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Structuring M&A transactions – Share versus Asset purchase

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☞ INTRODUCTION

Inorganic growth of business has spurred Indian and foreign companies on a buying spree. The factors that have propelled Mergers and Acquisitions ("**M&A"**) activity in India range from (a) liberalization of the Indian economy, including opening of various sectors for foreign investment, less regulation on repatriation of funds from India and abroad, increased technological collaborations, easing of trade barriers between countries, (b) securing better market share and product portfolio via M&A of existing entities, (c) acquisition of intellectual property rights, (d) consolidation of business models resulting in higher efficiency, economies of scales, and resultant improvements in profit margins, (e) creating a resource pool of financial, technical, and personnel, leading to increased competitiveness and cost-reduction, and (d) creating a tax advantage[1].

A business can be acquired either by buying shares of a target company that owns the business, or by purchasing the assets and goodwill which constitute the business. It is important to structure an M&A deal appropriately keeping in mind the ultimate objective of the acquirer and consequential tax implications. This newsletter evaluates two options of an asset deal versus a share purchase, including pros and cons and tax implications. We have not discussed the M&A transactions effected through court procedure and the resultant benefits in this newsletter in detail. However, some important aspects are highlighted.

1. Share Purchase

Acquisition of management and control of the company by means of purchase of shares is a clean option. Share acquisition not only gives the acquirer control over assets but also management control of the target company.

On the flip side, acquisition of shares brings with it inherent liabilities of the company, including those about which the acquirer may have no knowledge. Though, a due diligence highlights the financial and legal facts about the target company and proper indemnities can be taken contractually but, any undisclosed past liability may be a burden on the new management and the efficacy of the indemnities can be questionable when its time to implement.

1.1 Approvals

In case of investment by foreign companies an approval from the Foreign Investment Promotion Board ("**FIPB**") has to be obtained if acquisition of shares does not fall under automatic route of investment[2]. Approval from Securities Exchange Board of India ("**SEBI**") has to be sought in case of acquisition of more than 15%[3] shares of a listed Indian company. Approvals may also be required from other statutory authorities like financial institutions (if the target company had taken loans

[1] This can be accomplished where one merging entity has accumulated losses and any unabsorbed depreciation which can be set off against the accumulated revenues of the profit making entity, thereby, reducing its tax burden.

[2] Approval from FIPB has to be obtained by the foreigners before making investments if: (a) there is a sectoral cap on investment and such cap is exceeded, (b) investment in the 'same' field of activity where foreigner has an existing venture or technical collaboration agreement, (c) investment of more than 24% in the company engaged in the manufacturing activity reserved for small-scale sector.

[3] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

and condition of allotment stipulates such approval), or land authorities (if the target company has taken the premises on lease) where the acquisition leads to change in the shareholding pattern.

1.2 Shares in lieu of

Under Indian law shares can be issued for consideration other than cash in case of:

- Transfer of technology - As per the Foreign Direct Investment ("**FDI**") policy of government of India payments can be made to a foreigner for technical collaboration, including technical know-how fees, design and drawing, engineering services, lumpsum and royalty fees[4]. An Indian company may issue shares to the foreign technology collaborator towards consideration of lumpsum or royalty as and when it becomes due and payable[5].

- External Commercial Borrowings ("**ECB**") - Any amount due towards repayment of an ECB availed towards import of technical know-how can be converted into equity subject to fulfilling the requirements stipulated by Reserve Bank of India ("**RBI**") and filing requisite forms. However, import dues by Indian companies, which are deemed as trade (buyers/suppliers) credit or ECBs in terms of RBI guidelines, cannot be converted into equity[6].

- Consideration for assets, contract of service or sale - Any consideration payable by the company on account of purchase of assets, contract of sale or service can also be converted to shares[7].

1.3 Duties and Taxes

Acquisition of shares from an existing shareholder involves payment of share transfer duty of INR 0.25 per INR 100 value of the shares transferred. Share transfer duty is generally borne by the transferee. No duty is payable on shares directly issued by a company as the stamp duty has to be borne by the company and it varies from one Indian state to another.

1.3.1 Dividend tax

From the tax perspective, the advantage to the acquirer in taking up shares of the company lies in the fact that any dividend declared by the Indian company out of the profits earned by it are tax free in the hands of the shareholders[8]. No withholding tax is payable on the repatriation of such dividend to a foreign shareholder.

1.3.2 Capital gains

From a seller's perspective, sale of shares attracts capital gains. Capital gains on the sale of shares in India are either short or long-term. As per the applicable provisions of Income Tax Act, 1961 ('**IT Act**'), shares of an Indian company transferred within 12 months of their purchase attract short-term capital gains[9]. The applicable tax rates on short-term and long-term capital gains vary in case of listed and unlisted companies and whether an Indian or a foreign company holds those shares.

For transfer of shares of an unlisted company, the earnings upon transfer within 12 months of purchase shall be treated as business income and short-term capital gains tax shall be 42.23%[10] on a foreign company, and 33.99%[11] on domestic companies[12]. In contrast, long-term capital gains tax[13] shall be 21.115%[14]on foreign companies and 22.66%[15] on domestic companies[16].

Where a foreign company holds shares of an Indian company, on amalgamation or de-merger of the foreign company with another foreign company,

[4] Payment for foreign technology collaboration by Indian companies are allowed under the automatic route (without prior government approval) subject to the following limits: (i) the lump sum payments must not exceed US$2 million; and (ii) royalty payable is limited to 5 per cent for domestic sales and 8 per cent for exports, without any restriction on the duration of the royalty payments.

[5] AP (DIR Series) Circular No. 34 dated 14.11.2003.

[6] Press Note 3 (2003 Series) dated July, 2003 read with AP (DIR Series) Circular No. 34 dated 14.11.2003.

[7] Section 75(1)(b) of the Companies Act, 1956.

[8] Section 115-O of the Income Tax Act, 1961.

[9] Section 2 (42A) of the IT Act.

[10] 40% plus 2.5% surcharge and education cess of 3%.

[11] 30% plus 10% surcharge (if the taxable income is more that INR 10,000,000) and education cess of 3%.

[12] Finance (No. 2) Act, 2004.

[13] Section 45 of the IT Act.

[14] 20% tax plus 2.5% surcharge and education cess of 3%.

[15] 20% tax plus 10% surcharge (if the taxable income is more that INR 10,000,000) and education cess of 3%.

[16] Section 48 of the IT Act.

the transfer of shares of an Indian company would enjoy exemption from capital gains tax, subject to the condition that (i) at least 25% shareholders of the amalgamating foreign company[17] and 75% of the shareholders of the de-merged foreign company[18] continue to remain shareholders of the amalgamated/resulting foreign company, and (ii) provided such transfer does not attract tax on capital gains in the country of incorporation of the amalgamated/resultant company.

Upon sale of shares of listed companies made on a stock exchange and chargeable to securities transaction tax either by foreign or domestic company, short-term capital gains shall be taxed @ 11.33%[19] whereas long-term tax is *'nil'*. Foreign companies investing from tax havens like Mauritius are exempted from paying any capital gains tax on the sale of shares of an Indian company[20].

1.3.3 Treatment of losses

One disadvantage of share purchase deal could be that the Indian company (in which the public is not substantially interested) whose shares are being acquired may not be able to carry forward its accumulated losses to any subsequent year from the year in which the acquisition takes place. However, the Act provides that such restriction shall not be imposed on companies where (i) the shareholding has changed pursuant to death of the shareholders or gift of the shareholding to a relative; (ii) 51% of the voting rights are continued to be held by the existing shareholders; and (iii) transfer of shares of the Indian company which is a subsidiary of a foreign company, occurs upon amalgamation or de-merger of such foreign company[21]. However, any unabsorbed depreciation may continue to be set off.

1.4 Why purchase shares?

The distinct advantage of the share purchase deal is that there would not be any change in the value of the assets pursuant to the share purchase structure. Valuation of shares may be done through various prescribed valuation criteria and the value is generally based on the business as a whole and the costs of the assets may not be revalued in a share purchase from the buyer's angle.

The direct expenses incurred on buy-out of the shares may be treated as capital expenditure and can be added to the cost of the shares which, effectively, means that such expenses are, therefore, eligible for tax deduction in determining capital gains on sale[22].

2. Asset purchase

Another option with the acquirer to gain control over the company is vide asset purchase. If assets are purchased, the acquirer may decide on the specific assets and liabilities that he wishes to acquire and may eliminate the non-performing assets.

An asset purchase requires more complex documentation, and agreements need to be drafted craftily. Further, it may involve many more consents and approvals including from customers and suppliers. The tax issues arising on the sale of shares are also different than the ones relating to disposal of assets, and though they are more of an issue for the seller, they need to be factored in.

In an asset deal, the acquirer can elect to buy the assets for a slump price that is, on a lump-sum basis and, based on a valuation report, allocate the purchase price properly to the respective assets to ensure the maximum benefit on account of depreciation and amortization. In India, the buyer is liable for stamp duty on transfer of immovable property at a rate which varies from state to state.

2.1 Consents and permissions

Acquisition of assets normally requires consent of third parties, such as, banks/financial institutions that have lent money to the target company. Frequently, loan documents restrict disposals of assets or a change in control of the company owning the assets without prior permission of the lenders. Consents may also be needed from the concerned ministries and departments depending on

[17] Section 47(via) of the IT Act.
[18] Section 47 (vic) of the IT Act.
[19] 10% plus 10% surcharge and 3% education cess.
[20] Circular No. 682, dated 30-3-1994.
[21] Section 79 of the IT Act.

[22] Section 48 of the IT Act.

the sectors in which the target company operates[23]. Further, approvals and permissions have to be taken from labour authorities for transfer employees and their benefits such as gratuity, provident fund, employee state insurance to name a few.

2.2 Variation in valuation

One important consideration to be kept in mind in asset purchase deals is regarding change in valuation of assets from the date of start of negotiations till actual acquisition, on account of depreciation, disposals, or additions. Hence, an asset-purchase agreement has to adequately provide for any variable price. Any increase or decrease of valuation of net assets transferred on closing versus the pre-determined price has to be adequately provided for. Alternatively, the consideration payable may be the "enterprise value of the business operation" acquired as a whole and not just the net asset value, which is somewhat of a fixed valuation. The business valuation will differ if the deal is for the transfer of business as opposed to mere assets. In case of transfer of business where the client portfolio is also transferred the valuation has to consider the business profits that such assets would generate in future and the transaction is valued accordingly. In case the purchase price considers the enterprise or business value the estimated price shall be inclusive of sustainable future annual earnings plus any cash in the business, less any debt or liability if it is a debt-free transaction or else the value of the debts can be discounted from the sale price[24].

2.2.1 Working capital in the business

Another essential factor is working capital requirement of the acquired business. It is imperative that upon acquisition, the business must have enough reserves to fund its day-to-day operations. The consideration payable by an acquirer has to be structured to cover any variation from the normal level of working capital. If working capital upon completion of the transaction is lower than the normal level, that is, the level required for undertaking and sustaining the daily operations of the business, there may be a reduction in the price payable. To enable the price to be adjusted, it is common for the asset purchase agreement to provide for accounts to be drawn on any pre-determined cut-off date mutually agreed by the parties prior to closing in order to determining the final value of the assets to be paid by the acquirer.

Once the valuation is frozen and if there is a time gap from the date of execution of the agreements and actual transfer of the assets in the books of the acquirer or the transfer of assets is to take place in phases over a period of time the target company should be prevented from extracting value from the business by declaring dividends or making any other payments to directors or relatives, other than payments agreed mutually by the parties and required for the operation of the business in the ordinary course, till the actual closing of the transaction or the transfer of assets in the books of the acquirer.

2.3 Goodwill and Intellectual Property Rights (IPR)

Goodwill of business and IPR portfolios (trademark, brand name, copyright, patents, industrial designs) of a target company are major considerations that drive M&A especially in knowledge-based sectors such as biotech, software technology and media industry. Being intangible in nature their valuation varies substantially from the stand point of the seller and acquirer.

In case an acquirer plans to take these assets it is important to conduct an IPR audit of the target company to (i) ensure true ownership of IPR (ii) determine that there is no infringement of the IPRs of third party, (iii) examine licensing, sub-licensing, cross-licensing or any other issues that could affect the IPRs, (iv) evaluate the possibility of licensing of IPRs to third parties, determine scope of the licence, rights granted thereto, conditions and consequences of termination and royalties payable, and (v) analyze any restrictive conditions on use or further licensing of the IPRs obtained from third parties. Outcome of

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[23] For example, an acquirer of an aviation company would have to obtain clearance from the Ministry of Civil Aviations and Directorate General of Civil Aviation for transfer and operation of acquired assets.

[24] Earning based valuation is one of the techniques of valuation adopted by accountants to arrive at the value of a deal. The method takes into account the future earnings of the business i.e. the projected revenues and cost of running the business in future.

the audit goes a long way in determining the value of the IPRs.

2.4 Employee issues

Human resource is essential for any business. The assets acquired need adequate amount of people to operate them and unit has to be functional on a stand-alone basis. Generally, the acquirer takes over substantial number of employees employed in the business on the same terms and conditions which they enjoyed before. An acquirer needs to ensure that there is no disruption of the operations upon completion of the acquisition. Transfer of employees in India can prove to be an uphill climb as the laws are stringent, numerous and pro-employee.

2.5 Duties and taxes

Transfer of assets attracts payment of stamp duty both on movable and immovable property and VAT on sale of assets and inventory. In India these duties are state specific and levied on the basis of location of the assets. Excise duty is also levied on the value of finished goods being transferred.

However, where the consideration declared to be received or accruing as a result of the transfer of land or building, or both, is less than the value of the assets adopted by the appropriate authority of the State Government, the stamp duty on such assets shall be payable on the basis of the value as ascertained by the authorities[25].

2.5.1 Computation of tax

The tax payable on the sale of assets is assessed on the basis of the nature of the sale made which may be categorized as slump sale or treated as business income.

Slump sale[26] stems from the word "lump sum" and attracts certain capital gains tax. Simply put, it is the transfer of one or more undertakings by way of sale for a lump sum consideration without assigning any values to the individual assets and liabilities of the undertaking. Here the undertaking itself is treated as a capital asset. In other words, profits or gains arising from the slump sale are chargeable to income tax as capital gains, short-term or long-term, in the year of such sale in the hands of the seller/transferring company. If the business has been carried on for more than 36 months by the target company the proceeds are taxable as long-term capital gains, otherwise as short-term capital gains. The net worth of the business transferred is treated as the cost of acquisition and also cost of improvement, if any, and the aggregate of the two shall be the cost to the acquirer. In order to calculate the capital gains the 'net worth' of the assets of the undertaking is deducted from its sale price. Costs of individual assets have to be ignored in case of slump sale, as it is the holding of the business which is important for calculating tax and not the price of individual assets.

However, if the sale is structured in such a manner that values are assigned to individual assets and liabilities, it will not be treated as a slump sale and capital gains will be computed on each capital asset separately. Further, the profit on sale of assets in hand will be taxable as business income[27] in the hands of the target company/seller.

2.5.1.1 Treatment of losses

In case of a sale of assets the target company/transferor may continue to avail the benefits of carry forward and set of unabsorbed business losses and depreciation but, the acquirer/transferee company may not be able to avail such benefits.

2.5.1.2 Amortization of expenses in asset deals and amalgamations

The goodwill arising out of an asset deal cannot be amortized by the buyer to claim tax benefits. However, the benefit of the cost of acquisition is available on subsequent disposal. On the other hand, goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortized to income on a systematic basis over its useful life[28]. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore,

[25] Section 50C of the IT Act.
[26] Section 50B of the IT Act.
[27] For applicable rate of taxation, refer to Section 2.3.2.
[28] Section 55 of the IT Act.

made on a prudent basis. Accordingly, it is considered appropriate to amortize goodwill over a period not exceeding five years unless a somewhat longer period can be justified[29].

The expenses incurred by the acquirer wholly and exclusively for the purposes of amalgamation or de-merger may be amortized over a period of five years[30]. In the absence of any other similar provisions for acquisition of assets by way of slump sale or otherwise, the expenditure incurred may not be deductible and will be treated as capital expenditure.

It is pertinent to mention here that despite change in ownership of assets any past tax liability of the acquired entity may be asserted on the acquirer. It is not unusual for tax authorities to re-assess income tax returns upto six preceding years. Therefore, adequate provisions should be made in the asset purchase agreement for any inherent tax liability at the time of transfer of assets.

☞ CONCLUSION

M&A creates choices not only for buyers but for sellers as well. Structuring of M&A deals assume primary importance, which largely depend on what an acquirer in trying to achieve. Further, the respective considerations of the buyer and seller will depend on the facts of each case. Purely from a buyer's perspective it is essential to decide an appropriate structure after considering tax efficiencies; the question to be asked is whether enhancing assets via an asset acquisition will be worth it? It is important to measure the costs of the asset acquisition versus the high stamp duty, loss of unabsorbed losses and depreciation and VAT considerations. The eventual objective in most cases is improving shareholder value and optimizing return on investments. Based on the foregoing analysis we are of the view that a share purchase is a better option from a tax angle.

(Adity Gupta)

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[29] Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include: (a) the foreseeable life of the business or industry; (b) the effects of product obsolescence, (c) service life expectancies of key individuals or groups of employees; (d) expected actions by competitors or potential competitors; and (e) legal, regulatory or contractual provisions affecting the useful life.

[30] 35DD of the IT Act.

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