Cross Border Mergers – A Summary of Recent Developments

Over the past one year, a number of significant developments have taken place in terms of the regulatory regime governing cross border mergers. Marking a major amendment from the erstwhile Companies Act 1956, which contemplated only inbound mergers, the provisions under the Companies Act 2013 **(Companies Act)** *prescribes regulations for both inbound and outbound mergers.*

*The Ministry of Corporate Affairs, Government of India (***MCA***) notified Section 234 of the Companies Act with effect from April 13, 2017 which permitted cross border mergers. Further, in consultation with the Reserve Bank of India ('RBI'), the MCA also notified corresponding amendments to the Companies (Compromises, Arrangements and Amalgamations) Rules 2016* ***(Companies Merger Rules)*** *vide Rule 25A with effect from April 13, 2017.*

The regulations under the Companies Act governing cross border provide that RBI approval is mandatory for such mergers. Accordingly, with a view to establishing a regulatory framework for regulating cross-border mergers, on 26 April 2017, RBI released the draft of Foreign Exchange Management (Cross Border Merger) Regulations, 2017 ***(Draft FEMA Merger Regulations)*** *on which RBI sought public comments till May 9, 2017. Subsequently, RBI issued the Foreign Exchange Management (Cross Border Merger) Regulations, 2018* ***(FEMA Merger Regulations)*** *on March 20, 2018. Read on to know more...*

Tax and Regulatory Framework

The salient features of the regulatory and tax regime governing cross border mergers is briefly discussed below:

A. Companies Act, 2013

Section 234 of the Companies Act and Rule 25A of the Companies Merger Rules read with Section 230 to 232 of the Companies Act (together referred to as *Company Law Regulations*) lay down the comprehensive framework governing cross border mergers.

The Company Law Regulations provide that the provisions of Section 230 to 232 of the Companies Act relating to mergers/amalgamations in the domestic context shall apply *mutatis mutandis* to both inbound and outbound mergers. This shall include various requirements *inter alia* filing an application before the jurisdictional National Company Law Tribunal (NCLT) for obtaining its approval, conducting meeting of shareholders/creditors, notification to income tax authorities, other sectoral regulators, publication of advertisement with respect to merger, etc.

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The Company Law Regulations also envisage that a scheme of merger may *inter alia* provide for the payment of consideration to the shareholders of the merging company in cash, or in Depository Receipts, or partly in cash and partly in Depository Receipts, as the case may be.

Further, both inbound and outbound mergers are subject to prior RBI approval.

Rule 25A provides a list of specified jurisdictions[1] for outbound mergers. In other words, in case of an outbound merger, the foreign transferee entity shall be required to be incorporated in the permitted jurisdiction. However, no such jurisdictions are prescribed in the case of inbound mergers. Accordingly, a foreign company situated in any jurisdiction can merge into an Indian company.

Also, the transferee company is required to ensure that the valuation is conducted by valuers who are members of a recognised professional body in the transferee company's jurisdiction and such valuation is in accordance with internationally accepted principles of accounting and valuation. In this regard, a declaration is required to be submitted along with the application to Reserve Bank of India (RBI) for obtaining its approval for the merger.

B. Foreign Exchange Management Act, 1999

In terms of FEMA Merger Regulations, a 'Cross-border merger' is defined to mean *'any merger, amalgamation or arrangement between Indian company(ies) and foreign company(ies) in accordance with Companies (Compromises, Arrangements and Amalgamation) Rules, 2016 notified under the Companies Act, 2013.'*

The FEMA Merger Regulations provide that any transaction undertaken in relation to a cross-border merger (both inbound and outbound mergers) shall be deemed to have prior approval of the RBI as required under the abovementioned Rule 25A. Thus, if all the conditions set out in the FEMA Merger Regulations are complied with, no separate application is required to be made to the RBI for its approval. Inclusion of such deeming approval provision under the FEMA Merger Regulations has relaxed the mandatory requirement, as set out under the Companies Act, to seek prior approval of the RBI for cross border mergers.

Further, the FEMA Merger Regulations require that the valuation of the Indian company and the foreign company for the purpose of cross-border merger shall be done in accordance with abovementioned Rule 25A of the Companies Merger Rules.

It is also required that a certificate from the Managing Director/Whole Time Director/Company Secretary of the company(ies) concerned ensuring compliance with the FEMA Regulations be filed along with the application made to the NCLT in relation to such merger.

The FEMA Merger Regulations also make it mandatory for the Indian company and the Foreign Company involved in the cross-border merger to furnish reports as may be prescribed by RBI in consultation with the Government of India.

i) Inbound Mergers

Inbound mergers refer to a situation where a Foreign Company merges into an Indian Company and accordingly, all properties, assets and liabilities of the Foreign Company are transferred to the Indian company.

The key provisions relating to Inbound Mergers as provided in the FEMA Merger Regulations are as follows:

- *Issue or transfer of security by the resultant Indian company to non-resident*
  Any issue or transfer of security by the resultant Indian company to a person resident outside India should comply with the pricing guidelines, entry routes, sectoral caps, attendant conditions and reporting requirements for foreign investment laid down in the FEMA Inbound Investment Regulations i.e. Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017.

- *Merger of Joint Venture/Wholly owned Subsidiary with its Indian Parent company*
  Where the foreign company is a Joint Venture (JV)/Wholly owned Subsidiary (WOS) of an Indian company, the Indian company shall have to comply with the conditions prescribed for transfer of shares of such JV/WOS as laid down

[1] The specified jurisdictions under Rule 25A are as follows:
- Jurisdictions whose securities market regulator is a signatory to International Organisation of Securities Commission's Multilateral Memorandum of Understanding or a signatory to the Bilateral Memorandum of understanding with SEBI or;
- Jurisdiction whose central bank is a member of Bank for International Settlement; and
- Jurisdiction not identified in public statement of Financial Action Task Force as (i) having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies or (ii) jurisdiction that has not made sufficient progress in addressing deficiencies or has not committed to action plan developed with Financial Action Task Force to address the deficiencies.

in the FEMA Outbound Investment Regulations i.e. Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004. Where the inbound merger of such JV/WOS results in the Indian company acquiring shares of the foreign step down subsidiaries of the JV/WOS, the Indian company shall be required to comply with Regulation 6 and 7 of the FEMA Outbound Investment Regulations *inter alia* including adherence with the prescribed limit for financial commitment, sectoral restrictions, method of funding, etc.

- *Overseas offices of Foreign Company to become branch/office of the Indian Company*
  Any offices outside India of the foreign company pursuant to the sanction of scheme of cross border merger shall be deemed to be the branch/office outside India of the resultant Indian company in accordance with Foreign Exchange Management (Foreign Currency Account by a Person Resident in India) Regulations, 2015.

- *Guarantees or outstanding borrowings from overseas sources obtained by the merging Foreign Company*
  Any outstanding borrowings or guarantees from overseas sources obtained by the merging foreign company, which becomes borrowing of the resultant Indian company, or any borrowing from overseas sources entering into the books of the resultant Indian company pursuant to the inbound merger, should comply with external commercial borrowing norms or trade credit norms or other foreign borrowing norms, as laid down under Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations 2000, Foreign Exchange Management (Borrowing or Lending in Rupees) Regulations, 2000 or Foreign Exchange Management (Guarantee) Regulations 2000.
  Further, the FEMA Merger Regulations provide a period of two years from the date of sanction of scheme by the NCLT to bring overseas borrowings/guarantees which are assumed by the resultant Indian company, in conformity with the respective Regulations under FEMA.
  It has also been specified that end use restrictions shall not apply to such overseas borrowings. However, no remittance for repayment of such assumed liability can be made during the two year period.

- *Assets/Liabilities outside India of foreign company*
  The resultant Indian company may acquire and hold any asset outside India which an Indian company is permitted under the relevant provisions of FEMA. Such assets can be transferred by the resultant Indian company for undertaking a transaction permitted under FEMA.
  In case the resultant Indian company is not permitted to acquire or hold any asset/security under the provisions of FEMA, then such Indian company shall sell such asset/security within a period of two years from the date of sanction of the merger scheme by NCLT and the sale proceeds would be required to be repatriated to India immediately through banking channels.
  Where any liability outside India is not permitted to be held by the resultant Indian Company, such liability would need to be extinguished from the sale proceeds of such overseas assets within the prescribed period of two years.

- *Opening of foreign currency bank account by Indian Company in overseas jurisdiction*
  The resultant Indian company is permitted to open a foreign currency bank account in the overseas jurisdiction for a maximum period of two years from the date of sanction of the cross border merger by the NCLT for undertaking the transactions incidental to cross border merger.

ii) Outbound Merger

Outbound mergers refer to a situation where an Indian company merges into a foreign company, pursuant to which all properties, assets and liabilities of the Indian company are transferred to the Foreign Company.

The key provisions relating to outbound mergers as provided in the FEMA Merger Regulations are as follows:

- *Acquisition of securities of Foreign Company by residents*
  A person resident in India may acquire or hold securities of the resultant foreign company, in accordance with the FEMA Outbound Investment Regulations. If a resident individual acquires securities of a foreign company, the fair market value of such securities should be within the limit prescribed under the Liberalised

Remittance Scheme i.e. USD 250,000 per financial year.

- *Indian offices of Indian company to become branch/office of the Foreign Company*
  An office in India of the merging Indian company, pursuant to the scheme of merger, shall be deemed to be the branch office in India of the resultant foreign company and shall be required to comply with the provisions of the Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016 (including permissible activities applicable to a branch office).

- *Guarantees or outstanding borrowings of the Indian Company to be assumed by Foreign Company*
  Any guarantees and outstanding borrowings of the Indian company, which become the liability of the resultant foreign company pursuant to the outbound merger, shall be repaid in terms of the scheme of merger sanctioned by the NCLT.
  Any assumption of liability in Rupees by a foreign company towards an Indian lender must comply with the provisions of FEMA and a no-objection certificate would be required from the Indian lender.

- *Assets in India of merging Indian Company*
  The resultant foreign company may acquire and hold assets in India which a foreign company is permitted to acquire under the relevant provisions of FEMA. Such assets can be transferred by the foreign company for undertaking a transaction permissible under FEMA.
  In case the resultant foreign company is not permitted to acquire or hold the asset/security in India, the resultant foreign company shall sell such asset/security within a period of two years from the date of sanction of the merger scheme by NCLT and the sale proceeds would need to be repatriated outside India immediately through banking channels.
  Repayments of Indian liabilities from the sale proceeds of such assets/ securities shall be permissible within the said period of two years.

- *Opening of bank account by Foreign Company in India*
  The resultant foreign company is permitted to open a Special Non-Resident Rupee Account (SNRR Account) in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016 for undertaking the transactions contemplated under the FEMA Merger Regulations. The bank account shall run for a maximum period of two years from the date of sanction of the merger scheme by NCLT.

C. Income Tax Act, 1961

(i) Inbound Merger

The key provisions relating to inbound mergers as provided under the Income-tax Act, 1961 are as follows:

- *Capital Gains exemption in the hands of the merging foreign company and the shareholders of such company*
  Section 47(vi) of the Income-tax Act, 1961 (IT Act) provides that any transfer in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company, if the amalgamated company is an Indian company shall not be regarded within the meaning of the term 'transfer'.
  Further, under Section 47(vii) of the IT Act, any transfer by a shareholder in a scheme of amalgamation, of a capital asset, being shares held in the amalgamating company shall not be regarded within the meaning of the term 'transfer' if the transfer is made in consideration of the allotments to him of any shares in the amalgamated company and the amalgamated company is an Indian company.
  Based on the above, no capital gains tax shall arise on account of inbound mergers both in the hands of the foreign transferor company and in the hands of the shareholders of such company provided that the abovementioned conditions are satisfied.

(ii) Outbound Merger

- *No Capital Gains exemption in the hands of the merging Indian company and the shareholders of such company*
  On the flipside, no such parallel tax neutral provisions are contemplated in the case of outbound mergers under the IT Act.
  Consequently, the capital gains arising from such outbound mergers may result in tax liabilities both in the hands of the transferor company at the corporate level and in the hands of shareholders.

Key Considerations

Based on the above mentioned regulations, the key considerations relating to cross border mergers are discussed below:

A. Foreign Exchange Management Act/ Companies Act

- *Whether Demergers are covered*
  Under the FEMA Merger Regulations, a 'cross-border merger' is defined to include an arrangement in addition to a merger and amalgamation as contemplated under the relevant provisions of the Companies Act. However, Section 234 of the Companies Act and Rule 25A of the Companies Merger Rules refer to 'mergers and amalgamations' without any express mention of 'arrangement'. Therefore, the possibility of a foreign company demerging its business undertaking to an Indian company or *vice-versa* is not covered under the regime relating to cross border mergers. In this regard, it may be worthwhile to consider an amendment to the relevant provisions of the Companies Act to explicitly include the term 'demerger' in addition to mergers or amalgamations in order to facilitate demergers.

- *Fast track facility not available for cross border mergers*
  Further, the facility for fast-track mergers provided under Section 233 of the Companies Act, as applicable to domestic transactions, is not available for cross border mergers. Under Section 233 of the Companies Act, a fast-track process has been provided for mergers between two or more small companies, or between holding companies and their wholly-owned subsidiaries, whereby a relatively easier and shorter process for mergers may be followed without applying to the NCLT.

- *Requirement of specified jurisdictions applicable to both inbound and outbound mergers*
  Under the FEMA Merger Regulations, the explanation to the definition of the term 'foreign company' states that the foreign company should be incorporated in the specified jurisdiction as contained in the relevant Companies Merger Rules. The term 'foreign company' under the FEMA Merger Regulations is used with reference to both inbound and outbound mergers, thereby resulting in the applicability of the requirement of specified jurisdictions to both inbound and outbound mergers. This is in conflict with the provisions laid down under Rule 25A of the Companies Merger Rules where the requirement for specified jurisdictions is restricted only to the outbound mergers. Accordingly, the Company Merger Rules and FEMA Merger Regulations would need to be appropriately aligned.

- *Valuation requirements for Cross Border Mergers*
  The FEMA Merger Regulations prescribe the valuation requirement for both Inbound and outbound mergers in accordance with Rule 25A of the Companies Merger Rules. However, the Companies Merger Rules provide the valuation requirement only in case of outbound mergers and are silent on the valuation requirements for inbound mergers. Therefore, the Companies Merger Rules are not completely aligned with the FEMA Merger Regulations.

- *Limited scope of activities of Branch office in India of the resultant Foreign Company under an Outbound Merger*
  Any office of the Indian company in India shall be deemed to be a branch office of the foreign company and accordingly, its activities will be restricted to the specific activities permissible under FEMA i.e. export/import of goods, rendering consultancy and IT services, research, promoting collaboration with its group companies, acting as a buying/selling agent, development of software, etc.

- *Adequacy of prescribed transition time period*
  The requirement to sell assets which are not permitted to be held or acquired under FEMA may entail onerous stamp duty and tax implications and also penalty provisions on account of contravention under the FEMA regulations, if the sale of assets and repatriation of sale proceeds is not completed in accordance with the FEMA Merger Regulations.
  The timeframe to sell assets not permitted to be held or acquired under FEMA has been increased from 180 days (under the Draft FEMA Merger Regulations) to 2 years (under the FEMA Merger Regulations) from the date of sanction of the scheme. However, whether such increased timeframe would be sufficient for sale of foreign assets in light of compliance under tax and

regulatory laws of the foreign jurisdiction is yet to be seen based on future experience with cross border merger transactions.

- *Compliance in respect of immovable property acquired in/outside India*
  The resultant Indian Company/Foreign Company would be required to comply with the relevant provisions of FEMA in order to hold the immovable property transferred pursuant to a scheme of merger. In case such immovable property is not permitted to be held, the time period of two years may prove insufficient for sale of such immovable property based on the prevailing market prices in the real estate sector.

- *Merger of Foreign LLPs with Indian Company and vice versa*
  Under the Companies Merger Rules and the FEMA Merger Regulations, a foreign company is defined to include a body corporate incorporated outside India whether having a place of business in India or not. Further, under Section 2(d) of the Limited Liability Partnership (LLP) Act, 2008 a body corporate is defined to include an LLP incorporated outside India.
  Accordingly, the implications of a merger of a foreign LLP with an Indian Company under an inbound merger and *vice versa* under an outbound merger would need to be examined carefully keeping in mind the FEMA Inbound Investment Regulations and FEMA Outbound Investment Regulations.

- *Prescription for special purpose bank accounts*
  It may be useful for the RBI to prescribe the permissible debits and credits for the special purpose bank accounts (i.e. SNRR account in India of the foreign company in case of outbound merger and foreign currency bank account outside India of the Indian Company) in order to avoid any ambiguity.

- *Deemed Approval*
  While the FEMA Merger Regulations specify that Cross Border Mergers which meet the provisions mentioned therein shall have deemed RBI approval, such regulations at the same time prescribe that the regulatory actions connected with non-compliance or contravention of FEMA would need to be completed prior to the merger.

B. Income Tax

- *Capital Gains exemption not available for outbound mergers*
  The IT Act exempts from income tax a transaction of amalgamation, where the amalgamated company is an Indian company. Therefore, the IT Act provides tax exemption from the capital gains arising to the transferor company and its shareholders in the case of inbound mergers by treating such mergers as being tax neutral subject to fulfilment of the prescribed conditions. However, such benefit does not extend to outbound mergers i.e.; where an Indian company merges into a foreign company and accordingly such a merger would be liable to tax both in the hands of the transferor company and its shareholders.

- *Permanent Establishment exposure for resultant foreign company in case of outbound mergers*
  In case of an outbound merger, assets, liabilities and employees of the Indian company shall be transferred to the foreign company. In such a case, the tax authorities may attempt to characterise the operations of the Indian Company as constituting a Permanent Establishment (PE) of the Foreign Company in India, which may result in business profits attributable to the Foreign Company from its operations in India being liable to income tax in India @ 40% plus applicable surcharge and cess.

Conclusion

With the advent of the regulations under the Companies Act and FEMA, a definitive roadmap has been laid down to facilitate cross border mergers. The regulations are expected to allow Indian Companies to unlock their global potential and expand their business overseas and to assist foreign companies with Indian subsidiaries to effectively integrate their Indian operations at the global level without resorting to the cumbersome process of winding up.

While some of the unresolved issues in the Draft FEMA Merger Regulations now stand clarified under the FEMA Merger Regulations, there still exist some anomalies amongst the various regulations, which we expect may be suitably addressed by the regulatory and tax authorities in India through suitable amendments and clarifications in due course. ■

There is no success without hardship. - Sophocles