INDEMNIFICATION ISSUES IN PRIVATE EQUITY EXITS

The period from 2006 to 2011 witnessed a significant inflow of private equity investment into India, making it the second most favoured investment destination after China. However, the subsequent decline in capital markets had led to a shift in exits from public offerings to other exit routes such as third party sales which are beset with its own set of challenges, especially in light of the uncertainty around treatment of withholding tax brought about by the Vodafone case. There were several exit related deals that hit a dead end during this period after long drawn negotiations due to differences between parties in arriving at the manner of dealing with withholding tax and related mitigating factors.

The Vodafone Case.

The genesis of the uncertainty around the treatment of withholding tax involved the acquisition by Vodafone Netherlands of CGP Investments Holdings Ltd (CGP)., a company registered in the Cayman Islands and controlled by the Hutchison Group for a consideration of USD $11 billion. As part of this overseas acquisition Vodafone also acquired Hutchison Essar Limited (HEL), a subsidiary of CGP in India. Under Indian tax laws, liability to withhold tax is upon the purchaser and default of such obligation makes such payer a defaulter and consequently liable for the principal sum, interest and penalties. As Vodafone Netherlands did not withhold tax on the sale consideration paid to CGP, Indian tax authorities alleged that the acquisition of HEL *via* CGP (the Cayman entity) by Vodafone Netherlands was structured as such to avoid tax. Indian tax authorities contended that in substance, the acquisition (of CGP) pertained to Indian assets represented in HEL, and accordingly raised assessments demanding withholding tax to the tune of $2.1 billion, representing capital gains made by the seller.

In dealing with this matter, the Bombay High Court largely upheld the tax department's demand and observed that though the isolated sale of CGP shares is not taxable in India, the transaction has to be given a purposive intent. It further held that the transferred assets also represented 'rights and entitlement' (by way of use of the Hutch brand, non-compete agreement, loan obligations, option for acquiring additional 15% interest in HEL, etc.) and not the isolated sale of CGP's shares.

On appeal the Supreme Court concluded that the transfer of shares in CGP did not result in the transfer of a capital asset situated in India, and gains from such transfer could not be subject to taxation in India. Although the Supreme Court's decision came as a relief to private equity and financial investors, this case has led to a change in the manner in which indemnities, in particular with respect to tax, in exits are dealt with.

After Effects on Exits.

Considering the exit related contingencies that investors have to deal with, as was demonstrated in the Vodafone matter, it is paramount that adequate risk mitigators be negotiated with care and adopted in PE exits. Some of the points for consideration include:

Tax withholding by Purchasers, which has emerged as one of the key points of discussion considering the tendency of tax authorities to challenge treaty benefits in the absence of 'real substance' of companies situated in favorable tax jurisdictions. Also, the judiciary's interpretation of existing taxation laws differently in matters such as the Vodafone case, Azadi Bachao Andolan case (where the Supreme Court validated the benefits of the Treaty for residents of Mauritius, subject to there being a valid tax residency certificate issue by the Mauritian Government), and the Aditya Birla Group case (in which the Bombay High Court dismissed the writ petitions filed by Aditya Birla Nuvo Limited, New Cingular Wireless Services Inc., in relation to transfer of shares of an Indian joint venture company, Idea Cellular Ltd. (ICL) and also the transfer of shares of a Mauritian company which held shares in ICL and expressed its prima facie view that such sale of shares is liable for capital gains tax in India) has given credence to this approach.

Tax indemnities by exiting investors, where earlier the norm was to specifically exclude PE investors from the requirement of providing warranties or indemnities (other than with respect to authority, due execution and the title of securities being transferred) to acquirers in an exit sale. Pursuant to the Vodafone case and the proposed introduction of the general anti-avoidance rules, many PE investors are not completely averse to also providing tax indemnities to buyers during their exit.

Escrow mechanisms, as an alternative to providing indemnities in favor of the purchaser to block applicable tax amounts till clarity on the tax related position or authorities issuing final clearances.

Clawback provisions, in situations where an exiting PE investor is not in a position to provide tax indemnities that survive upto the entire period of limitation (typically being 7 years) due to expiry of its fund life, indemnities may be sought from the General Partners (GPs) of such investor for remainder of such period.

Exploring alternative routes, such as obtaining advance rulings from tax authorities or obtaining nil withholding tax certificates from tax authorities.

Conclusion.

Negotiation of indemnities in PE exits is beset with a number of legal, regulatory and operational issues which become even more critical when exiting investors have had substantial operational involvement in investee companies. Following the Indian Finance Minister, Mr. Arun Jaitley, stating in his budget speech of 2016-17, about the government's commitment to not undertake retrospective amendments to the Income Tax Act, 1961, it would be interesting to see the manner in which tax indemnities are structured and evolve going forward. This would be more so in light of the recent amendments to the Indo-Mauritian Tax Treaty (introducing levy of capital gains tax on investment in shares through Mauritius), the government negotiating a similar arrangement under the Singapore DTAA and the Cabinet approval of the Agreement and the Protocol between India and Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion.