

M&A Tax Jurisprudence – Key Highlights 2023

29 January 2024

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This update covers:

1	Introduction	2
2	Key Developments	2
2.1	Angel tax regime expanded, made applicable to foreign investors	2
2.2	Tax jurisprudence on share valuations – a mixed bag	3
2.3	Unfavourable MFN ruling for offshore investors	3
2.4	Rise in reverse flipping - Indian start-ups march homewards	3
2.5	No tax on conversion to CCPS – a short-lived dream?	4
2.6	Forex neutrality withdrawn - capital gains tax proceedings to intensify	4
2.7	Reinforcing rights of secured creditors	5
2.8	A rise in investigations	5
2.9	Re-examination of established principles for eligibility to tax treaty benefits	5
3	Conclusion: The Way Forward	6

1 Introduction

The year 2023 witnessed a global slowdown in M&A activity, amidst rising geopolitical tensions, soaring interest rates, and a dampening of the global investment climate. At USD 71 billion, deal value in India may have dropped to a third of 2022 figures. With valuations getting more realistic, the focus shifted to smaller, strategic acquisitions for integrating specific and targeted capabilities. However, not all is bleak – with global institutions projecting India to grow by 6.50% in 2024, India anticipates sustained M&A growth in the near future.

Against this backdrop, we reflect on key developments in M&A tax jurisprudence during 2023 – the expanded scope of angel tax provisions, a rising trend of reverse flipping, and a myriad of noteworthy tax rulings.

2 Key Developments

2.1 Angel tax regime expanded, made applicable to foreign investors

Angel tax provisions in India seek to tax share subscription amounts received by private limited companies in excess of their fair market value. Until financial year 2022-23, shares issued to overseas investors were outside the scope of these provisions. With amendments in early 2023, the scope of the angel tax regime was expanded to include overseas investments (albeit with limited relief for funds raised by certified start-ups from certain categories of investors from select jurisdictions). Further, additional valuation methodologies were prescribed for shares issued to non residents in line with recognised global methodologies (which include the comparable company multiple method, option pricing method, and probability weighted expected return method, amongst others). The valuation methodologies for equity shares were extended to also apply to compulsorily convertible preference shares. In a welcome move, a safe harbour margin of 10% was introduced. However, many issues persist with respect to applicability to and valuation of convertible instruments, including situations where there are different valuation requirements for regulatory and tax purposes or if there is a down round in the same financial year. (To read our detailed analysis of the new valuation rules under the angel tax regime, [click here](#).)

On a positive note though, the Delhi Income Tax Appellate Tribunal (ITAT) ruled on the inapplicability of angel tax on shares issued by wholly owned subsidiaries to parent companies, as no external benefits exist.¹ In this case, the Indian company had issued certain shares to its holding company at a premium. The tax officer initiated proceedings asserting that the creditworthiness of share premium subscribers and genuineness of the transactions were not established. Aggrieved by this, the company preferred an appeal before the ITAT. Citing past precedents, the Delhi ITAT ruled that angel tax provisions do not apply to transactions between

This update outlines some key developments in M&A tax jurisprudence during 2023, which include the expanded scope of angel tax provisions, practicalities of share valuation, the decision on most favoured nation clauses in tax treaties, grandfathering benefit under tax treaty availability for convertible instruments, and denial of forex neutrality provisions, amongst others. These developments will have a significant impact on the M&A landscape as we progress into 2024.

¹ *BLP Vayu (Project-1) Pvt Ltd v PCIT (ITA No.4895/Del/2019)*

holding and subsidiary companies. This follows previous decisions of the Ahmedabad and Delhi ITATs which have held that the transfer of shares at a premium, when executed between holding and subsidiary companies, has to be seen holistically as a transaction to self and thus, a transaction where no benefit was derived by the taxpayer. This ruling emphasises that angel tax provisions aim to prevent illegitimate gains through capital receipts, and highlights that taxing deemed income in legitimate transactions where no benefits arise contradicts the intended purpose of these provisions.

Reinforcing established principles, the Gujarat High Court in another matter held that fresh issues of shares were not subject to provisions of 'gift tax' (which seek to tax transfers of sums or assets for inadequate consideration).² Similarly, the Delhi ITAT asserted the inapplicability of gift tax to buy-back transactions.³

2.2 Tax jurisprudence on share valuations – a mixed bag

The Delhi ITAT upheld the rejection of a valuation certificate which did not bear references to audited financial statements of the company.⁴ It is important to note here that the valuation certificate did not bear references to the audited financial statements on account of practical challenges arising from the fact that the Annual General Meeting of the company was pending to be conducted as on the date of valuation. The judgement highlights the importance of complying with certain requirements laid down while undertaking share valuations. While there are favourable precedents holding that a duly issued valuation report may not be contested by the tax officer, valuations that are not in accordance with prescribed standards (such as ICAI Valuation Standards, 2018, or the Companies (Registered Valuers and Valuation) Rules, 2017) may open the door to a potential challenge.

On the other hand, in a laudable judgement, the Bombay High Court held that proceedings could not be re-initiated on the grounds of improper valuation of shares, where the valuation report was previously accepted by the tax officer.⁵ It is pertinent that in this case there was no failure on the part of the taxpayer to disclose material facts, nor did any tangible material exist with the tax officer which would have otherwise justified the re-opening of the assessment.

2.3 Unfavourable MFN ruling for offshore investors

The Supreme Court of India recently ruled in favour of the tax authority denying benefits to non residents claiming a lower rate or narrower scope of taxation on dividends, interest, royalty or fee for technical services based on the most favoured nation (MFN) clauses present in India's tax treaties.⁶ While the judgment was in the context of India's treaties with France, Netherlands, and Switzerland, it lays down the law for interpreting and applying MFN clauses in all of India's tax treaties. (To read our detailed update on the Supreme Court ruling on the MFN clause, [click here](#).)

2.4 Rise in reverse flipping - Indian start-ups march homewards

The year 2023 witnessed scores of Indian-founded but overseas-headquartered start-ups mapping their way back to India. The great migration may be attributed to a favourable environment created by government initiatives, the maturity of Indian markets, and recent regulatory changes on round-tripping. Renowned companies like Pepperfry and PhonePe have recently flipped their headquarters back into India, while some

² *PCIT Vs Jigar Jashwantlal Shah (R/Tax Appeal No. 80 of 2023)*

³ *DCIT v Globe Capital Market Ltd (ITA No. 967/Del/2023)*

⁴ *Sagitarious Securities Pvt Ltd. v DCIT (ITA No. 6353/DEL/2018)*

⁵ *Suminter Organic and Fair Trade Cotton Ginning Mill Pvt Ltd v DCIT (WP No. 2179 of 2022)*

⁶ *AO v M/s Nestle SA, (CA No. 1420 of 2023)*

Y-combinator backed companies are also looking for a way back to India. The Indian government continues to support the trend of reverse flipping through initiatives such as the National Initiative for Developing and Harnessing Innovations, Fund of Funds for Start-ups, the Atal Innovation Mission, and the Gujarat International Finance Tech-City International Financial Services Centre (**GIFT IFSC**) regime.

Specifically, the Indian government has initiated efforts in this direction by setting up GIFT IFSC as a distinct international financial jurisdiction to attract overseas-domiciled business and to provide a competitive business-friendly ecosystem through a predictable regulatory regime, ease of doing business, and better synchronisation amongst regulators.

Some key dispensations enjoyed by GIFT IFSC companies are in relation to loans, guarantees, and investments. GIFT IFSC companies can bypass special resolution requirements for loan/guarantee thresholds through a board resolution, granting investments without prescribed limits. These companies have relaxed director consent and prior approval requirements providing these companies flexibility and are also exempted from the restriction on investments limited to two layers of investment companies, which benefits holding companies with multi-level subsidiaries. A favourable tax regime is also recommended with features such as tax-neutral relocation to GIFT IFSC, extending neutrality to investors/shareholders, grandfathering existing offshore investments, ensuring onshore compliance parity for GIFT IFSC holding company investors, and preventing lapses in losses for Indian entities and offshore holding company losses, post re-location to GIFT IFSC.

As companies and investors foresee value in the Indian market, the journey back home may entail an appraisal of tax costs (for instance, PhonePe's movement reportedly cost the company and its investors about USD 1 billion in Indian taxes).

2.5 No tax on conversion to CCPS – a short-lived dream?

To the surprise of investors and tax experts alike, the Delhi ITAT ruled that equity shares arising from conversion of Indian compulsorily convertible preference shares (**CCPS**) acquired prior to 1 April 2017 would be grandfathered from the 2017 amendments to India-Mauritius Tax Treaty (which seeks to tax the gains from these investments in India). While investors seek to take advantage of this ruling, one may note that this ruling does not appear to have paid heed to underlying nuances under corporate law as well as pronouncements by higher forums in India, which distinguish between different forms of shares and note that the existence of a converted share arises only after its formal issuance. This oversight renders the issue prone to further litigation.

2.6 Forex neutrality withdrawn - capital gains tax proceedings to intensify

In the matter of Legatum Ventures ⁷ before the Mumbai ITAT, the taxpayer (a UAE-based company engaged in investment activities) sold shares of an unlisted Indian company resulting in losses of INR 36 million. Subsequently, a tax return reflecting nil income was filed under general capital gains provisions in India. However, the tax authorities contended that the capital gains should be computed exclusively under specific capital gains computation provisions as applicable to non residents, which led to the determination of long-term capital gains exceeding INR 170 million. The Mumbai ITAT concluded that special provisions prevail over general provisions and hence, the capital gains computation by tax authorities was upheld.

⁷ *Legatum Ventures Limited v ACIT ITA no.1627/Mum./2022*

2.7 Reinforcing rights of secured creditors

In a recent decision⁸ centred on financial assistance provided by secured creditors and the order of precedence in case of recovery by creditors vis-à-vis dues to tax authorities, the Madras High Court ruled that between an unsecured creditor and crown debt, the crown debt prevails. However, the High Court clarified that tax provisions which declare certain transactions to be void during the pendency of tax proceedings (i.e., Section 281), do not create a charge in favour of the tax department. The court emphasised that statutes in India intended to grant primacy to secured creditors (including Section 26E of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and Section 31B of the Recovery Of Debts And Bankruptcy Act, 1993) must prevail over tax provisions in case of conflict. Applying purposive construction, the Madras High Court concluded that these statutes were introduced to protect the interests of secured creditors vis-à-vis tax recovery, aligning with the superior purpose of economic growth and ease of doing business.

2.8 A rise in investigations

Pursuant to inquests into gaming companies and a range of inter-company transactions, tax authorities seem to have arrived at the doors of the venture capital (VC) industry in the latter half of 2023. The ramped-up investigations against VCs spanned a range of issues including questions on the fund structure, substance, investment arrangements, denial of tax treaty benefits, and valuation issues. Further, in an unusual move, multinational corporations across sectors with India interests were served notices seeking information on investments, exchange control compliances, and travel details of key executives to India.

Investors from Cyprus, Singapore and Mauritius received notices in relation to investments in compulsorily convertible debentures (CCD). Generally, while such investments are treated as equity for exchange control purposes, these are viewed as debt for tax purposes until conversion, leading to legal incongruencies. Foreign investors often contend the non-taxability of securities other than shares, based on amendments after 2017 to various tax treaties which suggest that capital gains taxation applicable to "shares" must not extend to debt instruments. In the past, the tax department has made some attempts to treat the gains made on sale of CCDs as interest income but the Delhi High Court in the Zaheer Mauritius case⁹ held that gains on CCDs should be characterised as capital gains. Notices targeted at CCD investments may not align with the government's intent to provide a business-conducive ecosystem for foreign investors.

2.9 Re-examination of established principles for eligibility to tax treaty benefits

Courts in India have on multiple occasions held that tax authorities could not question the validity of a tax residence certificate (TRC) issued by competent authorities in overseas jurisdictions, and that the TRC is sufficient evidence of a foreign entity to demonstrate its residential status and its eligibility to benefits under the relevant tax treaty. A step in this direction was also taken by the Delhi High Court in the case of Blackstone.¹⁰ Further in the case of Sapien Funds Ltd.,¹¹ the assessee (set up as a Collective Investment Vehicle), was incorporated in Mauritius and held a valid TRC of Mauritius. The taxpayer earned income from derivatives on which it claimed benefits under the tax treaty. However, the Indian tax department said the TRC is not itself sufficient to establish residential status if the substance establishes otherwise – contending

⁸ *State Bank of India v Tax Recovery Officer (W.A. Nos.1512 of 2021, 60, 1249 and 1385 of 2022)*

⁹ *Zaheer Mauritius v Director of Income Tax (International Taxation)-II (W.P.(C) 1648/2013 & CM NO.3105/2013)*

¹⁰ *Blackstone Capital Partners (Singapore) VI FDI Three Pte. Ltd. v ACIT (W.P.(C) 2562/2022)*

¹¹ *Sapien Funds Ltd v CIT(International Taxation) (ITA No. 976/Del/2022)*

that the ultimate shareholder of the entity and its fund manager entity were based in UK. However, the Delhi ITAT relying on the cases of Azadi Bachao¹² and Blackstone Capital, quashed the tax authority’s claims and held that a TRC is the only evidence required for tax treaty eligibility.

Notably the ruling of the Delhi High Court in the case of Blackstone has been momentarily stayed by the Supreme Court at the beginning of 2024. The outcome of the Supreme Court proceedings would have a significant impact on many overseas investors and ongoing tax proceedings. This comes as a setback to investors who may not have foreseen a challenge to prevailing positions as part of deal structuring.

3 Conclusion: The Way Forward

2023 was indeed an interesting year for the M&A community, marked by both rising investor confidence in India Inc. on the one hand, as well as some surprises and setbacks, on the other. While global investors may be concerned by the course of events of the Blackstone matter in the beginning of the new year, as the drapes of 2024 unlace, the global business community is hoping for further policy measures that would help curb the rise in investigations and the re-examination of settled legal positions. Until then, the focus remains on the interim financial budget 2024 that will be presented in the coming days.

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¹² *Union of India v. Azadi Bachao Andolan 263 ITR 706 (SC)*