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FEMA CROSS BORDER MERGER REGULATIONS ISSUED BY RBI

4 April 2018

Background

Section 234 of the Companies Act, 2013 (Companies Act) and Rule 25A of the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016 (Companies Merger Rules) permit mergers and amalgamations between Indian companies and companies incorporated in certain jurisdictions. These provisions mandate prior approval of the Reserve Bank of India (RBI) for any such cross-border mergers.

After extensive public consultations, the RBI issued the Foreign Exchange Management (Cross Border Merger) Regulations, 2018 (FEMA Regulations) on 20 March 2018 to address various issues that may arise in relation to cross border mergers from an exchange control perspective.

Key provisions of the FEMA Regulations

Deemed approval of RBI

The FEMA Regulations provide that any transaction undertaken in relation to a cross-border merger in accordance with the FEMA Regulations shall be deemed to be approved by the RBI (as required in terms of Rule 25A of the Companies Merger Rules). The FEMA Regulations also require the managing director/whole time director and company secretary of the company(ies) involved in such cross-border merger to furnish a certificate undertaking to ensure compliance with the FEMA Regulations along with the application made to the relevant National Company Law Tribunal (NCLT) in relation to such merger.

Definition of 'cross border merger'

'Cross border merger' has been defined in the FEMA Regulations as "*any merger, amalgamation or arrangement between Indian company and foreign company in accordance with Companies (Compromises, Arrangements and Amalgamation) Rules, 2016 notified under the Companies Act, 2013*".

Interestingly, while the FEMA Regulations intend to cover cross border 'merger, amalgamation or arrangement' (which would include demergers), Section 234 of the Companies Act and Rule 25A of the Companies Merger Rules, which deal with cross border mergers, only refer to 'mergers and amalgamations' without any express mention

of 'arrangement'. Since the Companies Act is the governing legislation relating to compromises, arrangements and amalgamations, it appears that cross border demergers or other forms of arrangement are not permitted, even though they are contemplated in the FEMA Regulations.

Provisions in relation to merger or amalgamation of foreign company with Indian company (Inbound Merger)

In an Inbound Merger, a foreign company will merge into an Indian company and accordingly, all properties, assets, liabilities and employees of the foreign company will be transferred to the Indian company. The FEMA Regulations stipulate the following conditions in relation to Inbound Mergers:

- *Issuance or transfer of security by Indian company to non-resident:*

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

- *Merger of joint venture (JV) / wholly owned subsidiary (WOS) with its Indian parent company:*

  If a JV/WOS of an Indian company merges with its Indian parent company, the Indian parent company shall have to comply with the conditions prescribed for transfer of shares of such JV/WOS as laid down in the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 (ODI Regulations).

  If the JV/WOS has further step-down subsidiaries outside India, the merger of the JV/WOS with the Indian parent company will result in the Indian parent company acquiring shares of the foreign step down subsidiaries of the JV/WOS and accordingly, the Indian parent company shall have to comply with Regulation 6 and 7 of the ODI Regulations.

- *Offshore offices of foreign company to become branch/office of the Indian company outside India:*

  Any offices outside India of the foreign company merging with the Indian company pursuant to the Inbound Merger shall be deemed to be the branch/office outside India of the 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:*

  Understandably, the RBI has concerns on assumption of offshore liabilities by Indian companies and potential misuse of this route to undertake transactions which are otherwise not permissible under FEMA.

  The RBI has sought to address its concerns by stipulating that any outstanding borrowings or guarantees from overseas sources obtained by the merging foreign company, that becomes borrowing of the 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, within a period of two years from the date of sanction of such merger by the NCLT. Further, end use restrictions will not apply to such borrowings. If the Indian company is not permitted to assume any particular liability, such liability may be extinguished by selling the assets outside India of the merging foreign company within two years from the date of sanction of such merger by the NCLT.

However, no remittance can be made for the repayment of such liability from India, within the abovementioned period of two years.

- *Assets outside India of foreign company:*

  - The Indian company may acquire and hold any asset outside India of the foreign company (pursuant to a cross border merger), which an Indian company is permitted to acquire under the Foreign Exchange Management Act, 1999 (FEMA). Such assets can be transferred by the Indian company if such a transaction is permitted under FEMA.

  - If the Indian company is barred under FEMA from acquiring and holding any asset/security, then such Indian company shall have to sell such asset/security within two years from the date of sanction of the merger by the NCLT and the sale proceeds must be repatriated to India immediately through banking channels.

<u>Provisions in relation to merger or amalgamation of Indian company with foreign company (Outbound Merger)</u>

In an Outbound Merger, an Indian company will merge into a foreign company and accordingly, all properties, assets, liabilities and employees of the Indian company will be transferred to the foreign company. The FEMA Regulations stipulate the following conditions in relation to Outbound Mergers:

- *Residents permitted to acquire securities of foreign company pursuant to Outbound Merger:*

  A person resident in India, being a holder of securities in the Indian company, is permitted to acquire or hold securities of the foreign company, in accordance with the ODI Regulations. If a resident individual acquires securities of a foreign company, the fair market value of such securities should be within the limits prescribed under the Liberalised Remittance Scheme (which presently stands at USD 250,000 per financial year).

- *Offices of Indian company deemed to be branch office of the foreign company:*

  Any offices in India of the Indian company merging with the foreign company pursuant to the Outbound Merger shall be deemed to be the branch office in India of the 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 restrictions on activities applicable to a branch office).

- *Borrowings of Indian company to be transferred to foreign company:*

  Any guarantees and outstanding borrowings of the Indian company, which shall be transferred to the 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 FEMA and must be consented to by such Indian lender.

- *Assets in India of merging Indian company:*

  - The foreign company may acquire and hold assets in India which a foreign company is permitted to acquire under FEMA. Any transfer of assets acquired by the foreign company (pursuant to the Outbound Merger) must comply with FEMA.

  - If FEMA bars a foreign company from acquiring and holding any asset/security that is proposed to be transferred pursuant to the Outbound Merger, then such foreign company would have to sell such asset/security within two years from the date of sanction of the merger by the NCLT and the sale proceeds must be repatriated outside India immediately through banking channels.

- *Bank accounts of the foreign resultant company in India:*

  The 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 a maximum period of two years from the date of sanction of the cross border merger by the NCLT, for undertaking the transactions contemplated by the FEMA Regulations.

Valuation

In terms of the FEMA Regulations, valuation of the Indian company and the foreign company is required to be carried out in accordance with Rule 25A of the Companies Merger Rules.

Reporting of Transactions

The FEMA Regulations provide that the resultant company and/or the companies involved in the cross-border merger shall be required to furnish reports as may be prescribed by the RBI.

Comment

We had mentioned in our newsflash on cross border mergers that the exchange control norms, amongst others, need to be aligned to enable cross border mergers. We had also, in our previous newsflash on the draft Foreign Exchange Management (Cross Border Merger) Regulations, 2017 (Draft Regulations), highlighted certain deficiencies in the Draft Regulations, some of which have been incorporated in the FEMA Regulations.

While the overarching exchange control framework has now been laid down by virtue of the FEMA Regulations, there are still gaps in the existing legislative framework to make a compelling case to utilise an Outbound Merger over the more 'traditional' approach of acquisition of the Indian target by way of share acquisition by the acquirer or an asset acquisition / business transfer through an Indian subsidiary. Further, it remains to be seen whether the NCLTs will be forthcoming in approving cross border mergers, given the complexities involved. Accordingly, transaction certainty and timing will be pertinent

issues to consider before proceeding with any cross-border merger, at least until there are sufficient precedents that can be relied on.

We have enlisted below some of the hits and misses in the FEMA Regulations and key tax risks in case of Outbound Mergers.

Hits

- *Deemed RBI approval*: The inclusion of deemed approval subject to compliance with FEMA Regulations is a welcome step, since this relaxes the mandatory requirement (set out under Companies Act) of seeking prior approval of RBI for all cross border mergers.

- *Two-year window*: The time frame of two years granted to Indian companies and foreign companies to ensure that the underlying transaction complies with FEMA is indeed a welcome step.

Misses

- *Inbound Mergers – Assumption of liability*: In case of Inbound Mergers, the borrowings from overseas sources obtained by the merging foreign company will have to conform to the extant FEMA regulations (since the two-year window has not been extended to such assumption of liability). As a result, such liabilities may have to be settled before proceeding with the implementation of the merger, which may have adverse implications on the Indian company's cash flows. If such liabilities are to be settled prior to implementing the merger, such settlement must be incorporated as a condition to the scheme of amalgamation.

- *Branch office*: In 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 severely restricted and such office would be permitted to engage only in 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. Further, such branch office may be treated as a permanent establishment (PE) / business connection of the foreign company, in which case, the profits attributable to such PE / business connection may be taxable at a higher rate of 40 percent, increased by applicable surcharge and cess.

- *PE / business connection risks in an Outbound Merger*: In an Outbound Merger, assets, liabilities and employees of the Indian company will be transferred to the foreign company. This would raise a host of issues from an Indian tax perspective, including the likelihood of the foreign company having a PE / business connection in India, in which case profits of the foreign company from its operations in India could be taxed at 40 percent, increased by applicable surcharge and cess.

- *Tax risk in an Outbound Merger*: Section 47(vi) of the Income-tax Act, 1961 (IT Act) exempts capital gains only in relation to transfer of a capital asset where the resultant entity is an Indian company. Accordingly, presently, an Outbound Merger may not be capital gains tax-neutral. Further, even the resultant foreign entity may have to pay tax on receipt of assets situated in India, resulting in double taxation. Such additional tax may be levied at the rate of 40%, increased by applicable surcharge and cess. Additionally, Section 47(vii) of the IT Act exempts capital gains only in relation to transfer of shares of amalgamating company, where the amalgamated / resultant entity is an Indian company. Accordingly, shareholders of amalgamating company in case of an Outbound Merger may be subject to capital gains tax.

- *Tax on issuance of shares in an Outbound Merger*: Issuance of shares to shareholders of Indian company, as part of the Outbound Merger, may be subject to tax in the hands of such shareholders, in accordance with Section 56(2)(x) of the IT Act. Such tax may be levied at the fair market value of the shares, at the rate of 30%, increased by surcharge and cess. Where the shareholder is a foreign entity, the rate of tax may be 40%, increased by applicable surcharge and cess.

- *Atul Pandey (Associate Partner), Abhishek Sanyal (Principal Associate), Indruj Rai (Principal Associate) and Hirak Mukhopadhyay (Associate)*

For any queries please contact: editors@khaitanco.com

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Mumbai
One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi
Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru
Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata
Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com