or talent pools, enabling them to stay ahead in their respective industries.

2.1.5 Strategic Diversification & Divestments:

Companies may pursue M&A as a strategy to diversify their business portfolios, reduce risk, and explore new revenue streams, especially in sectors with cyclical or volatile market conditions. On the other hand, companies may divest non-core businesses to focus on core businesses.

2.1.6 Regulatory Changes:

Regulatory reforms and policy initiatives by the Indian government, such as the liberalization of foreign investment norms, tax reforms, and sector-specific regulations, can influence M&A activity by creating opportunities or facilitating easier transactions.

2.1.7 Access to Capital:

M&A transactions are often facilitated by access to capital through various sources such as private equity firms, venture capital funds, and financial institutions, which provide funding for acquisitions and expansion initiatives.

2.1.8 Unlocking Value:

In case of companies having multiple businesses or business segments, it is possible that the overall valuation does not reflect the true potential of the underlying businesses. In such cases, demerger of the different businesses or sale of some of the businesses may unlock the economic value.

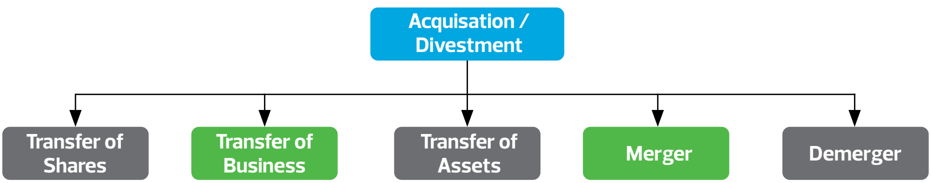
2.1.9 Distressed Assets & De-leveraging:

Economic downturns or industry-specific challenges may lead to distressed asset sales, presenting opportunities for companies to acquire assets at attractive valuations or gain market share through distressed M&A transactions.

These drivers collectively shape the landscape of M&A activity in India, influencing the strategic decisions of companies and investors seeking growth, expansion, and value creation opportunities.

2.2 Modes of Mergers & Acquisitions

The Indian tax and regulatory framework permit various forms of acquisition / divestment which would include transfer of shares, transfer of business on a going concern basis (slump sale), transfer of specific assets including intangibles, merger and demerger. The various forms of acquisition are depicted in the picture below.



We now describe each of the modes of acquisition in brief.

- **Transfer of Shares** – In this case, the Seller may transfer his entire or part of the shareholding in an entity/company to a prospective Buyer depending on the business exigencies. Where the Seller is looking for an exit, he may transfer entire shareholding and where he's looking at strategic partnership, he may transfer partial stake. Also, there are circumstances where the transfer is carried out in phases where the Buyer may acquire a controlling stake and then acquire the balance shareholding over a period to ensure continuity and smooth business transition. In case of listed entities, the transfer of shares may be from the promoter group.

- **Transfer of Business** – At times, the Seller or the Buyer are interested in only particular business which is a division of the company. As such, the Seller may transfer only particular business on a going concern basis with all the assets and liabilities including customer contracts, intellectual property rights, employees by way of slump sale for a lump sum consideration. Unlike share transfer, in case of business transfer, the historical liabilities do not tag along in case of business transfer. This option may also be used when the company has liabilities or litigation which the Buyer is not interested to acquire.

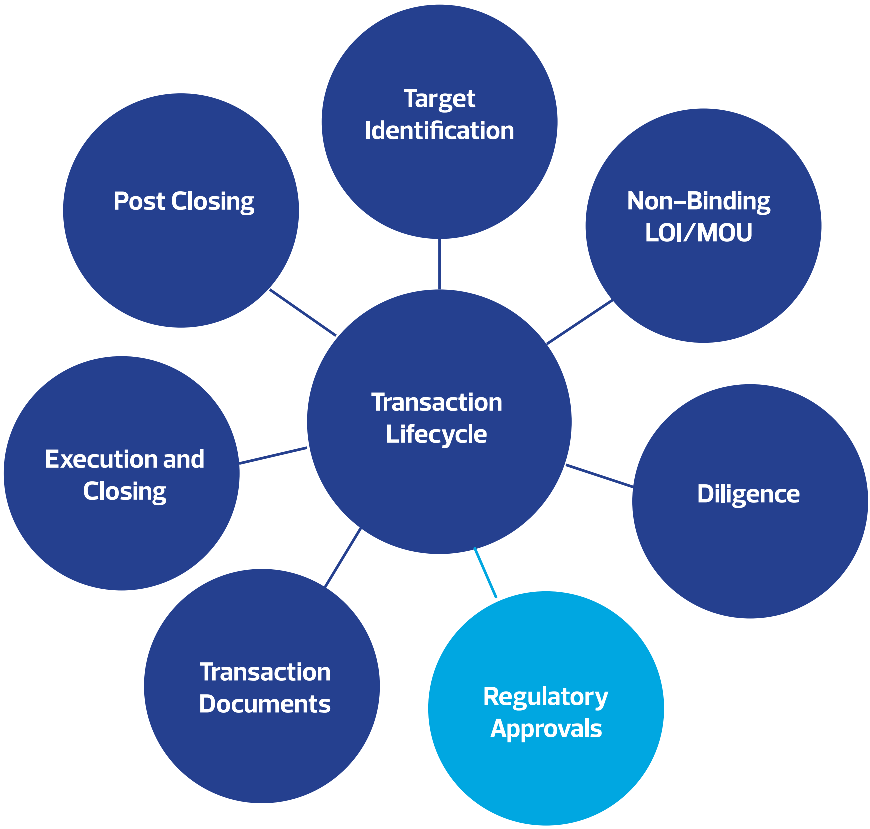
- **Transfer of Assets** – In this case, only assets are transferred as opposed to business transfer. This could include transfer of immovable property, Intellectual Property / Intangibles, loan portfolio, etc. which are individually transferred.

- **Merger** – Certain acquisitions are carried out by way of merger under a court approval process. In a merger, one company is merged into another company and as consideration, the shareholders of the merging company receive shares of the surviving company or the amalgamated company. The merger route is generally to carry on the legacy of the merging entity or even in the case of a private company looking at acquiring a stake in a listed company thereby providing an opportunity to public shareholders for an exit.

- **Demerger** – This is identical to transfer of business; however, it is carried out through a scheme of arrangement under a court approval process. In a demerger all the assets and liabilities of the business being demerged are transferred to another entity and the shareholders of the demerged company receive shares of the surviving company or the resulting company as consideration for the demerger.

2.3 Transaction Life Cycle

The transaction life cycle would typically involve the following stages:



The transaction life cycle inter alia includes the following stages:

- **Target Identification** – This is the first stage where the Buyer identifies a Target or in some cases, the Seller is looking at hiving off / exit from the business and identifies a willing Buyer.

- **Non-Binding / Binding Letter of Interest / Memorandum of Understanding** – Post identification of the Target, the parties may enter into a non-binding offer where principal terms are agreed upon. The non-binding offer does not enforce the Seller or the Buyer to carry out the transactions and only lays down the principal terms including the time-period for providing a binding offer.

- **Due Diligence** – Upon signing of the non-binding offer / letter, the Buyer is provided an opportunity to assess the identified target in terms of commercial, business, financial, tax and legal due diligence, etc. The Buyer would nominate his team (including any external consultants) to carry out due diligence on the Target from all aspects.

  On completion of the non-binding offer period, basis the outcome of the due diligence exercise, the Buyer may float a binding offer to the Seller with certain pre-conditions / compliance requirements.

- **Regulatory Approvals** – Once the parties have finalized the commercial terms and wish to proceed with the transaction, it may be necessary to seek regulatory approvals. These approvals could be shareholders' approval, approval of the applicable regulatory body for the industry concerned, foreign exchange management law related approvals, Competition Commission approval and so on.

- **Transaction Documents** – Once the parties have agreed to consummate the transaction, agreements are entered into documenting the transaction for purchase and sale including the consideration to be discharged. The agreement would also contain certain conditions precedent and conditions subsequent that the seller needs to fulfill before effectuating the transfer. Further, the agreement may also contain clauses for deferred consideration, consideration linked to performance, escrow, etc.

- **Execution and Closing** – Once the transaction documents are finalised and the conditions precedent are fulfilled, the parties will execute the documents and close the transaction. On the closing, the parties will complete the process of purchase and sale by executing additional documents such as share transfer forms, delivery challan, etc.

- **Post Closing** – Once the transaction is completed, the parties may agree to announce the transaction through media release. In the case of listed companies, the transaction may require compliance with SEBI and LODR regulations including open offer to the other shareholders. In case the transaction involves a foreign (non-resident) seller or buyer, compliances under Foreign Exchange Management Act may be required. Further, once transaction is closed, depending on the nature of the transaction, the Buyer would need to intimate various stakeholders / regulators of the proposed transaction which inter alia include the employees, customers, vendors, tax authorities for surrender of registrations, if applicable, banks and financial institutions, etc. The Buyer may also review the policies (accounting, HR, marketing, operations, etc.), and align the same with its own policies to ensure synergy in the business and there is no overlapping.

2.4 Key Factors to be considered – Mergers & Acquisitions

Certain key factors to be considered in a Merger & Acquisition transaction are:

- **Funding of the Transaction**

  From the Buyer's perspective, the most important factor is the funding required for the transaction and the time frame. The acquisition price can be in the form of shares of the Buyer company (merger), security instrument (debenture or debt instrument), raising funds by issue of shares to investors, bank loans, internal accruals or other sources.

- **Tax Aspects**

The Merger & Acquisition transactions if properly structured can be fiscally efficient. As a result, a clear understanding of the tax incidence in each of the modes of acquisition is necessary. The taxes could be income-tax, capital gains tax, GST (Goods & Services Tax), stamp duties and reversal of tax benefits availed due to change of ownership. We have discussed these aspects at length in this publication.

- **Foreign Exchange Regulations**

  In case the Seller or the Buyer or both are foreign persons, the transaction needs to be compliant with the Foreign Exchange Management Act, 1999 and the rules and regulations formed thereunder (FEMA). The FEMA regulations do not permit foreign investment in certain sectors or permit investment upto the sectoral cap specified. Even in cases where foreign investment is permissible, there are pricing and reporting requirements. We have covered these aspects in this publication.

- **Corporate Laws**

  In case of listed companies, SEBI regulations require various actions and compliances. These include open offer to public shareholders, approval of the shareholders, disclosure requirements, minimum public shareholding requirements, change of directors and key managerial personnel (KMPs) and so on.

2.5 Transfer of shares

2.5.1 Tax Regulations

- **Chargeability** – Section 45 of the IT Act deals with chargeability of income arising on transfer of capital assets. Section 45 states that any profits or gains arising from the transfer of a capital asset effected in the previous year shall be chargeable to income-tax under the head "Capital gains".

- **Capital Asset** – Under Section 2(14) of the IT Act, the shares of a company would be treated as capital asset unless the shares are held as "stock-in-trade".

- **Applicable Tax Rates**

Period of Holding: The applicable tax rates depend on the period for which shares have been held by the Seller. Capital gains would be long-term capital gains if the capital asset being share of a company (not being a share listed on a recognized stock exchange in India) is held by the taxpayer for a period of exceeding 24 months. In the case of shares / securities listed on a recognized stock exchange, the period of holding is reduced to 12 months for it to be treated as a long-term capital asset.

Rates: Section 111A, section 112 and section 112A of the IT Act prescribe the rates for tax on capital gains. In respect of transfer of listed securities held for more than 12 months over the stock exchange, the capital gains are chargeable to tax at 10% (plus applicable surcharge not exceeding 15% and Higher Education Cess of 4%) effectively resulting in a tax rate of 11.96%. This is subject to the condition that Securities Transaction Tax (STT) has been paid at the time of purchase as well as sale of such shares, except for some specified exceptions. The Central Board of Direct Taxes (CBDT) has provided exemption from payment of STT on shares acquired prior to 1 October 2004 or where the shares are acquired after 1 October 2004 pursuant to approval by the Supreme Court, High Court, National Company Law Tribunal.

Grandfathering benefit: In case of shares acquired prior to 1 February 2018, the cost of acquisition is higher of:

(a) Actual cost or

(b) lower of (i) highest price of shares on 31 January 2018 or (ii) consideration received on sale of such shares.

Further, in the case of non-residents, the fluctuation in foreign currency is not available to compute the cost of acquisition.

Further, to reduce litigation and maintain consistency in approach in assessments, the CBDT has instructed that income arising from transfer of listed shares and securities, which are held for more than 12 months would be taxed under the head 'Capital Gain' unless the taxpayer itself treats these as its stock-in-trade and transfer thereof as its business income. However, once the taxpayer has opted for the treatment of income as capital gains or business income, he/she would need to apply the same stand in subsequent years as well.

Where the listed shares are held for a period of up to 12 months and STT is paid, the gains will be short-term capital gains chargeable to tax at 15% (plus applicable surcharge not exceeding 15% and Higher Education Cess of 4%). The CBDT has provided guidelines basis certain judicial decisions to determine the chargeability of surplus income on transfer of shares as capital gains or business income and one would need to evaluate the position based on facts and circumstances.

In case of transfer of unlisted securities, the gains will be long-term capital gains if the shares are held for more than 24 months and chargeable to tax at 20% (plus applicable surcharge not exceeding 15% and Higher Education Cess of 4%) in case of residents and they would be able to avail indexation benefit for computing the cost of acquisition. In the case of non-residents, the capital gains are chargeable to tax at 10% (plus applicable surcharge not exceeding 15% and Higher Education Cess of 4%) and they would not be able to claim benefit of foreign currency fluctuation.

The transfer of unlisted securities held for a period of up to 24 months are chargeable to tax at normal rates for residents (applicable slab rate in case of individuals and HUF, tax rate for business income in case of corporate and non-corporate taxpayers) increased by applicable surcharge not exceeding 15% and Higher Education Cess of 4%. The short-term capital gains are taxable in the hands of non-residents at 40% (tax rate applicable to foreign companies).

The summary of tax rates is tabulated below for reference:

Particulars	Section and Tax Rates[1]		
	Section 111A (Short-term Capital Gain)	Section 112	Section 112A
Listed Securities (STT paid on purchase and sale)	15%	-	10% on gains exceeding INR 1.00 lakh
Listed Securities (STT not paid) (resident)	Applicable tax Rate	20% with indexation and 10% without indexation	-
Listed Securities (STT not paid) (non-resident)	Applicable tax Rate	20%	-
Unlisted Shares (resident)	Applicable tax Rate	20% with indexation	-
Unlisted Shares (non-resident)	Applicable tax Rate	10%	-

- **Withholding Obligations** – Section 195 of the IT Act states that any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest (not being interest referred to in section 194LB or section 194LC) or section 194LD or any other sum chargeable under the provisions of this Act (not being income chargeable under the head "Salaries") shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force. Having said that, the CBDT Circular has clarified that in case of a remittance to a country with which India has DTAA,

[1] The tax rates will be increased by applicable surcharge (not exceeding 15%) and Higher Education Cess of 4%. Separately in case of non-resident shareholders the provisions of the Double Tax Avoidance Agreement (DTAA) also needs to be analysed.

the tax should be deducted at rate provided in the IT Act or DTAA, whichever is more beneficial to the taxpayer.

It is pertinent to note that where the Seller is a non-resident, the Buyer generally insists on withholding tax at full rate and not granting benefit of the DTAA. In such case, the Seller may apply for lower or nil withholding certificate under section 197 of the IT Act.

We would also like to draw attention to section 206(1H) which casts an obligation on the seller who receives any amount as consideration for sale of goods to collect tax at source (TCS) @0.1% if the aggregate value of such sale exceeds INR 50 lakh during relevant financial year and if the Buyer does not provide a Permanent Account Number (PAN), the seller would be required to collect tax at 1%. The term goods is not defined under the IT Act. The provision simply states that the TCS is applicable to sale of any goods. In the absence of a clear definition in the said Act, the Sale of Goods Act which is the main law shall be applicable. As per section 2(7) of the Sale of Goods Act, ''goods'' means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale. Accordingly, it can be stated that shares will be considered as goods for the purpose of section 206C(1H) of the IT Act. However, CBDT has provided exception for TCS which inter alia states that if the Buyer is required to withhold tax then the seller would not be required to collect TCS.

- **Fair Market Value** – The IT Act provides deeming fiction for ascertaining consideration for transfer of unlisted shares in the hands of the seller. As per the said provisions, if the seller transfers the shares at less than the fair market value (FMV), to be determined in accordance with the prescribed rules, then the FMV shall be deemed to be the consideration for transfer of shares.

  Also, if the buyer acquires the shares at less than the FMV, the difference between the FMV and the consideration paid by the buyer is deemed as Income from Other Sources in the hands of the buyer and taxed at applicable tax rates.

The FMV for both the seller and buyer, as prescribed in the rules, is essentially based on the intrinsic value, wherein the book value of certain assets viz., immovable property, jewellery, artistic work, investment in listed securities, is replaced with the market value of such assets. In case the company has investments in another unlisted company, the value of such investments will also be based on such valuation rules.

- **Indirect Transfer** – While the above implications are for direct transfer of shares of an Indian Company (listed or unlisted), the Finance Act was amended in 2012 to also provide for taxability of indirect transfer of shares / interest in an Indian entity. In other words, where shares / interest in a foreign entity are transferred the gains may be taxable in India provided such shares / interest derive its value substantially from assets located in India. The share or interest shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if, on the specified date, the value of such assets—

  (i) Exceeds the amount of INR 100 million; and

  (ii) Such assets represent at least 50% of the fair market value of all the assets owned by the foreign entity.

  The taxpayer may avail benefit under the Double Taxation Avoidance Agreement (DTAA) entered between India and the host jurisdiction of the foreign entity transferring the shares, if applicable.

- **No Objection Certificate from Tax Authorities** – Section 281 empowers the tax authorities to treat a transaction of transfer of any asset being land, building, machinery, plant, shares and securities or fixed deposits, as null and void, if there are any pending proceedings / demands outstanding against the seller / company. In such a case, the buyer insists that the seller obtains a no objection certificate from the tax authorities to consummate the transaction.

- **Impact of losses** – As per section 79 of the IT Act, where a change in shareholding has taken place during the relevant year, in the case of company, not being a company in which public are substantially interested, no loss incurred in any prior year to the relevant year shall be carried forward and set-off against the income of the relevant year, unless on the last day of the previous year, the shares of the company carrying not less than 51% of the voting power were beneficially held by persons who beneficially held shares of the company carrying not less than 51% if the voting power on the last day of the year or years in which the loss was incurred.

  In other words, if the buyer acquires 51% of the voting power in the company in a year, all the losses incurred by the company prior to such year shall not be allowed to be carried forward and set off in subsequent years.

  The aforesaid provisions apply only to business losses and do not impact carry forward and set-off of unabsorbed depreciation.

- **Goods and Services Tax** – There is no implication under GST laws on transfer of shares.

- **Stamp Duty** – Transfer of shares is subject to stamp duty at 0.015% on the consideration to be paid for transfer of shares. Generally, the buyer incurs the cost of stamp duty; however, it may be negotiated between the parties to bear the stamp duty cost equally. In case the shares are held in a dematerialized form (Demat), the stamp duty would still be applicable.

2.5.2 Foreign Exchange Management Regulations

- **Applicable Regulations** – While the Indian economy is liberalised, foreign investments are still regulated and Investments in, and acquisitions (complete and partial) of, Indian companies by non-resident entities and individuals, are governed by the terms of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ("NDI Rules"). These Rules have been issued in supersession of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India)

Regulations, 2000 (the "FDI Regulations") and the press notes issued by the Department of Industrial Policy and Promotion, Government of India.

- **Non-Debt Instruments** – are defined as (i) all investments in equity instruments in incorporated entities (public, private, listed and unlisted) (ii) capital participation in Limited Liability Partnership, (iii) all instruments of investment recognized in FDI policy notified from time to time, (iv) investments in units of Alternative Investment Funds (AIFs), Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InVITs); (v) investments in units of mutual funds or Exchange-Traded funds (ETFs) which invest more than 50% in equity, (vi) junior-most layer (i.e., equity tranche) of securitization structure; (vii) acquisition, sale, or dealing directly in immovable property, (viii) contribution to trusts; and (ix) depository receipts issued against equity instruments.

- **Permissible Transaction** – Regulation 9 of the NDI Rules allows a person resident outside India holding equity instruments of an Indian company or units in accordance with the rules, may transfer such equity instruments or units so held by him in compliance with the conditions, if any, specified in the Schedules of the rules and subject to certain terms and conditions.

- **Pricing** – In case of transfer of shares of an Indian company involving a non-resident buyer, the same need to be carried out as per the pricing guidelines specified in the NDI Rules. It may be noted that the pricing guidelines do not apply in case of transfer by way of sale done in accordance with the Securities and Exchange Board of India regulations where the pricing is specified by the Securities and Exchange Board of India.

  In case of transfer of shares by a person resident in India to a person resident outside India, the price of equity instruments of the Indian company shall not be less than:

  (i) the price worked out in accordance with the Securities and Exchange Board of India guidelines in case of a listed India company;

(ii) the price at which a preferential allotment of shares can be made under the Securities and Exchange Board of India Guidelines, as applicable, in case of a listed Indian company or in case of a company going through delisting process as per the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009;

(iii) the valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with Securities and Exchange Board of India or a practicing Cost Accountant, in case of an unlisted company.

In case of transfer of shares by a person resident outside India to a person resident in India, the price of equity instruments of the Indian company shall not exceed:

(iv) the price worked out in accordance with the relevant Securities and Exchange Board of India guidelines in case of a listed India company;

(v) the price at which a preferential allotment of shares can be made under the Securities and Exchange Board of India Guidelines, as applicable, in case of a listed Indian company or in case of a company going through delisting process as per the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009;

Provided that the price determined for such duration as specified in the Securities and Exchange Board of India Guidelines, preceding the relevant date, which shall be the date of purchase or sale of shares.

(vi) the valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with Securities and Exchange Board of India or a practicing Cost Accountant, in case of an unlisted company.

➢ **Deferred Consideration** – In case of transfer of equity instruments between a person resident in India and a person resident outside India, an amount not exceeding 25% of the total consideration –

(i) may be paid by the buyer on a deferred basis within a period not exceeding 18 months from the date of transfer agreement; or

(ii) may be settled through an escrow arrangement between the buyer and the seller for a period not exceeding 18 months from the date of the transfer agreement; or

(iii) may be indemnified by the seller for a period not exceeding 18 months from the date of payment of full consideration, if the total consideration has been paid by the buyer to the seller.

➢ **Reporting** – Form FC-TRS shall be filed for transfer of equity instruments in accordance with the rules, between:

(i) a person resident outside India holding equity instruments in an Indian company on a repatriable basis and person resident outside India holding equity instruments on a non-repatriable basis; and

(ii) a person resident outside India holding equity instruments in an Indian company on a repatriable basis and a person resident in India.

The onus of reporting shall be on the resident transferor / transferee or the person resident outside India holding equity instruments on a non-repatriable basis, as the case may be.

The Form FC-TRS shall be filed within 60 days of transfer of equity instruments or receipt / remittance of funds, whichever is earlier.

➢ **Downstream Investments** – Indian entity which has received indirect foreign investment shall comply with the entry route, sectoral caps and pricing guidelines and other attendant conditions as may be applicable for foreign investment.

Downstream investment shall mean investment made by an Indian entity which has total foreign investment in it, or an Investment Vehicle in the capital instruments or the capital, as the case may be, of another Indian company.

In view of the above, in case of transfer of shares between two resident companies and the buyer entity has foreign investments, the acquisition by the Indian entity would be treated as downstream investments resulting in compliance with the NDI rules for entry route, sectoral caps, pricing guidelines. Further, the buyer would also need to report such downstream investments in the prescribed form.

2.5.3 Company Law Regulations

Section 179 of the Companies Act, 2013 ("the Cos Act") provides that the Board of Directors of a company shall exercise the powers on behalf of the company by means of resolutions passed at meetings of the Board which inter alia include, investing of funds of the company, approve amalgamation, merger or reconstruction, take over a company or acquire a controlling stake in another company. Section 186 of the Cos Act provides for limits up to which investment can be made by a company and the circumstances under which approval of shareholders is required. The Seller company also needs authorization to sell the shares from the board of directors and in case the investment constitutes a substantial undertaking, approval of shareholders may also be required. In all cases, the Memorandum of Association of the Buyer company and the Seller company must provide for investment in shares.

- **Transfer Document** – Section 56 of the Cos Act provides that a company shall not register a transfer of securities of the company, unless a proper instrument of transfer, in the prescribed from (Form SH4), duly stamped, dated and executed by or behalf of the transferor and transferee and specifying the name, address and occupation, if any, of the transferee has been delivered to the company by the transferor or the transferee within a period of sixty days from the date of execution, along with the certificate relating to the securities, or if no such certificate is in existence, along with letter of allotment of shares.

Further, the company shall deliver the certificate of all securities transferred within a period of one month from the date of receipt by the company of the instrument of transfer.

In case the shares of the company are in held in dematerialized form, the above-mentioned provisions under the Cos Act shall not be applicable for transfer of shares and the provisions of Depositories Act shall apply for such transfers.

2.5.4 Securities Exchange Board of India (SEBI) Regulations

- **Applicability and Compliance under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011**

  - In the case of listed companies, direct and indirect acquisition of shares or voting rights in, or control over target company (i.e. listed entity), SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (SAST Regulations) shall be applicable.

  - As per Regulation 3(1) of SAST Regulations, no acquirer shall acquire shares or voting rights in a target (listed) company which taken together with shares or voting rights, if any, held by him and by persons acting in concert with him in such listed company, entitle them to exercise 25% or more of the voting rights in such target company unless the acquirer makes a public announcement of an open offer for acquiring shares of such target company in accordance with SAST Regulations.

  - As per Regulation 3(2) of SAST Regulations, no acquirer, who together with persons acting in concert with him, has acquired and holds shares or voting rights in a target company entitling them to exercise 25% or more of the voting rights in the target company but less than the maximum permissible non-public shareholding, shall acquire within any financial year additional shares or voting rights in such target company entitling them to exercise more than 5% of the voting rights, unless the acquirer makes a public announcement of an open offer for acquiring shares of such target company in accordance with SAST Regulations.

- o As per Regulation 29 of SAST Regulations, certain disclosures regarding aggregate shareholding and voting rights or changes thereto, are to be made by acquirer / promoter group, etc.

➢ **Applicability and Compliance under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 [Listing Regulations]**

The provisions of Regulation 40 of Listing Regulations shall also be applicable for transfer of shares of listed entity in addition to Depositories Act.

2.6 Transfer of Business

2.6.1 Tax Regulations

➢ **Chargeability** – The concept of slump sale was introduced in the IT Act through section 2(42C) and section 50B in Assessment Year 2000-01. Section 2(42C) defines slump sale as a sale of one or more undertakings as a going concern by the Transferor to a Transferee, for a lumpsum consideration without specific values being assigned to individual assets.

➢ **Computation of Capital Gains on Slump Sale** – Section 50B specifies the way capital gains are computed for transfer of an undertaking under slump sale. As per section 50B, capital gains on slump sale is computed as under:

Sr. No.	Particulars	Amount (INR)
1	Sales Consideration for slump sale	XX
	Minus	
2	Net worth of the undertaking or division	XX

The net worth of the undertaking is computed as under:

Sr. No.	Particulars	Amount (INR)
1	aggregate value of total assets of the undertaking or division	XX

Sr. No.	Particulars	Amount (INR)
	Minus	
2	value of liabilities of such undertaking or division as appearing in its books if account	XX

Further, aggregate value of total assets is calculated as under:

Sr. No.	Particulars	Amount (INR)
1	In the case of depreciable assets, the written down value of the block of assets determined in accordance with the provisions contained in sub-item (C) of item (i) of sub-clause (c) of clause (6) if section 43	XX
	Add	
2	In the case of capital asset in respect of which the whole of the expenditure has been allowed or is allowable as a deduction under section 35AD – Nil	XX
	Add	
3	In the case of other assets, the book value of such assets	XX

- **Definition of Undertaking** – One of the key aspects of a slump sale is – what constitutes an undertaking. The IT Act defines 'undertaking' is to mean any part of an undertaking, or a unit or a division of an undertaking or a business activity taken as a whole but does not include individual assets or liabilities or any combination thereof not constituting business activity.

  As such, undertaking would include the assets and liabilities in relation to the undertaking. The assets / liabilities would include tangible and intangible assets, Trade Receivables, Inventory, Cash / Bank Balance and Trade Payables, Employee Liabilities, Sundry / Current Liabilities. However, at times, the Buyer is not keen on taking over certain assets / liabilities and a question may arise whether exclusion of any assets / liabilities would deviate from the concept of slump sale and treat the transfer as asset transfer. In this context, there have been several judicial precedents which have provided guidance on what constitutes an undertaking. The principal tests to be complied with are:

i. The assets and liabilities transferred (excluding certain assets / liabilities) is a business activity which can be carried on without the excluded assets / liabilities.

ii. It is not a combination of individual asset and liability.

iii. The consideration is lump sum consideration and not determined basis individual value of any asset / liability. It may be clarified that determination of the value of an asset or liability for the sole purpose of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities.

- **Applicable Tax Rates** – In case of slump sale, if the undertaking / division being transferred is held for more than 36 months, the gains will be long-term capital gains chargeable to tax at 20% (plus applicable surcharge and higher education cess of 4%). In case the undertaking is held for upto 36 months, the gains will be short-term capital gains chargeable to tax at normal rates (plus applicable surcharge and higher education cess of 4%).

- **Withholding Obligations** – In the case of slump sale by a resident, there is no requirement for withholding tax at the time of discharging the consideration.

- **Sales Consideration** – Section 50B(2) was amended vide Finance Act 2021 to provide that the fair market value of the capital assets as on the date of transfer calculated in the prescribed manner, shall be deemed to be the full value of consideration received or accruing as a result of the transfer of such capital asset.

  As per the prescribed mechanism, the sales consideration shall be higher of the FMV computed as per formula (FMV1) and FMV of the consideration received or accruing as a result of transfer by way of slump sale (FMV2).

FMV1 – is the intrinsic value of the assets and liabilities wherein the book value of certain assets, viz., immovable property, jewellery, artistic work, investments is replaced with the market value of such assets.

FMV2 – is the consideration discharged by the buyer in case of monetary consideration. Where the consideration is discharged in kind, the FMV of such asset given as consideration would be determined to arrive at FMV2.

- **Impact of losses** – In case of slump sale, the brought forward business loss or unabsorbed depreciation are not transferred to the buyer and would continue to be available to the seller for set-off against his future tax liabilities.

- **No Objection Certificate from Tax Authorities** – As mentioned in section of transfer of shares, section 281 empowers the tax authorities to treat the transaction of transfer of any asset being land, building, machinery, plant, shares and securities or fixed deposits, as null and void, if there are any pending proceedings / demands outstanding against the seller / company. In such case, the buyer insists that the seller obtains a no objection certificate from the tax authorities to consummate the transaction.

- **Cost Base for buyer** – The buyer would need to carry out Purchase Price Allocation (PPA) allocating the sales consideration over the assets acquired which may include tangible and intangible assets. Goodwill, if any, acquired as part of the undertaking is a non-depreciable asset and depreciation can be claimed on other intangibles identified and allocated pursuant to PPA. Further, if the slump sale is during the year, depreciation that can be claimed by the buyer shall not exceed depreciation that would have been allowed had the transfer not taken place. In other words, though the buyer may allocate purchase price, the depreciation in first year is restricted to the extent of depreciation which would have been allowable on the original written down value of the asset.

- **Goods and Services Tax** – The GST authorities vide notification no. 12/2017 – Central Tax (Rate) dated 28 June 2017 has clarified that in case of "services by way of transfer of a going concern, as a whole or an independent part thereof, will be Nil Rated supply. Thus, there are no GST implications on transfer of business.

However, the buyer may carry forward the unutilised input tax credit available in the seller's electronic credit ledger by filing prescribed form and on the common portal along with request for transfer of unutilised input tax credit.

- **Stamp Duty** – The agreement for transfer of business on a going concern basis is an instrument of transfer and would be subjected to stamp duty basis the entry in the schedule for the State where the transaction is consummated.

2.6.2 Foreign Exchange Management Regulations

- Generally, the Indian Exchange Control Regulations would not be applicable in case of transfer of business. However, the following aspects need to be considered:
  - In case the Buyer company has received foreign direct investment, the business being acquired should be permissible under automatic route.
  - In case the business is acquired by the Buyer company through a special purpose vehicle (SPV), the downstream investment reporting requirements may be applicable.

2.6.3 Companies Act Regulations

- **Approval of Shareholders** – As per section 180 of the Cos Act, the Board of Directors shall exercise following powers only with the consent of the company by a special resolution:

  (a) to sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company or where the company owns more than one undertaking, of the whole or substantially the whole of any such undertaking.

'Undertaking' for the above clause is defined to mean an undertaking in which the investment of the company exceeds 20% of its net worth as per the audited balance sheet of the preceding financial year or an undertaking which generates 20% of the total income of the company during the preceding financial year.

It may be noted that the aforesaid provisions do not apply in the case of a private company.

2.6.4 Securities Exchange Board of India Regulations

- **Approval of Shareholders** – As per regulation 37A of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations), a listed entity carrying out sale, lease or otherwise disposal of the whole or substantially the whole of the undertaking of such entity or where it owns more than one undertaking, of the whole or substantially the whole of any of such undertakings, shall:
    - take prior approval of shareholders by way of special resolution;
    - disclose the object and commercial rationale for carrying out such sale, lease or otherwise disposal of whole or substantially the whole of the undertaking of the entity and the use of proceeds arising therefrom, in the statement annexed to the notice.
- Listed company shall abide by the Policy on determination of materiality of events as required under Regulation 30 of Listing Regulations and accordingly file disclosures with Stock Exchanges

2.7 Transfer of Assets without Scheme of Arrangement

2.7.1 Tax Regulations

- **Chargeability** – As per section 45 of the IT Act, any profits or gains arising from the transfer of capital asset shall be chargeable to tax under the head

"Capital Gains".

- **Computation of Capital Gains** – The IT Act contains specific provisions for computing capital gains for certain assets. For e.g., section 50 deals with computation of capital gains on transfer of depreciable assets, section 50C deals with computation of capital gains on transfer of immovable assets being land or building or both.

- **Cost of Acquisition** – Section 48 of the IT Act provides the mechanism for computing the cost of acquisition for assets and allows indexation benefit in case of long-term capital assets, except depreciable assets which are treated as short-term capital asset.

- **Tax Rates** – Where the capital asset is held for more than 36 months, the gains will be long term capital gains chargeable to tax at 20% (plus applicable surcharge and higher education cess of 4%). If the capital asset is held for upto 36 months or is a depreciable asset, the gains will be short-term capital gains chargeable to tax at normal rates (plus applicable surcharge and higher education cess of 4%).

- **Withholding Obligations** – As per section 194IA of the IT Act, the buyer would be required to withhold tax at 1% on the consideration or the stamp duty value of the property whichever is higher provided the consideration or stamp duty value is in excess of INR 50 lakhs.

  In other cases, the buyer would be required to withhold tax at 0.1% of the consideration exceeding INR 50 lakhs provided the turnover or gross receipts from the business of the buyer exceeds INR 10 crore during the preceding financial year.

  In case of transfer of assets by a non-resident, the buyer would be liable to withhold tax at the applicable rates subject to benefit under the DTAA, if any.

- **Fair Market Value** – The IT Act provides specific deeming provisions for treating the fair market value as the full value of consideration. For e.g., in case of transfer of immovable property, where the consideration received or accruing as a result of transfer is less than the value adopted or assessed or assessable for the purpose of stamp duty, the value so adopted, assessed or assessable shall be deemed to be the full value of consideration for computing capital gains. Further, section 50D provides that where the consideration received or accruing as a result of the transfer of capital asset is not ascertainable or cannot be determined, then, for the purpose of computing income chargeable as capital gains, the fair market value of the said asset on the date of transfer shall be deemed to be full value of consideration received or accruing as a result of transfer.

- **No objection certificate** – Similar to transfer of shares / slump sale, the tax authorities may treat the transaction of transfer of any asset being land, building, machinery, plant, shares and securities or fixed deposits, as null and void, if there are any pending proceedings / demands outstanding against the seller / company. In such case, the buyer insists that the seller obtains a no objection certificate from the tax authorities to consummate the transaction.

- **Goods and Services Tax** – The itemized transfer of assets would be subject to GST at the applicable rate depending on the classification of the asset.

- **Stamp Duty** – As mentioned in slump sale, stamp duty is a State levy and is levied on instrument of transfer. Generally, all States provide stamp duty rates on transfer of immovable property which is transferred through a registered document. For movable assets, depending on the nature of asset, if delivered through novation / physical delivery, it may not be subjected to stamp duty. Further, stamp duty is generally borne by the buyer unless commercially negotiated.

2.7.2 Foreign Exchange Management Regulations

- The Indian Exchange Control Regulations would not be applicable in case of itemized transfer of assets.

2.7.3 Companies Act Regulations

- While there are no specific provisions dealing with the approval or otherwise for transfer of assets, as a good governance policy, the Board of Directors should approve transfer of assets and authorise one of the Directors to carry out all such acts as may be necessary to consummate the transaction.

2.7.4 Securities Exchange Board of India Regulations

- The SEBI regulatory implications on the transfer of assets are same as that of in the case of transfer of business which have been discussed in detail hereinabove in section 2.5 of this publication.

2.8 Merger

2.8.1 Tax Regulations

In certain cases, the buyer and the seller may agree to acquisition through the merger route. Under merger, one or more companies consolidate into another entity or may form an entirely new entity. The merger is effected through a scheme of arrangement with the blessings of the National Company Law Tribunal ("NCLT"). The merger route is widely adopted due to tax exemption in eligible cases and does not entail cash outflow. However, it is more complex and takes longer time to consummate (8 to 18 months in most cases) due to approval of NCLT and procedural aspects.

- **Chargeability** – The transfer of assets and liabilities under the merger route are exempted under the IT Act. Further, the shareholders receiving the shares of the merged company in lieu of their shareholding in the merging company are also exempt. However, the merger needs to comply with the conditions for it to be tax neutral.

- **Merger** – The IT Act does not define merger but provides definition of amalgamation to mean, merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies while so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of merger, as the amalgamated company), in such a manner that:

- o all the property of the amalgamating company(ies) immediately before amalgamation becomes the property of the amalgamated company by virtue of amalgamation;
- o all the liabilities of the amalgamating company(ies) immediately before amalgamation becomes the liabilities of the amalgamated company by virtue of amalgamation;
- o shareholders holding not less than three-fourths in value of the shares in the amalgamating company(ies) (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of amalgamation.

- ➢ **Cost of Acquisition and period of holding of shares received on amalgamation** – As per the provisions of the IT Act, the cost of acquisition of shares of the amalgamating company(ies) shall be the cost of acquisition of the shares of the amalgamated company. Further, for computing the period of holding of the shares received on amalgamation, the period of holding of the shares of the amalgamating company(ies) would be included.

- ➢ **Cost base of depreciable assets for the amalgamated company** – As per provisions of the IT Act, the tax written down value of the depreciable assets prior to amalgamation shall be the cost of acquisition post amalgamation and the amalgamated company shall claim depreciation thereon.

- ➢ **Impact on losses** – As per section 72A of the IT Act in case of amalgamation, the accumulated losses and unabsorbed depreciation of the amalgamating company(ies) shall be allowed to be carried forward and set-off by the amalgamated company provided the amalgamating company is an industrial undertaking complies with certain conditions such as:

- o the amalgamating company has been engaged in the business, in which the accumulated losses or depreciation remains unabsorbed, for three or more years;
- o the amalgamating company has held continuously as on the date of amalgamation at least three-fourths of the book value of fixed assets for two years prior to the date of amalgamation;
- o the amalgamated company holds continuously for a minimum period of five years from the date of amalgamation at least three-fourths of the book value of fixed assets of the amalgamating company acquired in scheme of amalgamation;
- o the amalgamated company continues the business of the amalgamating company for a minimum period of five years from the date of amalgamation;
- o the amalgamated company must achieve the level of production of at least 50% of the installed capacity before the end of four years from the date of amalgamation and continue to maintain the same level or production till the end of five years from the date of amalgamation.

Subject to fulfillment of the above conditions, the amalgamated company would be able to carry forward the accumulated losses for a fresh period of 8 years.

It may be noted that section 72A deals with accumulated business loss and unabsorbed depreciation and does not deal with capital loss. There are no other provisions dealing with carry forward and set-off of capital loss on merger and thus, it is likely that the capital loss would not be allowed to be carry forward and set-off by the amalgamated company.

➢ **Deductibility of Amalgamation Expenses** – The IT Act specifically provides for deduction of expenses incurred on amalgamation over a period of five years beginning with the year in which the amalgamation takes place.

- **Goods and Services Tax** – There would be no GST implications on merger as the business is transferred on a going concern basis (similar to slump sale). Further, the amalgamated company should be able to utilize the unutilised input tax credit of the amalgamating company(ies).

- **Stamp Duty** – The NCLT order approving the scheme of amalgamation is an instrument of transfer. Most of the State Acts provide for stamp duty on NCLT order and it is levied as a percentage of the value of immovable property or value of shares whichever is higher. In some State Acts, there is no entry for NCLT order; however, there have been judicial precedents wherein it has been held that NCLT order is an instrument of transfer and since the business as a whole is transferred, it being movable asset, stamp duty would be levied as applicable for transfer of movable assets.

2.9 Demerger

2.9.1 Tax Regulations

The seller in certain cases may have several businesses / undertakings and it proposes to hive off only one particular business / undertaking. The seller may hive off the business / undertaking under the demerger route where the business / undertaking is transferred to the buyer. Like merger, demerger is effected through a scheme of arrangement with the blessings of the NCLT.

- **Chargeability** – The transfer of business / undertaking under the demerger route is exempted under the IT Act. Further, the shareholders receiving the shares of the resulting company in lieu of their shareholding in the demerged company are also exempt. However, the demerger needs to comply with the conditions for it to be tax neutral.

- **Demerger** – The IT Act does define demerger to mean the transfer, pursuant to a scheme of arrangement by a demerged company of its one or more undertakings to any resulting company in such a manner that:

- all the property of the undertaking, being transferred by the demerged company, immediately before demerger becomes the property of the resulting company by virtue of demerger;

- all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before demerger becomes the liabilities of the resulting company by virtue of demerger;

- the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;

- the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis [except where the resulting company itself is a shareholder of the demerged company]

- the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger;

- the transfer of the undertaking is on a going concern basis;

- the demerger is in accordance with the conditions, if any, notified under section 72A of the IT Act by the Central Government in this behalf.

➢ **Cost of Acquisition and period of holding of shares received on demerger** – As per the provisions of the IT Act, the cost of acquisition of the shares of the resulting company shall be the amount which bears to the cost of acquisition of the shares held by the shareholder in the demerged company the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger. Further, for computing the period of holding of the shares received on demerger, the period of holding of the shares of the demerged company would be included.

- **Cost base of depreciable assets for the amalgamated company** – As per provisions of the IT Act, the tax written down value of the depreciable assets prior to demerger shall be the cost of acquisition post demerger and the resulting company shall claim depreciation thereon.

- **Impact on losses** – As per section 72A of the IT Act in case of demerger, the accumulated losses and unabsorbed depreciation of the undertaking shall

  - where such loss or unabsorbed depreciation is directly relatable to the undertakings transferred to the resulting company, be allowed to be carried forward and set off in the hands of the resulting company;

  - where such loss or unabsorbed depreciation is not directly relatable to the undertakings transferred to the resulting company, be apportioned between the demerged company and the resulting company in the same proportion in which the assets of the undertakings have been retained by the demerged company and transferred to the resulting company, and be allowed to be carried forward and set off in the hands of the resulting company, as the case may be.

  Unlike merger, there are no specific conditions prescribed for carry forward and set off of accumulated losses and unabsorbed depreciation. However, the resulting company can carry forward and set off the accumulated losses for the balance period of out of the 8-year period.

- **Deductibility of demerger Expenses** – The IT Act specifically provides for deduction of expenses incurred on demerger over a period of five years beginning with the year in which the demerger takes place.

- **Goods and Services Tax** – There would be no GST implications on demerger as the business is transferred on a going concern basis (like slump sale).

Further, the resulting company should be able to utilize the unutilised input tax credit relatable to the undertaking transferred by the demerged company to the resulting company.

- **Stamp Duty** – The NCLT order approving the scheme of demerger is an instrument of transfer. Most of the State Acts provide for stamp duty on NCLT order and it is levied as a percentage of the value of immovable property or value of shares, whichever is higher. In some State Acts, there is no entry for NCLT order; however, there have been judicial precedents wherein it has been held that NCLT order is an instrument of transfer and since the business as a whole is transferred, it being movable asset, stamp duty would be levied as applicable for transfer of movable assets.

2.9.2 Foreign Exchange Management Regulations under Merger / Demerger

- **Permissible Transaction** – Regulation 9 of the NDI Rules deals with transfer / issue of shares on merger / demerger. As per the said regulations, where a scheme of compromise or arrangement or merger or amalgamation of two or more Indian companies or reconstruction by way of demerger or otherwise of an India company or transfer of an undertaking of one or more Indian company to another Indian company, or involving division of one or more Indian company, has been approved by the National Company Law Tribunal or other authority competent to do so by law, the transferee company or the new company, as the case may be, may issue equity instruments to the existing shareholders of the transferor company resident outside India, subject to the following conditions,

  (a) the transfer or issue is in compliance with entry routes, sectoral caps or investment limits, as the case may be and the attendant conditionalities of investment by a person resident outside India:

  Provided that where the percentage is likely to breach the sectoral caps or the attendant conditionalities, the transferor company or the transferee company or new company may obtain necessary approval from the Central Government.

(b) the transferor company or the transferee company or the new company is not engaged in any sector prohibited for investment by a person resident outside India.

- **Pricing** – The regulations are silent on applicability of pricing guidelines in case of issue of shares on merger / demerger. However, considering the fact that there could be resident shareholders as well, it may be inferred that pricing guidelines would not apply when shares are issued to a non-resident, pursuant to merger / demerger.

- **Reporting** – An Indian company issuing equity instruments to a person resident outside India and where such issue is reckoned as Foreign Direct Investment, defined under the rules, shall report such issue in Form FC-GPR within 30 days from the date of issue of equity instruments.

2.9.3 Companies Act Regulations under Merger / Demerger

- **Approval by the National Company Law Tribunal (NCLT)** – Section 230 of the Cos Act enables a company to compromise or make arrangements with creditors and members. It states that:

(1) Where a compromise or arrangement is proposed

(a) between a company and its creditors or any class of them; or

(b) between a company and its members or any class of them the NCLT may, on the application of the company or of any creditor or member of the company, or in the case of a company which is being wound up, of the liquidator, appointed under this Act or under the Insolvency and Bankruptcy Code, 2016, as the case may be, order a meeting of the creditors or class of creditors, or of the members or class of members, as the case may be, to be called, held and conducted in such manner as the Tribunal directs.

Further, the companies involved in merger / demerger would need to comply with directions for holding meeting shareholders / creditors as may be directed by the NCLT, issuing notices to Regional Director, Income-tax Department, Official Liquidator (in case of merger) and other applicable sectoral regulators. The NCLT then shall pass an order providing for all or anything of the following matters:

(a) where the compromise or arrangement provides for conversion of preference shares into equity shares, such preference shareholders shall be given an option to either obtain arrears of dividend in case or accept equity shares equal to the value of the dividend payable;

(b) the protection of any class of creditors;

(c) if the compromise or arrangement results in the variation of the shareholder's rights, it shall be given effect to under the provisions of section 48;

(d) if the compromise or arrangement is agreed to by the creditors under sub-section (6), any proceedings pending before the Board for Industrial and Financial Reconstruction established under section 4 of the Sick Industrial Companies (Special Provisions) Act, 1985 shall abate;

(e) such other matters including exit offer to dissenting shareholders, if any, as are in the opinion of the NCLT necessary to effectively implement the terms of the compromise or arrangement.

The companies would also need to obtain a certificate from the company's auditor stating that the accounting treatment, if any, proposed in the scheme of compromise or arrangement is in conformity with the Accounting Standards prescribed under section 133 of the Cos Act.

The order of the NCLT is to be filed with the Registrar of Companies within a period of thirty days of the receipt of the order.

➢ **Scheme of Arrangement / Amalgamation** – The scheme of arrangement /

amalgamation provides for various which *inter alia* includes:

(a) **Appointed Date and Effective Date** – the Appointed Date is the date from which the merger / demerger is effective as on the Effective Date which is generally, the date of filing of the order of the NCLT with the Registrar of Companies.

(b) **Transfer of undertaking / merger** – the Scheme provides for transfer of undertaking of the amalgamating / demerged company with the amalgamated company / resulting company.

(c) **Consideration** – the scheme shall specify the swap ratio or consideration to be discharged by the amalgamated company / resulting company basis a valuation report obtained from a Registered Valuer

(d) **Transfer of Employees** – the employees of the amalgamating company / demerged company shall be transferred at the same terms and conditions or other terms which are not adverse in comparison to the existing terms and conditions.

(e) **Transfer of contracts / continuation of litigation** – the contracts / continuing litigation of the amalgamating company / demerged company shall be transferred / continued by the amalgamated company / resulting company.

2.9.4 Securities Exchange Board of India Regulations under Merger / Demerger

➢ **Master Circular on Schemes of Arrangement by Listed entities issued by SEBI on 20th June, 2023** – Where a scheme of arrangement involves listed entities, following shall be complied with:

(i) The Listing Regulations place obligations with respect to Scheme of Arrangement on Listed Entities and Stock Exchange(s) in Regulation 11, 37, 94 and 94A.

(ii) Regulation 11 of the Listing Regulations, inter-alia, provides that any scheme of arrangement / amalgamation / merger / reconstruction / reduction of capital etc. to be presented to any Court or Tribunal does not in any way violate, override or limit the provisions of securities laws or requirements of the Stock Exchanges.

(iii) Regulation 37 of Listing Regulations provides that the listed entities desirous of undertaking scheme of arrangement or involved in a scheme of arrangement shall obtain No-objection Letter from Stock Exchanges, before filing such scheme with any Court or Tribunal. Regulations shall be applicable in case of companies that have listed their specified securities.

(iv) The Provisions of this circular shall not apply to schemes which solely provide for merger of a wholly owned subsidiary or its division with the parent company. However, such draft schemes shall be filed with the Stock Exchanges for the purpose of disclosures and the Stock Exchanges shall disseminate the scheme documents on their websites.

➢ **Submission of Documents** – The Listed entity shall submit the following documents to the Stock Exchange(s)

i. Draft Scheme of arrangement/ amalgamation/ merger/ reconstruction/ reduction of capital, etc.;

ii. Valuation Report from a Registered Valuer;

iii. Report of the Audit Committee recommending the draft scheme, taking into consideration, inter alia, valuation report and shall comment on the rationale for the scheme of merger / demerger / amalgamation / arrangement, synergies of business of the entities involved in the scheme, impact of the scheme on the shareholders, cost benefit analysis of the scheme.

iv. Fairness opinion by a SEBI Registered merchant banker on valuation of assets / shares done by the valuer for the listed entity and unlisted entity;

v. Pre and post shareholding pattern of unlisted entity;

vi. Audited financial statements of last 3 years (financials not being more than 6 months old) of unlisted entity;

vii. Auditor's certificate to the effect that the accounting treatment contained in the scheme is in compliance with all the accounting standards;

viii. Detailed compliance report duly certified by the Company Secretary, Chief Financial Officer and the Managing Director, confirming compliance with various regulatory requirements specified for schemes of arrangement and all accounting standards;

ix. Report from the committee of Independent Directors recommending the draft scheme, taking into consideration, inter alia, that the scheme is not detrimental to the shareholders of the listed entity.

x. Declaration from the listed entity on any past defaults of listed debt obligations of the entities forming part of the scheme.

xi. No Objection Certificate (NOC) from the lending scheduled commercial banks/financial institutions/debenture trustees, from not less than 75% of the secured creditors in value.

xii. Report on Complaints on the draft scheme

➢ **Approval by Stock Exchange(s)** – On receipt of the draft scheme of arrangement and documents,

- o The Stock Exchanges shall forward the scheme of arrangement and documents to SEBI within 3 working days;
- o The 'Report on Complaints' in the prescribed format shall be forwarded before SEBI communicates its comments on the Draft

Scheme to the Stock Exchanges.

- o Stock Exchanges shall provide the 'No-Objection' letter to SEBI on the draft scheme; in co-ordination with each other. SEBI shall issue Comment letter upon receipt of "No-Objection' letter from Stock Exchanges having nationwide trading terminals. In other cases, SEBI shall issue Comment letter upon receipt of "No-Objection' letter from the Designated Stock Exchange

- o The 'Unpaid Dues Report' in prescribed format shall be forwarded by the Stock Exchanges to SEBI before SEBI communicates its comments on the Draft Scheme to the Stock Exchanges.

2.10 Competition Act Regulation

2.10.1 General

Over the years, India has liberalised its economic policies and opened its doors for global companies. As a result, the Indian market should be ready to face competition within the country and outside. The Monopolies and Restrictive Trade Practices Act, 1969 has become obsolete in certain respects in the light of international economic developments relating more particularly to competition laws and there is a need to shift our focus from curbing monopolies to promoting competition.

Accordingly, the Government introduced the Competition Act, 2002 (CA Act) for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto.

➢ **Key Definitions under the CA Act**

(a) "acquisition" means, directly or indirectly, acquiring or agreeing to acquire –

(i) shares or voting rights or assets of any enterprise; or

(ii) control over management or control over assets of any enterprise.

(b) "agreement" includes any arrangement or understanding or action in concert –

(i) whether or not, such arrangement, understanding or action is formal or in writing; or

(ii) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings

2.10.2 Acquisition of Shares / Business / Merger / Demerger

➢ **Regulation on Combinations** – Section 6 of the CA Act regulates the approval for combinations. The key provisions are listed hereunder:

(1) of the CA Act states that no person or enterprise shall enter into a combination which causes or is likely to cause an appreciable adverse effect on competition within the relevant market in India and such a combination shall be void.

(2) Subject to provisions of sub-section (1), any person or enterprise, who or which proposes to enter into a combination, shall give notice to the Commission, in the prescribed form along with the fee which may be determined, by regulations, disclosing the details of the proposed combination within 30 days of

(a) Approval of the proposal relating to merger or amalgamation, by the Board of Directors of the enterprise concerned with such merger or amalgamation, as the case may be.

(b) Execution of agreement or other document for acquisition or acquiring control.

(2A) No combination shall come into effect until 210 days have passed from the day on which the notice has been given to the Commission or the Commission has passed orders.

- **Definition of Combination** – Section 5 of the CA Act defines the combination to mean – the acquisition of one or more enterprises by one or more persons or merger or amalgamation of enterprise shall be a combination of such enterprise and persons or enterprise, if

(a) any acquisition where

(i) the parties to acquisition, being the acquirer and the enterprise, whose control, shares, voting rights or assets have been acquired or are being acquired jointly have –

(A) either, in India, the assets of the value of more than INR 1,000 crore or turnover more than INR 3,000 crore

(B) in India or outside India, in aggregate, the assets of the value of more than US$ 500 million including at least INR 500 crore in India, or turnover more than US$ 1,500 million, including at least INR 1,500 crore in India; or

(ii) the group to which the enterprise whose control, shares, assets or voting rights have been acquired or are being acquired, would belong after acquisition, jointly have or would jointly have –

(A) either in India, the assets of the value of more than INR 4,000 crore or turnover of INR 12,000 crore; or

(B) in India or outside India, in aggregate, the assets of the value of more than US$ 2 billion, including at least INR 500 crore in India, or turnover of more than US$ 6 billion including at least INR 1,500 crore in India.

(b) acquiring of control by a person over an enterprise when such person has already direct or indirect control over another enterprise engaged in production, distribution or trading of a similar or identical or substitutable goods or provision of a similar or identical or substitutable service, if –

(i) the enterprise over which control has been acquired along with the enterprise over which the acquirer already has direct or indirect control, jointly have –

(A) either in India, the assets of the value of more than INR 1,000 crore or turnover more than INR 3,000 crore; or

(B) in India or outside India, in aggregate, the assets of the value of more than US$ 500 million, including at least INR 500 crore in India, or turnover more than US$ 1,500 million, including at least INR 1,500 crore in India

(ii) the group, to which enterprise whose control has been acquired, or is being acquired, would belong after the acquisition, jointly have or would jointly have –

(A) either in India, the assets of the value of more than INR 4,000 crore or turnover of more than INR 12,000 crore; or

(B) in India or outside India, in aggregate, the assets of the value of US$ 2 billion, including at least INR 500 crore in India, or turnover more than US$ 6 billion including at least INR 1,500 crore in India; or

(c) any merger or amalgamation in which –

(i) the enterprise remaining after merger or the enterprise created as a result of the amalgamation, as the case may be, have –

(A) either in India, the assets of the value more than INR

1,000 crore or turnover of more than INR 3,000 crore; or

(B) in India or outside India, in aggregate, the asset of the value of more than US$ 500 million including at least INR 500 crore in India, or turnover more than US$ 1,500 million including at least INR 1,500 crore in India; or

(ii) the group, to which the enterprise remaining after the merger or the enterprise created as a result of the amalgamation, would belong after the merger or the amalgamation, as the case may be, have or would have –

(A) either in India, the assets of the value of more than INR 4,000 crore or turnover of more than INR 12,000 crore; or

(B) in India or outside India, in aggregate, the assets of the value of US$ 2 billion, including at least INR 500 crore in India, or turnover more than US$ 6 billion including at least INR 1,500 crore in India;

➢ **Approval by the Commission** – Section 29 to section 31 deals with the provisions for the Commission lays down the procedure for investigating the combination and passing orders approving the combination or denying the combination. If the Commission does not pass an order or issue direction within the period of 210 days, the combination shall be deemed to have been approved by the Commission.

The CA Act has been amended vide Competition (Amendment) Act, 2023 which received the assent of the President in April 2023. However, the amendments would come into effect into force on such date as the Central Government may by, notification, in the official gazette specify. Further, different dates may be appointed for different provisions of the Act. The key amendments include:

o Broadening the scope of anti-competitive agreements

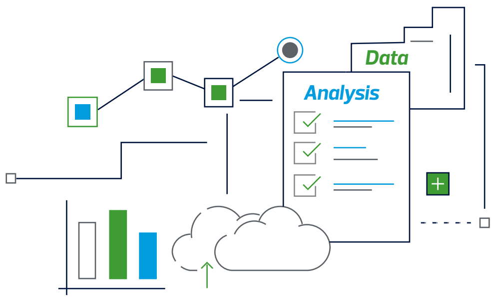
- Reduction in time limit for review of M&As from 210 days to 150 days
- Introduction of Deal Value as another criterion for notifying M&As
- Limitation period of 3 years for filing information
- Penalty indexed to Global Turnover
- Introduction of Settlement & Commitment framework for faster market correction
- Hub-and-Spoke type arrangements brought under the presumptive rule of Applicable Adverse Effect on Competition
- Leniency plus
- Framing regulations after public consultations
- Issuance of guidelines
- Appointment of Director General by the Commission, with prior approval of Central Government

While some of the amendments have come into effect, several significant provisions, including ones pertaining to deal value thresholds, allowing post facto notification in case of market purchase, penalty on global turnover, introduction of settlement and commitments are yet to be notified. The CCI is likely to issue draft regulations for public comments.

2.11 Financial, Tax and Legal Due Diligence

2.11.1 Financial Due Diligence (FDD)

➢ Transactional Due Diligence, especially Financial Due Diligence, occupies a very important place in the Deal Trajectory. A thorough and well-planned due diligence will go a long way in determining the success of the transaction. Of the many reasons



attributed to the failure of mergers and acquisitions, a larger share of the blame lies with inadequate due diligence.

- The starting point must be essentially establishing whether the proposed transaction is in complete alignment with the strategy of the acquirer or the investor. This alignment needs to be examined and assessed in the light of several factors:

  i. Realistic assessment of the financial, operational, or managerial synergies

  ii. Establishing that the bases of valuation are authentic and well captured.

  iii. Basic financial health of the company and the robustness of its earnings and cash flows as depicted in the financial reports.

  iv. The financial parameters used for arriving at the valuation are properly assessed.

  v. The various financial parameters are examined in the light of the commercial and competitive environment prevalent in the industry.

  vi. Extenuating factors that may necessitate upward or downward adjustment of the purchase consideration.

  vii. Suitability of the method of payment of purchase consideration outright cash or earnouts, contingent consideration etc.

  At the core of the exercise the above considerations should dominate.

- **Complexity in Financial Due Diligence:**

  o The complexity of the FDD exercise increases with the cross-border transactions. It includes an additional exercise of examining two different regimes related to financial, tax, accounting, and legal matters. To add to this complexity is also the differing framework for intellectual property rights, anti-trust legislation and foreign exchange management regulations.

- o Further the FDD exercise becomes more challenging where the target is a private entity as compared to a public listed entity. Private entities are subjected to far less disclosure and financial reporting requirements. Away from the intense regulatory spotlight, these companies may not always follow the industry standards for reporting or financial controls.

- o Assessment of financial synergies is different in different types of mergers be it a horizontal or vertical merger or a conglomerate merger.

The whole exercise is to be pivoted towards determining all potential risks and liabilities in the proposed transaction. This will ultimately help in assessing whether it is value accretive or value destructive. It will also help in knowing whether the value creation is happening in the manner, form and time bound framework as intended and laid out in the investor/ acquirer's strategy.

2.11.2 Tax Due Diligence (TDD)

- ➢ **Objective** – Whether a transaction involves acquisition of shares, merger, or demerger, it is essential for the parties to review and analyse the tax risks of the target entity, compliance status, open litigation, quantify tax exposure, make adjustments / seek indemnity in respect of identified tax exposure. The review would also assist in understanding the post-acquisition tax position and minimize tax exposure.

- ➢ **Process** – The TDD process involves investigation and validation of tax returns, positions taken by the target entity on certain abnormal issues vis-à-vis the industry stand, discussion with target company's tax consultant, any restructuring exercise undertaken by the target entity in the past and its tax implications on the current transaction, refunds due and outstanding demands, etc.

The TDD would generally cover:

- Corporate taxes (in certain countries, there are federal, state and canton/city level taxes)
- Withholding taxes (in India, there are widespread withholding tax obligation on payments made to non-residents, salaries and other payments)
- Goods and Service Tax (GST)/ Value Added Taxes (VAT)/ Customs duties and other indirect taxes
- Tax litigations, investigations, show cause notices and industry wide issues

The TDD report will help the acquirer understand the issues, tax exposures and if the valuation needs to be adjusted or deal needs to be restructured in any manner.

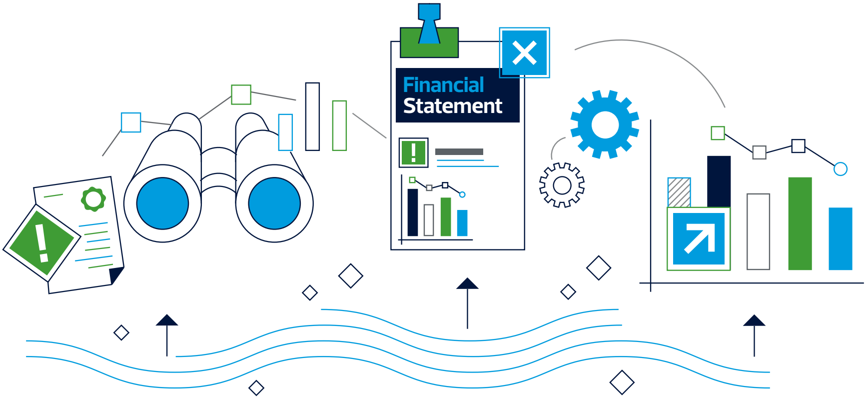
2.11.3 Legal Due Diligence (LDD)

- **Objective** – The objective of LDD would be to review and assess the validity, legal status of the seller, ownership / title documents, legal rights to dispose / hive-off shares, business, assets, etc. Additionally, the LDD would also undertake review of material agreements to examine rights / obligations and liabilities of the target entity under such contracts, any ongoing litigation by or against the target company, lien, pledge, mortgage of any property / assets against the borrowings of the target company. The LDD encompasses review of any litigation (civil or otherwise) against the Directors / Shareholders of the target company.

- **Process** – The LDD process would involve review of charter documents, ownership / title documents with regards to shares, immovable property, material contracts, litigation documents by or against the target company, quantification of exposure from any proceedings, penalties for non-compliance with Cos Act provisions or any other Law as may be applicable to the target company.

2.12 Other Relevant Considerations

- **Industry Specific License / Approvals** – The buyer may need to evaluate if there are any industry specific licenses, approvals required and may initiate necessary action to obtain such licenses / approvals.



Chapter 3: Assessing Private Equity / Venture Capital

Chapter 3: Accessing Private Equity / Venture Capital

3.1 Key Drivers for Private Equity / Venture Capital

3.1.1 Continued faith in India's growth potential

Private Equity investment in India has reached a degree of maturity over the last decade. The strategies and themes that evolved period of time have changed. Thanks to rapid digitization, the vibrant start-up space, increasing pace of urbanization, growing middle-class, young discerning population have all resulted in new and emerging private equity investment themes.

3.1.2 Private Equity Funds had held back on investments in the wake of the COVID pandemic. These funds with record undeployed capital have been busy with acquisitions in the post COVID recovery scenario.

3.1.3 India's share of Asian private equity allocation vis-à-vis its other Asian peers has been increasing. India is now viewed as a long-term structural growth story. The PE funds are betting on India evolving as a global manufacturing and exports, services hub and greater formalisation of the Indian Economy.

3.1.4 Private Equity funds have greater visibility and assurance on securing profitable exits out of their investments. A relatively stable currency with resilient public capital markets have ensured profitable exits with high returns for Private Equity Funds.

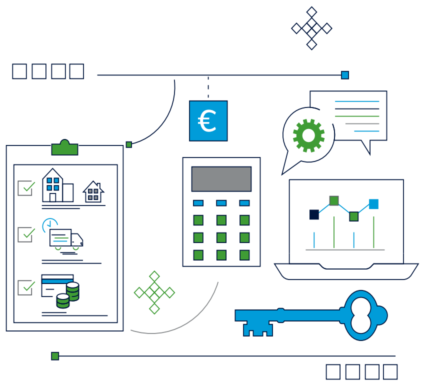
A total of ₹40,773 crore was raised by 46 mainboard public offers in 2023 up until the third week of November. Around half of it — ₹23,714 crore raised as offers-for-sale by promoters, existing investors and more. Of this, PE and VC players made as much as ₹10,007 crore across 17 IPOs via offers-for-sale, according to data by Primedatabase.

In as many as 29 large block deals since September, Softbank, Tiger Global, Bain and TPG sold stakes in new-age internet companies like PB Fintech, Delhivery, Zomato and Paytm, as per data by Kotak Institutional Equities.

The increasing participation of Private Equity and Venture Capital Funds seeking exit through public markets either through OFS route or post -listing block sale route has reassured the fund investors.

3.2 Key Considerations / Caveats

While Private Equity (PE) and Venture Capital Funds (VC) are effective source for fund raising especially in case of start-ups and companies looking for expansion, it comes with its own challenges. To highlight a few aspects which the investee company need to consider are:



3.2.1 Granting Board Seat and Restrictive Covenants – the PE / VC investor would seek a board seat in the investee company in lieu of its investments. They may also ask to introduce restrictive covenants wherein certain matters cannot be approved without the approval of the PE/VC.

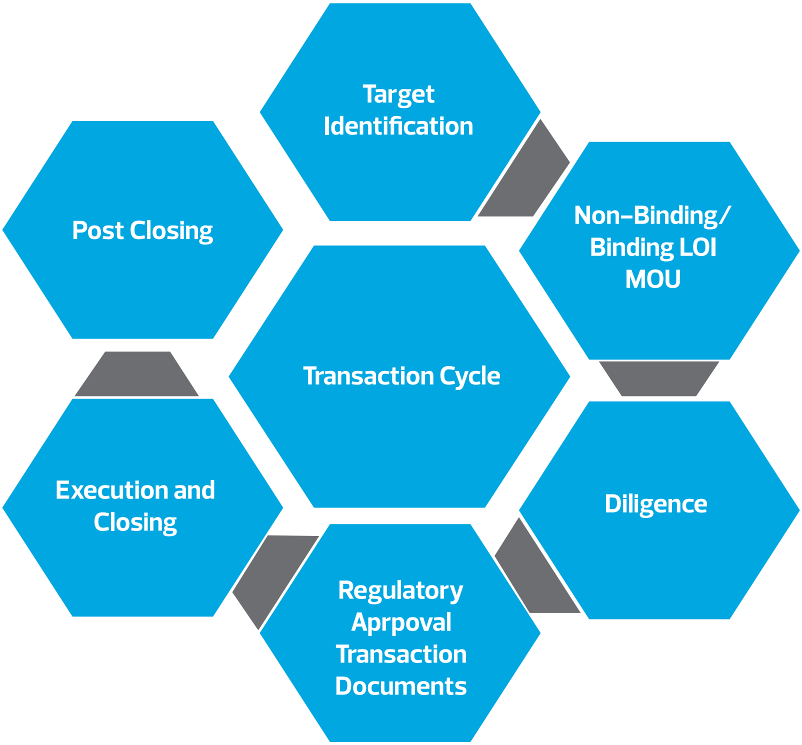
3.2.2 Shareholding and Restrictive Covenants – the PE / VC investor may seek restrictions on transfer of shares held by the promoters. These could be in the form of lock-in period, first right of refusal, call option, put option, tag along option, drag along option and anti-dilution provisions.

3.2.3 Introduction of hierarchical structure of reporting – the PE / VC may ask the investee company to bring on board key managerial personnel like a Chief Financial Officer, Chief Operating Officer, Chief Executive Officer.

3.2.4 Corporate Governance – the investee company would need to formulate a corporate governance framework and comply with the same.

3.3 Transaction Life cycle

The transaction life cycle would involve the following stages:



3.4 Issue of Shares

3.4.1 Tax Regulations

➢ Section 56(2)(viib) of the IT Act provides that where a closely held company issues shares (including preference shares) to a resident as well as non-resident investor at a value higher than the face value of such shares, then the excess of the issue price over the FMV will be taxed as income under the head Income from Other Sources in the hands of the company issuing the shares. Such excess consideration is commonly referred to as 'Angel Tax'. However, the said provision would not be applicable in certain cases where the issue of shares is received by a venture capital undertaking from a venture capital company or a venture capital fund or a specified fund. Further, CBDT vide Notification No 13/ 2019 and Circular 16/ 2019, clarified that the said provision will not apply to start-ups recognized by Department for Promotion of Industry and Internal Trade ('DPIIT'), subject to fulfillment of certain conditions.

➢ Further, the CBDT vide notification no. 29/2023 dated 24 May 2023, enlisted the categories of persons with respect to whom the provisions of section 56(2)(viib) shall not be applicable. The notified class or classes of person include:

- o Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled by the Government or where direct or indirect ownership of the Government is seventy-five percent or more;

- o Banks or Entities involved in Insurance Business where such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident;

- o Any of the following entities, which is a resident of any country or specified territory[1], and such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident:

  (a) entities registered with Securities and Exchange Board of India as Category-I Foreign Portfolio Investors;

  (b) endowment funds associated with a university, hospitals or charities;

  (c) pension funds created or established under the law of the foreign country or specified territory;

[1] Country / Specified Territory are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, United Kingdom, United States.

(d) Broad Based Pooled Investment Vehicle or fund where the number of investors in such vehicle or fund is more than fifty and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

- In view of the above, any issue of shares at a price more than the face value needs to be justified by the investee company (except in cases where the entities are exempted being start-ups or venture capital undertaking or investors are exempted basis CBDT notification). Further, the FMV can be determined using the book value or Discounted Cash Flow method and in case of non-residents, additional five methodologies have been prescribed.

  In case the investee company fails to justify the price at which shares are issued, the excess money received would be subjected to tax as Income from Other Sources in the hands of the investee company.

3.4.2 Foreign Exchange Management Regulations

- **Permissible Transaction** – Regulation 6 of the NDI Rules allows a person resident outside India to make investments in India by way of subscription, purchase and sell of equity instruments of an Indian company subject to terms and conditions specified in Schedule I.

  Further, Regulation 10 of the NDI Rules states that a Foreign Portfolio Investor (FPI) may make investments as under:

  (i) A FPI may purchase or sell equity instruments of an Indian company which is listed or to be listed on a recognized stock exchange in India, and / or may purchase or sell securities other than equity instruments, in the manner prescribed in Schedule II.

  However, the total holding of each FPI or an investor group, shall be less than 10% of the total paid-up equity capital on a fully diluted basis or less than 10% of the paid-up value of each series of debentures or preference shares or share warrants issued by an Indian company and the total holdings of all FPIs put together, including any other direct and indirect foreign investments in the Indian company by FPIs permitted under the rules shall not exceed 24% of the total paid-up equity capital on a fully diluted basis or paid-up value of each series of debentures or preference shares or share warrants.

➢ **Prohibited Sectors** – While most of the sectors have been opened for foreign investments there are handful of sectors wherein foreign investments is prohibited which inter alia include, the following:

(i) Lottery business including Government or private lottery, online lotteries, etc.
(ii) Gambling and betting including casinos, etc.
(iii) Chit funds
(iv) Nidhi company
(v) Trading in Transferrable Development Rights
(vi) Real estate business or construction of farmhouses

Explanation – For the purpose of this rule, real estate business means dealing in land and immovable property with a view to earning profit from there and does not include development of townships, construction of residential or commercial premises, road or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships, real estate broking services and Real Estate Investment Trusts (REITs) registered and regulated under the SEBI (REITs) Regulations, 2014, and earning of rent income on lease of the property not amounting to transfer.

vii) Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.

(viii) Activities or sectors not open to private sector investments e.g., (I) Atomic energy and (II) Railway operations (other than permitted activities)

(ix) Foreign technology collaborations in any form including licensing for franchise, trademark, brand name, management contract is also prohibited for lottery business and gambling and betting activities.

Further, certain sectors have caps for foreign investment permitting foreign investment up to 51% or 74%.

- **Pricing** – In case of issue of shares of an Indian company to a person resident outside India, the price of the equity instruments of the Indian company shall not be less than:

  (i) the price worked out in accordance with the Securities and Exchange Board of India guidelines in case of a listed Indian company or in case of a company going through delisting process as per the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009;

  (ii) the valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with the Securities and Exchange Board of India or a practicing Cost Accountant, in case of an unlisted Indian company.

  In case of convertible equity instruments, the price or conversion formula of the instrument should be determined upfront at the time of issue of the instrument. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with these rules.

- **Reporting** – An Indian company issuing equity instruments to a person resident outside India and where such issue is reckoned as Foreign Direct Investment, defined under the rules, shall report such issue in Form FC-GPR within 30 days from the date of issue of equity instruments.

3.4.3 Companies Act Regulations

The Cos Act states that the share capital of a company limited by shares shall be of two kinds:

(a) equity share capital –

(i) with voting rights; or

(ii) with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed and

(b) preference share capital.

➢ **Modes of Issue** – Section 23 of the Cos Act provides for mode of issue of securities by public company and private company. As per the said section,

o A public company may issue securities to public through prospectus or through private placement or through rights issue or bonus issue.

o A private company may issue securities by way of rights issue or bonus issue or through private placement.

The public company / private company would need to comply with the provisions of the Cos Act while issuing shares under any route.

3.5 Transfer of Shares

➢ The tax and other regulatory implications on the transfer of shares have been discussed in detail in section 2.4 of this publication. In summary, the gains arising on transfer of shares would be liable to tax as capital gains. The gains will be long-term capital gains if the shares are held for more than 12 months (in case of listed securities) and more than 24 months (in case of unlisted shares). The table summarizing the tax rates is reproduced below.

Particulars	Section and Tax Rates[1]		
	Section 111A (Short Term Capital Gain)	Section 112	Section 112A
Listed Securities (STT paid on purchase and sale)	15%	-	10% on gains exceeding INR 1.00 lakh

[1] The tax rates will be increased by applicable surcharge (not exceeding 15%) and Higher Education Cess of 4%.

Particulars	Section and Tax Rates[1]		
	Section 111A (Short Term Capital Gain)	Section 112	Section 112A
Listed Securities (STT not paid) (resident)	Applicable tax Rate	20% with indexation and 10% without indexation	-
Listed Securities (STT not paid) (non-resident)	Applicable tax Rate	20%	-
Unlisted Shares (resident)	Applicable tax Rate	20% with indexation	-
Unlisted Shares (non-resident)	Applicable tax Rate	10%	-

3.6 Financial, Tax and Legal Due Diligence

Due diligence is of paramount importance that is undertaken prior to consummating a deal, including but not limited to investments by PE / VC.

Due diligence is an extensive process that covers many facets of a business, viz., financial position, business viability, compliance with statutes and regulatory compliances, key personnel, key customers, vendors, etc.

It is essential for any investor to evaluate the investee entity on various parameters to ensure that investors are investing in the right business, people, product, etc.

Basis the due diligence, the PE / VC may strategize and incorporate its terms and conditions in the definitive documents for its proposed investments in the investee company.

Further, we have already discussed some key aspects involved in Financial, Tax and Legal Due Diligence in section 2.11 above. However, depending on the scale and size of the business, investment amount, the PE / VC may carry out a high-level due diligence and safeguard its interest through a Shareholder's Agreement between the PE / VC, Investee Company and the Promoters.

Abbreviations

- CA – Competition Act, 2002
- CAGR – Compound Annual Growth Rate
- CBDT –Central Board of Direct Taxes
- CCI – Competition Commission of India
- Cos Act - Companies Act, 2013
- CY – Current Year
- DTAA – Double Taxation Avoidance Agreement
- FDD – Financial Due Diligence
- FDI – Foreign Direct Investment
- FDI Regulations – Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000
- FII – Foreign Institutional Investors
- FMV – Fair Market Value
- FPI – Foreign Portfolio Investors
- FY - Financial Year
- GDP – Gross Domestic Product
- GST – Goods and Services Tax
- IPR – Intellectual Property Right
- IT Act – Income-tax Act 1961
- IMAA – Institute for Mergers, Acquisitions and Alliances
- LDD – Legal Due Diligence
- M&A – Mergers & Acquisitions
- NCLT – National Company Law Tribunal
- NDI – Non-debt Instruments
- NDI Rules - Foreign Exchange Management (Non-Debt Instruments) Rules, 2019
- PE – Private Equity
- SAST Regulations - SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011
- STT – Securities Transaction Tax
- TCS – Tax Collected at Source
- TDD – Tax Due Diligence
- u/s – under section
- VC – Venture Capital Funds

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