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## Stage set for corporate reforms in India

### Proposed Changes in Laws Could Alter the Status of Mauritius

The proposals are part of efforts by Indian regulators to raise more tax revenue from the financial services sector. The proposals, which are currently in a comment period, cover a wide variety of measures including a draft bill to override the tax treaty with Mauritius.

The bill would have a significant impact on investments coming into India as currently 80% to 90% of foreign investment into the country flows through Mauritius, a small tropical island off the coast of Africa.

Under the current double taxation treaty, capital gains on Indian shares that are held by a Mauritian company aren't subject to Indian tax. Mauritian companies are simply taxed according to Mauritius tax laws, which are extremely favorable.

Hoping to raise some revenue, Indian lawmakers have introduced new provisions that have caused an uproar among the foreign investment community. One is a draft bill that could override current tax treaties that exclude investment firms from paying a capital-gains tax. Another is a proposed flat tax rate of 30% on capital gains.

The introduced provisions are currently in a comment period. The move to change Mauritius' tax treaty with India come as governments around the world look for ways to raise money to pay for stimulus moves during the global economic slump. In India, the proposed tax changes are also a sign of the government's desire to exert greater control on offshore money flowing into the country. Regulators have made moves limiting the use of promissory notes in order to increase market transparency.

These promissory notes, or P-notes, have been widely used by foreign investors that haven't registered with Indian regulators, allowing them to buy shares anonymously.

### Highlights

- Hoping to raise some revenue, Indian lawmakers have introduced new provisions that have caused an uproar among the foreign investment community. One is a draft bill that could override current tax treaties that exclude investment firms from paying a capital-gains tax. Another is a proposed flat tax rate of 30% on capital gains.
- To initiate action against a company with share capital, there should be not less than one hundred members of the company or not less than one-tenth of its total number of members, whichever is lesser, or any member holding not less than one-tenth of the issued share capital. Besides these applicants should have paid all calls and other sums due on his/their shares. In case of a company not having a share capital, the minimum limit is not less than one-fifth of the total number of members. These conditions could be extended to class action suits as well.
- Sebi, appointed panel likely to raise the shareholding threshold that triggers open offers from 15% to 35%. With the increase in the threshold to 35%, the mandatory open offer limit too will be raised. The open offer could be for the entire stake of the target firm. If that happens, it will significantly increase the cost of acquisitions in India. If a company acquiring a stake in excess of 35% in another is required to make an open offer for all shares, it could lead to the delisting of the target company.
- Sections 56 and 57 of the LLP Act, 2008 allow conversion of a private company or an unlisted public company into an LLP. Such conversion has tax implications. Transfer of assets on conversion attracts capital gains tax. A successor LLP is deprived of the benefit of carry forward of losses and unabsorbed depreciation. Finance Bill 2010 proposes that transfer of assets on conversion of a company into an LLP will not attract capital gains tax only if certain stringent conditions are fulfilled.
- Foreign investors may soon be able to set up Limited Liability Partnerships, or LLPs, in India, as the government is all set to allow foreign direct investment in this new form of business organisation. Initially, FDI up to 49% may be allowed in LLPs in select sectors such as manufacturing.



### Rules to be stringent for filing class action suits

To prevent misuse of class action suits, the new Companies Act may specify a minimum number of shareholders or creditors of companies for exercising the right to file such cases. This is a major change from the current position on class action suits as mentioned in the Companies Bill, 2009, which is now before the Parliamentary Standing Committee on Finance.

The present provisions say that class action suits can be filed against a company by even a single member or creditor on finding that the company is being run against their interests.

Many companies and lawyers feel this could lead to disgruntled shareholders or creditors holding companies to ransom by filing such suits in different courts. They want the law to specify a minimum limit on the number of shareholders and the amount involved in such a collective action.

Class action suits are for enabling an aggrieved class of shareholders or creditors of a company to get compensation, damages and disgorgement (or a court order asking the wrongdoers in the company to repay their ill-gotten gains) amounts.

The Section on prevention of oppression and mismanagement in the Companies Bill, 2009, says minority shareholders can sue a company if it is being run against their interests. But there are riders.

To initiate action against a company with share capital, there should be not less than one hundred members of the company or not less than one-tenth of its total number of members, whichever is lesser, or any member holding not less than one-tenth of the issued share capital.

Besides, these applicants should have paid all calls and other sums due on his/their shares. In case of a company not having a share capital, the minimum limit is not less than one-fifth of the total number of members. These conditions could be extended to class action suits as well.

### Threshold for open offer may rise to 35%

The mergers and acquisitions, or M&As, game in India may change for ever with a Securities and Exchange Board of India, or Sebi, appointed panel likely to raise the shareholding threshold that triggers open offers from 15% to 35%. At present, if a company acquires a stake of at least 15% in another firm, it is required to make a mandatory open offer to buy at least another 20% of the second company's shares from the market.

With the increase in the threshold to 35%, the mandatory open offer limit too will be raised. The open offer could be for the entire stake of the target firm. If that happens, it will significantly increase the cost of acquisitions in India. If a company acquiring a stake in excess of 35% in another is required to make an open offer for all shares, it could lead to the delisting of the target company.

India has the lowest threshold for triggering an open offer in the world. If the threshold is increased from the existing 15% to more than 25%, from a corporate law perspective, it would mean that the acquirer would get statutory rights to block special resolution matters without triggering an open offer.

According to the Companies Act, 1956, the passing of a special resolution requires a minimum of 75% shareholding. Therefore, the new threshold will help strategic investors to acquire powers to block a resolution. At present, they get these rights contractually by getting into shareholder agreements; now these powers will be statutory once they acquire a stake of 26%.

Current norms require an acquirer to give the public shareholders an exit option after acquiring 26% or more. This norm might also need an alteration if the open offer trigger threshold is increased to 35%.



### Limited benefits to LLPs

Sections 56 and 57 of the LLP Act, 2008 allow conversion of a private company or an unlisted public company into an LLP. Such conversion has tax implications. Transfer of assets on conversion attracts capital gains tax. A successor LLP is deprived of the benefit of carry forward of losses and unabsorbed depreciation.



### Finance Bill 2010 proposes that transfer of assets on conversion of a company into an LLP will not attract capital gains tax only if certain stringent conditions are fulfilled.

- The transfer of assets should be in accordance with Sections 56 and 57 of the LLP Act, 2008.
- In the immediately preceding three previous years, the sales turnover or gross receipts in the business of the company should not exceed Rs 60 lakh.
- Shareholders of the company should become partners of the LLP in the same proportion as their shareholding in the company.
- There will be no consideration for the transfer other than share in profits and capital contribution in the LLP.
- Erstwhile shareholders of the company should continue to be entitled to receive at least 50 per cent of the profits of the LLP for a period of five years from the date of conversion.
- All assets and liabilities of the company should become the assets and liabilities of the LLP.
- For a period of three years after conversion, no partner should get any amount out of the accumulated profits of the company.

On fulfilment of these stringent conditions, the new LLP will get the benefit of carry forward and set off of business loss and unabsorbed depreciation.

Violation of these conditions will mean that the benefit enjoyed by the company shall be deemed to be the profits of the successor LLP chargeable to tax for the previous year in which violations of the conditions took place.

### Select LLPs may get 49% FDI

Foreign investors may soon be able to set up Limited Liability Partnerships, or LLPs, in India, as the government is all set to allow foreign direct investment in this new form of business organisation.

Initially, FDI up to 49% may be allowed in LLPs in select sectors such as manufacturing. This could help make this form of business organisation more popular. So far, only 914 LLPs have been registered in the country. The current thinking within the government is to allow FDI in LLP selectively and cap it at 49% even in sectors where companies can have 100% foreign investment. LLPs are business entities that are a hybrid between companies and partnership firms. As the name suggests, partners' liability is limited to the extent of their stake in the LLP. Unlike private limited companies where number of shareholders is limited to 50, an LLP can have unlimited number of partners. Besides, LLPs are not burdened with cumbersome compliance such as meetings and maintenance of statutory records. Many countries allow 100% foreign investment in LLPs though they may not be allowed to undertake certain sectoral activities. The 49% cap on FDI will ensure that control in LLP rests in Indian hands.

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